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ABSTRACT

In order to understand the relevance and applicability of current criteria restricting institutional lending and the possible need for further restrictions, the Congress of the United States mandated a study of institutional lender policy. The study's resources were a background report and literature review, case studies of state loan systems, a formal call for papers and views of over 50 representatives of the postsecondary education community, several analytical papers and a symposium on the effects of eliminating the criteria currently in place. The study found that the potential advantages of eliminating current criteria were significantly outweighed by potential disadvantages. Under the most common institutional conditions criteria elimination would not improve access, reduce defaults, or produce substantial revenues for school lenders. The potential disadvantages include a decline in the quality of commercial lender and secondary market portfolios and a heightening of problems that guaranty agencies now face. The text includes six figures, and three appendixes listing members of the Advisory Committee on Student Financial Assistance, participants in the Advisory Committee's Symposium on Institutional Lending, and case study participants. (Author/JB)

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Special Institutional Lender Study

Final Report
to the Congress of the United States

Advisory Committee on Student Financial Assistance

June 2, 1989

HE 024 895

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FOREWORD

The Congress of the United States, as part of Public Law 99-498, established an Advisory Committee on Student Financial Assistance "to provide advice and counsel to the Congress and the Secretary of Education" on issues related to student financial aid. Public Law 100-50 also mandated a thorough study of institutional lender policy in the Stafford Student Loan Program. This law requires the Committee to prepare and submit a report on the Study to the Committee on Education and Labor of the House of Representatives and the Committee on Labor and Human Resources of the United States Senate by June 3, 1989.

In accordance with the Congressional mandated objectives for this study, the Advisory Committee has explored what effects elimination of current institutional lender criteria would have on institutional lenders, students, parents, commercial lenders, guaranty agencies, secondary loan markets, and the Stafford Program in general. The Committee evaluated a range of possible advantages and disadvantages that might accompany increased institutional lending, weighing the likelihood and repercussions of each. In addition to its core findings concerning institutional lending, the Committee identified a set of important issues for further study, which have long-term implications for the Stafford Program. It is hoped that these findings will prove useful to the Congress in providing guidance for legislative planning.

This final report to Congress synthesizes a review of institutional involvement in lending as well as scholarly work and professional literature, special analyses of important institutional lending issues, the information from case studies, formal views of the postsecondary education community, and the Symposium on Institutional Lending presentations and discussion.

The Committee is grateful for the assistance and counsel of the many members of the postsecondary education community, U.S. Department of Education officials, and Congressional staff members. The Committee also wishes to express appreciation to the consultants who supported the study including Rita Bayless, Ruth Beer Bletzinger, Elaine Eckels Glover, Frank Nassetta, Morgan Paley Reed, Sandra Schattman, Sara Stott and Richard Wabnick. In particular, the Committee would like to thank Jamie Merisotis, who wrote the final report. As Chairman, I extend my thanks to James Flippin, who served as Chairman of the Subcommittee that guided the study.

James R. Craig
Chairman

June 2, 1989
Washington, D.C.

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EXECUTIVE SUMMARY

Lending by institutions of higher education has a history dating back to the 1950s. First in the National Defense Student Loan (NDSL, now Perkins) Program and then in the Federally Insured Student Loan (FISL) Program, institutions made thousands of loans to needy students to pursue postsecondary education. Today, while the Perkins Program continues to thrive as a source of loans, generating from $600 to $900 million annually since 1980, institutional lending in the Stafford (formerly Guaranteed Student Loan) Program has declined sharply from the mid-1970s Stafford school lending now occurs only at a few, mostly selective institutions with national student bodies; total loan volume in 1987 was $31 million. This represents less than one percent of annual Stafford Program loan volume.

The decline in institutional lending in Stafford has been a direct result of the Education Amendments of 1976. These amendments made important changes in special allowance payments for commercial lenders, offered inducements to states to establish guaranty agency programs, and implemented stricter eligibility requirements for institutional lenders. Restrictions on who institutions could lend to and how much they could lend, criteria for disqualification based on program performance, detailed termination procedures, and extensive audits exposed institutional lenders to the highest degree of government control and scrutiny. Motivated largely by abuses that attended the explosion of institutional lending in the late 1960s and early 1970s, many of the changes made in 1976 are still in place today.

Since 1976 few changes have been made that have had an appreciable impact on institutional lending. However, for a brief period between October 17, 1986 and July 1, 1987, Congress removed two restrictions: that an institution could not lend to more than 50% of its students; and that it could not make loans to an undergraduate student unless the student had previously borrowed from the institution or had been denied a loan by a commercial lender. If the brief removal of these restrictions represents uncertainty about their relevance, the ensuing debate and quick reinstatement epitomized Congress' continuing concern for program stability. As if to punctuate that concern, Congress also called in 1986 for the disqualification of any lender offering incentives or inducements to institutions or students.

Study Purpose and Approach

To help resolve the issue of the current relevance and applicability of criteria restricting institutional lending and the need for further restrictions, Congress charged the Advisory Committee to conduct a thorough study of institutional lender policy. This study accordingly has been designed largely as a legislative planning tool to provide broad guidance to Congress on the possible system-wide implications of eliminating the current criteria and adding or substituting other restrictions. Its primary approach is to explore the advantages and disadvantages of elimination of the criteria for students, institutions, lenders, secondary market agencies, and state agencies. Due to the complexity of the issues involved, limitations of self-reported and conjectural data, the lack of nationally representative program data, and time and resource constraints, the Advisory Committee selected a multifaceted, investigative study design aimed at acquiring existing analyses and expert opinion on the key study issues. Primary study components included:

- a background report and literature review;
- case studies of state loan systems;
- a formal call for papers and views of more than 50 representatives of the postsecondary education community;
- several analytical papers;
- a symposium on the effects of eliminating the criteria.

Each of these components was driven by a common set of specific study questions and hypotheses.

Issues

The study investigated whether the elimination of criteria could result in a substantial increase in institutional lending and whether such an increase could have several potential benefits, such as:

- improved access to loans;
- better service to students and the easing of administrative burden of schools;
- reduction in defaults;
- substantial revenues to schools that might defray rising costs of attendance.

These benefits represent a composite view of the arguments made in favor of eliminating the criteria by various proponents.

The study also investigated whether an increase in institutional lending fostered by elimination of the criteria could have several potential disadvantages, such as:

- negative effects on both the primary and secondary markets for loans in the form of portfolio effects and concentration;

- increases in inducements and/or arrangements between schools and lenders or secondary market agencies;

- instability for guaranty agencies, including lender of last resort programs.

In general, these potential disadvantages represent a composite view of arguments made over the last decade against significant expansion in institutional lending.

Findings

While study results necessarily are rather qualitative, resting on the expert views of loan program participants, they are nonetheless unambiguous and conclusive. The study found that the potential advantages of eliminating current criteria were significantly outweighed by potential disadvantages. Only under the most ideal circumstances--where only a small number of schools became new lenders, used their own capital, and held the loans to maturity--would eliminating the criteria capture the potential advantages of better service to students and administrative convenience for institutions. However, under the more likely conditions--schools without endowment raising capital through arrangements with commercial lenders or secondary market agencies and selling loans to secondary markets to assure liquidity--these advantages disappear. Further, such potential advantages as improved access, reduction of defaults, and substantial revenues for school lenders were found to be unlikely outcomes under expected conditions.

On the other hand, the study found that the potential disadvantages of eliminating criteria were very real and probable. The propensity for schools with low risk borrowers to become lenders or direct their loans to a single lender or secondary market agency could result in a marked decline in the quality of other commercial lender and secondary market portfolios. In addition, a substantial increase in institutional lending could heighten problems that guaranty agencies are now experiencing with portfolio mix and strain lender of last resort programs. These outcomes could lead to access problems where none now exist.

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Because current criteria effectively limit institutional lending, the study found no need to add further restrictions in the form of default rates, use of special allowance, or minimum holding periods. However, in the event that current criteria were eliminated, these other restrictions would represent a minimum set of substitute criteria.

The study uncovered several important issues worthy of further study. First, some of the current arrangements between institutions and large banks or secondary market agencies need to be reviewed for consistency with legislative intent. Second, while students' access to loans was not found to be a problem generally, pockets of access problems are emerging--primarily in the proprietary sector. It is unlikely that current lender of last resort programs can solve these problems in the long run. Third, current problems with loan servicing, resulting in confusion and sometimes "technical default" by borrowers, was consistently mentioned by study participants and should be examined in further detail. Finally, the broader context for student loan defaults, which are largely responsible for current and possibly future instabilities in the Stafford Program, was inextricably linked with many issues related to institutional lending, and should continue to be the focus of future refinements to the program. The tensions among default costs, access to loans for students, and adequate program management must be reconciled.

I. INTRODUCTION

Section 491(j) of the Higher Education Act of 1965 requires the Advisory Committee on Student Financial Assistance to conduct a "thorough study of institutional lender policy" in the Stafford Student Loan and other Part B programs, with the primary goal of considering an increased role for institutions as lenders in Part B. This report fulfills that requirement by reporting on the results of the Advisory Committee's study of institutional lender policy.

This section provides a brief overview of the history of institutional lending leading up to the Congressional request for this report. It also explores the study objectives and methods, and outlines the major questions that guided the overall study. Section II reviews the historical context for institutional lending based on the study's background report and review of the literature. The legislative and regulatory history of institutional lending, including the antecedents for current policies, are explored in some detail in this section. These findings formed an integral component in the planning of the Committee's later study activities. Section III reports on the findings of the major study tasks. These are organized under three headings: the relevance and applicability of current legislative and regulatory criteria related to institutional lending in the Stafford Program; the potential advantages of eliminating these criteria; and the potential disadvantages of eliminating these criteria. The conclusion, Section IV, weighs the potential advantages and disadvantages, examines the need for further restrictions on institutional lender eligibility, and explores issues for further study.

Overview of Federal Institutional Lending

Institutional lending in the Federal student aid programs has existed for more than three decades. The first manifestation of institutional lending at the Federal level was through the National Defense Education Act of 1958. The Act authorized the development of an institution-based student loan plan that provided for a Federal guarantee against default and 90 percent of the loan capital needed to establish an institutional revolving fund. Though the National Defense Student Loan (NDSL, now Perkins) Program was a more or less hastily devised scheme largely patterned after existing non-Federal student loan plans, it represented an important first step for the Federal government in providing "more adequate educational opportunity" for students desiring to pursue a postsecondary education. [P.L. 85-864, Section 101]. Today, the Perkins Program continues to thrive as a source of loan funds to postsecondary students, generating from $600 to $900 million annually since 1980.

The decision to design the Perkins Program as institution-based was largely due to its antecedents at the state and institutional levels. At the outset, it was never expected to garner the great enthusiasm it received from both institutions and students.

By and large it was seen as a national version of other loan plans, where schools were expected to originate loans and service accounts, just as in the state and institutional prototypes.

By 1964, many Federal legislators were convinced of the value of guaranteed loans to students. The success of the Perkins Program and the continued growth of state plans led to the development of the Stafford (formerly the Guaranteed Student Loan) Program, now the largest of all Federal student aid programs. The innovations of the Stafford Program that are relevant to the issue of school lending are worth noting here. First, to those involved in the development of Stafford, the major drawback of the Perkins Program was the inadequate supply of capital. The Stafford Program solved this by encouraging the investment of private capital.

Second, several of the state programs had demonstrated that the use of private capital sources greatly enhanced a student loan program's effectiveness. Agencies such as those in New York and Massachusetts had demonstrated their proficiency at raising private capital, earning the respect of institutions, and keeping overall costs down; a state level alternative appeared to be the most prudent method of furthering educational opportunity.

Thus Federal legislators believed they had happened onto a proposal that would make loans available to all who desired them. The Higher Education Act of 1965 promulgated the first explicit Federal government commitment to a national system of access to student loans. The original purpose of the Stafford Program was to encourage the establishment of state level guaranty agencies and the involvement of private capital sources, though direct Federal involvement would dominate the program for most of the first decade of its existence. Institutional lenders do not appear to have been given major consideration in the original design of the program.

Institutional lending currently plays a relatively minor role in the Stafford Program. Active school lenders generate less than one percent of its annual loan volume, and a handful of institutions account for most of this volume. Despite the almost negligible impact that school lenders now have on the Stafford Program, in the past school lenders have seen days of greater activity both in terms of loan volume and number of institutional lenders. This was especially true during the early to middle 1970s, when the Federally Insured Student Loan Program (FISL) played a fairly dominant role in overall Stafford lending. Over the last dozen or so years, however, this activity has been curtailed.

An increased role for institutional lenders has piqued the interest of analysts and policymakers intermittently in recent years, in part because of its purported advantages. These include: access to loans, improved levels of service to students, streamlining of administrative functions for institutions, potentially lower levels of default, and revenues that institutions could direct back into other need-based student aid. In some instances, this interest in an increased role for institutional lenders has led to comparisons between the Perkins and Stafford programs. However, the Committee's analysis suggests that the differences between the two programs are great. Disparate definitions of lender eligibility, the different methods by which capital for loans is obtained, and other factors make direct comparisons between the programs unsuitable and uninformative.

The increased interest in institutional lending has also been heightened in recent years by the advancing and sometimes uncontrollable costs of the Stafford Program to the Federal government. Indeed, the request by Congress for this Advisory Committee report arose as a result of increased support for institutional lending in the House of Representatives during the 1986 reauthorization of the Higher Education Act. This report by the Advisory Committee served as a compromise between House and Senate conferees, leaving open the possibility of future Congressional action.

Study Objectives, Methods, and Questions

The Congressional charge to the Committee [Section 491(j)] related to the conduct of this study states:

> The Advisory Committee shall conduct a thorough study of institutional lender policy. In carrying out the study, the Advisory Committee shall examine, but not be limited to:
> (A) the relevance and applicability of the institutional lender criteria established in section 435(d);
> (B) the appropriateness of using default rates for loans made under Part E (Perkins Loan Program) or other institutional criteria to determine institutional participation;
> (C) whether or not a portion or all of any special allowance or other payments paid to institutional lenders should benefit need-based scholarship or grant programs;
> (D) whether or not institutional lenders should be required to hold loans made to eligible borrowers through graduation or termination of matriculation;
> (E) the extent and degree to which student access to loan capital would be adversely affected by the restrictions contained in section 435(d)(2); and
> (F) the potential impact on State secondary markets and lender portfolios if student borrowers at higher cost colleges and universities, who come from higher income families, concentrate their lending with a few large lenders and secondary markets.

