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AUTHOR Frazier, Franklin
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ABSTRACT

This statement of the Director of Education and Employment Issues of the General Accounting Office's Human Resources Division discusses how the Stafford Student Loan program works, the growth in loans guaranteed and defaulted, and the concerns surrounding the financial problems being experienced by the Higher Education Assistance Foundation (HEAF). The Stafford program consists of Stafford loans, Parent Loans for Undergraduate Students, and Supplemental Loans for Students, which together represent 61% of federal student aid for postsecondary education made available in fiscal year 1990. The program involves five parties: students; schools; lenders; guaranty agencies; and the Department of Education. The amount of new loans guaranteed increased 83% from 1983 to 1989, while defaults increased 352% from $444 million to $2 billion. Default costs (payments to guaranty agencies) have risen from about 10% of total program costs in fiscal year 1980 to 36% in 1989. HEAF is the largest guarantor in the Stafford program and the biggest payer of default claims to lenders. Risks faced by lenders, the Student Loan Marketing Association, and the federal government if HEAF becomes insolvent are noted. A flow chart depicts the life of a Stafford loan. (JDD)

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Financial Problems in the Stafford Student Loan Program

Statement of
Franklin Frazier, Director
Education and Employment Issues
Human Resources Division

Before the
Committee on Banking, Housing and Urban Affairs
United States Senate

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SUMMARY OF GAO TESTIMONY ON THE FINANCIAL PROBLEMS IN THE STAFFORD STUDENT LOAN PROGRAM

The Stafford Student Loan Program (formerly called the Guaranteed Student Loan Program) makes three kinds of student loans: Stafford Loans, Supplemental Loans for Students (SLS), and Parent Loans for Undergraduate Students (PLUS). Stafford loans are low interest (currently 8 percent) loans made on the basis of financial need; the federal government pays interest on the loan while students are in school; and students generally begin repayment within 6 months after leaving school. SLS and PLUS loans are not based on financial need; interest rates vary annually (currently 11.49 percent); both can provide assistance up to $20,000; and repayment generally begins 60 days after the loan is made.

In 1989, the Stafford Student Loan Program made over 4 million loans in the amount about $12 billion. The program accounts for about 61 percent of student aid provided by the Department of Education. Both public and private postsecondary schools participate in the program. Each loan is insured by one of the 47 state or nonprofit guaranty agencies which administer the program and report to the Department of Education. Guaranty agencies can collect an insurance premium of up to 3 percent for each loan; they serve as lenders of last resort for students unable to obtain loans through other lenders; and they reimburse lenders for 100 percent of defaulted claims if the loans were properly serviced. The Department of Education oversees the program; reinsures the guaranty agencies for 100 percent of defaulted loans, except in those cases where the agencies have high default rates; and makes interest payments to lenders for Stafford loan borrowers while they are in school.

<u>GROWTH IN LOANS, DEFAULTS, AND PROGRAM COSTS</u>
Between 1983 and 1989, loans grew from about $7 billion to over $12 billion annually--an 83 percent increase. Similarly, the number of loans increased 56 percent from 3 million to 4.7 million. During the same period, defaults increased 352 percent from $444 million to $2 billion. In terms of program costs, defaults increased from 10 percent in 1983 to about 36 percent in 1989.

<u>FINANCIAL RISKS ASSOCIATED WITH STUDENT LOANS</u>
Under normal circumstances lenders that properly originate and service student loans are guaranteed 100 percent reimbursement by one of the 47 guaranty agencies. The Department reinsures the guaranty agencies for 80 percent to 100 percent of loans depending upon their default rates. In the case that a guaranty agency encounters financial difficulty, such as HEAF, who would honor the guarantee for the lender becomes unclear. The Department has authority which it can use to guarantee loans held by lenders; however, they do not have an obligation to do so.

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss the Stafford Student Loan Program. This program is of extreme importance to students seeking a postsecondary education and to the future work force of our nation. However, in recent years it has been the subject of greater scrutiny and much of that has focused on those student-borrowers who have defaulted on their loans, and the resulting financial liability to the federal government.

I will focus my comments today on (1) how the Stafford program works, (2) the growth in loans guaranteed and defaulted, and (3) the concerns surrounding the financial problems being experienced by the Higher Education Assistance Foundation (HEAF).

