DOCUMENT RESUME

ED 322 824 HE 023 753

TITLE	Consolidated Student Loans. Borrowers Benefit but Costs to Them and the Government Grow. Report to Congressional Requesters.
INSTITUTION	General Accounting Office, Washington, D.C. Div. of Human Resources.
REPORT NO	GAO-HRD-90-8
PUB DATE	Jun 90
NOTE	64p.
AVAILABLE FROM	U.S. General Accounting Office, P. O. Box 6015, Gaithersburg, MD 20877 (first 5 copies free, additional copies $2.00).
PUB TYPE	Reports - General (140)
EDRS PRICE	MF01/PC03 Plus Postage.
DESCRIPTORS	*Cost Estimates; Government Publications; Government Role; Grants; Higher Education; *Interest (Finance); *Loan Default; *Loan Repayment; Paying for College; *Program Effectiveness; *Student Loan Programs
IDENTIFIERS	Higher Education Act Amendments 1986; *Student Loan Consolidation Program

ABSTRACT

In response to the requirements of the Higher Education Amendments of 1986, this report addresses the impact of the two-year-old Student Loan Consolidation Program. Principle findings of the investigation concern the higher interst costs to the borrower that are brought about by longer payment plans and the fact that the government's subsidy costs will increase because of loan consolidation. Several options are presented for the Congress to consider for changing the program in order to reduce the government's costs. The Department of Education and four of the five lenders providing data for review also provided written comments on a draft of the report; the lenders also provided technical comments. Appendices include a description of the methodology used to eliminate consolidated loan costs as well as default statistics, a list of lenders, and information related to reducing the subsidy costs. (GLR)

ers

but
the

GAO

United States
General Accounting Office
Washington, D.C. 20548

Human Resources Division

B-204708

June 15, 1990

The Honorable Edward M. Kennedy
Chairman, Committee on Labor and
Human Resources
United States Senate

The Honorable Augustus F. Hawkins
Chairman, Committee on Education
and Labor
House of Representatives

In response to the requirements of the Higher Education Amendments of 1986, this report addresses the impact of the student loan consolidation program.

We found that the program has benefited borrowers by reducing their monthly payments, thereby easing their repayment burden. However, because consolidated borrowers have longer repayment periods, their total interest costs are higher. In addition, the government's interest subsidy payments to lenders increase primarily because of the longer repayment periods. This report contains several options for the Congress to consider for changing the program to reduce the government's costs.

We are sending copies of this report to the Secretary of Education, appropriate congressional committees, and other interested parties.

This report was prepared under my direction, and I can be reached on (202) 275-1793 if you have any questions. Other major contributors are listed in appendix X.

Franklin Frazier

Franklin Frazier
Director, Education and
Employment Issues

Executive Summary

Purpose

During the 1980s, student-loan debt burden grew steadily as the cost of a postsecondary education increased. Annual student loan default costs also increased from $235 million in fiscal year 1981 to nearly $1.4 billion in 1986. The Congress established the student loan consolidation program in 1986 to respond to this rise in debt burden and default costs. Under this program, borrowers can refinance loans received from a variety of lenders and loan programs. Typically, the monthly payments are lower after consolidation than they would be in aggregate for borrowers with multiple loans. The Congress's intent was to reduce borrowers' monthly payments so as to help decrease federal loan default costs.

The program will end in fiscal year 1992 unless reauthorized by the Congress. GAO is required to evaluate this program by the Higher Education Amendments of 1986. To do so, GAO examined the possible cost effects the consolidation program is having on borrowers, defaults, and government interest subsidies.

Background

Student borrowers must have a minimum of $5,000 in eligible student loan debt in order to consolidate their loans. Depending on the total amount owed, students are allowed from 10 to 25 years to repay a consolidated loan. The interest rate charged on consolidated loans is set by law at the higher of 9 percent or a weighted average of the interest rates on loans being consolidated (rounded to the nearest whole percentage rate). In addition, unlike the bulk of the original underlying loans, borrowers pay no loan origination fee for consolidated loans. For example, the Stafford Student Loan Program carries a 5-percent up-front fee, payable to the federal government, to help offset government program costs. Such a one-time fee is not uncommon when a borrower refinances a consumer loan.

About 63,000 borrowers consolidated approximately $905 million in student loans between October 1986—when the program began—and September 30, 1988. These consolidations are insured against losses by state and private nonprofit guaranty agencies; these agencies, in turn, are reinsured by the Department of Education.

GAO gathered information on participating lenders and their loan portfolios from the guaranty agencies and the Department of Education. GAO also analyzed the consolidated loan portfolios of 36 lenders who held about $790 million, or about 87 percent, of all consolidated loans made by September 30, 1988. GAO discounted the stream of future payments (costs) into present value terms. This allows comparisons of costs

incurred in different time periods. Cited cost projections are given in both present value and as the simple sum of payments (undiscounted).

Results in Brief

The loan consolidation program has been successful in reducing borrowers' monthly payments, thereby easing their payment burden. However, borrowers' lower payments and longer repayment terms are offset by higher interest costs because of the extended repayment lengths of their loans. In addition, borrowers who consolidated their loans have rarely defaulted—only 107 of 63,000 such borrowers defaulted through September 1988. However, it is too early to assess the overall impact on default reduction because the program had been in existence less than 2 years and some of those borrowers that consolidated may yet default.

Loan consolidation has resulted in, and will probably continue to result in, larger government interest subsidies than would have resulted had the underlying loans remained unconsolidated. GAO estimates that for those loans consolidated for the 36 lenders, as of September 30, 1988, the government's subsidy costs could be $7.5 million higher ($48 million undiscounted) than had the same loans gone unconsolidated. However, any default avoidance resulting from this program could help offset these increased costs. GAO also projects that the additional costs for loans consolidated through 1994—assuming that the program is reauthorized—may be $365 million ($860 million undiscounted). The Congress, therefore, in the future, may want to consider changes to the program to help defray or avoid part or all of these additional costs as the program continues to grow.

Principal Findings

Consolidated Borrowers Have Lower Monthly Payments but Higher Interest Costs

The longer repayment terms of consolidated loans make it easier for borrowers to repay their student loans by reducing their monthly payments, but consolidation also increases their total interest costs. For example, a borrower owing $10,000 could pay about $101 a month after consolidating his or her loan, compared with about $121 a month he or she was paying for a number of individual loans with the same total value. However, this borrower's total interest payments will be higher over the 15-year life of the consolidated loan, increasing from $3,419 ($4,559 undiscounted) if the loans were not consolidated to $5,371 ($8,257 undiscounted) if they were.

Few Consolidated Borrowers Had Defaulted on Their Loans

As of September 1988, only 107 of the approximately 63,000 consolidated borrowers had defaulted, at a cost of about $1.4 million. It is difficult to estimate just how many of those consolidated borrowers who are now repaying their loans might have defaulted if there was no consolidation program. It is too early to assess the overall impact on default reduction as a result of this program. The program had been in existence less than 2 years and for the loans GAO analyzed, some of those borrowers who consolidated might default in subsequent years.

Consolidation Results in Increased Subsidy Costs

Students in federally guaranteed loan programs generally receive loans from lenders at below-market rates of interest (statutorily-set). Lenders receive a special allowance payment (or interest subsidy) from the government to bring their yields more in line with market rates charged on other kinds of consumer loans. However, these interest subsidy payments are higher when consolidated for three reasons:

- The maximum repayment period for unconsolidated loans is 10 years, but the government pays subsidies for a longer period—up to 25 years—for consolidated loans. (See p. 23.)
- The government also subsidizes certain loans that were unsubsidized before consolidation. (See p. 24.)
- Higher subsidy costs under consolidation are associated with graduated loan repayments. (See p. 26.)

For the consolidated loans GAO analyzed, these factors could increase program costs by as much as $7.5 million ($48 million undiscounted) over the repayment life of these loans. More important, these costs are for loans consolidated only through fiscal year 1988. Subsequent loans will increase the program cost further. For example, the Department of Education estimates that another $6.6 billion in loans may be consolidated during fiscal years 1989-94. If this growth does occur and these future loans have characteristics that are, on average, similar to those GAO analyzed, the possible increase in interest subsidy costs may be another $365 million ($860 million undiscounted). (See p. 27.)

These increased interest subsidy costs could be reduced if legislative provisions similar to those enacted by the Consolidated Omnibus Budget Reconciliation Act of 1985 for consolidated loans were still in effect. At that time, the interest rate was the higher of 10 percent or the highest rate of the loans being consolidated; the special allowance payment factor, at 3 percent, was one-quarter of 1 percent lower. If these provisions were now in effect, the government's subsidy costs would be negated. In

addition, charging consolidated borrowers an origination or refinancing fee would also raise revenue to help offset program costs.

Matters for Consideration by the Congress

GAO has identified four options that the Congress may wish to consider in its deliberations. These options should be considered in relationship to how much this program may reduce loan defaults. The first option would be to let the program expire in 1992, as currently authorized, or rescind its authority before that time. The other three would better balance the benefits available to borrowers who wish to consolidate their student loans, but these options would reduce the additional interest subsidy costs to the government while it continues to operate the program (see p. 35). Program participation by lenders and borrowers may be affected with the enactment of these options because they either increase the costs to borrowers or reduce lender profits. Although program cost impacts have been estimated, no data existed, at the time of GAO's review, for estimates of possible changes in participation rates.

Agency Comments

The Department of Education and four of the five lenders providing data for GAO's review provided written comments on a draft of this report (see apps. VIII and IX). The Department stated that GAO had presented the Congress with several good options to consider. The lenders generally stated that more data were needed to determine the impact of the program on loan defaults and on reducing default costs. While GAO does not disagree with the lenders' views, it made its analyses with the data that were available, and it recognizes in the report the limitations of its evaluations. In addition, GAO incorporated in the report technical comments offered by the lenders.

Contents

Tables

Figures

Abbreviations

ALAS	Auxiliary Loans to Assist Students
CBO	Congressional Budget Office
COBRA	Consolida ed Omnibus Budget Reconciliation Act
GAO	General Accounting Office
HEAF	Higher Education Assistance Foundation
NELLIE MAE	New England Education Loan Marketing Corporation
SALLIE MAE	Student Loan Marketing Association
SLS	Supplemental Loans for Students
USAF	United Student Aid Funds, Inc.

Introduction

Steadily escalating postsecondary education costs in the 1980s have, in part, led to a growing number of students who accumulate large student loan debt by obtaining more federally guaranteed and subsidized loans. This growth has been accompanied by an increasing number of loan defaults, especially on loans issued under the Guaranteed Student Loan Program.[1] As loan volume increased to over $12 billion in fiscal year 1989, defaults on these kinds of loans rose from about $235 million, in fiscal year 1981; to about $1.4 billion, in fiscal year 1986; to almost $2 billion, in fiscal year 1989.

In 1986, to help students deal with the higher costs of loan repayments and to help reduce defaults on federally guaranteed student loans, the Congress established a loan consolidation program. Under this program, instead of making concurrent payments on several loans over a period usually limited to 10 years, students can consolidate these loans and make smaller monthly payments over 10 to 25 years, depending on the size of the consolidated loan. The program was authorized for 6 years, through fiscal year 1992.

Section 1314 of the Higher Education Amendments of 1986 requires GAO to evaluate the loan consolidation program. This report is in response to that mandate.

Loan Consolidation Program

Students who graduate, or otherwise leave school with a number of loans, can be faced with sizeable combined monthly payments. Each loan borrowed under a federal student loan program typically requires minimum payments of $50 a month, with a maximum repayment term of 10 years.

The consolidation program was established to provide a means to help student borrowers reduce their monthly payments. The program was authorized by the Consolidated Omnibus Budget Reconciliation Act (COBRA) of 1985 (P.L. 99-272), as amended by the Higher Education Amendments of 1986 (P.L. 99-498) and the Higher Education Technical Amendments Act of 1987 (P.L. 100-50). The program allows a student to combine multiple loans into a single loan, make one monthly payment, and, in most cases, repay the loan over a longer period.

To be eligible for a consolidated loan, a borrower must owe at least $5,000 in eligible student loans. These loans include

[1]Effective July 1, 1988, this program was renamed the Stafford Student Loan Program.

- "regular" guaranteed student loans, now called Stafford student loans;[2]
- Perkins loans (formerly called National Direct Student Loans);
- Federally Insured Student Loans;
- Supplemental Loans for Students (SLS);
- Auxiliary Loans to Assist Students (ALAS); and
- health professions student loans.