The study therefore was designed primarily as a legislative planning tool, and may be used by Congress for broad policy guidance on the possible system-wide implications of eliminating current criteria. However, several methodological constraints were raised by and discussed with Congressional staff, and the final study was designed to recognize those limitations. One limitation is that self-reported information--necessary in a study of probable changes in behavior--must be comprehensively gathered and analyzed. Under these circumstances, it has been important to the Advisory Committee to seek broad, informed, structured opinions and analyses about the likely effects of eliminating current criteria.

Another limitation is that the questions underlying this study are as complex as those in large data collection efforts, such as the National Postsecondary Student Aid Study. Time and resources available to the Committee, though, precluded large-scale surveys of institutions, lenders, guaranty agencies, secondary markets, and others. In any case, large surveys and multivariate analyses do not necessarily provide better legislative guidance for the Congress, and therefore were not considered critical elements.

Finally, no nationally representative data exist on the current financial condition and structure of current or future institutional lenders, or the environment under which they might operate if the current criteria were to be eliminated. Thus, standard large scale survey techniques and multivariate analyses were infeasible for this study.

In light of these constraints, the Committee opted for an eclectic, multifaceted, investigative study using a broad, structured analysis. The components of the study included:

- a background report;
- a review of the relevant literature;
- a descriptive analysis of profitability and operating characteristics of currently active institutional lenders;
- case studies of state loan systems that focused on institutional lenders and lending functions;
- the formal views of several dozen representatives of the postsecondary education community--including institutions, associations, lenders, guaranty agencies, loan servicers, and secondary market agencies--on a directed set of research questions;
- a symposium on the likely effects of eliminating current lending criteria;

- an analytical paper on the views of commercial lending experts on institutional lending;
- an analytical paper on the role of secondary market agencies in institutional lending.

The background report explored the historical context for the study, including legislative and regulatory actions, program performance data, and recent trends in institutional lending. The literature review brought together the writings of a number of experts who in recent years have addressed the many issues related to institutional lending. The analysis of profitability and operating characteristics served as a starting point for investigating potential advantages and disadvantages of eliminating current institutional lending criteria, as did the analytical papers on the roles of commercial lenders and secondary markets in institutional lending.

The Advisory Committee conducted case studies in six states: California, Illinois, Massachusetts, Mississippi, Pennsylvania, and Texas. Former, current, and potential institutional lenders were interviewed, and the views of guarantors and secondary market officials were solicited in each state. Information on other states was obtained as well, chiefly through the postsecondary education community's responses to research questions posed by the Committee.

Elements of all of these study components were brought together at the Advisory Committee's Symposium on Institutional Lending, held in Washington, D.C., on March 13, 1989. Four panels, representing the views of institutions, lenders, secondary markets (including guarantors) and the community at large, presented and discussed their views on the advantages and disadvantages of institutional lending and the changing environment in which it operates. The symposium was well attended, and offered an opportunity for an exhaustive deliberation to inform the Committee's subsequent discussions.

Each of these study components was applied toward a broad set of questions that guided the Advisory Committee's investigation of institutional lending. These primary study questions, shown in Exhibit 1, were then used to formulate a list of secondary questions that could be answered using the multifaceted activities of the study. These secondary questions examined specific topics raised during the development of the study plan and in subsequent activities of the study.

EXHIBIT 1

Primary and Secondary Study Questions

Primary	Secondary
1. What are the antecedents for current institutional lending in the Stafford Program?	• What are the legislative and regulatory antecedents for institutional lending in the FISL Program?
	• What is the history of program participation and performance for institutional lenders in the FISL Program?
	• What are the antecedents for institutional lending in the Stafford Program?
	• What are the most recent data on program participation and performance for Stafford institutional lenders?
2. Are current institutional lending criteria relevant and applicable?	• Have the current criteria had an effect on institutions participating as lenders?
	• Can the current criteria be used to explore the potential advantages and disadvantages of institutional lending?

EXHIBIT 1 (continued)

Primary	Secondary
3. What are the potential advantages of eliminating the criteria?	• Is there any evidence to suggest that problems with access to loans currently exist or could develop in the near future?
	• Can institutional lending be used to solve any potential problems with access?
	• Can institutional lending improve service to students--and thereby lower default costs--and ease the administrative burden to institutions?
	• Can institutional lending result in substantial revenues for institutions?
4. What are the potential disadvantages eliminating the criteria?	• Will institutional lending have negative effects on the primary of market for loans?
	--If current criteria were eliminated, would many schools enter the program as institutional lenders?
	--Could commercial lending portfolic be negatively affected by more institutional lenders?
	--Could the elimination of current criteria increase concentration of commercial lending in a smaller number of lenders?
	--Are there arrangements that might be established between primary market entities and school lenders?

EXHIBIT 1 (continued)

Primary	Secondary
	• Will institutional lending have negative effects on the secondary market for loans? --Are there arrangements that might be established between secondary market entities and institutional lenders? --Could the elimination of current criteria increase concentration in large secondary market agencies and banks? --Could the elimination of current criteria cause instabilities for guaranty agencies? --What effects would institutional lending have on lender of last resort programs at guaranty agencies?
5. Do these advantages appear to outweigh the disadvantages?	• Are the advantages of institutional lending likely and significant? • Are the disadvantages of institutional lending likely and significant? • Do the potential outcomes of eliminating current criteria suggest broad, program-wide effects or a more limited effect?

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EXHIBIT 1 (continued)

Primary	Secondary
6. Are further restrictions on institutional lender eligibility required?	• Should Perkins default rates or other institutional criteria be used to determine institutional eligibility? • Should a portion of special allowance be directed to need-based aid? • Should institutions be required to hold loans through graduation or termination of matriculation?
7. What issues require further study?	• Are current arrangements between lenders and institutions consistent with program intent? • Are current lender of last resort provisions and arrangements adequate to guarantee access? • What alternatives should be investigated to minimize loan application and repayment servicing problems? • How can minimizing default costs, ensuring access to loans and developing adequate program management be reconciled?

II. HISTORICAL CONTEXT

The first step in the Advisory Committee's study of institutional lender policy was to examine the historical context for current school-based lending. The Committee used this investigation as an important first step in its overall study.

What Are The Antecedents For Current Institutional Lending In The Stafford Program?

Several important questions guided the Committee's examination of antecedents to the current institutional lending structure. As noted in Exhibit 1, these questions included:

- What are the legislative and regulatory antecedents for institutional lending in the FISL Program?
- What is the history of program participation and performance for institutional lenders in the FISL Program?
- What are the antecedents for institutional lending in the Stafford Program?
- What are the most recent data on program participation and performance for Stafford institutional lenders?

What are the legislative and regulatory antecedents for institutional lending in the FISL Program?

Institutional lending in the Stafford Program occurred almost exclusively under the auspices of FISL in the program's earliest years. Conspicuous Federal involvement played an important role in the design of legislation and regulations affecting school lenders. This part looks at institutional lending under the FISL Program through the year 1975, when crucial government regulation of institutions and lenders was finalized but before the sweeping changes brought on by the 1976 Education Amendments.

Institutions were authorized under the original language of the Higher Education Act of 1965 to make loans to students. The law defined an "eligible lender" as "an eligible institution, an agency or instrumentality of a State, or a financial or credit institution (including an insurance company) which is subject to examination and supervision by an agency of the United States or of any State" [Section 435(e)]. The Act defined an eligible institution as one which "provides an educational program for which it awards a bachelor's degree or provides not less than a two year program which is acceptable for credit toward such a degree" and "is a public or other nonprofit institution" [Sections 435(a) 2 and 3]. Therefore vocational schools were not eligible as participants in the program and did not play a role as lenders, while traditional higher education institutions were fully authorized to become lenders under the law.

Another FISL requirement under the original Act stipulated that no certificate of Federal loan insurance could be granted to a lender residing in a state that had established a guaranty agency if the Commissioner of Education "determines that every eligible institution has reasonable access in that State to a State or private nonprofit student loan insurance program" [Section 423]. For school lenders, this provision meant that they could not become FISL lenders in any state that had established a guaranty agency.

A weakness developed in this strict requirement in 1968. As a result of the Higher Education Amendments of that year, lenders previously excluded because of the presence of a state guaranty agency could be issued certificates of insurance if they could demonstrate that, "by reason of the residence of borrowers, [lenders] will not have access to any single State or nonprofit private loan insurance program which will insure substantially all of the loans the lender intends to make to such borrowers" [Section 423(b)].

This provision was added to the law in part because the Federal government was finding it difficult to attract lenders to the program. Because of low interest rates, lack of easy access to loan capital, and other reasons, banks saw little advantage in Stafford lending. The provision was intended to convince commercial lenders to enter the Federally guaranteed student loan business under FISL, and to encourage institutions to become lenders. At the time, full access to loans was a primary goal of the program, and it was believed that this provision would spark more interest from both commercial lenders and schools.

The 1968 Amendments held another relevant change: vocational schools were included in the definition of eligible institutions under Part B of the Act. As the definition of eligible lenders continued to include eligible institutions, this opened the door to a large number of vocational institutions (usually proprietary schools) to serve as FISL lenders.

Because of the growth of institutional lending and the relative lack of control over institutions making loans, several regulatory changes were effected in the period between 1968 and 1975 to curb abuses of the program. One change stipulated that an agreement between the Commissioner and any eligible institution had to be executed to assure continued participation in Part B programs [45 CFR 177.61 (1975)]. The agreement simply acknowledged the institution's obligations to comply with all applicable laws and regulations. In practical terms, however, this new regulation allowed for periodic audits and reviews of institutional practices at regular intervals--usually the duration of the agreement's validity.

Most of the other changes applied to all eligible institutions, but a few appeared to be aimed primarily at schools originating loans under the program. For example, the regulations published in October of 1970 altered the definition of "eligible lender," adding a clarifying sentence that said, "A pension fund, institution of higher education or vocational school will not be approved by the Commissioner unless it can satisfactorily demonstrate that the procedures it has established for making or purchasing loans covered by this part are in accordance with generally accepted commercial lending practices and that it is able to carry out the duties and responsibilities required of it under this part." [45 CFR 177.1(h) (1975)].

The history of this seeming minor change is complex, and the effect it v 'd have on institutional lender eligibility for the duration of the FISL Program's existence is intricately tied to the Department of Education's experience with institutional lending. The Department clearly was not prepared for the explosion of interest in school lending between the fall of 1968--when the first certificate of insurance was granted--and the spring of 1970. In this one and a half year period, almost 200 schools applied for and were granted insurance certificates. Department officials soon realized that schools were being granted lending authority without any review of their administrative or financial qualifications to serve as lenders, affording the possibility of abuse of the loan program and its guarantee provisions.

The new definition of eligible lender allowed the Department to exercise some control over the application process by holding institutions responsible for meeting the "generally accepted commercial lending practices" requirement before a certificate of insurance was granted. To simplify and expedite this task, an Evaluation Committee was established within the Department to review and analyze all applications from would-be school lenders. This Evaluation Committee soon demonstrated significant influence over institutional lending in the Stafford Program (especially in its first five years of existence) and made important contributions to the further regulation of school lenders in later years.

The Evaluation Committee had two central functions. Initially, its purpose was to review applications for contracts of insurance from all "non-regulated" lenders, the overwhelming majority of which were schools. Institutions interested in becoming lenders were required to submit a variety of documents to the committee, including financial statements, credit references, and detailed procedures for loan collection, in order to demonstrate their financial and administrative capabilities to function as lenders. The Evaluation Committee applied fairly rigid standards, rejecting one applicant for every three it accepted in the first four years that it operated.

A second important task of the committee, acquired during its second year of existence, was to conduct continuing reviews of all active "non-regulated" lenders. The committee examined factors such as total assets and liabilities, net worth, current operating results, loan volume, and past and projected performance. The main interest of the committee here was to ensure that an institution was capable both of serving as a lender and maintaining its general financial stability.

According to the records of the committee, its overriding concern for both newly approved applicants and active lenders was that they not "bite off more than they could chew" in terms of annual loan volume. Generally, the committee restricted the dollar amount of new loans that a school could generate in its first year as a lender. As institutions became more experienced as lenders, the committee weighed requests for higher loan limits against the school's previous performance.

Other meaningful changes were made in the 1968 to 1975 time period. Perhaps the most important development for the program was the establishment in 1972 of the Student Loan Marketing Association (Sallie Mae). The creation of a secondary market allowed commercial lenders the opportunity to exchange their student loan holdings for cash, thereby allowing greater flexibility as financial conditions and lender needs changed over time. This ability to trade assets for greater liquidity helped to stimulate more commercial lender interest in student lending, and thereby implicitly diminished the need for educational institutions as lenders.

The experience of the Evaluation Committee, with its intricate knowledge of school lenders and the problems encountered with the administration of the program, was instrumental in the formulation of new regulations that sought to limit abuses of the Stafford Program. Regulations finalized in 1975 noted that if "any of the following conditions exist, the Commissioner may, pursuant to subpart G of this part, require reasonable and appropriate measures to alleviate such conditions as a requirement for an institution's initial or continued participation in programs under this part" [45 CFR 177.66 (1975)]. Simply put, these additional standards gave the Commissioner authority to invoke limitation, suspension, or termination proceedings (LS&T) if:

- the institution's cumulative default rate was more than 10 percent;
- the attrition rate for a school was above 20 percent for any given academic year;
- more than 60 percent of the students at an institution received Part B loans in a given academic year;
- the institution was under financial stress severe enough to threaten its educational mission.

The original LS&T provisions relevant to the Stafford Program applied equally to lenders and institutions. By using the same regulations, the Office of Education was able to maintain a particularly careful watch over institutional lenders. The effect of this authority, the previously noted limitations, and subsequently enacted provisions may have contributed to the gradual slowdown in the number of active school lenders and overall school lending activity.

The LS&T provisions put into effect in 1975 [45 CFR 177.71 (1975)] allowed a "designated official" of the Office of Education to suspend an institution or lender up to 60 days for violation of any statutory or regulatory provisions contained under Part B. Of the three categories of possible actions (limitations, suspensions, or terminations), this one was the only instance where the Office of Education could take independent action. In the cases of limitation or termination, the Office of Education initiated the action but the institution or lender could request a hearing before an administrative law judge (ALJ) on the matter. The Commissioner of Education had final authority on matters of appeal.

