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ABSTRACT

A study was conducted to determine: (1) whether federal savings could be expected by replacing Stafford student loans with direct loans under a direct loan program proposed by the National Association of State universities and Land Grant Colleges; and (2) what consequent administrative responsibilities would accrue to educational institution and the Department of Education under the proposed program. The analysis was done using a comparison of the federal costs of a 1-year cohort of loans under guaranteed and direct loan programs exclusive of transition costs and based on the proposed direct loan model. Results indicated that a direct loan program could save over 1 billion dollars. The Department of Education would acquire additional oversight roles under a direct loan program. In other ways the direct program would reduce some of the Department's administrative burden and improve accountability. Educational institutions would also engage in different activities in a direct program mostly involving loan forecasting and fund transfers. In addition, institutional paper work would be reduced and reporting requirements simplified. Schools would work with one or several servicers rather than hundreds of agencies. Deferment forms would become standardized. The findings are illustrated in 1 table and 26 figures which make up the bulk of the publication. (JB)

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United States General Accounting Office

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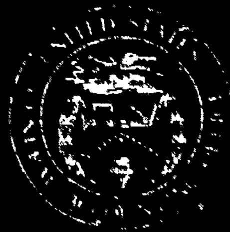
Briefing Report to the Chairman, Subcommittee on Postsecondary Education, Committee on Education and Labor, House of Representatives

September 1991

STUDENT LOANS

Direct Loans Could Save Money and Simplify Program Administration

ED338185



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

Human Resources Division

B-245769

September 27, 1991

The Honorable William D. Ford
Chairman, Subcommittee on
Postsecondary Education
Committee on Education and Labor
House of Representatives

Dear Mr. Chairman:

On June 11, 1991, you asked us to determine whether federal savings can be expected by replacing Stafford student loans with direct loans under a direct loan program proposed by the National Association of State Universities and Land Grant Colleges (NASULGC).[1] You also asked us to review the administrative responsibilities that would accrue to educational institutions and the Department of Education from direct lending.

On August 7, 1991, we briefed your office on the preliminary results of our analysis. This briefing report summarizes the information we provided to your staff. (See app. I.) In future reports we will provide additional comparative cost analyses, which will include a projection of transition costs, as well as a more comprehensive review of the administrative burden associated with a direct loan program.

Background

Advocates see direct loans as an opportunity to improve the major system delivering loan assistance for postsecondary education. Administrative complexity, high costs, and lack of accountability in the Stafford program have spurred the search for an alternative. Before recent changes in federal budget rules, the budgetary cost of direct loans was artificially inflated, so cost comparisons of guaranteed and direct loans were not meaningful. Current budget rules allow a more equitable comparison between the two types of loans. A direct loan program could simplify the loan process and reduce costs by eliminating several financial intermediaries.

Stafford Loan Program

The Stafford program is a complex and multilayered system. The program's delivery system involves over 8,000 educational institutions,

[1] Stafford loans are one component of the Stafford Student Loan Program, which also includes Supplemental Loans for Students, Parent Loans for Undergraduate Students, and Consolidation Loans.

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10,000 commercial lenders, 45 state or nonprofit agencies, and 35 secondary market institutions. Students typically apply through their school to borrow from a commercial bank or other lender. The original lender may hold the loan throughout its lifetime or sell it to a secondary market purchaser. Each state establishes or designates a guaranty agency to guarantee student loans under its jurisdiction. Guaranty agencies insure lenders against default and in turn are reinsured by the Department of Education. Guaranty agencies also monitor school and lender compliance with program rules.

The Stafford program's cost to the federal government consists primarily of interest subsidies and default claims. The Department pays interest on behalf of students while they are in school. It also pays lenders an interest subsidy throughout the life of the loan—the special allowance payment—to provide them with a competitive rate of return. These interest subsidies vary with interest rates. As interest rates increased, special allowance costs tripled between fiscal years 1987 and 1989. The Department reimburses guaranty agencies for 100 percent of default claims, unless defaults rise above specified levels in a given year. Reimbursements have risen steadily over time, and default claims doubled between fiscal years 1985 and 1989.

