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ABSTRACT

This report discusses the Federal Family Education Loan (FFEL) Programs, formerly referred to as the Guaranteed Student Loan (GSL) Programs, which are designed to insure and subsidize loans private lenders make to students and their parents to help them meet the cost of postsecondary education. Chapter 1 outlines the major features of the FFEL Program. Chapter 2 describes the characteristics of three FFEL programs: Federal Stafford loans (subsidized and unsubsidized), Federal PLUS loans, and Federal Consolidated loans. Chapter 3 examines the administration of the FFEL program by lenders and guaranty agencies. Chapter 4 discusses borrower repayment relief, while chapter 5 reviews loan default and its consequences. Two appendixes provide basic program data and default statistics.
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CRS Report for Congress

The Federal Family Education Loan Programs

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THE FEDERAL FAMILY EDUCATION LOAN PROGRAMS

SUMMARY

Federal Family Education Loan (FFEL) programs, formerly referred to as the Guaranteed Student Loan (GSL) programs, insure and subsidize loans private lenders make to students and their parents to help them meet the costs of postsecondary education. FFEL programs were recently reauthorized through FY 1998 by title IV of P.L. 102-325, the Higher Education Amendments of 1992. Technical amendments to the 1992 amendments and to the Higher Education Act of 1965 (HEA) were passed in 1993 in P.L. 103-208. In addition, the Omnibus Budget Reconciliation Act of 1993, P.L. 103-66, made further changes to the program. A previous CRS Report, *Federal Family Education Loans: A Program Description*, by Charlotte J. Fraas (93-149 EPW), described the FFEL programs as amended in 1992.

Several types of FFELs are available to support postsecondary student expenses: Federal Stafford loans, subsidized or unsubsidized; Federal PLUS loans; and Federal Consolidation loans. Federal Supplemental Loans for Students (SLS) were available through the 1993-94 school year. A common feature of all these loans is that the Federal Government guarantees lenders and other loan holders against loss through borrower default, and pays for the discharge of loans in cases of borrower death, disability, bankruptcy, and in other limited instances. These loan programs also provide an interest subsidy to lenders (the special allowance), if the borrower's fixed or variable interest rate does not afford a sufficient return given financial market conditions.

Each FFEL program serves a specific type of borrower and loan terms vary. The only program serving financially needy borrowers is the subsidized Stafford loan program, under which the Federal Government pays the borrower's interest while he or she is in school, and during a post-school grace period and deferments. Most FFELs must be repaid within 10 years after the borrower enters repayment, but the repayment period may be up to 30 years for Federal Consolidation loans.

Today, about 16 percent of undergraduate students attending colleges, universities and trade and technical schools use FFEL borrowing to finance educational costs. In 1993, an all-time high of \$16.5 billion in new loans were made to students. Since 1966, the FFEL (GSL) programs have provided over \$143 billion to students with about \$62 billion outstanding as of the end of FY 1992. As might be expected, the tremendous increase in FFEL borrowing has contributed to significant increases in Federal program costs. In FY 1993 alone, the net program obligations were approximately \$3.8 billion, primarily to pay for defaults and interest benefits.

Two key players in the administration of the FFEL programs are lenders and State-level guaranty agencies. Lenders provide the loan capital, originate and service the loans under federally prescribed guidelines. Guaranty agencies insure lenders against default, collect defaulted loans, and provide other administrative services.

Features of the FFEL programs such as income-sensitive or income-contingent repayment, deferments, forbearance, discharge and forgiveness provide repayment relief to borrowers, basically for default prevention. Defaults are costly, and have major consequences for borrowers such as ruined credit and ineligibility for future student aid.

TABLE OF CONTENTS

INTRODUCTION	1
CHAPTER 1. MAJOR FEATURES OF THE FFEL PROGRAM	3
Background	3
General Program Distinctions	4
Source of Loan Capital and Insurance	5
Student Eligibility	6
Institutional Eligibility	6
CHAPTER 2. FEDERAL FAMILY EDUCATION LOAN PROGRAM	
CHARACTERISTICS	9
Federal Stafford Loans (Subsidized and Unsubsidized)	9
Eligibility	9
Loan Limits	10
Interest Rates	11
Borrower Fees	12
Repayment	13
Federal PLUS Loans	13
Eligibility	13
Loan limits	14
Interest Rates	14
Borrower Fees	14
Repayment	14
Refinancing	15
Federal Consolidation Loans	15
Eligibility	15
Interest Rate	16
Repayment Terms	16
Borrower Fees	16
CHAPTER 3. PROGRAM ADMINISTRATION BY LENDERS AND	
GUARANTY AGENCIES	17
Provisions Affecting Lenders	18
Special Allowance Payment	18
Excess Interest	19
Lender Fees	19
Loan Disbursement	20
Credit Checks and Endorsement	21
Conditions Relating to Interest Charges	21
Disclosures	21
Notifications	22
Prohibitions	22
Exceptional Performance	22
Audits	23
Provisions Affecting Guaranty Agencies	23
Insurance Against Borrower Default	23