An institution or lender that was terminated under Part B was removed from eligibility for program participation for an indefinite period of time. Limitation meant that the institution or lender could continue to be eligible for program participation provided it complied with certain conditions or restrictions set as a result of its violation of applicable laws or regulations. The possible sanctions against violators included:

- limiting the number or total volume of loans a lender could make (noted above);
- limiting the number or percentage of students enrolled in an institution who could receive Part B loans;
- limiting the percentage of an institution's total receipts for tuition and fees that could be derived from Part B loans;
- requiring an institution to obtain a bond to provide assurance that it would be able to meet its financial obligations to students who had received Part B loans;
- requiring institutional lenders to use a special promissory note form.

In addition, the LS&T provisions required institutions or lenders to make reimbursements or refunds for any violation of laws or regulations that resulted in the improper receipt of monies.

What is the history of program participation and performance for institutional lenders in the FISL Program?

Data from the Department of Education on school lenders relative to program participation and performance are woefully inadequate. This is especially true for data relevant to FISL lending, which is sketchy and incomplete. Estimates of the number of active school lenders, loan volume, and participation by educational sector are provided below, but readers are cautioned that the exact or complete figures could not be obtained from the Department of Education in many instances.

Between 1968--when Rocky Mountain College in Billings, Montana, became the first institutional lender--and 1976, close to 300 educational institutions applied for certificates of insurance under the FISL Program. Of this number, two thirds were colleges and universities and the remainder vocational (usually proprietary) institutions. Data from the Evaluation Committee show that it received more than 250 applications from schools seeking to become lenders between 1971 and 1974.

As Exhibit 2 suggests, the rejection to approval ratio during this period was one to three, suggesting that the committee applied fairly stringent criteria to an application process that, prior to the committee's formation, had no criteria at all. The committee appears to have been cautious in allowing institutions to act as lenders in the first two years, as evidenced by the fact that more applications were rejected or tabled than approved. The number of applications received by the committee declined by nearly one half after its first year of existence and remained steady for the following three years. Officials familiar with the Evaluation Committee's activities have speculated that the mere existence of the committee, and its nearly instantaneous reputation for applying a critical eye to all applications, may have inhibited some schools from considering lender status.

Of the 50 applications rejected by the committee in the 1971 to 1974 period, only 3 were from collegiate institutions; the remaining 47 came from vocational schools. Similarly, the number of applications from the collegiate sector approved annually far exceeded the number rejected, while the vocational sector had more schools rejected by the committee than approved.

While comprehensive data on the Evaluation Committee reviews of active lenders are not readily available, figures tabulated from committee actions in 1973 show that the committee applied fairly stringent standards for institutions seeking to continue to serve as lenders. Of the 138 institutions subject to review in that year, 69 were granted continuances, 34 were suspended, and another 35 were tabled (which often

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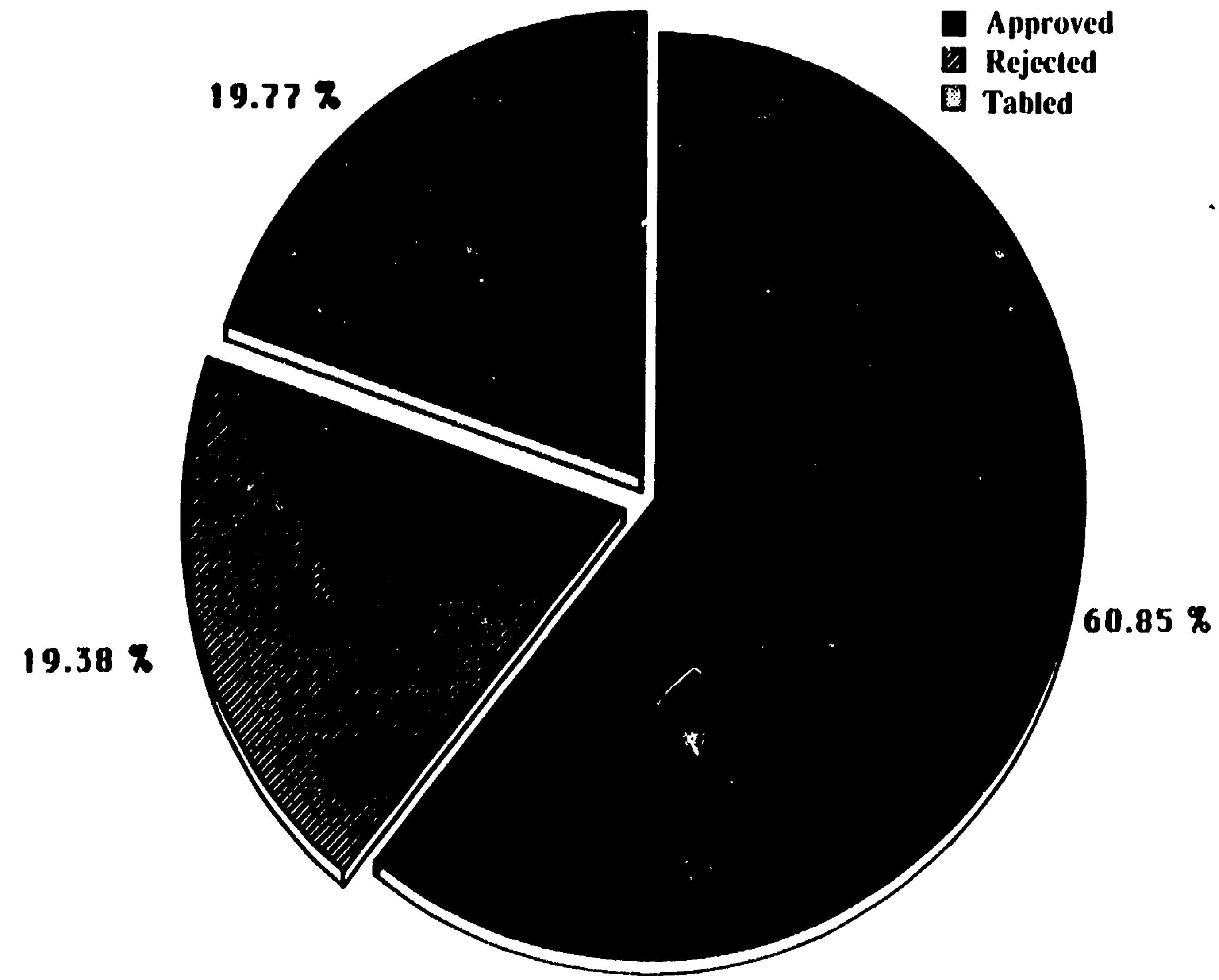
Exhibit 2
Summary of Evaluation Committee Actions on Applications from Prospective Institutional Lenders, 1971 through 1974



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Source: Advisory Committee on Student Financial Assistance research

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effectively suspended the school's lending authority until the committee took further action). This means that only half of the institutions were allowed to unconditionally proceed as lenders for the following year. All but one of the 69 institutions whose lending authority was suspended or tabled were from the vocational sector.

Data on the number of lenders actually active during the 1968 to 1976 period show that the three peak years were from 1974 to 1976. The high water mark for institutional lender activity in the Stafford Program was 1974. Data for the following two years show a gradual slowdown in the number of lenders, with the number of vocational school lenders decreasing by over one half in this three year period.

Collegiate lenders accounted for 1.4 percent of the total cumulative loan volume in the Stafford Program (FISL plus the guaranty agency portion) from fiscal year 1968 through 1973. Vocational schools made up a much larger 11.1 percent. Translated into dollar terms (roughly 50 percent of cumulative program volume through 1973 was in FISL), approximately $80 million had been lent by collegiate institutions and another $600 million by vocational schools. Thus vocational schools appear to have played a dominant role in overall school lending during these early years. As distributed across sectors, data suggest a relative stability in overall school lending during the period from 1974 to 1976, with a slowdown in vocational school activity and an upturn in collegiate sector activity.

In summary, these data suggest that the 1968 through 1975 period was one of great change in terms of institutional lender participation and performance. Clearly institutions were seen as a potentially important source of capital during this time when commercial lenders appeared hesitant to lend to students. The explosive growth in school lender activity during the first few years, however, concerned Federal officials, until gradually this activity slowed in the mid-1970s. Other factors, such as the creation of Sallie Mae and the corresponding growth in bank-based lending, also probably played an important part in this downturn in school lender activity.

What are the antecedents for institutional lending in the Stafford Program?

Many changes affecting institutions, lenders, and others in the Stafford Program took place in the period from 1976 to 1986, especially in the pre-1980 period. Particularly important were those changes that redefined the role of institutions as lenders in the program. Since 1980 some modifications have occurred, though most have been technical or administrative in nature.

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The Education Amendments of 1976 resulted in major changes for the scope, mission, and direction of the Stafford Program. Many of these changes had important implications for institutions as lenders. One of the most important modifications to the law was a revision of the formula for special allowance payments to lenders. These increased incentives for commercial lenders led to an influx of commercial lenders and was followed by a corresponding decrease in the number of active school lenders. Higher annual and aggregate loan limits and inducements that encouraged states to establish guaranty agency programs also contributed to the growth of the program. From 1976 to 1978 the FISL share of total annual loan volume decreased by half, while annual volume overall in the Stafford Program doubled between 1976 and 1980. General trends in the design and structure of the program therefore suggest that, in comparison to the late 1960s and early 1970s, school lenders were considered less important to the goal of broad access to student loans.

Lesser known about this period of rapid expansion and growth for the overall program are changes that directly affected institutional lender eligibility and disqualification. These changes may have contributed to the sharp decline in school lender activity and loan volume from the pre-1976 peak years. Many of the changes made in 1976 are still in place today.

One important legislative modification was the inclusion of stricter eligibility requirements for institutional lenders. New legislation and regulations required the Commissioner to enter into an agreement with each school lender [Section 433; 45 CFR 177.601 (1979)]. Institutions had to agree to the following terms:

1) to make loans to no more than 50 percent of the undergraduates enrolled at least half-time;

2) to make no loan to an undergraduate student who had not previously obtained a loan originated by the institution unless the student could produce evidence of a loan denial from a commercial lender;

3) to inform prospective borrowers that they must first make a good faith effort to obtain a loan from a commercial lender;

4) to make no loan to a first time undergraduate borrower in excess of the lesser of $2500 or half the estimated cost of attendance;

5) to make the loan in multiple disbursements if the loan amount exceeds $1500 or if the loan is to a first time undergraduate borrower.

Some exceptions and clarifications to this agreement were provided in the regulations. For example, the regulations included detailed requirements for establishing a loan denial by a commercial lender (2, above), and contained contingencies for a waiver of the 50 percent lending limit (1, above) for schools serving a high percentage of economically disadvantaged students.

The 1976 amendments also added two additional requirements for school lenders under the "eligible lender" section of the law [Section 435(g)(2)]. This section stated that in order to be an eligible lender for Part B programs, an eligible institution had to employ at least one person whose full-time responsibility was the administration of student aid programs; also, it could not be a home study school.

The section of the law immediately following this one further expanded the limitations placed on eligible lenders. In this case, the law applied criteria for disqualification of an otherwise eligible school lender based on program performance. The new provision [Section 435(g)(3)] said that an institution could be terminated as a school lender if the default rate for its borrowers exceeded 15 percent during each of the two most recent one-year periods for which data are available. The default rate measure used for this provision is a cumulative one, represented as a ratio of the original principal amount of all loans the school has ever made that went into default over the original principal amount of all loans the school has ever made.

Again, the legislation and subsequent regulations offered some exceptions and clarifications to this rule. The Commissioner was authorized to waive the 15 percent limit for those institutions that could demonstrate that termination would result in a hardship condition for the school or its students. The legislation empowered the Commissioner to waive this limit if the school could demonstrate that it had improved its collection procedures or if it could show that the educational opportunities it provided to economically disadvantaged students would be jeopardized by the termination action. The regulations carefully spelled out the conditions under which this exception applied, and also detailed the termination procedures, hearing process, and steps for reinstatement of previously terminated school lenders [45 CFR 177.611 (1979)].

The 1976 Amendments also separated LS&T provisions into two categories: one set of provisions applied solely to institutions; the other set applied to commercial lenders. The main difference between these distinct provisions--at least for the purposes of this report--was that institutional LS&T determinations required a "hearing on the record" before final action could be taken, while LS&T actions against commercial lenders did not [Section 497A]. In a legal sense, the main difference between these two is that a "hearing on the record" requires resolution of the issue before an ALJ, while hearings related to commercial lender LS&T simply call for a hearing before an impartial person selected by the Commissioner [45 CFR 177.701 (1979)].

In effect, then, institutional lenders were subject to audit and review by two distinct sets of auditors: one reviewing its participation in Title IV programs; the other, its role as a lender under Part B. This exposed school lenders to the highest degree of government scrutiny in program history, and so may have been a contributing factor in the sharp downturn in school lender activity observed since 1979.

Since the 1976 Amendments and ensuing final regulations in 1979, few changes have been effected either through legislation or regulation that might have an appreciable impact on school borrower eligibility, disqualification, or activity. Nonetheless, the 1986 reauthorization of the Higher Education Act did change, for a short period of time, the definition of eligible lender. The final version of the Act, enacted October 17, 1986, removed the stipulations that schools could not make loans to more than 50 percent of its students, and could not make any loans to an undergraduate student unless the student had previously borrowed from the institution or had been denied a loan by a commercial lender. After some debate on this matter, though, these provisions were reinserted through the Higher Education Technical Amendments Act of 1987 [P.L. 100-50]. Therefore school lenders were exempt from these two provisions in the period between October 17, 1986 and July 1, 1987.

Reauthorization established one further change that applies to all lenders: it calls for the disqualification of any lender who uses certain incentives or inducements to entice students to borrow. Lenders who offer inducements to institutions or students, or who conduct unsolicited mailings or engage in fraudulent or misleading advertising, may be terminated from eligibility according to this provision [Section 435(d) 5]. The applicability of this provision to school lenders may be determined when regulations based upon the 1986 Amendments are released, perhaps in 1989. Its importance is explored in detail in the Study Findings section below.

It is worth noting that the Department of Education's Evaluation Committee, established in 1970 to review applications from prospective school lenders and to audit the performance of active lenders, continued to operate into the 1980s. However, the committee's responsibilities lessened as school lender activity declined and effective control over lender review was gradually shifted to guaranty agencies. With the phaseout of the FISL Program completed in 1984, the Department of Education allowed the Evaluation Committee to expire.