Both we and the Department's Office of the Inspector General have identified substantial accountability problems related to the Department's management of guaranteed student loan programs. For example, in April 1991 we found that the Department's Student Loan Insurance Fund could not be audited (GAO/AFMD-91-53ML). In addition, in March 1991 the Office of the Inspector General and the Office of Management and Budget completed a study that found that the Department's management practices contribute to high default rates, fraud, and abuse in the guaranteed student loan programs.

Credit Reform

Before the Federal Credit Reform Act of 1990 (P. L. 101-508), budget rules favored guaranteed loans over direct loans. Under the old rules, a guaranteed loan's cost consisted of interest subsidies and loan defaults in the year federal funds were appropriated, regardless of future interest subsidies and defaults. A direct loan's cost was equivalent to the outlay for loan principal. Subsequent defaults and repayments were accounted for in the year they occurred, not when the loan was made. As a result of this accounting method, direct loans appeared much more expensive than guaranteed loans.

Since credit reform, the budgeting rules allow a more equitable cost comparison of guaranteed and direct loans. Under the new rules, the budgetary cost of each program for a 1-year loan cohort is the net present value of all costs associated with those loans.[2] A guaranteed loan's cost is the discounted value of all interest subsidy and default costs, while a direct loan's cost is the initial outlay less the discounted stream of anticipated principal and interest repayments.

Direct Loan Program

Under the NASULGC proposal, a direct student loan program could potentially reduce the complexity and federal costs involved in delivering loan assistance. NASULGC's program would eliminate commercial lenders, guaranty agencies, and secondary markets. Educational institutions would act as agents of the Department and use federal funds to make loans to students. The Department would contract with private firms to service and collect the loans. The federal government would raise loan capital by issuing Treasury securities rather than paying interest subsidies to commercial lenders.

Direct loans would require different responsibilities for educational institutions and the Department. Institutions would assume some of the duties that commercial lenders now perform, such as loan origination and disbursement. The Department would have increased oversight responsibilities for schools' and servicers' performance, but it would no longer monitor commercial lenders and guaranty agencies.

Scope and Methodology

We compared the federal cost of a 1-year cohort of loans under guaranteed and direct loan programs, exclusive of transition costs.[3] As agreed with your office, we based our analysis on the NASULGC direct loan model. We also identified the extent to which educational institutions and the Department would either assume new tasks or have tasks eliminated in a direct loan program.

We developed a cash-flow model to compare the costs associated with both the guaranteed and direct loan programs. In developing our cost estimates, we assumed a Stafford loan volume of about $9 billion—the

[2] The net present value of a series of future payments is the sum of the payments, with each payment discounted by an appropriate interest rate over the number of years in the future that payment occurs.

[3] We estimated the total cost of loans made in 1 year. In accordance with credit reform, this involved estimating the future costs of those loans on a year-by-year basis and then discounting those costs back to the initial year.

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Department's projection for fiscal year 1992. We also assumed that default rates and the loan terms for students, such as interest rates and loan origination and insurance fees, would remain the same for both programs.

We simulated the life cycle of these loans, with some students entering repayment almost immediately and others remaining in school for up to 4 years. We assumed that some students would default immediately upon entering repayment, while others would default after being in repayment for several years.

Our cost analysis includes some, but not all, costs associated with administering the loan programs. Our estimates include the fees paid to loan servicers in the direct loan program. The estimates also include an administrative cost allowance (ACA). In the guaranteed loan program, ACA is paid to guaranty agencies, while in the direct loan program, ACA would be paid to schools. The estimates do not include administrative costs that accrue to the Department in either program, such as personnel or computer support costs.

We developed our baseline estimate using the aforementioned assumptions. We then performed sensitivity analyses to determine how our results changed as we modified some of our assumptions. For example, in one analysis we doubled the loan-servicing fee we assumed in our baseline estimate for the direct loan program to isolate the effect of this assumption. Finally, to give a range for our cost estimates, we combined changes in certain assumptions to create low- and high-savings scenarios.

We interviewed officials from educational institutions that currently administer the Stafford and Perkins loan programs, including some that serve as institutional lenders in the Stafford program.[4] We also talked to Department of Education officials and representatives of the Student Loan Marketing Association—the largest holder of guaranteed student loans.