In addition, a borrower can neither be in default nor be over 90 days delinquent on any loan being consolidated.

The interest rates charged student borrowers on these loans vary. For example, Perkins loan borrowers pay an interest rate of 5 percent; SLS borrowers pay a market rate of interest, 10.45 percent for calendar year 1989. In comparison, interest rates on consolidated loans are set at 9 percent or at the weighted average of the interest rates on the loans being consolidated (rounded to the nearest whole percent), whichever is higher.

In many instances, the interest rate charged student borrowers is less than the rates lenders could charge for consumer credit activities, such as personal loans or credit cards. The federal government compensates lenders with an interest subsidy to bring lenders' rates of return more in line with market rates.

The size of the consolidation loan determines the repayment term. This is illustrated in table 1.1 for a 9-percent loan.

Table 1.1: Repayment Terms for a 9-Percent Consolidated Loan

Loan amount	Maximum repayment terms (in years)	Monthly payment range
$5,000-7,499	10	$63–$95
7,500-9,999	12	85–114
10,000-19,999	15	101–203
20,000-44,999	20	180–405
45,000 or more	25	378 or more

The 1986 amendments also allow borrowers with consolidated loans to establish graduated or income sensitive repayment schedules with their lenders. Graduated repayment plans reduce borrowers' monthly payments during the early years of repayment by allowing them to make

[2]For this report, we refer to loans issued on or after July 1, 1988, as "Stafford loans" and loans issued before that date as "regular" guaranteed student loans.

only interest payments and offset these with higher subsequent payments. In level payment plans, on the other hand, borrowers make the same monthly payments for the duration of a loan.

Federal Guarantees and Subsidies

Borrowers may obtain consolidated loans from a variety of participating lenders, including commercial banks, savings and loan associations, and credit unions. Guaranty agencies, which administer the program at the state level for the Department of Education, insure these loans by agreeing to repay lenders if borrowers fail to do so because of death, disability, bankruptcy, or default. The Department, in turn, reimburses guaranty agencies for these repayments.

The amount of interest subsidy the Department pays—to assure that consolidated loans provide lenders with close to market rates of return—can vary. This subsidy, which is paid quarterly, is called a "special allowance payment." The amount of this subsidy is based on a formula specified in the law. The formula establishes the student's interest rate as a floor, but allows lenders to receive higher returns on these loans if market interest rates go above a certain level. The formula does this by adding 3.25 percent to the average 91-day Treasury bill rate and then subtracting the loan's interest rate. For example, if the average 91-day Treasury bill rate was 6.75 percent and the loan interest rate was 9 percent, the formula would provide an annual subsidy rate of 1.00 percent, as shown in table 1.2. Because lenders receive this payment quarterly, the subsidy for an annual rate of 1.00 percent would be 0.25 percent (1.00 percent divided by 4).

Table 1.2: An Illustration of How the Special Allowance Payment Is Calculated

Factor	Percent
Average 91-day Treasury bill rate	6.75
Subsidy rate	+ 3.25
Market rate of return	10.00
Loan interest rate	- 9.00
Annual subsidy factor	1.00

When Treasury bill rates drop to 5.75 percent or lower, the government discontinues paying subsidies for 9-percent consolidated loans. During the first 2 years of the loan consolidation program, October 1986 to September 1988, the average 91-day Treasury bill rates ranged from 5.5 percent to 7.2 percent.

To help offset its costs for defaults and interest subsidies, the Department of Education receives a 5-percent loan origination fee, paid by borrowers, for Stafford loans. However, the consolidation program specifically prohibits the borrower from paying such a fee.

Growth of the Program

The total amount of loans consolidated under this program increased from $263 million, as of September 30, 1987, to $905 million, as of September 30, 1988, a 244-percent increase. As shown in table 1.3, only 249 lenders, of over 13,000 lenders that participate in federal student loan programs, held consolidated loans as of the end of fiscal year 1988. (This figure may double-count lenders who have consolidated loans guaranteed by more than one guaranty agency.) However, the 10 lenders with the largest consolidated loan portfolios held about $793 million, or about 88 percent, of these loans.

Table 1.3: Lenders' Consolidated Loan Portfolios Guaranteed (as of Sept. 30, 1988)

			Consolidated loans	
Portfolio size	Lenders	Loans	Amount (in millions)	Percent
$15,000,000 or more	4	49,639	$736.4	81.4
$10,000,000 to $14,999,999	2	2,371	28.5	3.2
$ 5,000,000 to $ 9,999,999	4	2,324	28.3	3.1
$ 1,000,000 to $ 4,999,999	37	6,406	80.8	8.9
Less than $1,000,000	202	2,486	30.5	3.4
Total	**249**	**63,226**	**$904.5**	**100.0**

Objectives, Scope, and Methodology

The 1986 amendments required that we evaluate the loan consolidation program. In subsequent discussions with the Subcommittee on Education, Arts, and the Humanities, Senate Committee on Labor and Human Resources, and the Subcommittee on Postsecondary Education, House Committee on Education and Labor, we agreed to examine the observed or potential effect of this program on (1) borrowers, (2) defaults costs, and (3) the interest subsidy costs to the government.

We obtained statistics on the consolidation program, as of the end of fiscal year 1988, from the Department. We held discussions with Department officials responsible for program policy, administration, and monitoring. We reviewed the legislation and regulations, as well as the Department's policy and procedural guidelines for the loan consolidation program. We subsequently discussed the results of our work with Department officials.

To develop nationwide information on the current program, we sent a data collection instrument to representatives of the 47 state and private nonprofit guaranty agencies, which either guarantee or service consolidated loans for the 50 states, the District of Columbia, Puerto Rico, the Virgin Islands, and the Pacific Islands. Agencies were to provide data, as of September 30, 1988, on the number and value of (1) consolidated loans they guaranteed and (2) defaulted consolidated loans. We asked the agencies to provide these data for each lender. All guaranty agencies responded, although not all agencies had guaranteed such loans. Appendix I summarizes these results.

We evaluated the program's effect on borrowers and the government by obtaining data from five lenders we judgmentally selected, based on the size of their consolidated loan portfolios and on the availability of loan data in their computerized data systems. The five were

- Student Loan Marketing Association, Washington, D.C.;
- Citibank Corporation, Rochester, New York;
- New England Education Loan Marketing Corporation, Braintree, Massachusetts;
- Virginia Education Loan Authority, Richmond, Virginia; and
- Pennsylvania Higher Education Assistance Agency, Harrisburg, Pennsylvania.

In addition to information on its own loan portfolio, the Pennsylvania agency provided us with data on 31 other lenders whose consolidated loans it services (bills and collects from the borrowers). These additional lenders brought the total number of lenders we reviewed to 36. In all, these 36 lenders held approximately $790 million, or about 87 percent, of the $905 million in consolidated loans guaranteed as of the end of fiscal year 1988. Appendix II lists the 36 lenders.

We measured the effect of the program on the government by (1) estimating the subsidies that the Department of Education would pay for students' consolidated loans, held in the 36 lenders' portfolios, and (2) comparing this with the estimate of the subsidies the Department would pay if these loans had remained unconsolidated. This permitted us to estimate the incremental costs of the program. When estimating future program costs, we discounted the stream of future payments (costs) into present value terms. This allows comparisons of costs incurred in different time periods. As a result, our cost projections are given in both present value and as the simple sum of payments—referred to in this report as undiscounted. Because the special allowance

payment is tied directly to the Treasury bill rate and influences the federal cost of the program, we also analyzed the sensitivity of this payment to changes in Treasury bill rates; this enabled us to determine how fluctuations in these rates could affect expected government subsidy costs. Appendix III contains a detailed description of the methodology we used to estimate these future interest subsidy costs.

There was no practical way by which we could estimate how many of the consolidated borrowers who are repaying their loans might have defaulted had there been no program. In addition, because the lenders had insufficient information on certain characteristics (such as students' courses of study or the length of school enrollments) of borrowers, we were unable to develop a profile of borrowers participating in the program. However, we obtained information from a guaranty agency on what it found on the attributes of consolidated borrowers; we then compared this information with information found during our previous review of student loan defaults.[3] We also obtained the views of lender and guaranty agency officials on what they believed was the impact of this program on default reduction.

Our field work was carried out from June 1988 through May 1989. Our review was conducted in accordance with generally accepted government auditing standards.

[3]Defaulted Student Loans. Preliminary Analysis of Student Loan Borrowers and Defaulters (GAO/HRD-88-112BR, June 14, 1988).

Borrowers Have Lower Monthly Payments and Higher Interest Costs—Few Default

The loan consolidation program was established for two principal reasons. One was to help student loan borrowers cope with their large student loan debts. The other was to reduce the government's costs by limiting loan defaults. It was believed that lower monthly payments available through the consolidated loan program would help borrowers avoid default, in turn benefiting the government through lower default costs on federally guaranteed loans.

We found the program helps borrowers reduce their monthly payments, but it can also increase the interest borrowers may pay over the life of their loans. It is less clear, however, how significantly the program will reduce student loan default costs. Although borrowers with only 107 of 63,000 consolidated loans have defaulted during the first 2 years of the program, we were unable to determine whether that number would have been different had there been no program. However, it is too early to assess the overall impact on default reduction.

Reduced Monthly Payments Possible

While consolidated loans have repayment terms of 10 to 25 years (depending on the amount borrowed), unconsolidated loans (which are referred to as the underlying loans) have maximum repayment terms of up to 10 years, regardless of the loan amount. In general, the larger the amount consolidated, the longer a borrower has to repay and the greater the benefit in terms of reduced monthly payments. The monthly payments for consolidated (at 9 percent interest) and underlying (at 8 percent interest) loans, ranging from $5,000 to $45,000, are shown in table 2.1. As shown, borrowers who consolidate $7,500 or more benefit in terms of reduced monthly payments, with those having the longest repayment terms receiving the greatest reduction in monthly payments. (The monthly payment amounts shown would repay the loan amounts over the full life—repayment length—of the loans.)

Table 2.1: Monthly Payments for Consolidated Loans Are Generally Lower

Amount	Consolidated payment length (in years)	Loan monthly payment		Increase/ decrease
		Underlying	Consolidated	
$5,000	10	$60.66	$63.34	$2.68
7,500	12	91.00	85.35	−5.65
10,000	15	121.33	101.43	−19.90
20,000	20	242.66	179.95	−62.71
45,000	25	545.97	377.64	−168.33

In the portfolios of the 36 lenders we reviewed, 83 percent of the consolidated loans were for $10,000 or more.

Graduated Repayment Further Reduces Monthly Payments

Graduated repayment plans reduce a borrower's monthly payments during the early years of repayment by allowing the borrower to make only interest payments. For example, under a 4-year graduated repayment plan, a borrower pays only interest for the first 4 years and then pays principal and interest for the remaining term. During the first 4 years under a 4-year graduated repayment plan, as shown in table 2.2, a borrower with a $15,000 consolidated loan (at 9 percent) will have a smaller monthly payment ($113 versus $152) and will pay $39 less a month than under a level payment plan, in which the monthly payment is the same throughout the repayment period. On the other hand, the borrower's payments for the 5th through 15th years will be higher than they would have been under a level payment plan.

Table 2.2: Graduated Repayment Plans Reduce Monthly Payments for a $15,000 Consolidated Loan

	Monthly payment amount for		
Repayment years	Level plan	2-year graduated plan	4-year graduated plan
1 and 2	$152	$113	$113
3 and 4	152	163	113
5 to 15	152	163	179

All but 1 of the 36 lenders we reviewed offer graduated repayment plans to borrowers who consolidated their loans. Of the approximately 53,000 consolidated loans held by these 35 lenders, about 40,000 (75 percent) were being repaid under a graduated repayment plan. Only 1 of these 35 lenders said it offered graduated repayment plans for unconsolidated loans.

Longer Repayment Periods Mean Higher Interest Costs

Borrowers who consolidate their student loans generally pay more in interest over the repayment life of the consolidated loan, and they must balance this additional cost with the benefits that they perceive accrue to them. For example, borrowers are able to reduce their monthly payments for their student loan debt; this allows them to use their current dollars for other purposes, including the payment of other consumer debts (such as credit cards), which have higher interest rates.

Because consolidated loans generally have longer repayment periods, their principal balances outstanding remain higher for a longer period.