MAJOR FINANCIAL AID PROGRAMS

The Department of Education offers seven major student financial aid programs. These programs were established by title IV of the Higher Education Act, as amended, and include Pell grants, Supplemental Educational Opportunity Grants, College Work Study, Perkins loans, Stafford loans, Parent Loans for Undergraduate Students (PLUS), and Supplemental Loans for Students (SLS). For fiscal year 1990, the Department estimates that the seven programs will make almost $18 billion of student aid available through over 9.7 million awards. (See table 1.)

Table 1: Estimated Aid Available and Number of Awards for the Seven Major Financial Aid Programs (Fiscal Year 1990)

Aid program	Aid available (in millions)	Number of awards (in thousands)
Pell grants	$4,763.0	3,214
Supplemental grants	467.9	678
Work study	823.3	876
Perkins loans	860 0	804
Stafford loans	8,769.0	3,331
PLUS	827.0	258
SLS	1,368.0	545
Totals	$17,898.2	9,706

The Stafford Student Loan Program, formerly called the Guaranteed Student Loan Program, consists of Stafford, PLUS, and SLS loans. These three kinds of loans will represent 61 percent of federal student aid made available in fiscal year 1990. These loans are guaranteed by the federal government against borrowers' death, disability, bankruptcy, and reinsured to the guaranty agency against default. Banks, credit unions, and savings and loan associations are the primary providers of student loans.

The three types of loans differ somewhat in their terms and conditions and I would like to highlight some of these differences.

Stafford Loans

Stafford loans--formerly called guaranteed student loans--are the largest of the three loan types (80 percent of loans guaranteed in 1990) and have been available since the program was created as part of the Higher Education Act of 1965. The loans are based on the student-borrower's financial needs, however, borrowers do not have to demonstrate their credit worthiness. Other key facts are:

--Interest rates for new borrowers are 8 percent for the first 4 years of repayment and 10 percent after that.

--Maximum loan limits are $17,250 for undergraduates and $54,750 for graduate students.

--Borrowers generally have a 6-month grace period after leaving school before repayment begins.

PLUS Loans

These loans enable parents to borrow funds for each dependent student (those who are not generally responsible for their own financial support) enrolled at a school. These loans basically started in 1981 and are not needs-based. Other key facts are:

--Interest rates are variable and are determined once a year with a ceiling of 11.49 percent, which is the current rate.

--Maximum loan limits for each dependent are $4,000 per year to a total of $20,000.

--There is normally no grace period and payment of principal and interest must generally begin within 60 days after the loan is made.

SLS Loans

These loans are available to independent undergraduates (those students generally responsible for their own financial support) and graduate students. These loans basically started in 1982[1] and like PLUS loans are not needs-based. Also like PLUS loans, SLS loans generally have the same interest rate, borrowing limits, and no grace period. However, legislation passed in December 1989 restricted the availability of SLS loans for such factors as the school's borrower default rate and the lack of a high school diploma or a general equivalency degree.

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[1]SLS were part of the Auxiliary Loans to Assist Students program prior to 1986 and their terms and conditions are similar, and both are reported by the Department as SLS loans.

HOW THE STAFFORD STUDENT LOAN PROGRAM OPERATES

The program involves five parties: students, schools, lenders, guaranty agencies, and the Department of Education. I would like to provide some information on each party, using Stafford loans as a case example. (We have attached a chart that displays the life cycle of a Stafford loan.)

The Student

The student initiates the loan process. The student provides eligibility information to the school, applies to a lender for the loan after the school approves eligibility, arranges for repayment with the lender, and repays the loan. Stafford loan borrowers receive a federal subsidy throughout the period of their loans, including a below market interest rate, and make no payments on the loan while they attend school. The student repays the loan after completing or otherwise leaving school. Between fiscal year 1983 and 1989, the number of Stafford loans guaranteed each year will have increased from about 3 million to almost 4.7 million.

The School

The schools verify students' eligibility and the amount of financial aid needed. There are about 8,000 schools participating in the Stafford program. The kinds of schools participating in the program are categorized by: 2-year public, 2-year private, 4-year public, 4-year private, and proprietary (for profit trade and vocational) schools.