We conducted our review from February through July 1991 in accordance with generally accepted government auditing standards.

[4]Institutional lenders in the Stafford program have been authorized by the Department of Education to make loans to their students. These lenders receive interest subsidies and may sell their loans in a secondary market just like other lenders in the program.

What We Found

A direct loan program operating in place of the Stafford loan program could save over $1 billion—present value terms—assuming the loans are made in fiscal year 1992. Our baseline estimate of the budgetary cost for a 1-year cohort of loans is $2.71 billion for Stafford loans as compared with $1.55 billion for direct loans. Depending on the assumptions we made, our estimated savings ranged from $620 million to $1.47 billion. These savings result primarily from the absence of in-school interest and special allowance payments to lenders. Table 1 illustrates how we derived the budgetary cost for each program.

Table 1: Federal Cost Comparison for Direct and Stafford Loan Programs

Dollars in millions

Flow of funds in year	Stafford loan	Direct loan
1	$276	$8,292
2	851	−147
3	667	−439
4	505	−645
5	320	−811
6	65	−803
7	29	−700
8	−3	−644
9	2	−603
10 and beyond	0	−1,954
Present value of federal cost	**$2,714**	**$1,547**

Note: Positive figures represent net federal payments; negative figures represent net federal receipts. These figures are in present value terms discounted to year 1. Columns do not add due to rounding.

The Department of Education would acquire additional oversight roles under a direct loan program. For example, the Department would need to ensure loan papers are properly documented and that schools meet requirements for participation in the program. In addition, it would need to closely monitor the performance of servicers to ensure that loan repayments are collected and credited in a timely manner.

In other ways, however, a direct loan program would reduce some of the Department's administrative burden, and it could improve accountability. The Department would no longer monitor lenders or guaranty agencies, make special allowance payments to lenders, nor reconcile special allowance and origination fee accounts with lenders. With fewer participants, the Department's ability to monitor the flow of funds in the program might improve.

Educational institutions would also engage in different activities in a direct loan program. At the beginning of each year, schools would perform new tasks, such as (1) forecasting loan volume, (2) requesting a transfer of funds from the Department, and (3) drawing down these funds as students receive their loans. Those schools that participate in the Perkins loan and Pell grant programs currently perform tasks similar to those required to operate a direct loan program.[5]

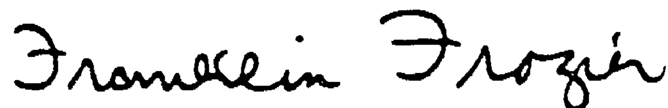
In addition, educational institutions' paperwork and reporting requirements could be simplified. Schools would work with one or several servicers rather than hundreds of lenders and multiple guaranty agencies. In addition, deferment forms, which now differ by guaranty agency, would become standardized.

Final resolution of some issues about a direct loan program could lower our estimated savings. For example, we did not account for the costs that the transition from a guaranteed to a direct loan program would entail. Also, the Department may encounter unforeseen additional costs in administering the program, such as an inability to negotiate servicing contracts as favorable as those reflected in our assumptions. These costs would reduce the savings anticipated from implementing a direct loan program. We plan to address these issues in future reports.

[5]The Perkins loan and Pell grant programs are federal programs administered by educational institutions on behalf of their students

We are sending copies of this briefing report to the Secretary of Education, appropriate congressional committees, and other interested parties. As agreed with your office, we did not obtain written comments on this report. We did, however, discuss its contents with Department program officials who were generally in agreement with our findings. Please call me on (202) 275-1793 if you or your staff have any questions about this briefing report. Other major contributors are listed in appendix II.