As a result, a borrower's total interest costs will increase. The total undiscounted interest that a borrower would pay on a consolidated loan (at 9 percent) and an unconsolidated loan (at 8 percent), for debts ranging from $5,000 to $45,000, are shown in table 2.3. The interest costs are higher for consolidated loans for each loan amount, and the difference is more significant as the loan amount increases. For example, the total interest for a $45,000 loan is nearly $18,000 higher in present value terms ($47,775 undiscounted) primarily because the (1) interest rate is higher and (2) repayment period has been extended from 10 to 25 years.

Table 2.3: Total Interest Costs Higher for Consolidated Loans

Amount of student debt	Borrowers's total loan interest		
	Unconsolidated	Consolidated	Increase
$ 5,000	$2,280	$2,601	$321
7,500	3,419	4,791	1,372
10,000	4,559	8,257	3,698
20,000	9,119	23,187	14,068
45,000	20,517	68,292	47,775

Graduated Repayments Increase Interest Costs

Graduated repayment plans can further increase a borrower's total interest costs. These plans cause a higher principal amount to remain outstanding for longer periods, resulting in additional costs for the borrower. For example, a borrower with a $10,000 consolidated loan repaid over 15 years will pay $653 ($1,131 undiscounted) more in interest under a 4-year graduated repayment plan than under a level payment plan ($6,024 versus $5,371 discounted). If that same borrower had a 2-year graduated plan, the increased interest cost would be $322 ($552 undiscounted).

Few Defaults Have Occurred

We were unable to determine how many borrowers who had consolidated their loans might have defaulted had there been no such program. We did, however, determine from information obtained from the guaranty agencies that borrowers with only 107 of the approximately 63,000 consolidated loans, representing about $1.4 million of the $905 million consolidated loans, had defaulted through September 1988.

We also identified data indicating that borrowers who consolidated their loans have different characteristics than most loan defaulters. In June 1988, we reported that, overall, 35 percent of vocational students defaulted on their loans in contrast to 12 percent of the students who

attended a traditional 2-year or 4-year school. Similarly, a study by the Higher Education Assistance Foundation (HEAF) (a guaranty agency) of the profile of borrowers who had consolidated their loans by December 31, 1988, found that (1) most loan consolidators attended schools in which enrollment periods were 2 years or longer and (2) the majority were in school for more than 1 year. This study's results appears to confirm our findings that borrowers with large student loan debt who attended school for longer periods—the profile of a student who consolidated his or her student loan—are less likely to default. (See table 2.4.)

Table 2.4: Borrowers Who Consolidate Attend Different Schools for Longer Periods Than Most Defaulters

Numbers in percent

Comparative factors	Consolidated borrowers	Defaulters
Kind of school attended		
Vocational	14	42
2-year or 4-year	83	43
Other	3	15
Years attended		
1 or less	37	63
More than 1	60	37
No information	3	0

Source: HEAF.

On the basis of our earlier work and the HEAF study, it appears that the loan consolidation program may not significantly reduce defaults. Most lender and guaranty agency officials we interviewed generally shared this belief. Borrowers who take the time and make an effort to consolidate, some of these officials said, were probably less prone to default on their loans. Defaulters, according to these officials, generally attend school for 1 year or less, and usually drop out of school.

Conclusions

The loan consolidation program can provide assistance to borrowers needing help repaying their student loans. Its lower monthly payments help borrowers more easily fit loan repayment into their budgets. However, the reduced monthly payments must be weighed against the increased interest costs these borrowers can pay. These increases can be considerable for borrowers with larger amounts of debt.

Whether the program leads to a decrease in defaults is still unanswered. The likelihood of this occurring to a significant degree is uncertain. In addition, borrowers who have the highest propensity to default are

unlikely to participate in the consolidation program. By contrast, those borrowers most likely to consolidate their loans are generally among those with the lowest default rates. However, because the loans we analyzed had been consolidated for less than 2 years, it is too early to assess the program's effect on default reduction.

Agency Comments and Our Evaluation

Lenders' Comments

The lenders have mixed opinions regarding our assessment of the likely impact the program has on reducing defaults. The New England Education Loan Marketing Corporation (NELLIE MAE) agreed that the program is likely to have little impact on reducing default costs. On the other hand, Citibank and the Pennsylvania Higher Education Assistance Agency said that (1) we understate the program's impact on default reduction and (2) additional time and study are required to more adequately address this matter.

The Student Loan Marketing Association (SALLIE MAE) also said that we understate the program's impact on default reduction and, after our review, provided new data from its portfolio showing that loan consolidation has a positive impact on repayment behavior. SALLIE MAE said its experience shows these rates: a 2-percent default rate for borrowers who consolidated their loans versus a 9.8 percent default rate for borrowers attending 4-year colleges who did not consolidate their loans.

These comments illustrate the uncertainty about how loan consolidation may reduce defaults. As the program matures, we agree that further study would be useful to more adequately evaluate these issues.

Citibank also provided information showing that the average amount of a consolidated loan in its portfolio decreased from approximately $12,300 during the period October 1986 through September 30, 1988, to $6,500 during the period October 1988 to December 1989. Citibank suggested we expand our study to include an analysis of this newly provided data.

This information was provided for a period subsequent to the completion of our analysis, and we agree that more study could be done in the

future. However, if this issue is examined further, future analysis should also determine whether Citibank's experience is being encountered by the other major lenders with consolidated loans.

Government's Subsidy Costs Will Increase

For the loans we analyzed, the loan consolidation program could result in a relatively small decrease in the government's interest subsidy costs for the first 10 years. However, almost half of the loans consolidated have repayment periods of 20 years or more, which can significantly increase the government's costs. For the 36 lenders we examined, the program may increase the government's subsidy by an estimated $7.5 million ($48 million undiscounted). Any default avoidance resulting from this program would help offset these increased costs.

As the program continues to grow, so can the interest subsidy costs to the government. The Department of Education estimates that another $6.6 billion in loans may be consolidated during fiscal years 1989-94. If these future loans have the same characteristics as those we analyzed, for these 6 years, the additional interest subsidy cost to the government could be about $365 million ($860 million undiscounted). The program's costs would be greater if interest rates on Treasury bills increase, but would decline if these rates decrease.

The Congress has several options that would minimize or offset these potential cost increases. The first option would be to let the program expire in 1992, as currently authorized. Other options, which would affect borrowers, include (1) charging them a loan origination fee or (2) increasing their loan interest rates. These two options would increase the borrowers' costs, which may limit their future participation in this program. A fourth option would affect lenders by reducing their interest subsidy payments—and income—which could limit or reduce their willingness to make consolidated loans in the future.

Government's Subsidy Costs Will Be Greater

The Department of Education's subsidy costs for the consolidated loan portfolio will rise during the loans' repayment periods. It is difficult to isolate each element of such cost increases, but there are three principal factors that contribute to them:

- Longer repayment terms available to borrowers make consolidated loans more expensive for the government to subsidize.
- The consolidation of certain kinds of loans, normally unsubsidized during their repayment, increases the loan portfolio subject to subsidy.
- The graduated repayment plans, which reduce borrowers' monthly payments, generally add to the government's costs because interest subsidies are paid on the loans' principal balances, which remain higher for longer periods.

We conducted a comparative cost analysis to determine whether the loan consolidation program could increase or decrease the government's subsidy costs. Using a 91-day Treasury bill rate of 7.99 percent (rate in effect for the loan portfolio on Oct. 1, 1988), we determined the subsidy costs for the loans that were consolidated and compared them with the subsidy costs had these same loans remained unconsolidated. We made this comparison using data from the 36 lenders whose consolidated loan portfolios totaled about $790 million through September 30, 1988. (App. III contains a detailed description of our methodology for estimating the program's cost.)

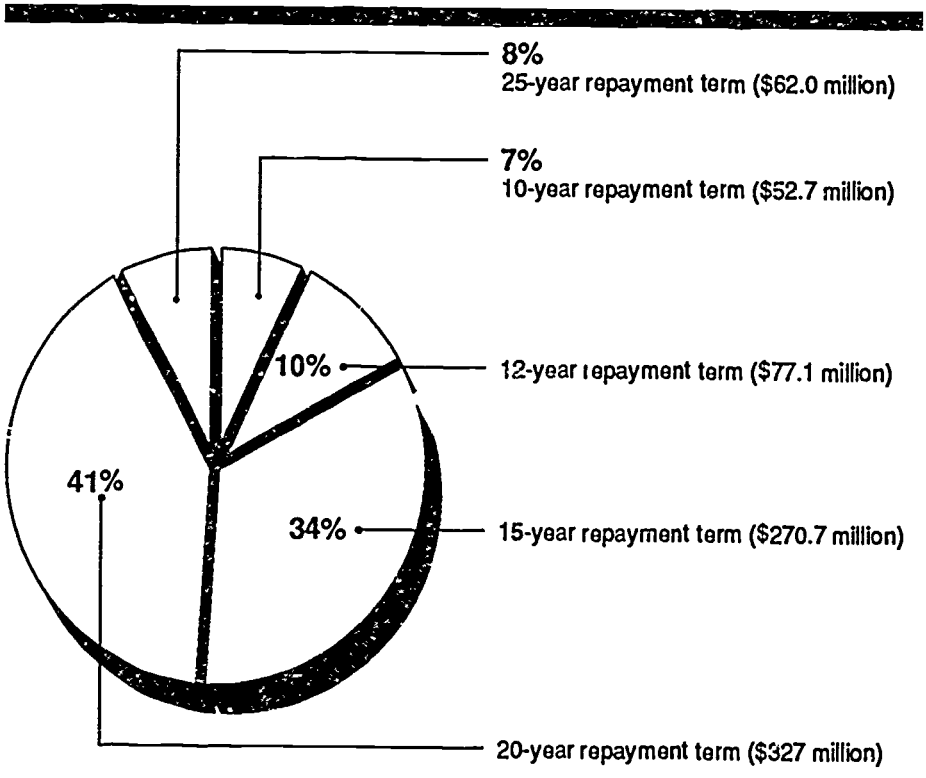
The combination of the three factors could increase the government's cost by about $7.5 million ($48 million undiscounted) for the consolidated loan portfolios held by the 36 lenders. For the loans we analyzed, the projected subsidy costs for the first 10 years were $9.1 million less ($4.5 million less undiscounted) for the underlying loans than loans consolidated. This reduction occurs, in part, because the underlying guaranteed student loans have an interest rate of 8 percent; the consolidated loans, 9 percent. As a result, the borrower pays an additional 1 percentage point of interest, thereby reducing the government's subsidy by the same percentage. If default savings of 1 percent were achieved on the principal amount ($790 million) of the loans we analyzed, the increased subsidy costs would be offset. However, we were unable to estimate what these default savings may be.

Longer Repayment Terms Increase Subsidy Costs

A first reason for increased subsidy is that the longer the repayment period, the more interest subsidy the government can pay. Consolidated loans have repayment terms ranging from 10 to 25 years, depending on the amount borrowed and consolidated; regardless of the loan amount. As discussed above, during the first 10 years of repayment, the subsidy costs on the borrowers' loans could be less if the loans were consolidated rather than if they had remained unconsolidated.

According to data provided by the lenders we reviewed, over 80 percent of their loan volume has repayment terms of 15 years or more. (See fig. 3.1.)