The Lender

Lenders make loans under the programs' guaranty provisions, and must exercise proper care in making, servicing, and collecting them. Lenders bill the Department each quarter for the federal interest subsidy payment for the loans they hold. These payments include (1) the students' interest while they are in school, and (2) during the life of the loan, an interest subsidy that is intended to provide lenders with a near-market rate of return. If borrowers fail to repay loans, lenders file default claims with the guaranty agency, but cannot be reimbursed for their claims until borrowers have been at least 180 days delinquent. They also receive 100 percent reimbursement if they have follow required procedures.

There are over 12,000 lenders participating in the program. As of September 30, 1989, they held about $50 billion in outstanding loans. Most of the loans are held by a small number of lenders. For example, 25 lenders had 54 percent of the $50 billion outstanding, and one organization--the federally chartered Student Loan Marketing Association--had 27 percent ($13.5 billion) of the total. (See table 2.)

Table 2: Ten Largest Holders in the Stafford Loan Program (as of September 30, 1989)
(Dollars in millions)

Loan holder	Amount outstanding
Student Loan Marketing Association	$13,483.3
Citibank (New York)	2,104.2
California Student Loan Finance Corp.	1,147.0
Nebraska Higher Education Loan Program	1,057.8
Chase Manhattan Bank (New York)	954.7
Chemical Bank (New York)	858.4
New England Education Loan Mktg. Corp	776.2
Penn. Higher Education Assistance Agency	521.3
Marine Midland Bank (New York)	503.1
Manufacturers Hanover Trust Company	456.3

The ultimate risk to lenders today is $50 billion plus accrued interest, assuming that the $50 billion in outstanding Stafford loans at the end of fiscal year 1989 was not guaranteed because all guaranty agencies were insolvent, and the government failed to provide a guarantee. This maximum liability also assumes that no part of the $50 billion in loans were repaid. From a practical point, however, the Department said that borrowers repay approximately 89 percent of the amounts due.

The Guaranty Agency

The guaranty agencies carry out several tasks, including: (1) issuing guarantees on qualifying loans, and when borrowers fail to repay their loans due to death, disability, bankruptcy, or default, reimbursing lenders for their claims; (2) charging students an insurance premium of up to 3 percent of the loan; (3) verifying that lenders properly service and attempt to collect loans before the agency pays default claims; (4) collecting the annual 1 percent administrative cost allowance for the Department; and (5) collecting on loans they retained after paying lenders claims, remitting to the Department its portion of monies the agency subsequently collect from defaulted borrowers.

If lenders choose not to make loans to eligible students--for example, those attending schools with high default rates--the guaranty agency must find another lender or become the "lender of last resort" itself. There are 47 guaranty agencies--state agencies or private nonprofit organizations--that report to the Department of Education on their administration of the program in the 50 states, District of Columbia, the Pacific Islands, Puerto Rico, and the Virgin Islands.

The risks to the guaranty agencies relate mostly to the difference between what it receives in reinsurance from the Department, and what it pays to lenders for their default claims. The reinsurance rate (100/90/80 percent) to guarantors depends on the agencies reaching a certain default rate threshold during each fiscal year. For example, if a guaranty agency's defaults in a fiscal year reach 5 percent of loans in repayment at the end of the previous fiscal year, its reinsurance rate would be 90 percent for the remainder of the fiscal year; if its defaults reach 9 percent of loans in repayment, the reinsurance rate decreases to 80 percent. The lower reinsurance rate remains in effect for the remainder of the fiscal year. With the start of the new fiscal year, guaranty agencies are again reimbursed for 100 percent of their claim payments to lenders until they reach the default rate thresholds.

The Department of Education

The Department of Education is responsible for administering the Stafford program and for overseeing the activities of the various participants. It pays lenders interest subsidies, and reimburses guaranty agencies for up to 100 percent of lenders' default claims. To partially offset program costs, the Department charges borrowers a 5 percent origination fee. It also receives payments from the guaranty agencies on collections from reinsured defaulted loans.

The federal government's risk on defaulted loans is, in general, the amount of monies it pays in reinsurance, less any amounts it receives in the subsequent collection of defaulted loans. Its risk in a worst case scenario could be 20 percent of outstanding loans. This assumes that all loans outstanding--approximately $50 billion--defaulted today, and all guaranty agencies would be insolvent. From a practical point, however, any expected loss would be much less. The net default rate for Stafford loans is about 11 percent; most borrowers repay their loans. In addition, the Department has said it historically has repaid reinsurance at approximately a 95.5 percent rate. Also, if guarantors become insolvent, their assets in any liquidation could also be available to offset lenders' defaulted loan claims. Therefore, any expected loss attributed to all guarantors becoming insolvent would be much less because not all outstanding Stafford loans would default.