Sincerely yours,



Franklin Frazier
Director, Education and
Employment Issues

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Abbreviations

ACA	administrative cost allowance
GAO	General Accounting Office
NASULGC	National Association of State Universities and Land Grant Colleges
T-bill	91-day Treasury bill

Direct Loans Could Save Money and Simplify Program Administration

Figure I.1

GAO Student Loans

Direct Loans Could Save Money and Simplify Program Administration

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Figure I.2

GAO **Background: Guaranteed Loan Program**

Stafford loan program
is multilayered system

Major players include over

- 10,000 commercial lenders
- 8,000 educational institutions
- 45 guaranty agencies
- 35 secondary market entities

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Figure I.3

GAO **Background:
Direct Loan Program**

Under the NASULGC proposal, the federal government would raise loan capital for schools to make loans to students, eliminating the need for

- Commercial lenders and special allowance payments
- Guaranty agencies and the secondary market

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Figure I.4

Objective

Analysis of potential cost savings associated with substituting the NASULGC's direct loan program proposal for the Stafford loan program

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Figure I.5

Scope

Compare the federal cost accruing from a 1-year cohort of loans under the guaranteed and direct loan programs, exclusive of transition costs

Determine the work load shift under a direct loan program for

- The Department of Education
- Schools

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Figure I.6

GAO Methodology

Developed a cash-flow model for cost comparisons

Interviewed representatives of schools participating in the Stafford program, including

- Schools that serve as institutional lenders
- Schools that also participate in the Perkins loan program

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Figure I.7

GAO Overview

We found that the direct loan program could

- Save over $1 billion--1992 present value
- Improve program accountability
- Increase the Department's oversight responsibilities
- Simplify paperwork for schools