Figure 3.1: Volume of Loans Consolidated by Repayment Term

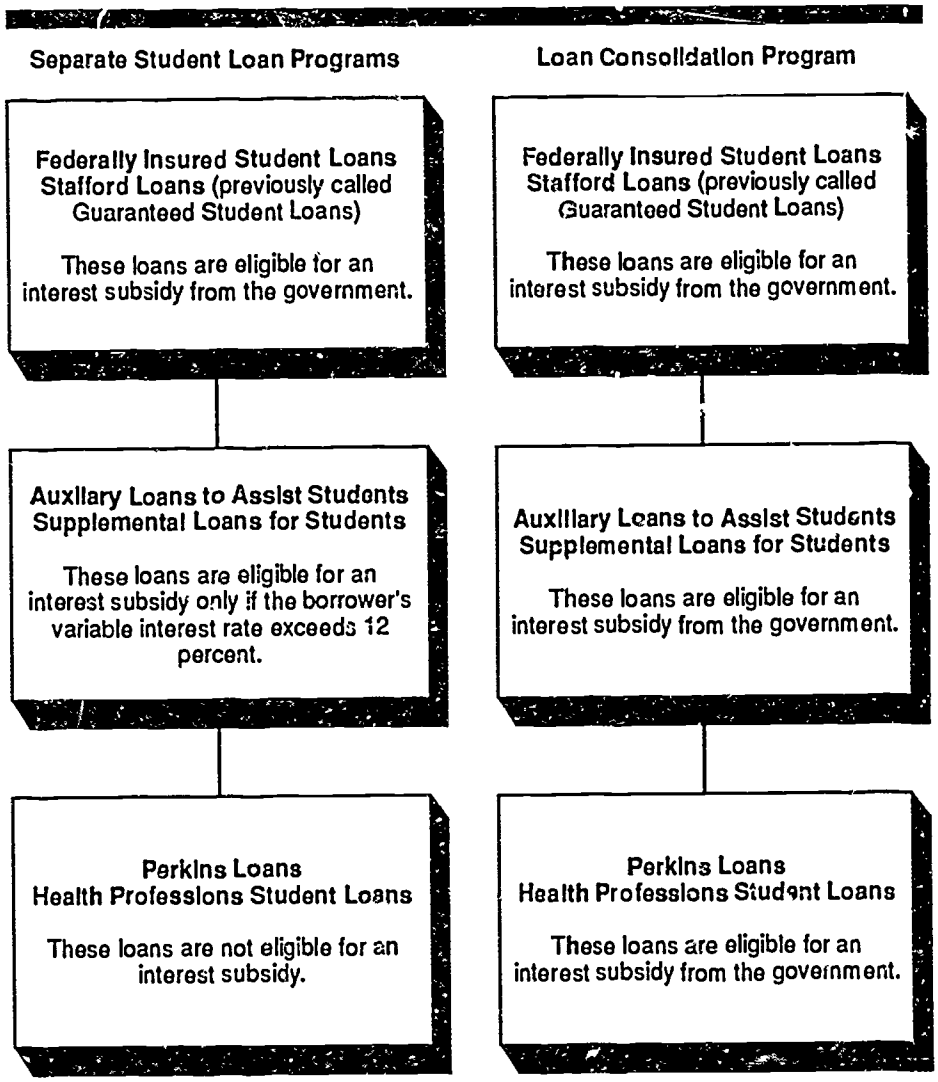


Previously Unsubsidized Loans Now Being Subsidized

A second reason for increased subsidy costs is that consolidating loans previously unsubsidized can add to the portfolio subject to subsidy. As shown in figure 3.2, of the kinds of loans eligible for consolidation, only two—Stafford loans and Federally Insured Student Loans—are eligible for interest subsidies before being included in a consolidated loan. In comparison, both Perkins and the health professions loans are unsubsidized.[1] The remaining two kinds of loans—ALAS and SLS—are generally unsubsidized, although they are subject to subsidy when Treasury bill rates exceed certain thresholds that are higher than those for Stafford loans.

[1]Perkins and health professions loans are made by the schools and receive no government subsidies, although the government does provide the schools with capital funds to help establish their programs. As such, the students borrow the moneys from the schools and repay their loans to the schools' revolving fund. These funds are then used to make loans to other students or are returned to the government.

Figure 3.2: Which Student Loans Are Eligible for Federal Subsidy?



Note. The variable interest rate is determined by adding 3.25 percent to the 52 week Treasury bill rate. As a result, the Treasury bill rate must exceed 8.75 percent before an interest subsidy is paid (3.25 percent + 8.75 percent = 12 percent)

If any Perkins and health professions loans are consolidated, the government can incur additional subsidy costs. For the lenders we reviewed, borrowers consolidated about $55 million of such loans. A summary of these loans by their repayment terms is shown in appendix IV.

Graduated Repayments Increase Subsidies Paid to Lenders

A third reason why the government pays more in interest subsidies for consolidated loans than underlying loans is attributed to graduated repayment plans. These plans increase the government's costs because subsidy payments are made on a larger principal balance for a longer period. Under graduated repayment plans, borrowers make only interest payments for a few years; their principal balances remain the same rather than decline as with an amortizing loan, which means that the government may pay more subsidies.

The 35 lenders that offer borrowers the option of using a graduated repayment plan used them for about 75 percent of their consolidated loan portfolios. We estimate that the government's subsidy costs to lenders using these plans could increase by about $7.4 million ($13 million undiscounted) over the repayment period for such loans; by about $114.3 million, if the borrowers used level payment plans; and by about $121.7 million, if the borrowers used a mix of level and graduated plans, as currently in these lenders' portfolios.

Consolidating New Stafford Loans Could Greatly Increase Subsidy Costs

The Higher Education Amendments of 1986 shifted more of the responsibility for paying interest on Stafford loans to the borrower by increasing the borrower's interest rate for these loans during the 5th and remaining years of repayment. Effective July 1, 1988, Stafford loans disbursed to new borrowers—those who borrowed under the Stafford Student Loan Program for the first time—carry an 8-percent interest rate during their first 4 years of repayment and a 10-percent interest rate thereafter (referred to as an 8/10 percent loan). Previously, guaranteed student loan borrowers paid interest at a single interest rate (typically 8 percent) throughout the repayment period. In addition, the 1986 amendments also reduced the government's special allowance payment factor from 3.5 percent to 3.25 percent on loans made to new borrowers for periods of enrollment on or after November 16, 1986. These changes were made to reduce the government's subsidy costs.

The savings from these revisions, however, will be partially offset for such loans when consolidated. To provide an indication of what may happen to the government's costs when Stafford loans with the new interest (8/10 percent) and subsidy (3.25 percent) rates are repaid, we recomputed the subsidy costs for the underlying guaranteed student loans in the consolidated loan portfolios of the 36 lenders. We substituted these new interest and subsidy rates for the previous rates of the underlying loans. We assumed that all borrowers would repay their loans using level payment plans. (This assumption was made because

there was no practical way to predict how many borrowers would choose graduated repayment plans if they had 8/10 percent underlying Stafford loans.)

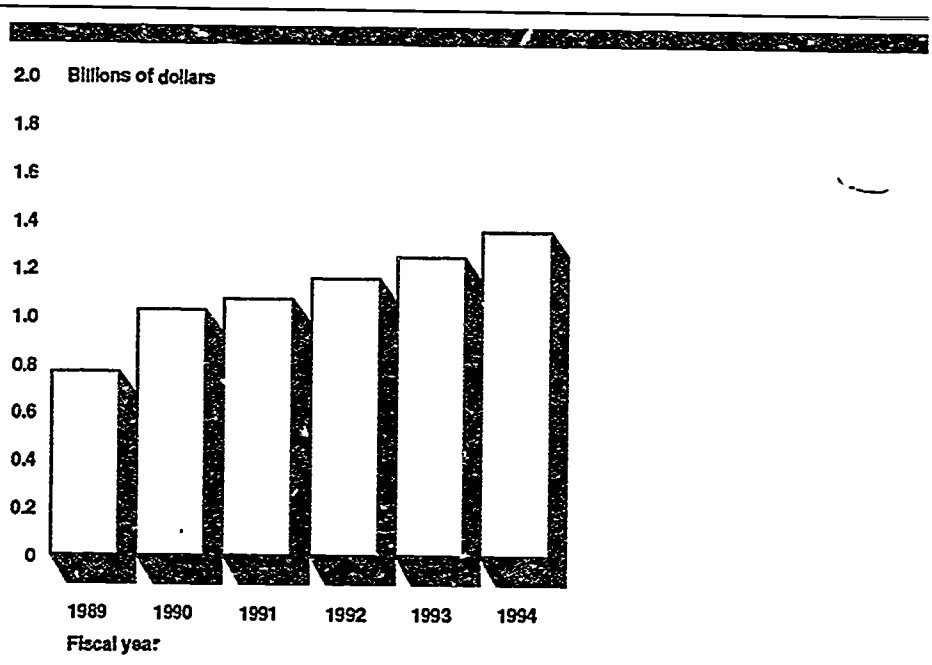
The new rates could reduce the government's subsidy costs for these loans from $94.4 million to $70.7 million ($126.4 million to $89 million, respectively, undiscounted) if the underlying loans were not consolidated. Therefore, when unconsolidated, the new rates could result in a subsidy cost savings of $23.7 million ($37.4 million undiscounted). When the new loans are consolidated, however, these cost savings are not realized because under loan consolidation, the subsidy costs would be $114.4 million ($191.8 million undiscounted).

Conversion of Stafford loans to consolidated loans could also add to the government's costs in another way. Borrowers subject to the increase in interest rates, from 8 to 10 percent, may decide to switch to a 9-percent consolidated loan before their 5th year of repayment, thereby avoiding the 10-percent interest rate during the remaining years of the Stafford loans. The government could then have to pay up to an additional 1 percentage point in interest subsidies, depending on Treasury bill rates. (It is too early to estimate to what extent this may occur because borrowers who have 8/10 percent loans have not yet entered their 5th year of repayment.)

Consolidation Program Growth Could Cause Additional Cost Increases

The loan consolidation program grew to almost $1 billion during its first 2 years. In fiscal year 1988, its 2nd year, the program grew by $642 million, from $263 million to a total of $905 million. The Department of Education estimated, in June 1989, that consolidated loan volume will continue to increase. As shown in figure 3.3, the Department projected the volume will increase in each succeeding fiscal year through 1994 (this assumes that the program will be extended beyond its authorized period ending in fiscal year 1992). The expected volume of new loans is $765 million in fiscal year 1989, increasing to $1.35 billion in fiscal year 1994, for a projected cumulative growth to about $6.6 billion.

Figure 3.3: Estimated Future Growth of the Consolidation Program



Source: Department of Education.

Future interest subsidy costs could also increase for these new consolidated loans. The potential incremental cost—as compared with the loans remaining unconsolidated—may total $365 million for the loans projected to be consolidated in fiscal years 1989-94 ($860 million undiscounted), as shown in table 3.1. This estimate assumes that (1) the future consolidated loan volume projected by the Department will have the same proportional mix of underlying loans as those held by the 36 lenders we reviewed, (2) lenders will receive a special allowance payment based on a 3.25 percentage rate for underlying Stafford loans, and (3) for their underlying Stafford loans, borrowers would be subject to the interest rate increase from 8 to 10 percent starting in the 5th year of repayment.

Table 3.1: Subsidy Costs Increase as Loan Volume Grows

Dollars in millions

Fiscal year	Projected consolidated loan volume	Total incremental subsidy cost[a]	Present value of incremental cost
1989	$765	$99.6	$42.2
1990	1,023	133.2	56.5
1991	1,067	138.9	58.9
1992	1,153	150.1	63.7
1993	1,245	162.1	68.8
1994	1,352	176.0	74.6
Total	**$6,605**	**$859.9**	**$364.7**

[a]These figures include total subsidy costs incurred over the repayment life of the consolidated loans originated each year.

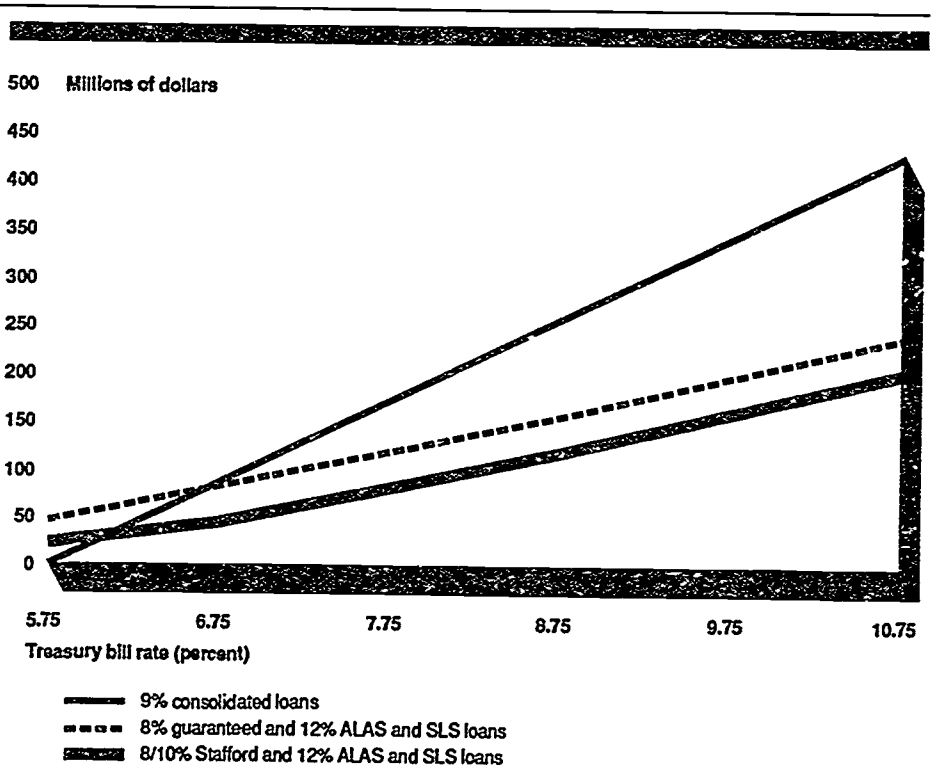
Program Costs Also Sensitive to Fluctuations in Treasury Bill Rates

The special allowance payment formula for consolidated loans is tied to 91-day Treasury bill rates. Increases and decreases in these rates can significantly affect the level of subsidies the government pays. The subsidy formulas for loans eligible for loan consolidation, except Perkins and health professions loans, are also tied to this Treasury bill rate. As such, changes in Treasury bill rates can affect the cost of these subsidy payments and comparisons between the underlying and consolidated loans.