STAFFORD PROGRAM PERSPECTIVE

The Department estimates that in fiscal year 1995, total loans outstanding will be about $70 billion. Now I would like to provide a further perspective on the Stafford program in terms of loan growth, defaults, and program costs.

Loan Growth

The Stafford program has grown during the 1980s, especially since 1983. The amount of new loans guaranteed[2] through fiscal year 1989 for the entire program increased 83 percent since 1983. Not unexpectedly, because PLUS and SLS loans were basically just starting during this period, their growth rates were high--407 percent and 1,832 percent, respectively. (See table 3.)

Table 3: Loan Volume Has Substantially Increased Since Fiscal Year 1983
(Dollars in millions)

Type of loan	Loans guaranteed Fiscal year 1983	Loans guaranteed Fiscal year 1989	Percent increase
Stafford	$6,537	$9,593	47
PLUS	147	746	407
SLS	110	2,125	1,832
Total program	$6,794	$12,464	83

[2]Loans guaranteed represent commitments made to lenders by guaranty agencies. However, actual loan disbursements would be less in those instances where students decide not to enroll in school and the loan was cancelled.

Default Growth

Defaults have risen dramatically. Defaults for the total program increased 352 percent in the last 6 years. Stafford loan defaults went up 278 percent from fiscal year 1983 through fiscal year 1989, while PLUS and SLS loan increases were 6,525 percent and 112,730 percent, respectively. (See table 4.)

Table 4: Defaults Have Dramatically Increased Since Fiscal Year 1983
(Dollars in thousands)

	Default payments to lenders		
Type of loan	Fiscal year 1983	Fiscal year 1989	Percent increase
Stafford	$444,022	$1,679,000	278
PLUS	483	32,000	a
SLS	265	299,000	a
Total program	$444,770	$2,010,000	352

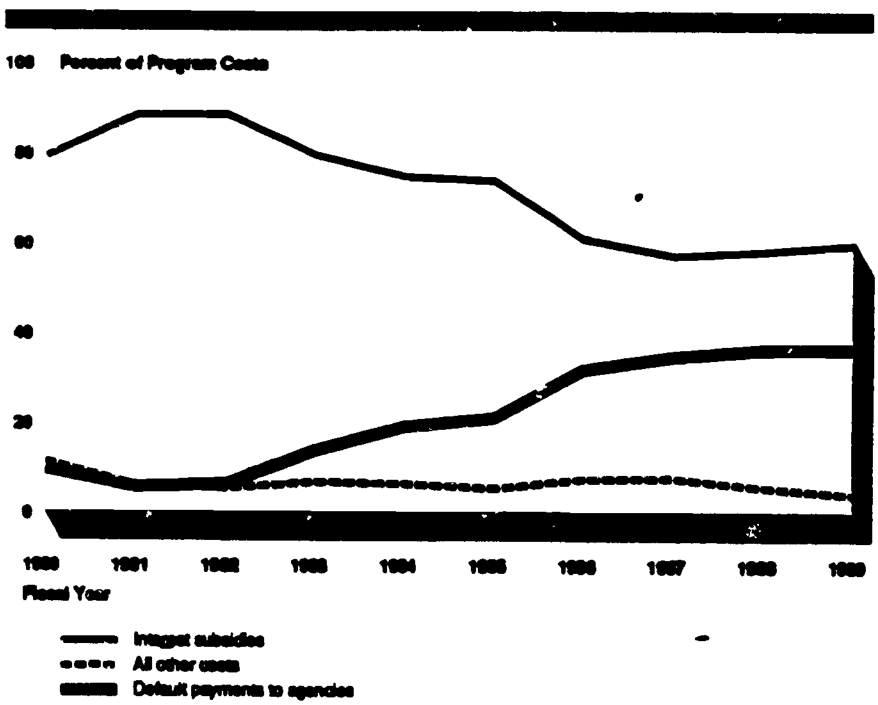
[a]Default rates for PLUS and SLS loans increased 6,525 percent and 112,730 percent, respectively, over the 6-year period. However, these loans were relatively new and the eligibility for SLS loans had been liberalized in the last 3 years. By all indications, default rates are rising rapidly for those two types of loans.