Assignment of Defaulted Loans to the Federal Government (Subrogation)	23
Lender of Last Resort (LLR)	24
Fees	25
Advances	25
Reserves and Solvency Requirements	26
CHAPTER 4. BORROWER REPAYMENT RELIEF	29
Repayment Adjustment Related to Income	29
Graduated or Income-Sensitive Repayment Schedules	29
Income-Contingent Repayment	30
Deferments and Forbearance	30
Deferments	31
Forbearance	33
Loan Discharge and Forgiveness	34
CHAPTER 5. LOAN DEFAULT AND ITS CONSEQUENCES	37
Consequences of Default for Borrowers	38
Report to Credit Bureau	38
Offset of Tax Refund	39
Wage Garnishment	39
Ineligibility for Student Aid	39
Lawsuit	39
Loan Rehabilitation	39
APPENDIX A: BASIC PROGRAM DATA	41
Recipients	41
Program Operation	42
Cumulative Loan Volume	43
Annual Federal Expenditures	43
APPENDIX B: DEFAULT STATISTICS	47
Annual Default Costs and Offsets	47
Cumulative Default Rates	47
Institutional Eligibility and Cohort Default Rates	49

LIST OF TABLES AND GRAPHS

TABLE 1.	Federal Stafford Loan Limits	11
TABLE A.1.	Characteristics of Undergraduate Stafford Loan Recipients (1989-90)	41
TABLE A.2.	FFELS Disbursed, FY 1992-FY 1994	42
TABLE A.3.	Number Of FFELS Disbursed, FY 1992-FY 1994	42
TABLE A.4.	Average FFEL Loan Size, FY 1992-FY 1994	43
TABLE B.1.	Stafford Borrower Default Rates, FY 85-89	48
TABLE B.2.	Stafford Dollar Default Rates, FY 85-89	48
TABLE B.3.	Federal Family Education Loans Cohort Default Rates, FY 1990, FY 1991, FY 1992	45
GRAPH 1.	FFEL Program Costs FY 1981-1992	46

THE FEDERAL FAMILY EDUCATION LOAN PROGRAMS

INTRODUCTION

Federal Family Education Loan (FFEL) programs, formerly referred to as the Guaranteed Student Loan (GSL) programs, insure and subsidize loans private lenders make to students and their parents to help them meet the costs of postsecondary education. FFELs are the largest source of Federal student aid. In FY 1993, these programs supported \$16.5 billion in loans to undergraduate students, parents of dependent undergraduates,¹ and graduate and professional students attending colleges, universities, and trade and technical schools. About \$3.8 billion in Federal funds were needed to pay for the FFEL programs that fiscal year.²

FFEL programs were recently reauthorized through FY 1998 by title IV of P.L. 102-325, the Higher Education Amendments of 1992. Significant program changes, such as the creation of an unsubsidized Federal Stafford loan program and the removal of borrowing limits on parent loans, were aimed at expanding access to loans; other changes, such as establishing a variable interest rate for Federal Stafford loans, requiring graduated repayment schedules, and changing the terms for deferment, were made to promote loan repayment. Major amendments made by this law also responded to concerns about defaults and the stability and integrity of program participants such as schools and guaranty agencies. Technical amendments to the 1992 amendments and to the Higher Education Act of 1965 (HEA) were passed prior to the end of the first session of the 103d Congress, P.L. 103-208.³

In addition, in the 103d Congress, the Clinton Administration proposed a major change in the delivery of Federal student loans by converting the FFEL programs into direct loans. Debate over a similar proposal had led to inclusion of a pilot program in the 1992 HEA reauthorization. A phase-in of the new Federal Direct Loan program was enacted in the Student Loan Reform Act of 1993 (SLRA), part of the Omnibus Budget Reconciliation Act of 1993 (OBRA 93), P.L. 103-66. In conjunction with the transition

¹Federal student aid programs, including the FFEL programs, distinguish between students who are dependent or independent of parental support as defined by the Higher Education Act (HEA).

²Net program obligations for FY 1993.

³For a summary of changes made in HEA title IV student aid programs by these acts and other recent legislation, see: U.S. Library of Congress. Congressional Research Service. *Recent Changes in Federal Student Aid*. CRS Report for Congress No. 94-10 EPW, by Margot A. Schenet. Washington, 1993.

from FFEL to the Direct Loan programs, and to effect additional cost savings, OBRA 93 also made changes to the FFEL programs.⁴

A previous CRS Report, *Federal Family Education Loans: A Program Description*, by Charlotte J. Fraas (93-149 EPW), described the FFEL programs, as amended in 1992. This paper describes the current FFEL programs, including more recent changes. Chapter 1 provides some background information and a basic description of the programs. Chapter 2 discusses eligibility and loan terms for each type of FFEL program. Chapter 3 describes major provisions of the law affecting the administration of the program by lenders and guaranty agencies. Chapter 4 outlines provisions for repayment relief, which are key features of default control efforts, and chapter 5 describes the course of a loan through default and its consequences for borrowers. The appendices summarize some basic program data and default statistics.