Our calculations use the 91-day Treasury bill rate in effect for the first quarter of fiscal year 1989. That rate, 7.99 percent, was used by the Department of Education to determine, for that quarter, the amount of interest subsidy payments due to lenders holding loans subject to interest subsidies. These payments are directly tied to the Treasury bill rate, that is, when the rate changes, so does the government's costs.

To analyze the sensitivity of program costs to changes in Treasury bill rates, we recomputed our estimates for the consolidated loan portfolios held by the 36 lenders we reviewed, using the same methodology and assumptions as before, except we substituted higher and lower Treasury bill rates in our baseline estimate. This analysis showed that declining Treasury bill rates would result in consolidated loans becoming less expensive to subsidize than either 8-percent guaranteed student loans, 8/10-percent Stafford loans, or 12-percent ALAS and SLS loans. However, as shown in figure 3.4, higher average Treasury bill rates over the life of these loans would result in additional costs, and consolidated loans become proportionately more costly as the rates increase.

Figure 3.4: Subsidy Costs Increase With Higher Treasury Bill Rates



What Can Be Done to Reduce the Government's Costs While Preserving the Program's Benefits?

The earlier actions of the Congress in considering, enacting, and modifying the loan consolidation program provide context and insight into how the costs of the program could be reduced.

How Selected Legislative Factors in the Program Determine Subsidy Costs

There are three principal factors, established by law, that affect the amount of government subsidy for the loan consolidation program: (1) the borrower's interest rate, (2) special allowance payments to the lender, and (3) length of the repayment period. As shown in table 3.2, these factors—as established in COBRA of 1985, which authorized the loan consolidation program—were subsequently modified by the Higher Education Amendments of 1986. These modifications clearly increased the government's potential subsidy costs because (1) borrower interest

rates decreased, (2) the lender special allowance payment factor increased, and (3) the maximum repayment period was lengthened.

Table 3.2: Selected Legislative Factors That Influence the Cost of the Loan Consolidation Program

Provision	COBRA of 1985	1986 amendments
Interest rate	10 percent or highest rate of loans being consolidated	Minimum of 9 percent or weighted average of loans being consolidated, rounded to nearest percent
Special allowance payment rate	Average of 91-day Treasury bills plus 3.0 percent	Average of 91-day Treasury bills plus 3.25 percent
Repayment length	Maximum of 15 years, depending on amount owed	Maximum of 25 years, depending on amount owed

The Congressional Budget Office's (CBO) cost estimate for the loan consolidation provisions in COBRA concluded that there would be some budget savings from creating the program, but did not provide a specific net savings estimate. CBO also predicted that other savings would occur due to default reductions. It estimated that perhaps 1 percent of those borrowers who consolidated their loans would have defaulted if there was no consolidation program. Overall, CBO stated that

"The special allowance costs would increase due to the extended repayment terms but would decrease due to the combined effect of setting the total yield at the 91-day treasury bill rate plus 3 percent and increasing the interest rate on the loan to 10 percent."

Policy Options for Reducing Government Subsidy Costs

On the basis of these earlier considerations, we developed and analyzed four options that could help defray part, or all, of the future estimated increase in the government's interest subsidy costs. The first would be to let the program expire in 1992, as currently authorized, or rescind its authority before that time. However, if the program is to preserve the principal benefit to students—the reduction of monthly payments for students with high debt—there are at least three other options.

Increase the Borrower's Interest Rate

The option that could reduce future program cost growth the most would be to increase the minimum loan interest rate charged borrowers for their consolidated loans. For example, an increase in the borrower's minimum interest rate, from 9 percent to 10 percent, could decrease the government's total subsidy costs by about $55 million for fiscal years 1989-94 (after adjusting for present value). Increasing the interest rate by 1 percentage point would more than offset the costs associated with the Department's projected program growth for fiscal years 1989-94, as

shown in table 3.3. In appendix V, we have also estimated the cost reduction associated with increasing loan interest rates from 9 to 10 percent in increments of 0.2ℓ percent. Although any increase in student costs could be expected to reduce student participation, the monthly payment reductions and consolidation of several payments would still provide a benefit to students. And under current Stafford loan rules, students will actually be paying 10-percent interest on their unconsolidated loans, beginning in their 5th year of repayment.

Table 3.3: A 10-Percent Loan Interest Rate Could Cover Future Program Costs (Present Value Costs)

Dollars in millions

Year	Incremental subsidy costs for 9 percent loan	Decrease in subsidy costs with 10-percent interest rate	Difference
1989	$42.2	$48.6	$6.4
1990	56.5	64.9	8.4
1991	58.9	67.7	8.8
1992	63.7	73.2	9.5
1993	68.7	79.0	10.3
1994	74.6	85.8	11.2
Total	**$364.7**	**$419.2**	**$54.5**

Note: Computations based on the Department's consolidated loan projections for the repayment life of the loans consolidated in each of these years.

Charge Borrowers a Loan Origination Fee

A second option that would increase borrower costs and offset higher program costs would be to charge consolidated loan borrowers an origination or refinancing fee. Such a one-time fee, similar to the fee charged borrowers of subsidized Stafford loans (currently 5 percent) and borrowers who consolidate or refinance their consumer debt, could be used by the Department of Education to help offset the program's additional subsidy costs. The lender would forward this fee to the Department after the loan was made. The Department would receive these moneys up front rather than over the life of the loan.

If consolidated loan borrowers were charged an origination fee, the money needed to pay this fee could be added to the principal balance of their loans, as is the current practice for Stafford loans. The resulting principal balances of the borrowers' loans would increase, which could subsequently offset some of the additional revenues the government would receive from the imposition of the fee. As shown in table 3.4, charging a 5-percent fee on the Department's projected consolidated loan growth for fiscal years 1989-94 would raise about $331 million of the $412 million needed to offset the estimated incremental costs of this

program.[2] (App. VI includes the amount of funds raised with a loan origination fee of 1, 2, 3, or 4 percent.)

Table 3.4: A 5-Percent Origination Fee Would Cover Most of the Estimated Future Incremental Program Costs (Present Value Costs)

Dollars in millions

Year	Incremental subsidy cost	Amount raised with a 5-percent fee	Difference
1989	$47.7	$38.3	−$9.4
1990	63.9	51.2	−12.7
1991	66.6	53.4	−13.2
1992	72.0	57.7	−14.3
1993	77.7	62.3	−15.4
1994	84.5	67.6	−16.9
Total	**$412.4**	**$330.5**	**−$81.9**

Note. Computations based on the Department's consolidated loan projections for the repayment life of the loans consolidated in each of these years.

Decrease the Lenders' Special Allowance Payment

A third option would be to decrease the special allowance payment to lenders, a provision COBRA included when the program was enacted. For example, lowering the current rate from the 91-day Treasury bill rate plus 3.25 percent to 3 percent would decrease the government's cost by about 29 percent. As shown in table 3.5, this reduction would raise $107 million—about $258 million short of what would be needed to offset the estimated future incremental subsidy costs.

Table 3.5: Decreasing the Special Allowance Rate to 3 Percent Covers Less Than Half of the Program's Estimated Future Present Value Costs

Dollars in millions

Fiscal year	Incremental subsidy cost using a 3.25-percent factor	Decrease in subsidy costs with a 3-percent payment factor	Difference
1989	$42.2	$12.3	$29.9
1990	56.5	16.6	39.9
1991	58.9	17.2	41.7
1992	63.7	18.7	45.0
1993	68.8	20.1	48.7
1994	74.6	21.8	52.8
Total	**$364.7**	**$106.7**	**$258.0**

Note. Computations based on the Department's consolidated loan projections for the repayment life of the loans consolidated in each of these years.

[2]The estimated present value costs for each fiscal year's portfolio are higher in table 3.4 than in table 3.3 because we analyzed each option independently and, as such, included loan origination fees in the loans' principal balances in table 3.4. Therefore, the total loan amounts eligible for interest subsidies would increase.

To offset the entire $364.7 million in future incremental costs, we estimate that the special allowance factor would have to be reduced to 2.25 percent. This and similar computations are shown in appendix VII for special allowance payment factors in 0.25 percent increments, from 2.25 percent to 3.25 percent.

Although a reduction in the special allowance payment rate would reduce lenders' profits, their continued participation in the program would be linked to the costs they incur in making and servicing loans in relationship to their income. Consolidated loans may be considerably more profitable to lenders than Stafford loans because their servicing costs are lower as a percentage of the loan amount. This is because (1) borrowers who consolidated their loans are less likely to become delinquent during repayment (less lender servicing necessary) and (2) consolidated loans are larger (over five times as large on average) and their default rate is much lower (less than 1 percent versus 10 percent) than those of Stafford loans.

Conclusions

The loan consolidation program will continue to cost the government more money through increased interest subsidies than had there been no such program. Although the government was expected to benefit, in part, through decreased loan defaults, no data existed to evaluate possible reduced default savings. Furthermore, the increase in federal costs of interest subsidies costs could be (1) substantial as loan volume grows and (2) more substantial if Treasury bill rates increase above current levels.

The program was designed primarily to assist student borrowers and, as such, they receive the benefit of reduced monthly payments. On the other hand, the larger loan amounts, as well as potentially lower loan-servicing costs associated with low-risk borrowers, could probably make the program more attractive and profitable to lenders than Stafford loans.

Any reduction in program costs will either raise student costs or decrease lender profit or both; both could be expected to reduce program participation. Although the cost savings of the various options can be readily estimated, we know of no data that would allow us to estimate the effect on program participation. We believe the benefits of this program, compared with its cost, can—and most likely will—be questioned during budget reconciliation discussions or reauthorization of the Higher Education Act. This is also likely given the continued budget

stringency that student aid programs face and will continue to face because of large federal deficits.

Therefore, the Congress, in its deliberations, may want to consider the options we identified to either (1) eliminate or not reauthorize the program or (2) better balance the benefits available to borrowers who wish to consolidate their student loans against the additional costs to the government in operating the program. These expected future costs should be evaluated by using their present value rather than not discounting the costs to better reflect the government's costs that can occur over a 10-year to 25-year loan repayment period.

Matters for Consideration by the Congress

If the Congress wishes to retain and reauthorize the program and maintain the benefits to students with loan consolidations, while reducing program costs, it may wish to consider enacting one or more of the following cost reduction measures:

- charging consolidated loan borrowers a loan origination fee,
- increasing the minimum interest rate on consolidated loans, or
- reducing the lenders' special allowance payment rate.

Agency Comments and Our Evaluation

Department of Education

The Department said that we had presented the Congress with several good options related to the loan consolidation program and had no further comment. The lenders' comments varied and are summarized below.

Lenders' Comments

Loan Subsidies

In general, the lenders expressed concern about how we made our cost comparisons, specifically, the methodology and discussion dealing with the government's interest subsidy (special allowance) payments for both consolidated and nonconsolidated (underlying) loans. NELLIE MAE and SALLIE MAE disagreed with our categorization of Perkins and health professions loans as unsubsidized loans, which we said become subsidized after they are consolidated. Both lenders said that these two kinds of loans receive indirect interest subsidies because their interest rates are lower than the rates at which the government borrows money. SALLIE MAE also suggested that with these two kinds of loans, consolidation saves the government money because the underlying Perkins and health loans are repaid more quickly, thereby making more funds available for loans to other students without additional government subsidies.

While we do not disagree that there are government costs associated with all federal student loan programs, such as seed money to help schools set up their Perkins loans, the discussion on pages 24-25 is directed to the special allowance payments these loans receive upon consolidation. Before consolidation, lenders holding Perkins and health professions loans (the schools) do not receive such federal payments.