What are the most recent data on program participation and performance for Stafford institutional lenders?

Data from the Department of Education show that between September 30, 1985, and September 30, 1987, 132 school lenders had some dollar amount of loans outstanding. These 132 institutions serve as a proxy for the universe of schools that have been active over the last 10 to 12 years--that is, these schools have made at least one loan as an institutional lender over the course of the past decade.

The dominance of four-year private institutions is clear from the data on this universe of institutions. One hundred and two of the schools are four-year private schools. Of the remainder, 16 are proprietary, 12 are four-year public, and 2 are two-year private. Four-year private schools alone account for more than three quarters of the institutions in the universe; together with four-year public schools, the collegiate sector makes up close to 90 percent of the total. These data--which are in sharp contrast to the trends noted in the previous section on FISL lending--are summarized in Exhibit 3.

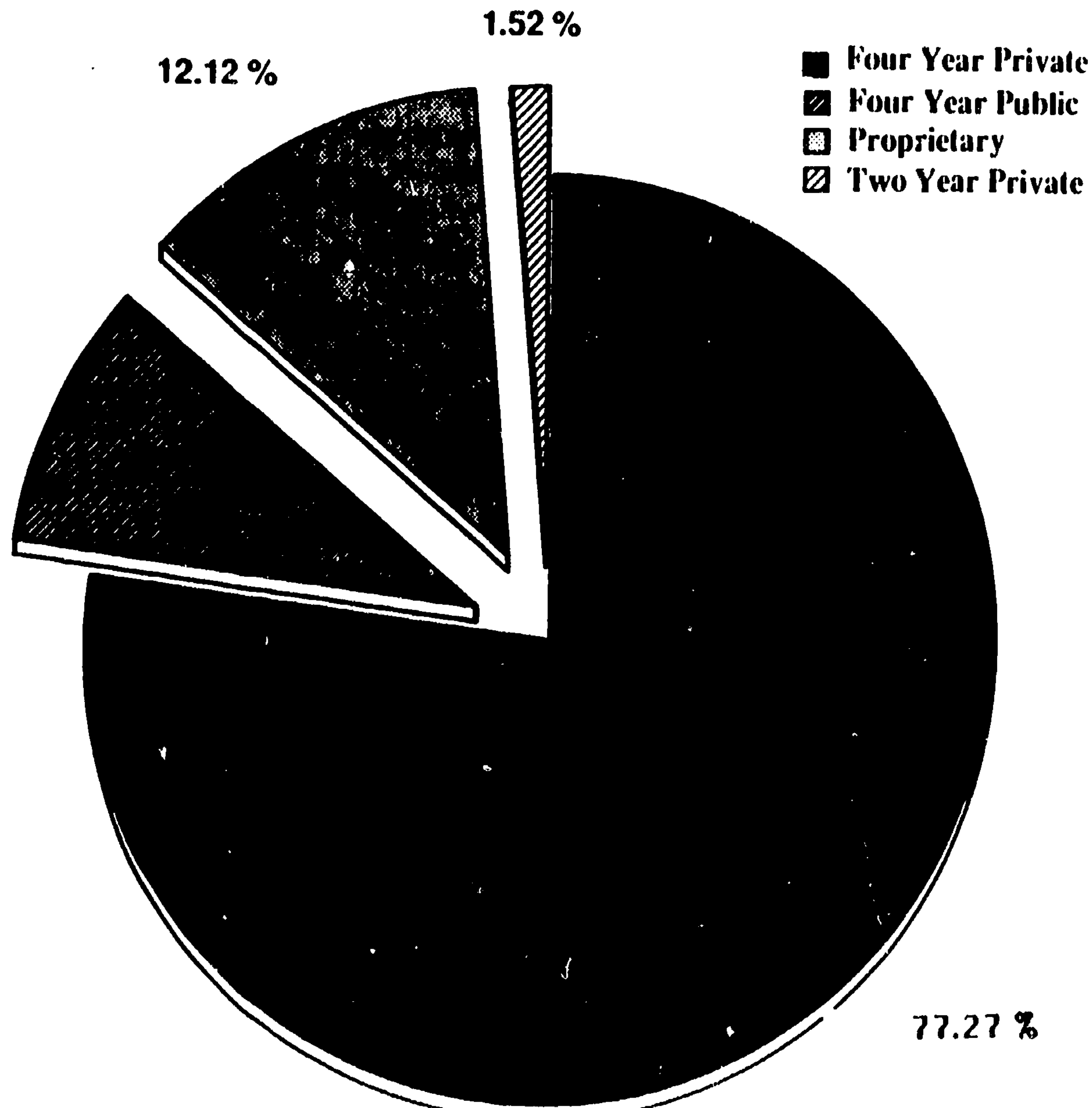
Geographically, 32 states are represented in this universe of school lenders. The four states with the largest number of school lenders (Indiana, Massachusetts, Ohio, and Pennsylvania) account for nearly one third of the total.

The prevalence of a small group of institutions in the school lending business over the last decade is demonstrated by examining data on dollars outstanding as of September 30, 1987. Among these 132 school lenders, only 15 had more than one million dollars outstanding. Four of these schools--Harvard, Northwestern, Princeton, and Yale Universities--accounted for close to $110 million of a total of $143 million outstanding for the universe. This means that four schools make up close to 75 percent of the total dollars outstanding. Harvard University alone has more dollars outstanding (approximately $80 million) than the rest of the universe of institutions combined (see Exhibit 4).

These data strongly suggest that school lending has played a comparatively minor role in the Stafford Program in the last decade. The 132 institution universe represents one percent of the nearly 13,000 lenders that have participated in Stafford Program lending in recent years. The $143 million outstanding represents an even smaller fraction of the total dollars outstanding in the program as of 1987. And the domination of lending activity by a select few institutions further demonstrates the limited impact school lending has had on institutions, students, and the program generally.

School lender activity has gradually declined in the last eight years--since the release of the 1979 regulations that included the sweeping changes brought on by the 1976 Education Amendments. There has been a sharp decline in the number of

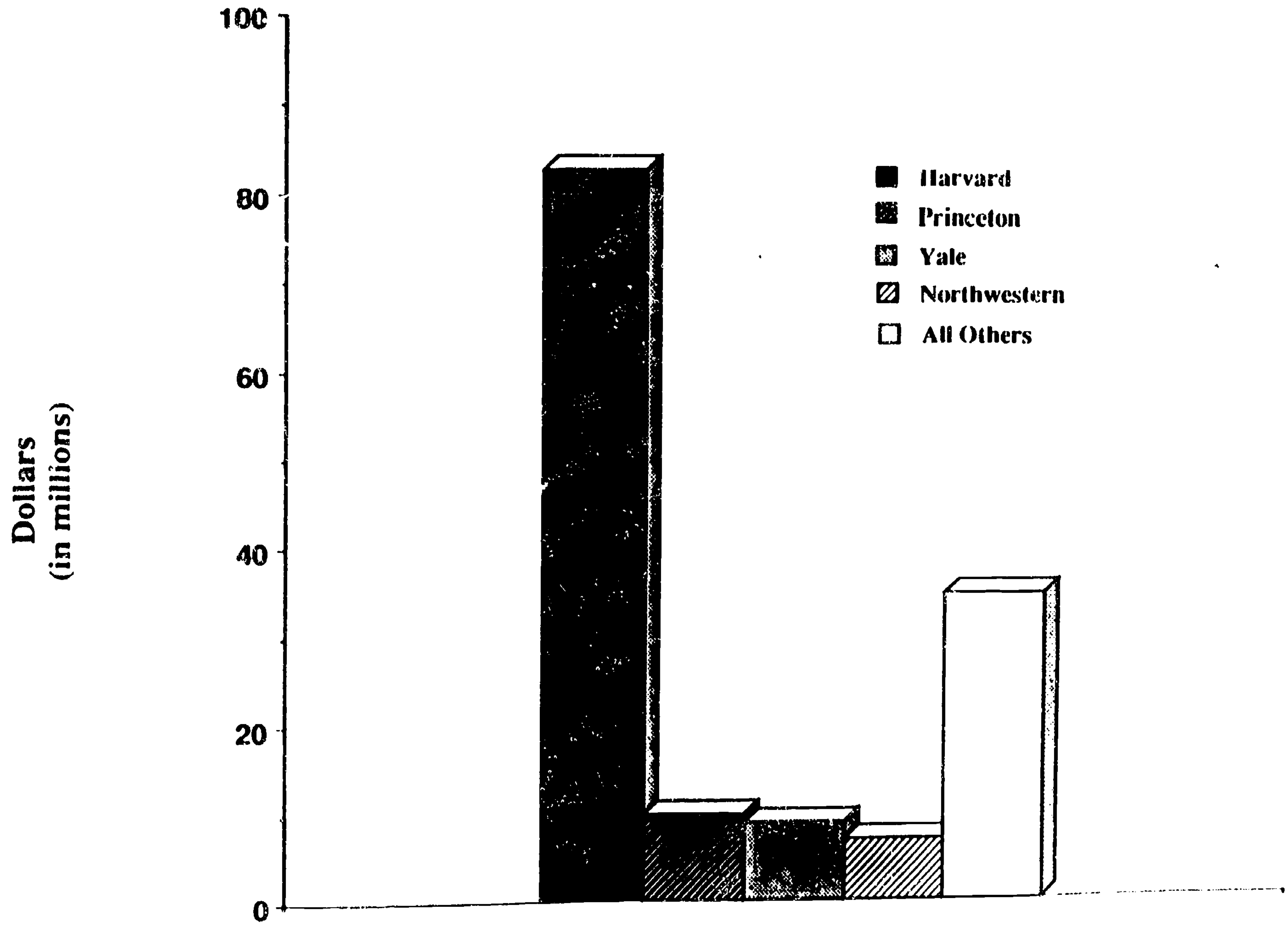
Exhibit 3
Institutional Lenders with Dollars Outstanding as of September 30, 1987, by Institutional Type



Source: Advisory Committee on Student Financial Assistance research

Exhibit 4

Total Dollars Outstanding as of September 30, 1987, by Institutional Lender



Source: Advisory Committee on Student Financial Assistance research

institutions serving as active lenders, with less than one third making loans to students in 1987 compared to 1979 (see Exhibit 5). The data on loan volume also show this decline in overall activity by school lenders, with a drop of more than one half over this time period.

The data on defaults show that institutional lenders have experienced a relatively low level of default in recent years. While defaults for school lenders in 1979 represented a measurable proportion of overall defaults in the program for that year (10.4 percent), by 1985 this figure had been reduced markedly. This is due in large part to the overwhelming majority of four-year institutions making loans in recent years, a sector that has experienced relatively few problems with defaults.

In summary, data on institutional lenders from 1976 through 1987 suggest that lending activity has sharply declined in recent years. Stafford school lending now occurs only at a few, mostly selective institutions of higher education, and those that do participate appear to have fairly low rates of default. The collective weight of significant regulatory and legislative restrictions, the growth in bank-based lending, and other factors have probably contributed to this downturn in school lender activity and its concentration in a small number of selective institutions.

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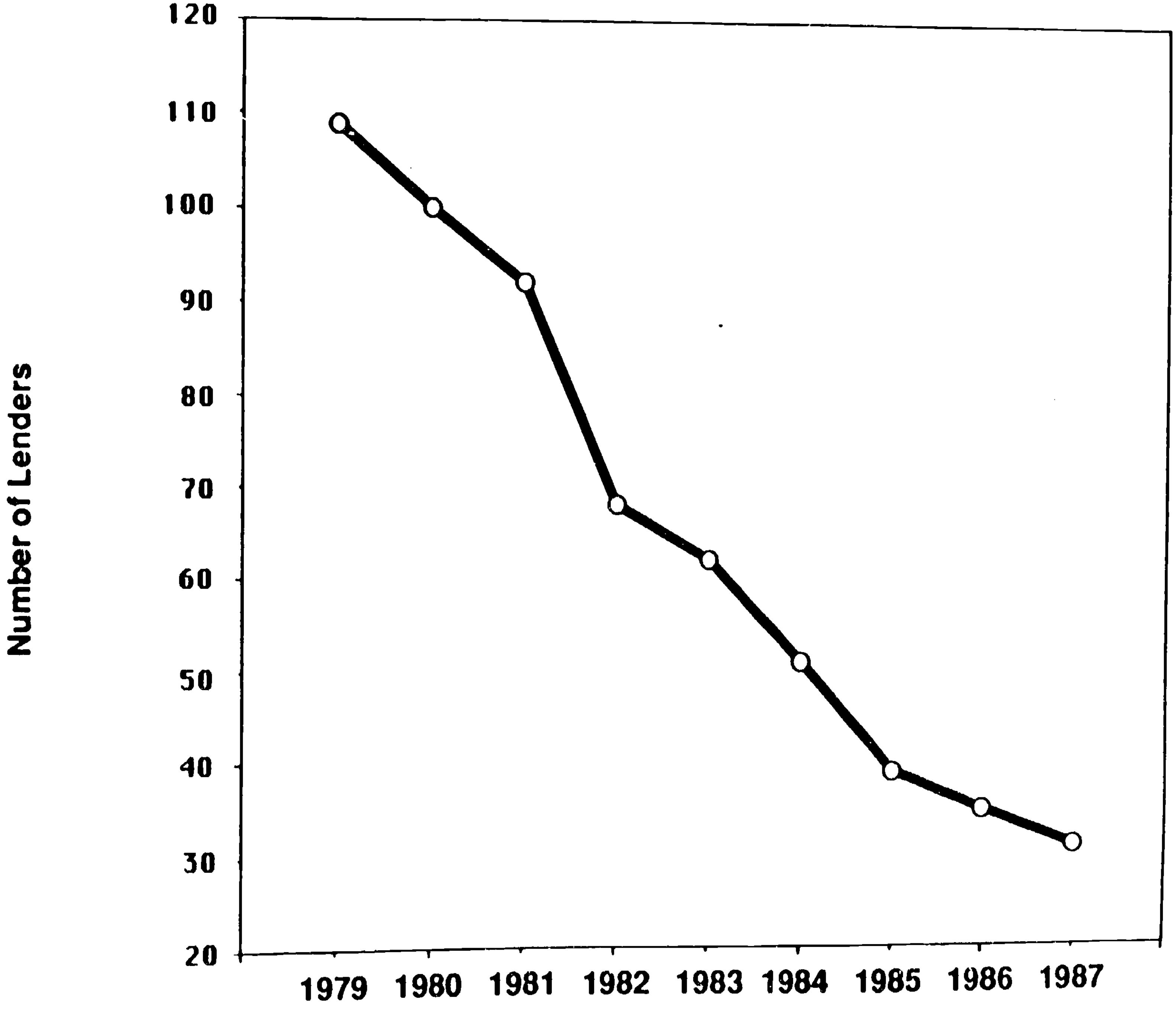
Exhibit 5
Number of Active Stafford Institutional Lenders



Source: Advisory Committee on Student Financial Assistance research

III. STUDY FINDINGS

The Introduction described the Advisory Committee's multifaceted approach to the study of institutional lending. Study components included a background paper, literature review, special analytic papers, postsecondary education community responses, case studies, and symposium. Findings from these components are summarized below.