Although both loan volume and loan defaults have increased dramatically over the last 6 years, the increase in defaults has far exceeded the increase in loan volume. For example, as I pointed out earlier, total loans increased 83 percent from fiscal year 1983 through 1989, while defaults increased 352 percent--four times faster than loan volume. The Department attributes a large portion of these default increases to the four-fold increase in Stafford loans from 1977 to 1983.

Program Costs

As a portion of total program costs, default costs[3] have risen from about 10 percent in fiscal year 1980 to 36 percent in 1989. Interest subsidies have decreased as a portion of total costs, and were about 60 percent of the program's costs in 1989. Other costs, including the Department's expenses for other claims, such as death and disability, have leveled off to 4 percent of program costs in 1989. (See figure 1.)

Figure 1: Defaults Are Becoming A Greater Portion of Program Costs



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[3]The default costs represent payments to guaranty agencies.

CONCERNS ABOUT THE FINANCIAL CONDITION OF THE HIGHER EDUCATION ASSISTANCE FOUNDATION

I would now like to focus on the problems currently faced by HEAF. I want to first compare HEAF's loan and default volume with other guaranty agencies. Then, Mr. Chairman, I shall address the three areas about HEAF that the Committee is most interested in: (1) what is the risk faced by lenders who hold loans guaranteed by HEAF? (2) what is the risk faced by the Student Loan Marketing Association (Sallie Mae)? and (3) what costs may be incurred by the federal government if HEAF becomes insolvent?

HEAF's Loan Volume

While most guaranty agencies generally serve only one state, HEAF and United Student Aid Funds, Inc. (USAF), are national guarantors and have been designated by several states to serve as their guarantor. As a result, HEAF is the designated guarantor for the District of Columbia, Kansas, Minnesota, Nebraska[4], West Virginia, and Wyoming.

In recent years HEAF has been the largest guarantor in the Stafford program. However, as shown in table 5, HEAF's share of loans began to decline in fiscal year 1989, from over 20 percent in each of the previous 3 years, to 14.4 percent in fiscal year 1989. In addition, HEAF's share of new loans guaranteed continued to decline so far this year, representing 12.2 percent of all loans guaranteed during the first 6 months of fiscal year 1990.

HEAF attributed its decline in new loan guarantees to its decision in July 1988 to cease guaranteeing loans in 18 states because its loan portfolio mix that year was mostly (70 percent) for students attending proprietary schools. Default rates on loans made to these

[4]The state of Nebraska has designated two guarantors, HEAF and the Nebraska Student Loan Program.

students are much higher than are default rates for students attending 4-year schools. HEAF said that the change made in 1988 reduced its 1989 portfolio of loans to borrowers attending proprietary schools to 35 percent, down from 70 percent.

Table 5: HEAF Has Had the Largest Share of Loan Dollars Guaranteed
(Numbers are percentages)

	Fiscal year			
Agency	1986	1987	1988	1989
HEAF	21.9	27.6	26.9	14.4
USAF	6.4	8.4	10.3	12.8
California	7.9	7.7	8.0	9.6
New York	9.6	8.3	7.9	7.9
Pennsylvania	5.7	6.2	6.8	8.1

Source: Department of Education

HEAF's Default Volume

As the largest guarantor of student loans, HEAF is also the biggest payer of default claims to lenders. During the last 4 fiscal years, HEAF's share of default claims paid to lenders has increased significantly from 12.0 percent in 1986 to 38.7 percent in 1989. Table 6 shows that HEAF's share of default claims is much higher compared to the four agencies guaranteeing the next largest numbers of Stafford loans. In contrast, Pennsylvania's default share steadily declined during the period.