Cost Assumptions

SALLIE MAE was also concerned that our cost comparisons overstate the additional subsidy costs attributed to consolidated loans because we excluded from our analysis the costs associated with defaults, delinquencies, deferments, and forebearances.

As we state in our methodology discussion in appendix III, we excluded these factors from our cost comparisons because, at the time of our review, lenders did not have data available to measure the extent to

which loan consolidation may be affected by these factors. Therefore, their exclusion was one of the premises for our assumptions about repayment terms.

Graduated Repayments

SALLIE MAE also expressed concern that we are not acknowledging the default reduction potential of proposed legislation (S. 29), which, if enacted, would extend graduated repayment terms to all Stafford loans. While we were aware of this pending legislation, we do not know whether it will be enacted. Further, we are not evaluating whether graduated repayment plans could reduce default costs. We, rather, state that these plans contribute to increasing the government's interest subsidy costs.

Growth Projections

SALLIE MAE disagreed with the projections we used on the growth of the consolidated loan portfolio through 1994. It stated that past program growth was influenced by borrower awareness, and that it is unlikely future growth would continue at such a high rate. SALLIE MAE said our projections through 1994 may be overstated by as much as $1.5 billion.

We have no basis to either agree or disagree with the SALLIE MAE estimate. We used the Department's estimate because it is the responsible federal agency for consolidated loans, and its growth projections are used when submitting its budget to the Congress.

Loan Profitability

All four lenders questioned our use of data on the costs to make and service both consolidated and Stafford loans because (1) the data were obtained from one lender and (2) we use the data to support an option for reducing the interest subsidy rate factor. We have revised our report and deleted the information showing the costs for this one lender to more clearly recognize that these costs are dependent on the economic situations of each lender.

Citibank also said that high-balance loans are generally more profitable than low-balance loans. In addition, Citibank said, a reduction in the federal subsidy rate for consolidated loans may result in lenders'—that now hold both consolidated and nonconsolidated loans—opting to concentrate on consolidated loans in the future. These lenders may be less willing to make the smaller, less profitable, nonconsolidated loans, thereby reducing student access to these loans.

We have no basis for agreeing or disagreeing with Citibank that this change in lender behavior may occur. However, given the relatively small number of originating lenders that had consolidated loans in their

portfolios, we are unsure of the extent such a change in behavior would occur.

Program Options

NELLIE MAE and SALLIE MAE were concerned that the options we offered—to charge students who chose to consolidate their loans an origination fee or increase their minimum interest rate or both—would make the program more costly for students.

Our analysis shows that in the long run, loan consolidation is more costly for students and can be more costly to the federal government, depending on the cost savings from reduced defaults. The extent to which these additional costs should be borne by the primary beneficiaries (the students) or the taxpayers is an issue that is subject to congressional debate. As a result, we are not recommending one option over another, but are providing information on the alternatives available should the Congress consider revising the structure of the consolidated loan program.

Other Issues

SALLIE MAE also expressed concern that our report does not acknowledge that a reduction of federal support for students, other than through loan programs, has contributed to increased loan volume and higher average loan balances. This is an issue we did not address and which goes beyond the scope of this study.

Cumulative Consolidated Student Loans and Defaults (as of Sept. 30, 1988)

Guaranty agency	Lenders	Loans		Defaults	
		No.	Amount	No.	Amount
Alabama	3	164	$2,167,424	5	$66,456
Arkansas	1	165	2,125,790	1	7,446
California	4	5,810	83,590,954	0	0
Colorado	8	1,566	19,621,766	4	80,226
Connecticut	6	27	356,418	0	0
HEAF[a]	48	7,082	105,113,605	0	0
Idaho	4	92	980,397	0	0
Illinois	21	1,484	23,628,223	0	0
Kentucky	1	195	2,640,093	0	0
Louisiana	:	154	2,402,848	1	13 848
Massachusetts	2	2,038	29,695,251	2	18,971
Michigan	19	261	3,022,784	0	0
Mississippi	1	93	1,166,988	0	0
Missouri	1	141	1,594,761	0	0
New Hampshire	2	121	1,633,172	0	0
New Jersey	10	510	5,352,015	0	0
New York	24	2,530	44,471,442	0	0
Ohio	4	75	920,949	0	0
Pennsylvania	32	3,764	48,445,649	1	12,074
Tennessee	1	66	877,580	0	0
Texas	9	272	3,334,159	1	6,939
USAF[b]	50	7,211	86,800,858	34	309,373
Utah	1	237	3,447,217	0	0
Vermont	2	218	2,768,717	0	0
Virginia	1	189	2,591,677	0	0
Washington	6	152	2,130,288	1	21,216
Wisconsin	3	28,609	423,632,916	57	816,401
Total	**265**	**63,226**	**$904,513,941**	**107**	**$1,352,950**

[a]The Higher Education Assistance Foundation (HEAF) reported guaranteeing consolidated loans for lenders in Arizona, the District of Columbia, Iowa, Kansas, Minnesota, Nebraska, Virginia, West Virginia, and Wyoming.

[b]United Student Aid Funds, Inc., (USAF) reported guaranteeing consolidated loans for lenders in Arizona, Delaware, Hawaii, Indiana, Iowa, Kansas, Louisiana, Missouri, Montana, New York, Ohio, Pennsylvania, Rhode Island, and Virginia.

Lenders Included in GAO Analysis

Lender	Location
Carteret Savings Bank	Parsippany, NJ
Cheltenham Bank	Rockledge, PA
Citibank Corporation	Rochester, NY
Commonwealth National Bank	Pittsburgh, PA
Dauphin Deposit Bank and Trust	Harrisburg, PA
Dollar Bank	Pittsburgh, PA
Equibank	Wilmington, DE
Fidelity Bank	Upper Darby, PA
First Eastern Bank	Wilkes-Barre, PA
First Fidelity	Newark, NJ
First Fidelity, South	Burlington, NJ
First Pennsylvania Bank	Philadelphia, PA
Fulton Bank	East Petersburg, PA
Gallatin National Bank	Uniontown, PA
Hershey Bank	Pittsburgh, PA
Horizon Financial	Huntingdon, PA
Howard Savings	Livingston, NJ
Lehigh Valley Bank	Bethlehem, PA
Marine Bank	Pittsburgh, PA
Meritor Credit Corporation	Plymouth Meeting, PA
McDowell National Bank	Sharon, PA
Mellon Bank, Central	Pittsburgh, PA
Mellon Bank, East	Pittsburgh, PA
Mellon Bank, North	Pittsburgh, PA
Mellon Bank, West	Pittsburgh, PA
Meridian Bank	Reading, PA
Montclair Savings Bank	Montclair, NJ
New England Education Loan Marketing Corporation	Braintree, MA
Northeastern Bank of Pennsylvania	Pittsburgh, PA
Pennsylvania Higher Education Assistance Agency	Harrisburg, PA
Pittsburgh National Bank	Pittsburgh, PA
Provident National Bank	Pittsburgh, PA
Southwest National Bank	Greensburg, PA
Starpointe Savings and Loan	Somerset, NJ
Student Loan Marketing Association	Washington, DC
Virginia Education Loan Authority	Richmond, VA

Methodology Used to Estimate Consolidated Loan Program Costs

To determine how loan consolidation may affect the overall interest subsidy costs of the Stafford Student Loan Program, we estimated the government's cost with and without the loan consolidation program. As a basis for our cost comparisons, we used data obtained from 36 lenders that had made consolidated loans guaranteed by the government. We selected these lenders based on (1) the size of their consolidated loan portfolios and (2) availability of loan data in their computerized data systems. These lenders held about 87 percent of all consolidated loans as of September 30, 1988.

Each lender provided us with data on the original balances of consolidated loans in its portfolio as of September 30, 1988, and most lenders stratified their loans by payment plan and repayment term.[1] We aggregated the lenders' data and did separate computations on each stratum. For example, we used a level payment amortization to compute subsidy costs for all 10-year consolidated loans reported as being repaid with level payment plans. We then computed the subsidy costs for the remainder of these 10-year loans and their graduated repayment plans. We computed each combination of loan term and payment plan separately and added the results to obtain the total subsidy costs.

We did this series of calculations to determine the total subsidy costs that the government may incur over the repayment periods of the consolidated loans. After this, we repeated the calculations on the underlying guaranteed student loans and the Federally Insured Student Loans to determine what the subsidy costs would have been without the consolidated loan program. We assumed these two kinds of loans would be paid in full over the statutory 10-year repayment period. We did not include Supplemental Loans for Students (SLS) or Auxiliary Loans to Assist Students (ALAS) in our computations of the subsidy costs for underlying loans; this is because these two kinds of loans normally are not eligible for interest subsidies at the Treasury bill rate we used for this analysis—7.99 percent. We compared the results to determine the incremental costs of the program. Our methodology is discussed below.

We also sent a copy of this appendix to the five organizations representing the 36 lenders that provided us with data for our cost analysis and asked them to review our methodology and provide us with any comments. Two organizations stated that our analysis should reflect that Stafford loans have a 3.25 percent rather than 3.5 percent subsidy rate.

[1]One lender provided random sample data, which we used to estimate the loan volumes in each category.

Our analysis in chapter 3 addresses this change in subsidy rates. Another also stated that our analysis should take into account the fact that ALAS and SLS will be subject to an interest subsidy, effective July 1, 1989. We factored this into our computations for our analysis of the subsidy costs under varying Treasury bill rates (see ch. 3).

Methodology Characteristics and Assumptions

Loan Principal

To determine the subsidy costs with the loan consolidation program, we used the original balances of all consolidated loans in the lenders' portfolios as of September 30, 1988.

To determine the subsidy costs without loan consolidation, we used the consolidated amounts of guaranteed student loans and Federally Insured Student Loans. This is because these amounts also were subject to a subsidy with the 7.99-percent Treasury bill rate we used for our analysis. We used the amounts consolidated because this gave us a principal amount identical to that of our first analysis. We assumed (1) all loans, both consolidated and unconsolidated, entered repayment at the same time and (2) that the first payment on these loans was made after September 30, 1988.

Repayment Terms

For our computations on the consolidated loans, we did repayment amortizations for each repayment period category specified in the 1986 Higher Education Amendments—10, 12, 15, 20, and 25 years. For our computations on unconsolidated loans, we used a 10-year repayment term, which is the maximum repayment term specified by the Higher Education Act. For these computations, we assumed that all loans ran full term; all payments were made monthly and on time; there were no prepayments; there were no deaths, disabilities, or bankruptcies; and there were no defaults, deferrals, or forebearances.

Subsidy Factors

Treasury bill rate. For both analyses, we used the 91-day Treasury bill rate for the first quarter of fiscal year 1989, which was 7 99 percent. We assumed this rate remained constant.

Special allowance rate. We used rates of 3.25 percent for consolidated loans and 3.5 percent for unconsolidated guaranteed student loans and Federally Insured Student Loans. When we included ALAS and SLS we used a 3.5 percent subsidy rate for these loans. We assumed the unconsolidated loans were issued prior to the 1986 amendments, which reduced the subsidy rate on all guaranteed student loans from 3.5 percent to 3.25 percent. We also assumed the subsidy rates for both the consolidated and unconsolidated loans remained constant during their repayment periods.

Interest rate. For consolidated loans, we used a 9-percent interest rate—which was the predominant interest rate for the consolidated loans in the portfolios of the lenders we reviewed. For computing the subsidy costs without the consolidation program, we used an 8-percent interest rate. Most guaranteed student loans and federally insured loans eligible for consolidation before September 30, 1988, had interest rates of 7, 8, or 9 percent. We used an interest rate of 8 percent in our calculations, which we believe would be conservative.

Payment Plans

The lenders we reviewed offered level payment plans and a variety of graduated repayment plans. We factored both kinds of plans, to the extent they were used by the lenders, into our loan amortization computations.

Present Value Analysis

To estimate the future subsidy costs, we discounted the stream of future payments (costs) into present value terms. This allowed us to compare the costs incurred in different time periods. To determine the present value of the subsidy costs, we used an 8.61-percent discount rate for both consolidated and unconsolidated subsidy costs. We calculated this rate by averaging the bond yields in effect on October 1, 1988, for Treasury bonds with maturities ranging from 1 to 25 years. We used these kinds of bonds because their maturity dates were similar to the repayment periods of consolidated loans.

Sensitivity Analysis

To determine the sensitivity of subsidy costs to changes in Treasury bill rates, we recomputed our cost calculations using several Treasury bill rates both above and below the 7.99-percent rate we used for our primary analysis. We assumed the various Treasury bill rates would remain constant throughout the repayment of the loans.