Are Current Institutional Lending Criteria Relevant and Applicable?

Congress charged the Committee with examining the relevance and applicability of the current criteria. In addressing this charge, the Committee identified two distinct dimensions of the issue: the effect of current criteria on institutions; and the possible elimination of these criteria.

Several means were used to determine whether the current criteria have an effect on institutions. First, historical data were used to identify trends in lending to determine if the criteria appear to have had any effects on institutions. Data included both the number of lenders and the volume of institutional lending. Second, the elimination of the criteria in 1986 and the subsequent restoration in 1987 was analyzed. The study sought to determine whether there was increased interest in lending after the first change, and diminished interest after the second. Finally, recent institutional decision-making regarding the feasibility of lending under the current criteria was analyzed to determine the degree to which current restrictions affected institutional decisions.

The Committee found that current criteria have had a substantial effect on the participation of institutional lenders. Two distinct effects of the current criteria were demonstrated through the Committee's study activities. First, loan volume by institutional lenders and the total number of schools participating as lenders has declined precipitously in the past decade. The current criteria were imposed in 1976. The large number of schools that had entered the Stafford Program as lenders in the early 1970s and the problems this caused in terms of program administration for the Department of Education led to the introduction of current criteria into the law. These legislative criteria and the Department regulations which followed remained in place virtually unchanged until 1986. In that time period, the volume of loans made by institutional lenders dropped by more than 75 percent, and the number of active school lenders fell by two-thirds.

Second, the study activities disclosed that the current criteria have had an effect on the decisions of many schools interested in becoming Stafford institutional lenders.

The case studies and other study activities showed that many schools have explored entering the Stafford Program as lenders but opted against it because the criteria make lending unprofitable, even for large state university systems. The specific reasons for these decisions are examined in ensuing sections.

In addition, the Committee found it necessary to explore the advantages and disadvantages of institutional lending. During the 1986 reauthorization of the Higher Education Act, Congress essentially removed all restrictions on institutions becoming lenders. Institutions were no longer limited to making loans only to graduate students or to lending to no more than 50 percent of the undergraduate students at the institution. However, as a result of concerns expressed by the Senate during discussion of the 1987 Technical Amendments, the original provisions were restored. As part of its charge related to the institutional lender study, Congress asked the Advisory Committee to examine the relevance and applicability of current criteria.

The diverse components of the study of institutional lending could be applied toward an investigation of the advantages and disadvantages of institutional lending. Since Congress' charge to the Committee clearly requires a thorough study of the effects of eliminating current criteria, these effects can be measured by weighing their potential merits.

Current criteria have an effect on the volume of lending that takes place and on the distribution of institutional lending by institutional type. Access to loans, service to students, institutional revenues, default costs, and the effects on primary markets, secondary markets, and long term program stability were all found to be significant issues that required exploration in the study. These issues are addressed in this section and weighed in the final section of this report.

What Are The Potential Advantages of Eliminating The Criteria?

In structuring its approach to the study of institutional lending, the Committee assumed that there could be some advantages if current criteria were to be eliminated. However, these advantages appear to be marginal relative to the broader problems facing the Stafford Loan Program.

The Committee posited that there could be several potential advantages of eliminating the current criteria. The questions used to explore these potential advantages were:

- Is there any evidence to suggest that problems with access to loans currently exist or could develop in the near future?

- Can institutional lending be used to solve any potential problems with access?

- Can institutional lending improve service to student--and thereby lower default costs--and ease the administrative burden to institutions?

- Can institutional lending result in substantial revenues for institutions?

Is there any evidence to suggest that problems with access to loans currently exist or could develop in the near future?

The background paper, case studies, literature review, and symposium all produced evidence showing that students' access to loans was a significant problem for the program through the middle 1970s. The creation of Sallie Mae in the early 1970s, and the subsequent growth of a vibrant secondary market, helped to relieve capital availability pressures on commercial lenders. The Education Amendments of 1976, which revised the formula for special allowance payments to lenders and invoked a full in-school interest subsidy to students, also aided in removing barriers to loan access. With more than 13,000 commercial lenders and guaranty agencies now operating in all 50 states, the prior problems with access to loans generally have been eliminated. Nevertheless, the Committee used its case studies and the responses from community representatives to explore whether pockets of access problems exist.

The case studies were conducted between November, 1988, and February, 1989, and during that time none of the six states visited were experiencing problems with loan access. Still, discussion of previous problems with loan access did arise during case study interviews. For example, the state of Mississippi was chosen by the Committee as one of its case study sites because of that state's known access problems in recent history. Strict state banking laws that inhibited the flow of capital for student loans into Mississippi were cited by Mississippi Guaranteed Student Loan Agency (MGSLA) officials as a cause for circumscribed access in the 1970s. In response, Millsaps College became a lender, extending loans to its own students and those attending other private institutions in Mississippi. Phillips Colleges, a chain of proprietary schools, was also a lender during the period when loans were difficult to obtain.

In 1981, MGSLA and the Mississippi Higher Education Assistance Corporation (MHEAC) were established as the state's guarantor and secondary market, respectively, providing lenders with both insurance and liquidity. The existence of MGSLA and MHEAC, along with changes in Stafford loan legislation and Mississippi banking laws, have eliminated any access problems. And though Millsaps remains a direct lender on a limited basis, Phillips Colleges has ceased lending activity. According to its financial aid director, Millsaps maintains its status as a lender should access once again become a problem; Phillips Colleges would resume lending only under the same eventuality.

Students in Texas have also had problems obtaining Stafford loans in years past. In 1979, Rice university became a FISL lender to help ease these problems, using money from its endowment as the primary source of loan capital. However, with the establishment of the Texas Guaranteed Student Loan Corporation (TGSLC) in the early 1980s, and the creation of a series of regional secondary market agencies, universal loan access was realized in Texas. As a result, Rice phased out its institutional lending program. Like Millsaps College in Mississippi, Rice would renew lending activities only if loan access were threatened.

In all of the states consulted for this study, state and institutional officials spoke of an impending access problem. Students attending junior and community colleges and proprietary schools (and any other potentially high-default populations) face possible problems obtaining loans due to several factors: the recent problems observed in California with the California Student Loan Finance Corporation and United Education and Software (discussed later in this report); the increased emphasis on default reduction at the federal level; and proposals for more risk-sharing amongst institutions, lenders, and guaranty agencies. Documenting such potential access problems was not possible within the framework and time constraints of this study. However, study data suggest that institutional lending would be an unlikely means of addressing this problem.

If loan access was to become a more serious problem, the Committee found some evidence to suggest that reliance on guaranty agency lender of last resort authority could become problematic. The limited financial reserves of some agencies, and the mandated spend-down of agency reserves recently required by the U.S. Department of Education, indicate that agency capital reserves would be depleted under more serious loan access conditions. The inherent fiscal problems of proposals for increased risk-sharing (by guaranty agencies) may also represent a serious threat to program stability. Guaranty agency lender of last resort authority is discussed in more detail later in this section.

Can institutional lending be used to solve any potential problems with access?

The Committee investigated whether institutional lending might be used as a means for addressing possible future problems with access to loans. To test this notion, the Committee closely studied symposium comments and examined the views of the postsecondary education community in response to a directed set of research questions. Likewise, the Committee used the case studies and other study activities to review likely responses to loan access problems in the future.

For several reasons, the Committee found that eliminating current criteria would be an unlikely means for addressing possible future access problems. First, in seeking to act as lenders, institutions would be subject to the same market forces that produce this potential access problem. Thus institutions would be subject to regulatory requirements and strong financial disincentives that could drive commercial lenders from the program. Second, many institutions, particularly public institutions, are unlikely to have their own funds to capitalize a lending program. Further, commercial lenders would likely be willing to lend to only the most financially stable institutions. In the long term, institutional lenders that face losses on their loan portfolios (most experts agreed that such loans are not profitable; this is discussed in greater detail in the following section) could soon lose capital from banks. The Committee found that some forces that could create these access problems could also limit lending by many institutions.

Ironically, the Committee found some evidence to suggest that eliminating the current institutional lender criteria could have the unintended effect of reducing access in certain sectors of postsecondary education. For example, officials from Mississippi, California, and Texas spoke extensively about the potential adverse effects of institutional lending on loan access. Those interviewed at MGSLA, Millsaps College, Phillips Colleges, the California Student Aid Commission (CSAC), the University of California System, and TGSLC agreed that expanded institutional lending could lead to decreased access.

The primary cause of reduced access to loans, according to these state officials, would be concern for lender profit margins. Access to loans depends on the ability of lenders to maintain adequate profitability. According to the case studies and the responses from the community, profits for commercial lenders could be affected if many traditional institutions--especially selective schools--chose to become lenders. Because these schools represent students least inclined to default, commercial lenders could be left with relatively more risky--and thus more costly--loan portfolios. Without balanced loan portfolios, some commercial lenders would probably exit the program. Students who do not attend institutions that offer Stafford loans could either have limited access or no access to Stafford loans from commercial lenders.

Indeed, commercial lenders are already evaluating alternative uses for funds because these factors are cutting into profits, according to California officials. Therefore, eliminating the restrictions on institutional lending in an environment of high default rates, reduced special allowances, administrative complexity and liability, and proposed risk sharing could exacerbate problems of access because profits may be further reduced.

Many attendees of the symposium also suggested that institutional lending could aggravate--not improve--problems students may have obtaining Stafford loans. This is because of the mismatch between schools that would have easier access to capital (traditional four-year institutions with endowments) and those that would probably need to lend (other institutions, especially proprietary schools). Thus, the community views, case studies, and symposium generally concurred that traditional institutions could have greater access to loan capital than others, resulting in disparities in access between different institutions and among states.

The Committee found that a safeguard currently exists for those students who may be denied a loan by a commercial lender. This is the provision under section 435(d) which permits school lenders to make loans to undergraduate students who can establish that they were denied a loan by a commercial lender. This provision is currently used by some school lenders and appears to be effective given current conditions. However, the declining number of institutional lenders in operation in recent years, and the general ease of access to loans that has been observed, limits the extent to which this back-up system is currently utilized.

In any case, the Committee found no evidence to suggest that institutional lending could adequately or even marginally address future loan access problems. Institutions in which access problems are likely to occur would probably not be able to act as lenders. Thus, the possible negative effects that eliminating current criteria could have on access vitiates its possible advantages.

Can institutional lending improve service to students--and thereby lower default costs--and ease the administrative burden to institutions?

The Committee investigated whether institutional lending could improve service to students and ease the administrative burden of student aid administration to institutions. To explore this issue, the Committee focused on the case studies, community views, background report information regarding current institutional lender performance, and other study activities.

Many of the study components, and in particular the case studies and expert views expressed by symposium attendees, concluded that institutional lending could provide service benefits to students and could streamline administrative functions for institutions. Service to students could improve if current criteria were eliminated because there would be fewer entities for the student to contend with (at least at some types of institutions). For example, eliminating the criteria could allow institutions to manage financial aid packaging more effectively because they could coordinate all student aid and expedite loan certification. Loan counseling functions could also be handled more effectively by an institution which knows the student's needs and financial circumstances well.

From the perspective of administrative streamlining, the current proliferation of bank and guaranty agency forms, policies, and procedures makes the tasks of financial aid officers difficult and time consuming. A representative of Yale University noted during the symposium that institutional lending could improve service to students by assuring administrative standardization in the Stafford Loan Program. Currently, institutions with national student bodies must contend with many guaranty agencies and lenders whose policies, procedures, forms, and reporting requirements are at variance. The time needed to devote to these tasks leaves less time for personal contact with students, therefore reducing the level of service some students deserve. It appears, then, that expanded institutional lending would reduce these administrative burdens for those schools that become lenders, and students also would benefit.

The Committee also found substantial, albeit anecdotal, evidence which suggests that problems with loan servicing--activities involving notification of students and repayment after termination of matriculation--currently exist. These problems appear to be particularly pronounced for students whose loans have been sold to one or more secondary markets. For example, several institutional, guaranty agency, and secondary market officials identified cases during the site visits in which servicing, and in particular loan tracking, is inadequate. Individual student portfolios may be sold to more than one secondary market agency, leaving the borrower--and sometimes the institution--confused about who should receive payments, deferments, and general correspondence. Furthermore, some borrowers apparently have difficulty in finding out who holds the loan. Several institutions reported being unable to determine who holds a particular student's loan note. Consequently, students sometimes become technical defaulters when the loan paper is sold and the student is either not notified of the sale or becomes confused about who should receive payments.

The issue of whether institutional lending could lower overall Stafford default costs by improving service to students was also raised during the Committee's study. However, the Committee found no evidence to suggest that this actually would occur. The argument contending that significant savings in default costs could be achieved by eliminating the current criteria depends on two assumptions that the Committee determined to be unfounded. First, the low default rates experienced by current institutional lenders are due to administrative factors (holding loans to maturity, consolidation, and improved tracking). Second, these administrative factors would prevail among institutions who would enter the program. The Committee found no evidence to support these assumptions.

For example, the Committee found that there could be some savings in defaults at schools where default rates are already low--selective schools with national student bodies. These schools make up the majority of present-day institutional lenders and therefore account for the low levels of default observed in the Historical Context section. However, the various study tasks showed that it would be unlikely that these savings could occur at the majority of new lenders. This is because savings could be offset by the entrance of institutions with high default rates and an increase in volume at those schools.

Further, two currently active school lenders--Millsaps College and Harvard University--were visited during the case studies. Officials at these schools noted that institutional lending is both labor and capital intensive. These schools contend that the probability of default increases if a school becomes a lender without the proper personnel and financial resources. Therefore schools that might become institutional lenders out of necessity (in response to loan access problems) could have higher levels of default.