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Figure I.8

GAO Flow of Funds: Guaranteed Loan

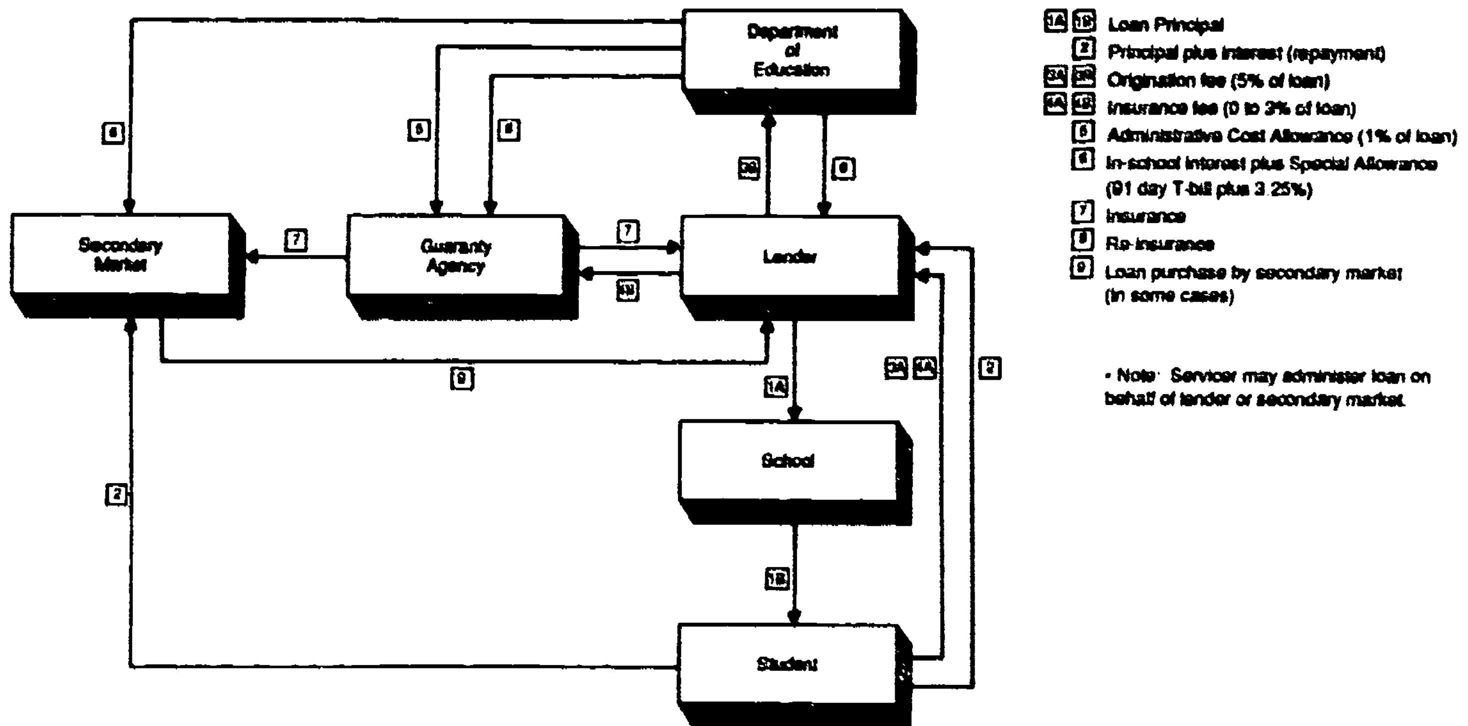

Figure I.9

GAO **Flow of Funds: Direct Loan**

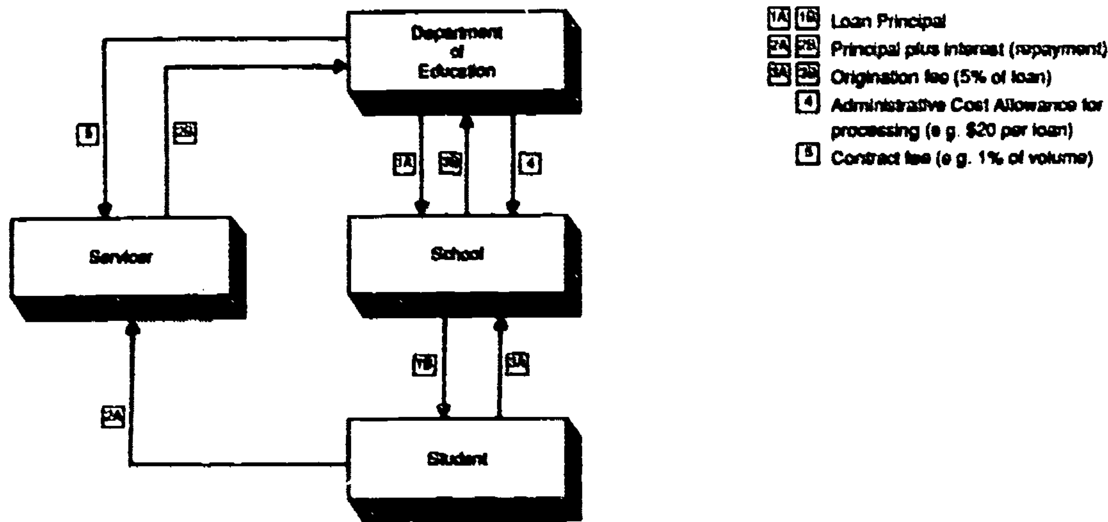

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Figure I.10

GAO **Baseline Savings Estimate in Present Value Terms**

Direct loan program saves over $1 billion for a 1-year cohort of loans

- Guaranteed loan program costs $2.71 billion
- Direct loan program costs $1.55 billion
- Our baseline savings estimate is about $1.17 billion

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Figure I.11

GAO **Assumptions Used in Baseline Estimate**

Assumptions for both programs

- 20% default rate
- 6% T-bill rate
- 6.9% discount rate
- Student's terms constant:
  - 5% origination fee
  - 1.6% insurance fee
  - 8% and 10% interest rate

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Figure I.11

Assumptions Used in Baseline Estimate (Continued)

We also assumed that the Department would pay

- Schools: a one-time fee of $20 per loan to offset their administrative costs
- Servicers:
  - 0.5% of loan volume for borrowers in school
  - 1% of loan volume for borrowers in repayment status

Figure I.12

Results of Sensitivity Analysis

Savings estimates sensitive to changing assumptions

- High-sensitivity factors:
  - loan-servicing costs
  - insurance fee
  - discount rate
- Low-sensitivity factors:
  - T-bill rate
  - default rate

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Figure I.13

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Figure I.13

Effect of Changing Baseline Assumptions (Continued)

Insurance Fee Assumption:

- Savings could rise to $1.29 billion if students pay a 3% insurance fee
- Savings could fall to $1.03 billion if students pay no insurance fee

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Figure I.13

GAO Effect of Changing Baseline Assumptions (Continued)