Underlying Loans Consolidated at Lenders Reviewed (as of Sept. 30, 1988)

Dollars in millions

Kind of loan consolidated	Loan amounts consolidated					Total
	10-year	12-year	15-year	20-year	25-year	
Stafford loans[a]	$45.3	$71.3	$235.5	$245.4	$42.6	$640.1
Supplemental Loans for Students[b]	4.0	2.8	17.6	59.0	11.1	94.5
Perkins loans	3.4	2.9	16.8	17.3	4.0	44.4
Health professions student loans	0.1	0.1	0.7	5.4	4.4	10.7
Total	**$52.8**	**$77.1**	**$270.6**	**$327.1**	**$62.1**	**$789.7**

[a]Includes Federally Insured Student Loans.

[b]Includes Auxiliary Loans to Assist Students.

Decrease in Future Subsidy Costs by Increasing Borrowers' Minimum Interest Rates

Dollars in millions

Loan	Loan interest rate (percent)	Fiscal year 1989	1990	1991	1992	1993	1994	Total
Consolidated	9.00	$110.77	$148.13	$154.50	$166.96	$180.28	$195.77	**$956.41**
Nonconsolidated	8/10	68.55	91.67	95.61	103.31	111.56	121.14	**591.84**
Additional subsidy needed		42.22	56.46	58.89	63.65	68.72	74.63	**364.57**
Consolidated	9.25	98.78	132.10	137.78	148.88	160.76	174.58	**852.88**
Nonconsolidated	8/10	68.55	91.67	95.61	103.31	111.56	121.14	**591.84**
Additional subsidy needed		$30.23	40.43	42.17	45.57	49.20	53.44	**261.04**
Consolidated	9.50	86.69	115.93	120.92	130.67	141.09	153.22	**748.52**
Nonconsolidated	8/10	68.55	91.67	95.61	103.31	111.56	121.14	**591.84**
Additional subsidy needed		18.14	24.26	25.31	27.36	29.53	32.08	**156.68**
Consolidated	9.75	74.51	99.64	103.93	112.30	121.27	131.69	**643.34**
Nonconsolidated	8/10	68.55	91.67	95.61	103.31	111.56	121.14	**591.84**
Additional subsidy needed		5.96	7.97	8.32	8.99	9.71	10.55	**51.50**
Consolidated	10.00	62.23	83.23	86.81	93.80	101.29	110.00	**537.36**
Nonconsolidated	8/10	68.55	91.67	95.61	103.31	111.56	121.14	**591.84**
Additional subsidy needed		−$6.32	−$8.44	−$8.80	−$9.51	−$10.27	−$11.14	**−$54.48**

Note Figures shown (1) are in present value (to adjust for the cost of money to the government, (2) were developed assuming that the loans were unconsolidated 8/10 percent Stafford loans with a 3 25 percent special allowance rate, (3) were based on Department of Education projected consolidated loan volumes, (4) assume the mix of loans are the same as in our lenders' profile as of September 30, 1988, and remained constant for all outlying years, and (5) are computed for the repayment life of the loans consolidated in each of these years.

Amount of Revenue Raised by Charging Various Loan Origination Fees to Offset Additional Future Interest Subsidy Costs

Dollars in millions

	Fiscal year						
Origination fee option	**1989**	**1990**	**1991**	**1992**	**1993**	**1994**	**Total**
Future subsidy cost	$43.33	$57.94	$59.44	$65.32	$70.52	$76.59	**$373.14**
Amount raised with 1% fee	7.65	10.23	10.67	11.53	12.45	13.52	**66.05**
Additional amount needed	35.68	47.71	48.77	53.79	58.07	63.07	**307.09**
Future subsidy cost	44.44	59.42	61.98	66.98	72.32	78.54	**383.68**
Amount raised with 2% fee	15.30	20.46	21.34	23.06	24.90	27.04	**132.10**
Additional amount needed	29.14	38.96	40.64	43.92	47.42	51.50	**251.58**
Future subsidy cost	45.55	60.90	63.53	68.66	74.13	80.50	**393.27**
Amount raised with 3% fee	22.95	30.69	32.01	34.59	37.35	40.56	**198.15**
Additional amount needed	22.60	30.21	31.52	34.07	36.78	39.94	**195.12**
Future subsidy cost	46.65	62.39	65.07	73.32	75.93	82.46	**405.82**
Amount raised with 4% fee	30.60	40.92	42.68	46.12	49.80	54.08	**264.20**
Additional amount needed	$16.05	$21.47	$22.39	$27.20	$26.13	$28.38	**$141.62**

Note. Figures shown (1) are in present value (to adjust for the cost of money to the government, (2) assume that the origination fee is added to the loan principal subject to interest subsidy, (3) are based on Department of Education projected consolidated loan volumes, (4) assume the mix of consolidated loans are the same as in our lenders' portfolios as of September 30, 1988, and remain constant, (5) assume all consolidated loans have a 9-percent interest rate and the nonconsolidated loans have an 8/10-percent interest rate, and (6) are computed for the repayment life of the loans consolidated in each of these years.

Decrease in Future Subsidy Costs by Lowering Special Allowance Payments to Lenders

Dollars in millions

Loan	Special allowance payments (percent)	Fiscal year 1989	1990	1991	1992	1993	1994	Total
Consolidated	3.25	$110.77	$148.13	$154.50	$166.96	$180.28	$195.77	**$956.41**
Nonconsolidated	3.25	68.55	91.67	95.61	103.31	111.56	121.14	**591.84**
Additional subsidy needed		42.22	56.46	58.89	63.65	68.72	74 63	**364.57**
Consolidated	3.00	98.41	131.60	137.26	148.32	160.16	173.92	**849.67**
Nonconsolidated	3.25	68.55	91.67	95.61	103.31	111.56	121.14	**591.84**
Additional subsidy needed		29.86	39.93	41.65	45.01	48.60	52.78	**257.83**
Consolidated	2.75	86.04	115.07	120.02	129.69	140.08	152.07	**742.93**
Nonconsolidated	3.25	68.55	91.67	95.61	103.31	111.56	121 14	**591.84**
Additional subsidy needed		17.49	23.40	24.41	26.38	28.52	30.93	**151.09**
Consolidated	2.50	73.68	98.53	102.77	111.06	119.92	130.22	**636.18**
Nonconsolidated	3.25	68.55	91.67	95.61	103.31	111.56	121.14	**591.84**
Additional subsidy needed		5.13	6.86	7.16	7.75	8.36	9.08	**44.34**
Consolidated	2.25	61.32	82.00	85.53	92.42	99.80	108.37	**529.44**
Nonconsolidated	3.25	68.55	91.67	95.61	103 31	111.56	121.14	**591.84**
Additional subsidy needed		−$7.23	−$9.67	−$10.08	−$10.89	−$11.76	−$12.77	**−$62.40**

Note Figures shown (1) are in present value (to adjust for the cost of money to the government), (2) were based on Department of Education projections for consolidated loans, (3) assume a 9-percent interest rate for consolidated loans and an 8/10-percent rate for nonconsolidated loans, (4) assume the mix of consolidated loans is the same as in our lenders' portfolios as of September 30, 1988, and remains constant, and (5) are computed for the repayment life of the loans consolidated in each of these years.

Comments From the Department of Education

UNITED STATES DEPARTMENT OF EDUCATION
OFFICE OF THE ASSISTANT SECRETARY FOR POSTSECONDARY EDUCATION

MAR 1 1990

Mr. Franklin Frazier
Director of Education and Employment Issues
United States General Accounting Office
Washington, DC 20548

Dear Mr. Frazier:

Thank you for the opportunity to review and comment on the draft GAO report, "Consolidated Student Loans: Borrowers Benefit But Cost to Them and the Government Grow," GAO/HRD 90-08.

We have found the GAO report to be thoroughly researched and well written. You have presented the Congress with several good options to consider. We have no further comments to offer.

Sincerely,

Leonard L. Haynes III
Assistant Secretary

400 MARYLAND AVE., S.W. WASHINGTON, D.C. 20202-

Comments From the Lenders

CITIBANK

Citibank (New York State)
A subsidiary of
Citicorp

Student Loan Business
P.O Box 22944
Rochester, N.Y.
14692

(716) 248 7189

Stephen C. Biklen
Vice President

February 5, 1990

Mr. Franklin Frazier
Director of Education and
Employment Issues
United States General Accounting Office
Human Resources Division
Washington, D.C. 20548

Dear Mr. Frazier:

Thank you very much for the opportunity to comment on the GAO draft report regarding consolidated student loans under the Stafford Student Loan Program.

Citibank does have several comments regarding the report. These comments are as follows:

1) The paper notes that consolidation borrowers have rarely defaulted. If at all possible, it would be extremely valuable to determine whether the consolidation program has an impact on defaults. In order to do this two groups of comparable borrowers would have to be monitored. One group would consist of borrowers who elected consolidation and the other group would consist of borrowers with similar characteristics who did not consolidate. Using statistical sampling techniques it would be possible to determine whether or not the consolidation program had an impact on defaults.

2) The GAO Study covered the period from October 1986 to September 30, 1988. Citibank's records indicate that the average balance of consolidation borrowers during this period was approximately $12,300M. During the period from October 1988 to December 1989, the average indebtedness of Citibank's consolidation borrowers is $6,500. We suspect that the reason for this decrease is simply that many borrowers attending shorter school programs who took out a Stafford loan and a SLS loan totaling $6,650 became aware of consolidation and elected to apply for it. It is probably appropriate to determine whether this is a nationwide trend (from everything we have heard from industry sources, we believe this is the case) and if so the GAO study should be expanded to look at this recent phenomenon.

Mr. Franklin Frazier
Page 2
February 5, 1990

3) The draft paper points out that there are negative aspects to the consolidation program, namely, increased costs to the government due to extended repayment terms, the conversion of previously unsubsidized loans to a subsidized status, and graduated repayment terms which delay principal repayment. A crucial question with respect to the consolidation program is whether these increased costs are offset by lower borrower defaults. Therefore, Citibank believes it is extremely important to pursue the point raised in item 1 above.

4) The GAO has identified four possible options with respect to the consolidation program. One is to discontinue the program. In order to reach a decision regarding this option, it is extremely important to answer the question raised in point 1 above.

The fourth alternative notes that consolidation loans are much less costly for the lender to service and therefore special allowance subsidies could be reduced thereby saving the government money. Citibank has two comments:

- This conclusion is based on statistics furnished by one lender under the consolidation program. Before quantifying the impact of consolidations on reduced servicing costs, additional lenders should be studied. Citibank would not support conclusions based on the results of one lender only.

- The second point is that lenders, when establishing profitability targets, view their portfolio as a whole. Even before loan consolidation existed a lender's portfolio was comprised of many different types of loans, some high balance, some low balance. There is no question that the high balance loans are more profitable than low balance loans. However, in an effort to serve as many borrowers as possible, a lender views their portfolio in total. The high balance loans would offset lower profits on the low balance loans. Similarly, loan consolidation must be viewed the same way. The higher balance consolidation loans enable a lender to offset lower profits on smaller balance loans. Were the profits on the consolidation loans to be cut back sharply, the effect would be to reduce a lender's overall profitability and would result in a lender's willingness to take the smaller balance loans, thereby reducing access.

We hope these comments are useful to you, and once again, thank you for the opportunity to comment on draft report. If you have any questions, please do not hesitate to contact me at (716) 248-7189.

Sincerely,

Stephen C. Biklen

Stephen C. Biklen

NETWORK
Student Loan Management Service

February 9, 1990

Mr. Franklin Frazier
Director of Education & Employment Issues
General Accounting Office
441 G. Street N.W.
Room #6737
Washington, D.C. 20548

Dear Mr. Frazier:

Thank you for the opportunity to respond concerning staff's draft that speaks about Consolidated Student Loans authorized by the Stafford Student Loan Program.

I have read this report and I must congratulate your staff on its content. The report is understandable and reasonably uncomplicated. It does, however, speak of a loan program that is managed by myself at PHEAA and has helped provide valuable debt management knowledge and services to over 11,000 PHEAA guaranteed borrowers to date.

I am compelled to comment on this report's position on curbing defaulters. It is my professional opinion that the relative benefits of this program as they relate to default are grossly understated and unrealized at this time. Additional time and studies, gathering of data, etc., will be required to adequately address this program's true ability to impact the student loan defaulter.