The Committee thus found that, under ideal circumstances, eliminating the current criteria for institutional lending could improve service to students and ease administrative problems. Nonetheless, there are reasons to believe that these ideal circumstances would be the exception rather than the rule. For instance, current law--and indeed experience with current institutional lenders--does not prevent a school from selling the loan paper just as commercial lenders do. Because capital availability for most schools would necessitate the use of secondary market services, students might not be any better served than is currently the case with commercial lenders. Thus institutional lending would not generally appear to be an answer to current loan servicing problems.

Can institutional lending result in substantial revenues for institutions?

In order to address this question, the Committee used a variety of techniques, including case studies, analyses of current institutional lender characteristics, and simulation models developed by current commercial lending institutions. The Committee also examined analyses--conducted by institutions in the wake of the elimination of current restrictions during the 1986 Reauthorization of the Higher Education Act--that examined school lending "profitability."

The Committee found that institutional lending can result in revenues for institutions, although only under the most favorable circumstances. Proponents of eliminating the current criteria suggest these revenues can be used to support needy students in the form of grants or other aid.

However, the Committee's analysis of school lender profitability found that profit margins for most school lenders are small and depend on several factors: the availability and cost of capital; the size and composition of the school's loan portfolio; and the individual loan size and per unit servicing cost. Also, as the case studies and symposium noted, the possibility that any revenues earned by an institution through its lending would be taxable is an issue yet to be resolved. The chances of an institutional lender producing significant revenues would therefore appear to be minimal and depend on many uncontrollable factors.

Data gathered through the case studies and symposium demonstrated that most schools would have difficulty generating meaningful revenues from institutional lending. Schools with low tuition, short programs of study, and above-average rates of default could have several insurmountable barriers to profitable participation as lenders. Schools that used endowment funds for loan capital, and who also sold their loans to a secondary market at par (and had a large loan portfolio to achieve economies of scale), could generate reasonable revenues. The number of schools that could meet these conditions appear to be quite small, according to all available evidence.

Using the case studies to illustrate, the Committee found that the University of California (UC) system--one of the nation's largest--conducted a feasibility study of institutional lending to graduate students. It concluded that, over a ten-year period, Stafford lending would provide enough revenues to fund other financial aid programs. However, if the capital used to make the loans was borrowed, extending loans would be unprofitable. The inability of a large state system such as the UC system to conclusively demonstrate that an adequate profit could be made in a reasonable period of time indicates that excess revenues for most schools probably would be nonexistent.

Similarly, guaranty agency officials in California, Massachusetts, Mississippi, Pennsylvania, and Texas stated in the case studies that there is little or no profit for institutions who engage in institutional lending under less than optimal circumstances. Aside from the availability of capital, cost of capital, and servicing costs, profits depend on lending volume in order to attain economies of scale in administering the program, including origination and servicing costs. These experts suggested that most schools would not be able to achieve the loan volume necessary to cover the attendant risks of lending and still generate excess revenues.

Further, some members of the community are troubled by the idea of using Stafford lending as a means for boosting institutional revenues. For example, some of the symposium and community responses cautioned against the use of profits for non-need-based student assistance purposes. Even proponents tended to argue in favor of institutional lending from an increased access perspective, anticipating major future dilemmas with loan access--not from an increased revenues perspective.

Inducements form another possible problem with using institutional lending to generate revenue. Title IV of the Higher Education Act prohibits lenders and guaranty agencies from offering or paying certain inducements in connection with Stafford loans. In addition, no inducements may be paid to a lender or other party to secure funds for a school to make loans or to induce a lender to make loans to or on behalf of students at a particular school. A violation of these provisions can result in the offender's disqualification from further program participation and the imposition of various other sanctions. The chance that such arrangements could be established is likely under any significant expansion of current institutional lending, as only a fairly small number of institutions would be capable of making loans from existing institutional funds.

The potential problems with these provisions for both institutional and commercial lenders are two-fold. First, the Committee found that several current and proposed arrangements between institutions and capital providers (usually commercial lenders or secondary market agencies) stipulate that loans made by the institution will be sold for a premium to a secondary market agency. Institutions could thereby be in the position of encouraging a student who may not need a loan to secure one for the sake of generating capital for future loans. This may be inconsistent with the intent of the law.

Second, both the institutional lender and the capital provider could lose authority to operate if points, premiums, or other inducements are offered to the educational institution to make its own loans as a lender. In circumstances where the institutional lender aggressively markets its own loan program, commercial lenders may effectively be shut out from doing business with any students attending that school. This could then result in legal action from the commercial lender and could further endanger the position of the institutional lender and the capital provider.

What Are The Potential Disadvantages Of Eliminating The Criteria?

The Advisory Committee assumed that there could be several disadvantages to eliminating current criteria related to institutional lenders--disadvantages that suggest the criteria probably cannot be eliminated without affecting the long term stability of the Stafford Program. The Committee asked the following questions to test this notion:

- Will institutional lending have negative effects on the primary market for loans?

  --If current criteria were eliminated, would many schools enter the program as institutional lenders?

  --Could commercial lender portfolios be negatively affected by more institutional lenders?

  --Could the elimination of current criteria increase concentration of commercial lending in a smaller number of lenders?

--Are there arrangements that might be established between primary market entities and school lenders?

- Will institutional lending have negative effects on the secondary market for loans?

  --Are there arrangements that might be established between secondary market entities and institutional lenders?

  --Could the elimination of current criteria increase concentration in large secondary market agencies and banks?

  --Could the elimination of current criteria cause instabilities for guaranty agencies?

  --What effects would institutional lending have on lender of last resort programs at guaranty agencies?

The Committee found that the most significant disadvantage of eliminating the criteria would be the heightened instability it could cause for the Stafford Program. This instability, occurring at both the primary market and secondary market level, could undermine the incentives for private capital sources to participate in the program, thereby diminishing the current high level of access to loans enjoyed by most students and institutions. Given the importance the program now plays in postsecondary financing, this would represent a marked erosion in the foundation of the program and Federal student assistance in general.

Will institutional lending have negative effects on the primary market for loans?

The Advisory Committee assessed whether eliminating the current criteria could have negative effects on the primary market for loans. To investigate this issue, the Committee relied on the case studies, community views, and the symposium, all of which solicited the opinions of lending representatives and others familiar with the primary student loan market.

All of the study components produced evidence suggesting that any increase in institutional lending resulting from the elimination of current criteria could have a significant negative impact on the primary market for loans. Study data indicate that even modest increases in the participation of institutions as Stafford lenders could have interdependent effects throughout the Stafford loan system that ultimately would weaken the program as a result of heightened instability. The effects would likely occur because increased participation in lending would directly affect the composition and quality of lender portfolios, indirectly affect the access to loans for students attending certain institutions, indirectly cause other institutions to become lenders, and result in the expansion of special arrangements between institutional lenders and commercial lenders or secondary markets that would further distort the distribution of loans in the secondary market.

While the data gathered were not conclusive, a considerable amount of evidence compiled in the Advisory Committee's study suggests that a moderate number of institutions would initially react to the elimination of current restrictions by considering becoming school lenders, but that more would follow. For example, several symposium participants, including educational institution representatives who currently are not Stafford lenders, indicated that the initial foray into unrestricted institutional lending would probably come from selective institutions with national student bodies. These schools, most of which have substantial endowments, would probably react to the apparent revenue potential of institutional lending (noted earlier) and the possible improvement in service to students by becoming active institutional lenders. Similar sentiments were expressed in some of the community responses received by the Committee.

One immediate consequence this could have, according to lenders and guaranty agencies, is that commercial lender portfolios would rapidly decline in quality. As the special analysis of profitability (and banking representatives participating in the symposium) noted, commercial lenders require a certain level of low-risk loans in their portfolios to ensure an adequate profit. This, in turn, assures their continued participation as Stafford lenders. An influx of selective institutions--where the low-risk students are typically concentrated--into institutional lending could result in much of the low-risk loan paper being siphoned out of commercial lender portfolios and into institutional lender portfolios. As a result of this "creaming" effect, commercial lenders would be left with higher-risk loans, which typically have higher servicing costs that reduce profits. Lower profits would direct lenders to explore other investments and could therefore mean the loss of some commercial lenders from the program. Access to loans, in turn, would be impaired.

For example, symposium participants demonstrated that the most profitable loans have longer statistical lives, higher amounts, and lower delinquencies. These loans are normally associated with students who attend traditional colleges and graduate schools--the schools most likely to become institutional lenders. Should these institutions skim this high quality paper, commercial lenders would be left with the unprofitable, costly paper characterized by shorter statistical lives, smaller balances, and more defaults. Lenders would either leave the program or make loans more selectively by excluding educational sectors with high default rates.

Increased participation in lending by selective schools could have further consequences. One is that another wave of institutional lending could follow the initial foray by selective schools. These other schools could become concerned about diminished access and strive to compete with, and emulate, the nation's most prominent institutions by becoming active lenders. This point was made by institutional representatives who responded to the Committee's call for community responses. Some expressed considerable opposition to the elimination of current criteria (for many of the same reasons cited here), but conceded that the actual removal of restrictions would force their institutions to consider becoming lenders. Competition among institutions thus appears to be one potential by-product of eliminating the criteria. Further, most of the study components produced evidence indicating that four-year public and private institutions would become the most active lenders, though there was some belief that large proprietary institutions could also become involved.

If these modest to significant increases in institutional lending did occur, data available to the Committee suggest that at least some commercial lenders would leave the Stafford Program. Banks and credit unions that were relegated to making loans only to high risk students--those attending proprietary schools and community or junior colleges--would probably opt not to participate, according to all available evidence. A decline in the number of commercial lenders making Stafford loans could thereby lead to prominent areas of limited loan access for students, culminating in unknown instabilities for the program in general. The remaining loans made by commercial lenders would clearly be highly concentrated in fewer banks.

Concentration of loans in a small number of banks was already a concern for some of the case study subjects and symposium participants. According to the Department of Education, fewer than 50 (out of 13,000 total) lenders make about 40 percent of all Stafford loans to students. Actions taken by a comparatively small number of these banks could have an important impact on the program and the current high levels of access to loans enjoyed by most students. Increases in institutional lending, leading to losses in the ranks of commercial lenders, would presumably exacerbate this concentration, causing further potential problems with loan access.

Data suggest that increases in institutional lending would not necessarily lead to the wholesale removal of private capital sources from the program. The role of commercial lenders in Stafford lending could change from one where they provide capital to individual students into one where they offer lines of credit to institutional lenders with capital needs. Thus the role of banks in the program could change from active (dealing with student borrowers on an individual basis) to passive (providing capital to schools lenders, which in turn could be lent to students). Commercial lenders that participated aggressively in establishing these client arrangements would benefit directly from the elimination of current criteria.

The evidence gathered by the Committee supporting this notion was revealing. For example, one symposium participant described the financial services industry as in a state of flux, indicating that the lenders that persist in the Stafford Program will be the ones that "become the most creative in arranging financial services for institutions and families." Another participant indicated that most schools, with the exception of heavily endowed institutions, would have difficulty selling their Stafford loans. Similarly, officials interviewed for the case studies in Mississippi and California projected that, increasingly, institutions, banks, and secondary markets would formulate special arrangements if current restrictions were removed.

An important study finding relates to the existence of arrangements between capital providers and educational institutions. For example, Sallie Mae markets a program for institutions interested in becoming lenders that offers schools the financial and other benefits that accrue from lending to their students without the worries of loan servicing and other concerns. First Bank of Milwaukee prepared an extensive proposal for Marquette University when the University considered becoming a school lender between the time when the 1986 Reauthorization was passed and the 1987 Technical Amendments. And United Student Aid Funds currently has a program for institutions interested in becoming Stafford lenders that was described during the Symposium. These examples suggest that some financial institutions are already using creative approaches to market institutional lending.

These arrangements generally troubled symposium attendees, community respondents, and other study participants. Concern about these arrangements occurred on two fronts: reduced service, and the intent of the law. The benefits to institutions and students were questioned because of concerns about profitability and the likelihood that schools would sell the loan to a secondary market (thus limiting any conceivable service advantages that institutional lending could have over a commercial lending). For example, two of the active institutional lenders in the case studies sell their loans to secondary markets. One former lender did the same. Also, in its feasibility study, the UC system assumed that their Stafford loans would not be serviced by the institution. At the time the Pennsylvania case study was conducted, Pennsylvania State University said it would consider the option of selling its loans should the institution become a lender.

Further, several study participants expressed concern about these arrangements because of the possible circumvention of the intent of the law. As noted previously, Title IV of the Higher Education Act prohibits lenders and guaranty agencies from offering or paying certain inducements in connection with Stafford loans. In addition, no inducements may be paid to a lender or other party to secure funds for a school to make loans or to induce a lender to make loans to or on behalf of students at a particular school. The issue raised by study participants is that these arrangements

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could be interpreted as directing loans to a particular lender, since in most cases a lender (or secondary market agency) would be handling virtually all steps of the loan process for the institution.

If the current criteria were eliminated, arrangements between institutions and capital providers would be likely. The Committee found that enhanced revenues and competition could entice many schools into becoming Stafford lenders. Most of these schools would not have sufficient institutional capital to make loans, forcing them to turn to outside sources. Accordingly, arrangements between commercial lenders and institutional lenders could become commonplace, but would not afford students many of the potential benefits of institution-based loans.

Thus eliminating the current criteria could result in a restructuring of the loan system and a significant loss of control by the Federal government over the future of the Stafford Program. Currently Congress may make changes to program guidelines that directly affect lenders--changes to the special allowance or in-school interest subsidy, for example. However, if current institutional lender criteria were eliminated, institutional lenders would likely rely on commercial lenders and other financial institutions for capital, servicing, and other needs. With institutions acting as lenders and some commercial lenders acting as capital providers to institutions (instead of to students), a significant shift in the structure of the student loan system would occur. This, in effect, would remove lenders yet one more step from the Federal government, resulting in diminished Federal control over the program's future direction.

Will institutional lending have negative effects on the secondary market for loans?

The Committee developed assumptions which proposed that eliminating the current criteria could have negative effects on the secondary market for loans (defined here broadly as both agencies which deal with previously issued obligations, such as Sallie Mae, as well as guaranty agencies). To test these assumptions, large and small secondary markets were consulted during the case studies and symposium. In addition, a substantial number of the responses received from the postsecondary education community came from secondary market agencies. Guaranty agency officials from several states and other experts also were contacted through several of the study activities. This section focuses on secondary markets, guaranty agencies, and the guarantor lender of last resort function. The Committee assumed that the general effects of eliminating the criteria on both secondary market agencies and guarantors would be related.