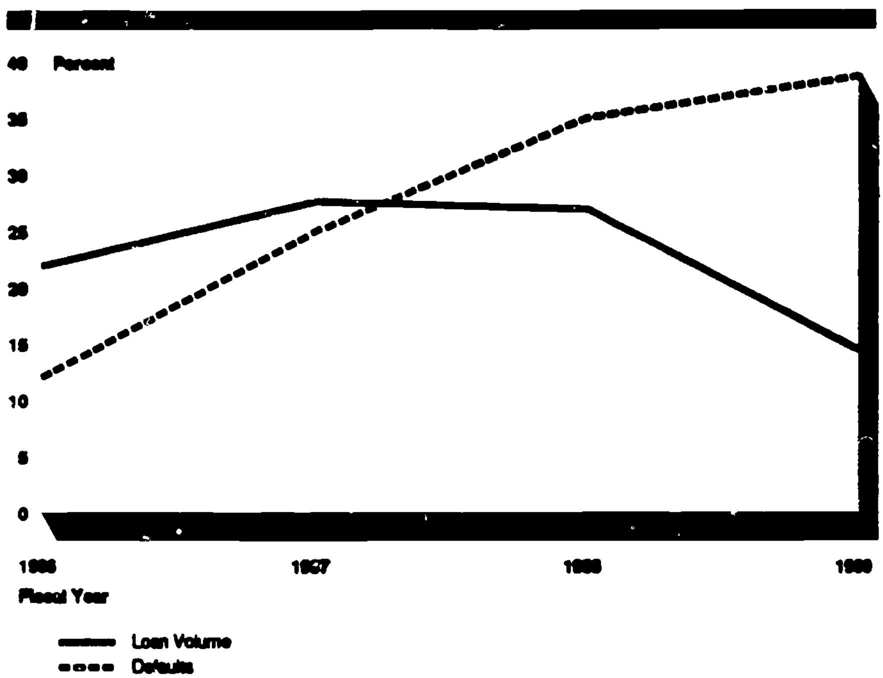
Table 6: HEAF Has Had the Largest Share of Default Dollars
(Numbers are percentages)

	Fiscal year			
Agency	1986	1987	1988	1989
HEAF	12.0	24.9	35.0	38.7
USAF	5.4	5.3	5.6	7.0
California	12.7	8.9	6.8	8.9
New York	15.1	11.7	9.4	9.8
Pennsylvania	6.7	4.8	3.7	2.6

Source: Department of Education

Figure 2 shows that HEAF's share of default claims paid to lenders increased as its loan volume remained steady and subsequently decreased.

Figure 2: HEAF's Share of Total Stafford Program Defaults Now Exceeds Its Share of Loan Volume



Source: Department of Education

Risk to Lenders with HEAF-Guaranteed Loans

Under normal circumstances, lenders are reimbursed 100 percent for default claims if they properly originate and service their student loans. As a result, lenders with HEAF-guaranteed loans are paid the full amount of their defaulted loans if they followed established procedures. HEAF told us that as of July 17, 1990, it had $8.8 billion in outstanding guaranteed loans. Therefore, if HEAF ceased operations that day, that amount--and any accrued interest--would be the maximum risk for these lenders on their loan portfolios if borrowers stopped making or never made any payments. This also assumes that the government would pay no reinsurance on lenders' default claims. Of course in a liquidation, HEAF's assets could be available to help offset lenders default claims. HEAF also reports that 10 lenders held about 75 percent of its outstanding loans as of July 17, 1990.

Risk to Sallie Mae

As I stated earlier, lenders have some risk in the Stafford program if they fail to follow proper procedures in originating and servicing a loan. Sallie Mae's risk would be no different than other holders of student loans. HEAF reports that Sallie Mae has the largest share of HEAF-guaranteed loans, almost $2.9 billion as of July 17, 1990.

Risk to the Federal Government

If HEAF should fail and is unable to meet its commitments to pay lenders for defaulted guaranteed loans, the question becomes: is the payment of lenders' default claims a responsibility of the federal government? Under the Higher Education Act, as amended, the Department of Education has no direct legal obligation to lenders if a guaranty agency, such as HEAF, becomes insolvent or otherwise fails to meet its obligations. The contract the

Department entered into with the guaranty agency does not extend to the lender--the Department is not insuring lenders. Therefore, the Department has no legal responsibility to pay lenders claims if HEAF should fail.

However, the Secretary of Education has broad legal powers in connection with the Stafford Student Loan Program which may be used in such cases. Although not required or obligated by the law to take any particular action, the Department could assert that it has the authority to pay lenders' claims on defaulted student loans.