Discount Rate Assumption:

- Savings could fall to $930 million if we use a 7.4% discount rate

- Savings could rise to $1.41 billion if we use a 6.4% discount rate

Figure I.13

GAO **Effect of Changing Baseline Assumptions (Continued)**

T-Bill Rate Assumption:

- Savings could fall to $1.13 billion if T-bill drops to 5.5%

- Savings could rise to

  - $1.20 billion if T-bill increases to 6.5%
  - $1.30 billion if T-bill increases to 7.5%

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Figure I.13

GAO **Effect of Changing Baseline Assumptions (Continued)**

Default Rate Assumption:

- Savings could fall to $1.13 billion if the default rate rises to 30%
- Savings could rise to $1.20 billion if the default rate falls to 10%

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Figure I.14

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Figure I.15

GAO **Anatomy of Low-Savings Scenario**

Savings of $620 million assumes

- Interest rate falls to 5.5%
- No insurance fee
- High servicing costs
- A 30% default rate

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Figure I.16

GAO **Anatomy of High-Savings Scenario**

Savings of $1.47 billion assumes

- Interest rate rises to 7.5%
- A 3% insurance fee
- Low servicing costs
- A 10% default rate

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Figure I.17

GAO **Flow of Responsibilities: Guaranteed Loan**

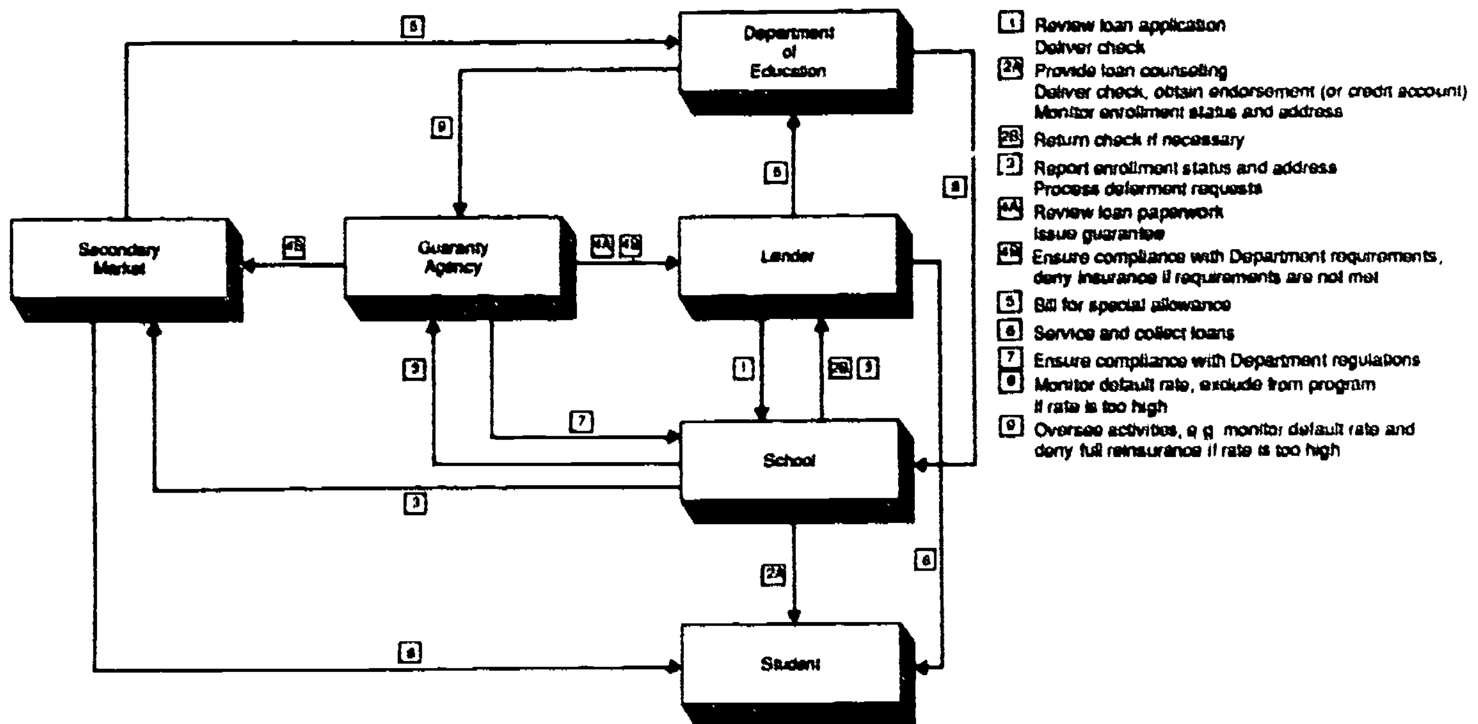
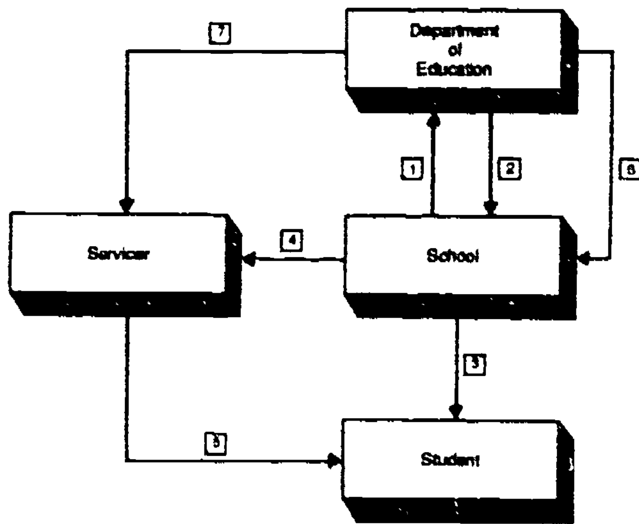