To date, the Guaranteed Consolidation Loan portfolio serviced by PHEAA has enjoyed a default rate of .02 percent. PHEAA has guaranteed consolidation loans since September, 1987.

Pennsylvania Higher Education Assistance Agency (PHEAA)
Network Consolidation Program
P.O. Box 8134 • Harrisburg, PA 17105 • 1-800-338-5000

Further comments will be made by myself and the PHEAA Loan Guarantee Division following Congressional action.

In closing, thank you for the opportunity to respond, and as in the past, I remain actively available as a resource for this study.

Sincerely,

Randy

Randy C. Knapp
Manager, Loan Consolidation

RCK:plh
cc: Lou Bianchi
File

The New England Education Loan Marketing Corporation

February 23, 1990

Mr. Franklin Frazier
Director of Education and Employment Issues
General Accounting Office
Human Resources Division
Washington, DC 20548

Dear Mr. Frazier:

Thank you for the opportunity to comment on the draft of GAO's CONSOLIDATED STUDENT LOAN STUDY. Generally, I believe the draft study accurately reflects the limited benefit of the current loan consolidation program to student loan borrowers and the increases in costs to a borrowers, lenders and the government in the current program structure.

Deleted.

Page 2 - Nellie Mae has been an active consolidator of loans for reasons relating to costs of education in New England, a large graduate student population and for reasons of portfolio stability. We do not believe that loan consolidation is "generally attractive" to borrowers because of the single, lower monthly payment. Our program literature and application clearly point out to borrowers that in exchange for this lower monthly payment, the borrower will pay substantially more in interest charges over the life of the loan. Borrowers realize this and many eligible borrowers choose not to consolidate for this reason.

Now on p. 2.

I would recommend restating the second sentence of the second paragraph on page 2 as follows: "Nearly all these consolidations were handled by about 250 of over 13,000 eligible lenders, each of which entered into a specific consolidation guarantee agreement with guarantors electing to guarantee consolidation loans at no additional fee. Guarantors have reinsurance agreements with the Department of Education".

This restatement would correctly state the insurance-reinsurance relationships which exist and correct any misimpression that the Department of Education has 58 regional offices. It would also eliminate the need for the misleading footnote which characterizes guaranty agencies as "middlemen" when in fact they assume primary insurance responsibility with contingent reinsurance provided by the Department.

50 Braintree Hill Park, Suite 300, Braintree, Massachusetts 02184-1763
617-849-1325 800-EDU-LOAN

Now on p. 3.

Page 3 - I agree that high balance borrowers default at a much lower rate than low balance borrowers. The numbers simply reflect that high balance borrowers borrowed to complete more years of education, improving their own economic position and thus their ability to repay. I don't think that focus of a consolidation program should be default savings because there will likely be little. I think the focus is better placed on the reasonableness of requiring repayment of high balance loans within a 10 year period.

I agree that the consolidation program permits loans previously unsubsidized to become partially subsidized after consolidation but do not believe that the full costs of the subsidy should be viewed alone. The Perkins loans which are eligible for consolidation are originally made with 90% federal money at low interest rates. Thus, this direct grant carries an implicit opportunity cost-revenues that the federal government is foregoing as a result of making the principal available at no cost to colleges and universities. Yes, there are subsidy costs but these costs are less than the opportunity cost of maintaining the Perkins loan.

I do not understand the reference to the GAO projection that there are potential "unanticipated costs" for loans consolidated through 1994 of $365 million. Your projections show that if the Congress determines to reauthorize and expand the consolidation program and if $6.6 Billion in loans are consolidated over the six year period 1989-1994 and if Treasury Bill rates remain constant, the subsidy costs will be $365 million (discounted).

If all of these events occur it will cost $365 million and will be the result of a conscious Congressional decision. They are not hidden or unanticipated cos .

Now on p. 4.

Page 5 - In the second line of the first full paragraph I would suggest substituting "federally established rates" for "below market rates". Lenders do not have discretion to set these rates at any level.

Now on p. 5.

Page 6 - The last paragraph refers to reductions in federal costs which could be attained through several changes in law passing additional charges onto students and further reduc'ng lender yield. It should be pointed out that students have already paid origination fees on the vast majority of the underlying loans being consolidated and that they will, as a result of consolidation, pay much more in interest over the life of the loan. Further, making a consolidation loan is enormously time consuming and costly for a lender and reducing yield is unwarranted.

The origination and servicing cost data presented in Table 3.7 on page 48 is far too low to accurately reflect actual dollar costs of origination or of annual servicing charges.

The New England Education Loan Marketing Corporation

Mr. Franklin Frazier
Page three

February 23, 1990

As I said at the outset, I think the study presents an accurate and fairly balanced description of the current consolidation program. It is burdened by a great deal of administrative complexity required by law and regulation. It is a program which offers limited benefits to certain student borrowers whose debt is so substantial and after-college earnings so limited that a monthly savings of $40 is worth the future cost of thousands more in interest. Student borrowers should be as concerned as the federal government that what offers such limited benefits costs so much.

Again, I appreciate the opportunity to participate in the study and to comment on the draft report. If we can be of further assistance, please contact me.

Very truly yours,

Lawrence W. O'Toole
President

LWO/dms

The New England Education Loan Marketing Corporation

STUDENT LOAN MARKETING ASSOCIATION
1050 Thomas Jefferson Street, N.W.
Washington, D.C. 20007-3871
202-333-8000

March 9, 1990

Mr. Joseph J. Eglin
Assistant Director, Human Resources Division
United States Government Accounting Office
Washington, D.C. 20548

Dear Jay,

We appreciated the opportunity to meet with you and your staff again last week to discuss your report to Congress regarding consolidated student loans. As we stated in this meeting, we feel the report would benefit from a more balanced presentation of facts. To reiterate our earlier discussions, we are concerned with the following aspects of the report:

- The failure of the report to incorporate the negative ramifications of delayed or lost payments (e.g. defaults, delinquencies, deferments and forbearances) in calculating subsidy differentials. In effect, GAO's analysis reviews the Stafford Student Loan Program as though it were a flawless and risk-free program. The consolidation program was established precisely in response to the default risks inherent in the Stafford Student Loan Program.

- Subsidy differentials are distorted because cumulative SAP payments for loans originated in a given year are expressed as a lump sum rather than in the year that they occur. This approach disguises the fact that the subsidy costs to the government are lower for consolidated loans in the first six years than they are for Stafford loans.

- The examination of program impact on borrowers is superficial. No consideration is given to current economic realities impacting students' abilities to manage growing education debt burdens. Additionally, the report suggests that borrower interest costs are too high but then goes on to recommend the assessment of additional borrower fees.

- The report does not acknowledge that reduction of Federal support for non-loan aid programs has also contributed to increased loan volume and higher average loan balances.

Mr. Joseph J. Eglin
March 9, 1990
Page Two

- The report misleads the reader by overstating term and loan amount in examples which explain the difference in cost between a consolidated and non-consolidated loan.

- The reference to government subsidy on eligible loan programs is incorrect. Four out of six are eligible for SAP payments and all programs are, in effect subsidized.

- The report data on the cost of originating and servicing consolidation loans is not representative. The implication that the information is from one of the largest lenders is misleading.

- The report does not acknowledge current efforts in Congress to apply graduated terms to all Stafford loans (Senate Bill #29).

It is our understanding that you were in agreement with us on a number of these points and that you would revise the presentation of certain information within the report. We have enclosed language that we suggest you utilize as footnotes to the analysis.

Again, thank you for meeting with us on this matter. Please let me know if you would like to have further discussions.

Sincerely yours,

Robert W. Jackson
Director, Product Development

Enclosure

Footnotes to be Added to Report on Consolidated Student Loans

Page Number	Suggested Language
Now on pp. 2, 22, and 26.	[1] The loan consolidation program was created as a default reduction initiative. Had such factors as defaults, delinquencies and forbearances been taken into consideration the differential in interest subsidies between consolidated and nonconsolidated loans would have been diminished.
Now on p. 4.	[1] The government provides an indirect subsidy on the programs administered by the schools because it borrows the money at a higher rate than the student borrower is charged.
Now on p. 24.	Revise the footnote as follows: [1] Perkins and health professions loans are made by the schools and receive indirect government interest subsidies. The government provides the schools with capital funds to help establish their programs. Money for these funds is raised at the T-bill rate. The student then borrows the monies at well below the T-bill rate and repays the loans to the schools' revolving fund, normally over a period of 10 years. Upon repayment, these funds are then used to make loans to other students, or are returned to the government. Consolidation allows the funds to be returned quickly to the revolving fund thereby reducing the amount of money that needs to be raised by the government, which in turn results in fewer government subsidies.
Now on pp. 4 and 26.	[1] Graduated repayment is considered an effective tool for reducing student loan defaults. Currently, Congress is reviewing legislation to apply graduated terms to all Stafford Loans. (Senate Bill #29).
Now on pp. 19-20	[1] Data shows that loan consolidation does have a positive impact on repayment behavior. One lender reported a 2% cohort default rate for consolidated loans and a 9.8% cohort default rate for loans taken out by borrowers attending four-year colleges.

	Page Number	Suggested Language
Now on pp. 27-28.		[1] Loan consolidation experienced high growth rates in the beginning years due to increasing borrower awareness; however, it is unlikely that the program will continue to grow at such a high rate. The cumulative growth through 1994 may be overstated by as much as $1.5 billion.
Deleted.		[2] Only two lenders responded to our request for data. We were not provided with underlying data so we couldn't confirm its validity. Due to unique origination and servicing requirements and qualifications imposed by individual programs, servicing costs may vary widely. For consolidated loans, the annual servicing cost data provided showed a range of $7.50 to $23.40 per account annually; origination cost data was in a range of $30 to $50 per account.
Now on pp. 46, 47, and 48.		Add to footnote.
		(5) additional subsidy figure may be overstated because the impact of defaults, delinquencies, forbearances and deferments was not measured.

Major Contributors to This Report

Human Resources Division, Washington, D.C.	Joseph J. Eglin, Assistant Director, (202) 275-5365 Christopher C. Crissman, Assignment Manager
Seattle Regional Office	Charles M. Novak, Senior Evaluator Charles H. Shervey, Evaluator-in-Charge Sharon K. Eubank, Evaluator Andrew Scott, Programmer/Analyst, Technical Assistance Group Evan Stoll, Programmer/Analyst, Technical Assistance Group Julie Rachiele, Technical Information Specialist

Related GAO Products

Guaranteed Student Loans: Credit Bureau Reporting Practices by Guaranty Agencies and Lenders (GAO/HRD-90-71BR, Apr. 9, 1990).

Supplemental Student Loans: Who Are the Largest Lenders? (GAO/HRD-90-72FS, Feb. 21, 1990).

GAO Views on the Stafford Student Loan Program (GAO/T-HRD-90-13, Feb. 20, 1990).

Supplemental Student Loans: Who Borrows and Who Defaults (GAO/HRD-90-33FS, Oct. 17, 1989).

Guaranteed Student Loans: Analysis of Student Default Rates at 7,800 Postsecondary Schools (GAO/HRD-89-63BR, July 5, 1989).

Defaulted Student Loans: Preliminary Analysis of Student Loan Borrowers and Defaulters (GAO/HRD-88-112BR, June 14, 1988).

GAO's Views on the Default Task Force's Recommendations for Reducing Default Costs in the Guaranteed Student Loan Program (GAO/T-HRD-88-7, Feb. 2, 1988).

Guaranteed Student Loans: Potential Default and Cost Reduction Options (GAO/HRD-88-52BR, Jan. 7, 1988).

Guaranteed Student Loans: Analysis of Insurance Premiums Charged by Guaranty Agencies (GAO/HRD-88-16BR, Oct. 7, 1987).

Guaranteed Student Loans: Legislative and Regulatory Changes Needed to Reduce Default Costs (GAO/HRD-87-76, Sept. 30, 1987).

Defaulted Student Loans: Private Lender Collection Efforts Often Inadequate (GAO/HRD-87-48, Aug. 20, 1987).

Defaulted Student Loans: Guaranty Agencies' Collection Practices and Procedures (GAO/HRD-86-114BR, July 17, 1986).

Request for copies of GAO reports should be sent to:

U.S. General Accounting Office
Post Office Box 6015
Gaitherburg, Maryland 20877

Telephone 202-275-6241

The first five copies of each report are free. Additional copies are $2.00 each.

There is a 25% discount on orders for 100 or more copies mailed to a single address.

Orders must be prepaid by cash or by check or money order made out to the Superintendent of Documents.