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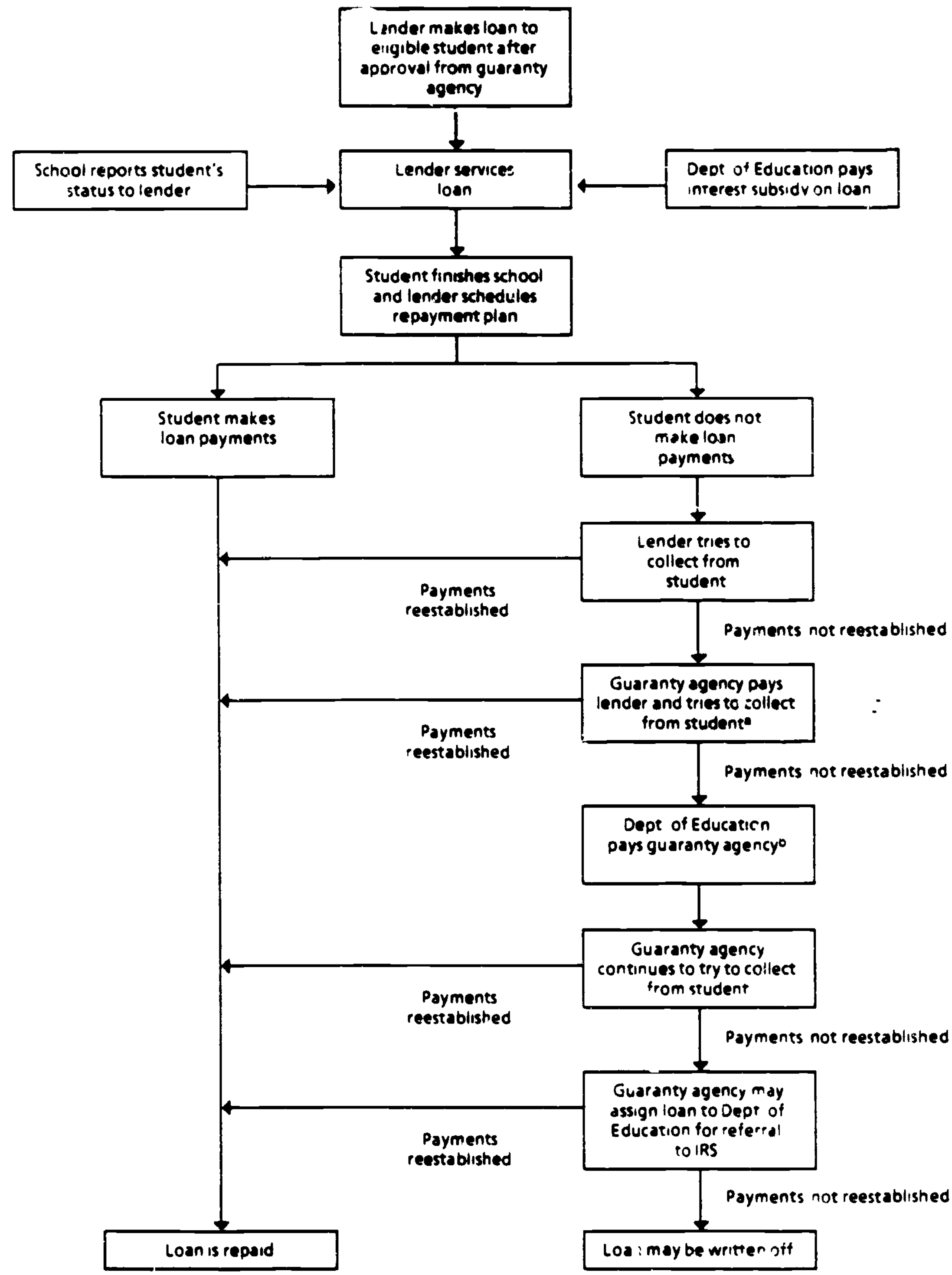
Mr. Chairman, that concludes my statement. My colleagues and I would be happy to answer any questions you or other Committee members may have.

Attachment

Life of a Stafford Loan



[a]Guaranty agency pays 100 percent of the lender's claim, if the loan was serviced properly
[b]The Dept of Education pays reinsurance to the guaranty agency, up to 100 percent of the claim
The Dept of Education may refer defaulted loan to IRS for income tax refund offset

Appendix 16

END

U.S. Dept. of Education

Office of Education
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ERIC

Date Filmed

March 21,1991