Figure I.18

GAO Flow of Responsibilities: Direct Loan



1. Request funds
   Reconcile account
2. Review fund request
   Transfer funds
3. Provide loan paperwork
   Obtain necessary signatures
   Provide loan counseling
   Deliver check, obtain endorsement (or credit account)
   Monitor enrollment status and address
4. Report enrollment status and address
   Process deferment requests
5. Service and collect loans
6. Ensure compliance with Department regulations
   Monitor default rate; exclude from program
   if rate is too high
7. Monitor service and collection performance

34

Figure I.19

GAO **Direct Loan Program: Impact on the Department**

Three stages primarily affected:

- Preapplication
- In-school
- Repayment

Figure I.20

GAO **Preapplication Stage**

Tasks Added for
the Department:

- Determining school eligibility and making participation agreement with school
- Processing fund requests and awarding capital
- Paying schools an administrative cost allowance

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Figure I.20

GAO **Preapplication Stage (Continued)**

Tasks Eliminated for the Department:

- Reviewing lender eligibility
- Reaching participation agreements with guaranty agencies

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Figure I.21

GAO In-School Stage

Tasks Added for
the Department:

- Reconciling school fund balances
- Monitoring school compliance
- Contracting with servicers to
  - hold and service loans and
  - monitor enrollment status and address changes

Figure I.21

GAO In-School Stage (Continued)

Tasks Eliminated for the Department:

- Administrative tasks associated with making special allowance payments
- Monitoring compliance of lenders and guaranty agencies

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Figure I.22

GAO **Repayment Stage**

Tasks Added for
the Department:

- Contracting with servicers to
  - collect repayments and
  - make initial default collection

Figure I.22

GAO **Repayment Stage (Continued)**

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Figure I.23

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Figure I.24

GAO Preapplication Stage

Tasks Added for Schools:

- Forecasting loan volume
- Requesting cash advance from the Department
- Receiving transfer of funds

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Figure I.25

GAO **Loan Award Stage**

Tasks Added for Schools:

- Providing promissory note and disclosure statement to student
- Obtaining student signatures
- Transferring promissory note to servicer

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Figure I.26

GAO **Subsequent Stages**

Tasks Eliminated for Schools:

- Disbursement stage:
  - returning checks to lenders
- In-school stage:
  - corresponding with multiple noteholders
- In-school/repayment stages:
  - processing different deferment forms

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