Study data indicate that any meaningful increase in institutional lending resulting from the elimination of current criteria could have a significant, negative impact on the secondary market for loans that would be felt both in secondary market agencies and in guaranty agencies. Some of these effects on secondary markets would be similar to those on primary markets.

The Committee found that the biggest "winners" of eliminating current criteria could be large banks and national and regional secondary market agencies. Arrangements between some secondary market agencies and institutions would probably be as plausible as those between commercial lenders and institutions, as noted in the previous section. This would especially be true for these large financial entities. Because they have few problems finding access to low cost money to fuel their loan purchases, Sallie Mae, regional secondary market agencies, and large banks where student loans are concentrated appear to be the strongest contenders in the event current criteria were eliminated. Their market advantages, and their ability to provide full service arrangements for school lenders, would probably make them a formidable force under these conditions.

Sallie Mae's abilities provide a good example. In its current marketing efforts to institutions considering becoming lenders, Sallie Mae is offering to advance schools the capital to finance loan originations or purchases, provide schools with full administrative and operational support through its loan servicing center, and purchase schools' loans prior to each borrower's termination of matriculation. Schools may thus recycle funds from loan sales to meet new borrowing demands from the next group of students.

The community responses revealed another likely effect on secondary markets: a decrease in smaller, state level secondary market agency activity and a marked shift in the composition of holdings. State secondary market agencies, which serve the majority of student loan secondary market needs nationally, would have a distinct disadvantage in attempting to compete with larger secondary market agencies for institutional lender business. This is because larger secondary market agencies have access to lower cost funds, and can service large numbers of loans. For example, the concentration of loans held by Sallie Mae--currently more than 20 percent of all Stafford loans ever made--could be heightened by eliminating current criteria. Regional and state secondary market agencies also suggested that they might have difficulty competing with Sallie Mae because of its superior marketing abilities. If this were to happen, liquidity for some lenders would be reduced and could cause instabilities for the program in the form of decreased access to loans for some borrowers.

Eliminating the criteria also could result in a weakening of the guaranty agency structure, which is already under tremendous stress, because guaranty agencies would be subject to the same pressures as secondary market agencies. Study participants suggested that, as with the secondary market agencies, the gains made by large multi-state guarantors would come at the expense of smaller guarantors, reducing the size and altering the composition of portfolios. Such shifts could deplete reserves due to lower reinsurance provisions.

The current stresses on the guaranty agency structure also cannot be minimized. With guaranty agencies operating in all 50 states, multi-state guarantee arrangements by some agencies have increased competition and protected loan access for most students. However, the foundation of the loan guarantee system has been weakened--partly through rising default rates--and this weakness threatens to undermine access to loans. One more likely stress on guarantors is the proposal to limit the Federal guarantee to lenders to less than 100 percent, and to further constrain guaranty agencies from receiving the full 100 percent reinsurance on guarantees from the Federal government. Both commercial lenders and guaranty agency officials are concerned about the long term viability of the Federal guarantee and the repercussions these risk sharing proposals could have on loan access.

Another destabilizing factor recently developed in California: the large liability of a loan servicer (United Education and Software) to a secondary market holder (California Student Loan Finance Corporation). Because of servicing errors that may have violated due diligence requirements, the Federal guarantee on several hundred million dollars worth of loans has been jeopardized. Though the California secondary market agency has attempted to put as many borrowers as possible into active repayment, thus averting loss of principal, it and one or more lenders may have to absorb the full loss on the remainder. The liability is so large that many financial institutions are closely watching the developments in this situation, which is thereby causing ripple effects throughout the industry.

One direct result of this is that foreign letter of credit providers (which provide backing for the bonds issued to purchase the loans) have become much more cautious and have withdrawn their support in some cases. These foreign banks also have begun to request limits on the proportion of proprietary school paper held by either the secondary market agency or its guarantor. For example, Nellie Mae was recently offered letters of credit from various entities under the condition that few or no proprietary loans be purchased (in this instance, Nellie Mae rejected the offers because its tax exempt financing prohibits selective loan purchases). As a consequence, some secondary market agencies may become less willing to purchase proprietary school loans. Thus, as liquidity for this type of lending begins to dry up, the proprietary sector may begin to find it difficult to find lenders for their students, leading to further problems with loan access.

This situation is one of the reasons why guarantor lender of last resort provisions were developed. However, the evidence gathered by the Committee suggests that there are distinct limits to the abilities of guaranty agencies to serve this function if serious loan access problems were to occur. Guaranty agency representatives, for example, noted that guaranty agency reserves in some states have been diminished because of Federal spend-down requirements. Other state agencies have never had substantial reserves to cover more than a trace amount of lender of last resort loan volume. Therefore the ability of guaranty agencies to meet these loan access demands is probably constrained.

Case studies indicated that little support would exist for guaranty agencies acting as lenders of last resort in the event of serious access problems. Several guarantors expressed concern that if access becomes a problem for a large segment of the student population, particularly the proprietary sector, guaranty agencies would not have the financial means to meet the demand. Should agencies deplete their funds for last resort loans, the political climate in some states could preclude state legislators from appropriating monies for student loans, especially if the loans are earmarked for high default educational sectors.

The Committee found that some proponents of institutional lending have used this inability of primary and secondary markets to meet the possible future loan access needs of some students as evidence of the need to eliminate current criteria. And yet current institutional lender criteria already stipulate that schools may make Stafford loans to any student who can establish that they were denied a loan by a commercial lender. Safeguards already in place may therefore be adequate to address some future loan access problems, according to some symposium participants.

The practical problem with this approach, as case study and symposium participants noted, is that the schools which probably would have the most problems in times of crisis for loan access--proprietary schools, vocational technical schools, and, to a lesser extent, community and junior colleges--probably would have the least resources to make loans out of institutional funds. In the unlikely event that such schools could take advantage of these arrangements with banks or secondary markets, many of the potential servicing benefits they could provide as institutional lenders would be lost.

The Advisory Committee found the Stafford Program's current instabilities to be of high concern. As already noted, most of these problems are related to a portfolio imbalance for commercial lenders or secondary market agencies. Because few schools would be able to make loans from institutional funds, most would be compelled to borrow capital to make these loans. Diminished benefits in servicing and other problems that could follow suggest that eliminating current criteria would only exacerbate potential program instability.

The potential effects that removal of current restrictions on institutional lending could have on primary and secondary markets led the Committee to conclude that long term stability for the program may be negatively affected by criteria elimination. The long range, multiplicative problems that could result from even modest increases in institutional lending--a very plausible scenario--could have harmful effects on a program already encumbered by problems with no clear solutions. Thus the potential disadvantages of eliminating current criteria could be extensive and severe for both the program and the students who rely on Stafford loans as a major element in the postsecondary education financing equation.

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IV. CONCLUSION

The previous section summarized the findings of the major study activities. This section weighs the advantages and disadvantages of eliminating current criteria and explores the need for further restrictions on institutional lender eligibility. Issues of potential interest to the Congress requiring further study are also examined.

Weighing Advantages And Disadvantages

In assessing the findings of this study, the Committee sought to weigh the potential advantages and disadvantages of eliminating current criteria. Two qualitative dimensions were of particular importance: the magnitude of the effect, and its scope. Exhibit 6 presents a summary of effects. It shows that advantages are minimal to modest, and restricted almost exclusively to selective institutions. Disadvantages, on the other hand, were found to be modest to significant, and mostly program-wide. The overall conclusion is that the advantages of eliminating current criteria are far outweighed in both magnitude and scope by the disadvantages.

Access

Perhaps the most important potential advantage of expanded institutional lending is improved access to loans for students and parents. However, the study found that access to loans was not a widespread problem in the current system. Institutions of all types and control reported adequate access to loans. The only exception was a growing realization that high defaults, primarily in the proprietary sector, are rapidly leading to pockets of access problems. Nevertheless, the Committee was not persuaded that allowing institutions with high risk students and educational programs to lend is the answer to this problem. Indeed, more than one participant in the study suggested that this policy would reduce access to loans in this sector in the long run. The study concluded that possible improvements in access to loans would be minimal and restricted only to selective institutions that currently have no problems with loan access.

Administrative Convenience

There is no doubt that expanded institutional lending would lead to administrative efficiencies for new institutional lenders, or for current institutional lenders who expand lending. The specific advantages would be in the areas of coordination of financial aid packaging, and standardization and streamlining of policies, procedures, forms and reporting requirements. These benefits could be program-wide if large numbers of institutions became new lenders.

EXHIBIT 6

Eliminating Current Criteria

Summary of Effects

Potential Advantages	Magnitude	Scope
• Improved access	Minimal	Selective schools
• Administrative convenience	Modest	Program-wide
• Service to students	Modest	Selective schools
• Revenue for institutions	Minimal-modest	Selective schools
• Lowered defaults	Minimal	Selective schools

Potential Disadvantages	Magnitude	Scope
• "Creaming" of loans	Modest-significant	Program-wide
• Loss of lenders	Modest-significant	Program-wide
• Loss of secondary markets	Modest-significant	Program-wide
• Proliferation of "arrangements"	Significant	Selective schools
• Weakened guaranty structure	Modest-significant	Program-wide

Service to Students

There is also no doubt that expanded institutional lending would improve service to students primarily in the areas of information, counseling, and loan consolidation. However, unlike administrative convenience to institutions, the most important specific benefit--loan consolidation--accrues to students only if schools hold loans to maturity or sell loans to banks or secondary markets that use a single servicer. This is a likely outcome only at selective institutions with national student bodies, whose loans are much sought after by large lenders and secondary market agencies. Therefore, the study concludes that benefits in the form of improved service to students would be modest and restricted primarily to selective institutions.

Revenue for Institutions

Perhaps the most intriguing potential advantage of expanded institutional lending is that it could be a new revenue source for institutions to help defray the rising cost of education. However, only under the most ideal conditions would a lending program generate significant revenues for institutions. Institutions with large endowments and low-risk students currently generate revenue for other uses. Even under special arrangements with large lenders and secondary market agencies, selective schools without capital of their own would reap only modest revenues. The average institution would see only a marginal return that could be easily eroded by small shifts in the cost of capital or servicing. The study concludes that revenues to institutions derived from expanded lending would be minimal at the vast majority of schools and only modest at selective ones.

Lowered Defaults

With default costs rising rapidly in certain sectors, it would be especially heartening to find that expanded institutional lending lowered such costs. However, in order to properly assess the impact of institutional lending on defaults, other important factors must be held constant--namely characteristics of students, institutions, and education programs. Only in the area of "technical" defaults resulting from administrative factors will institutional lending lead to reductions. It seems plausible that increased institutional lending at selective schools could slightly reduce default rates that are already low. However, to secure such a decrease at the average institution, it must be assured that sufficient administrative expertise would exist in these schools as well. The Committee was persuaded that the arrangements between schools and lenders or secondary market agencies that would follow elimination of the criteria would not result in programs where loans are held to maturity and serviced by a single entity. The study concludes that benefits in the form of lowered defaults would be minimal, restricted to selective schools, and easily eroded by higher defaults for new lenders with high risk students and programs.

Creaming of Loans

An immediate consequence of a substantial increase in institutional lending would be a rapid decline in the quality of lender portfolios. The study found that the likelihood of entrance and expansion primarily by selective schools almost guarantees such an effect. The Committee found it very unlikely that institutional lending would increase proportionally by sector, leaving portfolio quality relatively unchanged. The study thus concludes that creaming of loans would be modest to significant, with program-wide effects.

Loss of Lenders

In a program already beset by high default costs, uncertainty about special allowance, administrative complexity, and proposed risk-sharing, the study found that significant declines in anticipated profitability due to portfolio shifts could convince some commercial lenders to leave the program. The loss of lenders would likely be modest, given the existing concentration of lending, but the effects would be program-wide.

Loss of Secondary Markets

Since most of the "creamed" high quality loans would find their way to the largest lenders and secondary market agencies through special arrangements with institutions, other secondary market agencies could suffer much the same fate as commercial lenders who do not actively and successfully compete for the best loans. The study concludes that the impact could be modest to significant and program-wide--especially in smaller, state-level secondary market agencies.

Proliferation of Arrangements

The Committee is persuaded that the vision of the average institution implementing a successful model loan program and reaping significant revenues is highly unrealistic. Rather, increased institutional lending is most likely to lead to a wide array of special arrangements whereby large lenders or secondary market agencies provide short-term capital in return for the best loans. Not generally available to institutions where resources are most limited and loan access may be a problem, these arrangements were viewed by the Committee as revenue-driven, and of questionable policy merit. The study concludes that such arrangements might increase significantly at schools with low-risk students and programs.

Weakened Guaranty Structure

The Committee found that all of the negative effects above could exacerbate problems in the loan guaranty system. Proposals to further constrain guaranty agencies from receiving the full 100 percent reinsurance on guarantees from the Federal government have already raised concerns about the long-term viability of the Federal guarantee. If expanded institutional lending leads to loss of private capital and access problems where none now exist, some of the agencies will be taxed beyond their resources. The study concludes that this risk is unacceptably high, and has program-wide implications.

The Need For Further Restrictions

As part of the charge to the Committee, Congress directed an examination of three potential restrictions on current institutional lending in Stafford:

- use of the Perkins default rates or other institutional criteria to determine institutional participation;
- restrictions on the use of special allowance or other payments toward need-based aid;
- requirements to hold loans to graduation or termination of matriculation.

The Committee's findings on these three issues are closely related to and dependent upon its finding that current criteria are both relevant and applicable, and that their elimination is likely to produce a range of undesirable outcomes. In this context, the Committee found that additional restrictions are unwarranted for the following reasons:

- current criteria effectively limit institutional lending to a relatively small number of selective institutions with low default rates;
- revenue accruing to these programs are modest at best and are used primarily to defray administrative costs related to the Stafford Program;

- currently, loans are made predominantly to graduate students and little benefit would be provided by requirements to hold to graduation or termination of matriculation.

However, in the event that current restrictions were eliminated or relaxed, causing a change in the number and mix of lenders and loans, new criteria such as these would be required to minimize the effects predicted by this study. Also, in the event that serious loan access problems at proprietary schools or in other sectors caused increases in the number of such lenders, consideration of these and other restrictions would be appropriate. In any case, the use of Perkins default rates as a future criterion for participation as a Stafford lender should be avoided because of the considerable differences between the programs and administrative requirements, the implications of assignment for default rates, and the effect of capital contributions on default rates.

Issues For Further Study

The Committee's study of institutional lending uncovered several indirect findings which are issues worthy of further consideration. These issues may be important to Congress as it explores legislative planning in this area.

One important issue is the appropriateness of the arrangements which currently exist between institutions and commercial lenders or secondary market agencies. The growth in the marketing of these programs by lenders and secondary market agencies suggests that their popularity may be increasing. It may be appropriate to further review these arrangements and compare them with Congressional intent in the area of inducements, since some schools may become institutional lenders under current arrangements without providing capital for loans or holding the loans beyond origination.

Second, student access to loans, particularly at some future time in which guaranty agency lender of last resort authority may be relied upon as an important element in the loan process, is another important issue for further study. While students' access to loans was not found to be a general problem now, pockets of access problems are emerging, particularly in the proprietary sector. Adequacy of the current guaranty agency lender of last resort structure should be carefully reviewed and reexamined in light of these potential future concerns with loan access.

Third, current loan servicing problems also need to be carefully studied. Throughout the study the Committee received reports of students confused about who or when to repay. This may be contributing to the reported increase in incidences of technical defaults. Servicing problems must be addressed to protect the integrity of the program in the eyes of those it is intended to assist--students. One possible method for improving service to students would be to make the National Student Loan Data System operational.

Finally, no examination of the Stafford Program would be complete without emphasizing the paramount importance of reducing student loan defaults. Defaults are clearly the main source of current and future instabilities in the program. This study of institutional lending was thus inextricably linked with the concerns and problems with defaults. The reasons for loan default, and reasonable methods for limiting their incidence, should continue to be the central focus of future refinements to the program. Innovative means must be found to reconcile the competing objectives of reducing default, ensuring access to loans and other aid, and improving program management.

APPENDIX A

Members of the Advisory Committee on Student Financial Assistance

Name/address	Term of Appointment
Stephen C. Biklen Vice President Citibank 99 Garnsey Road Pittsford, New York 14534	5/9/88 - 9/30/89
Raymond M. Burse President Kentucky State University Frankfort, Kentucky 40601	10/1/87 - 9/30/89
James R. Craig Director of Financial Aid Services Montana State University Room 135, SUB Bozeman, Montana 59717 (Chairman)	10/1/87 - 9/30/90
Edward M. Elmendorf Vice President for Governmental Relations American Association of State Colleges and Universities One Dupont Circle, N.W., Suite 700 Washington, D.C. 20036	3/7/89 - 9/30/91
James L. Flippin Assistant Commissioner for Student Financiai Aid and Director Mississippi Guaranteed Student Loan Agency 3825 Ridgewood Jackson, Mississippi 39205	10/1/87 - 9/30/91

Members of the Advisory Committee (continued)

Robert V. Iosue President York College of Pennsylvania York, Pennsylvania 17405-3426	10/1/87 - 9/30/89
A. Dallas Martin Jr. President National Association of Student Financial Aid Administrators 1920 L Street, N.W., Suite 200 Washington, D.C. 20036	10/1/87 - 9/30/90
Joseph L. McCormick Executive Director Texas Guaranteed Student Loan Corporation P.O. Box 15996 Austin, Texas 78761	10/1/87 - 9/30/91
John Raisian Associate Director and Senior Research Fellow The Hoover Institution Stanford University Stanford, California 94305-6010	10/1/87 - 9/30/89
Linus Wright Paul R. Ray and Co., Inc. 2170 North Tower Plaza of the Americas 700 North Pearl Street Dallas, Texas 75201	3/7/89 - 9/30/90

APPENDIX B

Participants in the Advisory Committee's Symposium on Institutional Lending
March 13, 1989, Dirksen Senate Office Building, Washington, DC

William Banks*
Vice President
Chemical Bank

Larry Basserman
Vice President
Crestar Bank

David Baumann
Reporter
Education Daily

Kelly Beenen
Higher Education
Assistance Foundation

Ernst Benjamin
General Secretary
American Association of University
Professors

Stephen Biklen*
Vice President
Citibank

Stephen Blair
Executive Director
National Association of Trade and
Technical Schools

Ruth Beer Bletzinger
Consultant

Sharon Bob
Clohan & Dean

Susan Boren
Congressional Research Service
Library of Congress

Theodore Bracken
Director, Federal Relations
Consortium on Financing Higher Education

Thomas Butts
Office of Government Relations
University of Michigan

Mary Jane Calais
Director of Public Policy and Management
Programs
National Association of College and
University Business Officers

Eugene G. Cattie
Executive Director
Virginia Educational Loan Authority

* Served as a panelist

Symposium Participants (continued)

Anne Cherry
Deputy Press Secretary
Subcommittee on Education,
Arts and Humanities
United States Senate

Randy Cooper
Special Assistant
Office of the Deputy Assistant Secretary
U.S. Department of Education

James R. Craig
Chairman, Advisory Committee on Student
Financial Assistance
Director of Financial Aid Services
Montana State University

Winfield Crigler
William & Jensen

Jerry Davis
Director of Research & Policy Analysis
Pennsylvania Higher Education
Assistance Agency

John Dean*
Attorney
Clohan & Dean

Roberta B. Dunn
Education Policy Director
Committee on Labor and Human Resources
United States Senate

Edward Elmendorf
Vice President
American Association of State
Colleges and Universities

Sarah Flanagan
Professional Staff
Subcommittee on Education, Arts
and Humanities
United States Senate

Brian Fitzgerald*
Staff Director
Advisory Committee on Student
Financial Assistance

James Flippin*
Assistant Commissioner for Student
Financial Aid and Director
Mississippi Guaranteed Student Loan
Agency

Robert Fomer
Director
Colorado Student Loan Program

Ellen Frishberg
Director of Student Aid Policy
National Association of Independent
Colleges and Universities

Jean Frohlicher
Executive Director
National Council of Higher
Education Loan Programs, Inc.

Allicia Fryer
Contractor Support Staff
CROSSPATHS Management Systems, Inc.

William Gainer
Director
Human Resources Division
General Accounting Office

* Served as a panelist

Dennis L. Garvine
Banking Officer
Mellon Bank

Larry Gladieux
Executive Officer
Washington Office
The College Board

Elaine T. Glover
Consultant
CROSSPATHS Management Systems, Inc.

Bill Goggin
Staff Consultant
Advisory Committee on Student Financial Assistance

Hope Gray
Staff Assistant
Advisory Committee on Student Financial Assistance

Robert Hahn
Director of Student Financial Aid
University of Akron

Janet Hansen
Director for Policy Analysis
Washington Office
The College Board

Richard Hasting
Vice President
Career, Inc.

Lisa Hastye
Staff Secretary
Advisory Committee on Student Financial Assistance

Arthur Hauptman*
Consultant
American Council on Education

Marilyn C. Jaeger*
Director for Financial Aid and Loan Collection
University of California

Bob James
Director of Student Financial Services
ITT Educational Services

John F. Jennings
Counsel
Committee on Education and Labor
U.S. House of Representatives

Samuel M. Kipp, III*
Executive Director
California Student Aid Commission

Sharon Kirksey
Contractor Support Staff
CROSSPATHS Management Systems, Inc.

Michael Lance
Education Assistant
Subcommittee on Postsecondary Education
U.S. House of Representatives

* Served as a panelist

ERIC

Chris Largar
Senior Program Manager
National Association of College and
University Business Officers

Thomas Linney
Vice President
Council of Graduate Schools

Lawrence Lawson
Government Relations
National Computer Systems

A. Dallas Martin*
President
National Association of Student
Financial Aid Administrators

Maryln McAdam
Consultant
Tri-S, Inc.

Michael McShane
Manager of Government Relations
National Computer Systems

Frank Mensel
Vice President of Federal Relations
American Association of Community
and Junior Colleges

Jamie Merisotis
Consultant

Scott Miller
Student Loan Marketing Association

William Moran
Director of Policy and Program
Development
U.S. Department of Education

Charles Morris
Consumer Finance Officer
First Pennsylvania Bank

Daniel Morrissey
Program Analyst
Division of Postsecondary Education
U.S. Department of Education

Francis C. Nassetta
Vice President
CROSSPATHS Management Systems, Inc.

Dewey L. Newman
Deputy Assistant Secretary for Student
Financial Assistance
U.S. Department of Education

Roy Nicholson*
President
United Student Aid Funds, Inc.

Kenneth Ostberg
Director of Financial Aid
Georgetown University

Larry Oxendine
Deputy Director
Division of Policy and Program
Development
U.S. Department of Education

* Served as a panelist

Symposium Participants (continued)

Lawrence O'Toole*
President
The New England Education Loan
Marketing Corporation

Nicki Psyllas
Research Writer
Office of Representative Gaydos
Subcommittee on Postsecondary
Education
U.S. House of Representatives

Marissa Quinn
Staff Assistant
Subcommittee on Education, Arts
and Humanities
United States Senate

Schuyker Rainey
Legislative Assistant
Subcommittee on Postsecondary
Education
U.S. House of Representatives

Morgan Paley Reed
Consultant

Kenneth Reeher
Executive Director
Pennsylvania Higher Education
Assistance Agency

Phillip R. Rever
President
Higher Education Loan Program
Washington, Inc.

Vincent Roig*
Executive Director
Arizona Education Loan Marketing
Corporation

Donald Routh
Director of University Financial Aid
Yale University

Robin Sampson
Staff Consultant
Advisory Committee on Student
Financial Assistance

Nancy Sinsabaugh
Director of Student Financial Services
Harvard University

Patricia Smith
Director, Legislative Analysis
American Council on Education

James Stanley
Vice President of Administration
Phillips College

Patty Sullivan
Legislative Associate
Subcommittee on Postsecondary
Education
U.S. House of Representatives

Taige Thornton*
Vice President
First Bank System

Burke Tracey
Executive Director
Coalition of Higher Education
Assistance Organization

* Served as a panelist

Symposium Participants (continued)

Allen Watson
Executive Vice President
American Association of State Colleges and Universities

Father John Whalen
President
University Support Services

Robin Wilson
Reporter
Chronicle of Higher Education

Jennifer Wingard
Director
National Association of State Universities and Land-Grant Colleges

Jack Woodward
Director of Financial Aid
Millsaps College

Lawrence Zaglaniczny
Minority Senior Legislative Associate
Committee on Education and Labor
S. House of Representatives

APPENDIX C

Case Study Participants

California

Vince de Anda
Assistant Director of Financial Aid
University of California at Berkeley

Richard Black
Director of Financial Aid
University of California at Berkeley

Nancy Coolidge
Senior Analyst
Office of Financial Aid and
Loan Collections
University of California

Alice C. Cox
Assistant Vice President
Student Academic Services
University of California

Marilyn Jaeger
Director of Financial Aid And
Loan Collections
University of California

Kate Jeffrey
Assistant Director
Office of Financial Aid And
Loan Collections
University of California

Samuel M. Kipp
Executive Director
California Student Aid Commission

Jayne Shatz
Senior Analyst
Office of Financial Aid and
Loan Collections
University of California

Tamra Suslow-Ortiz
Senior Analyst
Office of Financial Aid and
Loan Collections
University of California

Case Study Participants (continued)

Illinois

Steve Bellin
Director of Financial Aid
Roosevelt University
Illinois State Scholarship Commission

Paul Eber
Rules Coordinator
Illinois State Scholarship Commission

Michael Kocelko
Bursar
The University of Chicago

Alicia Reyes
Director of College Financial Aid
The University of Chicago

Allen Sanderson
Associate Provost
The University of Chicago

Tom Breyer
Director
Illinois Opportunity Program

Cindy Kephart
Director of Graduate Financial Aid
The University of Chicago

Larry Matejka
Executive Director
Illinois State Scholarship Commission

Gary Rieman
Director
Illinois State Scholarship Commission

Massachusetts

Kent Condon
Vice President for Finance
Office of Financial Affairs
Boston University

Elizabeth Bauer Hicks
Assistant Dean of
Admissions and Financial Aid
Harvard and Radcliffe Colleges
Harvard University

Joseph M. Cronin
President
Massachusetts Higher Education
Assistance Corporation

Lawrence O'Toole
President
The New England Education Loan
Marketing Corporation

Case Study Participants (continued)

(Massachusetts, continued)

Nancy Sinsabaugh
Director of Student Financial Services
Office of Financial Systems
Harvard University

Judy B. Warren
Director of Finance and Accounting
Harvard University

Sara Stott
Vice President for Operations
Massachusetts Higher Education
Assistance Corporation

Beverly Wilson
Director of Lender and School
Relations
Massachusetts Higher Education
Assistance Corporation

Mississippi

Thomas Larry Blankenship
Associate Director
Mississippi Guaranteed Student
Loan Agency

George Harmon
President
Millsaps College

Jim Rhodes
Fiscal Officer
Mississippi Guaranteed Student
Loan Agency

Jeanie White
Lender Representative
Mississippi Guaranteed Student
Loan Agency

James L. Flippin
Director
Mississippi Guaranteed Student
Loan Agency

Ann Hyneman
Assistant Dean of Financial Aid
Millsaps College

James Stanley
Vice President of Student
Financial Assistance
Phillips Colleges

Jack L. Woodward
Dean of Financial Aid
Millsaps College

Advisory Committee on Student Financial Assistance
Room 4600, ROB-3
7th & "D" Streets, S.W.
Washington, D.C. 20202-7582
Telephone: 202/732-3439

Case Study **Participants** (continued)

Pennsylvania

Jerry S. Davis
Director of Research and
Policy Analysis
Pennsylvania Higher Education
Assistance Agency

Jay Evans
Deputy for Loans
Pennsylvania Higher Education
Assistance Agency

Robert W. Evans
Director of Financial Aid
Pennsylvania State University

Kenneth R. Reeher
Executive Director
Pennsylvania Higher Education
Assistance Agency

Donald J. Tressler
Bursar
Pennsylvania State University

Texas

David Hunt
Director of Financial Aid
Rice University

Joseph McCormick
Executive Director
Texas Guaranteed Student
Loan Corporation

George Rupp
President
Rice University

George Torress
Policy Analyst
Texas Guaranteed Student
Loan Corporation

Jeff Webster
Research Analyst
Texas Guaranteed Student
Loan Corporation

ERIC