⁴CRS is analyzing the new Federal Direct Loan program and will issue a report in the future.

CHAPTER 1. MAJOR FEATURES OF THE FFEL PROGRAMS

The FFEL programs are authorized by title IV, part B of the Higher Education Act of 1965 (HEA). As previously mentioned, P.L. 102-325, enacted July 23, 1992, provided the most recent authorization for part B; while further amendments were made during the 103d Congress. This chapter provides background information on the programs, a general overview of the different types of FFEL loans that are available to postsecondary students and their parents, the source of financing for the loans, and programwide eligibility requirements.

BACKGROUND

The FFEL loan programs have grown considerably since their origin as "Guaranteed Student Loans" (GSLs) in the HEA of 1965, both in terms of cost to the Federal Government and loan volume made available to students annually. Congress originally conceived the GSL program as a short-lived effort to provide an incentive for States to establish their own student loan programs through State agencies insuring commercial lenders. The Federal role in the program grew, however, and GSLs became a permanent and essential part of the Federal student assistance effort.

The purpose of the original Guaranteed Student Loan program was to provide a source of assistance to finance postsecondary education for students from middle income as well as lower income families by providing access to credit from commercial lenders. This was done in two ways: the Federal Government insured lenders against losses due to borrower default, death, disability, and bankruptcy; and the Federal Government provided an incentive for States to develop and enlarge their own guaranteed loan programs through interest-free advances for this purpose. Another important element of the original program was to provide a Federal subsidy for lower income students through paying their interest while they were in school and half their interest after they left school.

Major elements of the FFEL programs today were adopted to meet two program needs that had become apparent by the early 1970s: increasing student loan capital and lender participation in the program; and encouraging the development of program administration by States rather than the Federal Government. In 1969, after initial lender participation in the program was determined to be inadequate, the first "special allowance" interest subsidy was made available to lenders to assure a sufficient rate of return to them in periods of rising interest rates. In 1972, the legislation established the Student Loan Marketing Association (Sallie Mae) to provide a secondary market for lenders to sell their loans. Apparently a major obstacle to lender participation had been their inability to sell the long-term small balance GSLs to renew their capital base to make new loans.

While Federal payment to State guaranty agencies for defaults (reinsurance) was not available under the original GSL program, it was established in 1969 and expanded in 1976 to encourage States to develop their own loan insurance programs. Such a goal was adopted because it had become evident that the default rate was higher for loans directly

insured by the Federal Government than for loans insured through State agencies.⁵ Another provision that was important to the development of State programs was the Administrative Cost Allowance (ACA) the Federal Government paid States annually as a proportion of their new loan volume guaranteed. Such provisions had their desired effect and by 1984 all new GSLs were insured through State agencies.

Today, about 16 percent of undergraduate students attending colleges, universities and trade and technical schools use FFEL borrowing to finance educational costs.⁶ In 1993, an all-time high of \$16.5 billion in new loans were made to students. Less than half of this amount--\$6.2 billion--was borrowed by students only 11 years ago. Since 1966, the FFEL (GSL) programs have provided over \$143 billion to students with about \$62 billion outstanding as of the end of FY 1992.

As might be expected, the tremendous increase in FFEL borrowing has contributed to significant increases in Federal program costs. For the fiscal years 1966-1979, total appropriations were about \$4.5 billion for the GSL program. In FY 1993 alone, the net program obligations were approximately \$3.8 billion. The program is an entitlement and not subject to funding limitation through the appropriations process. Funds must be made available to meet program costs, and any limits on such costs may only result from changes in the program's authorizing statute.

Today, more than half of the gross FFEL program obligations pay for borrower defaults. The other major cost is Federal interest benefits for students in school or in grace and deferment periods. Special allowance payments to lenders, subsidizing the interest the borrower pays, have not been significant recently because interest rates are low, but can be a major factor in program costs during periods of high interest rates. FFEL program costs are offset by collections on defaulted loans and other Federal receipts, primarily origination and insurance fees.

GENERAL PROGRAM DISTINCTIONS

Several types of FFELs are available to support postsecondary student expenses: Federal Stafford loans, subsidized or unsubsidized; and Federal PLUS loans. Federal Supplemental Loans for Students (SLS) were available through the 1993-94 school year. The program was repealed beginning with the 1994-95 award year.⁷ Payments on these and other student loans may be combined under a Federal Consolidation loan. A common feature of all these loans is that the Federal Government guarantees lenders and other loan holders against loss through borrower default, and pays for the discharge of loans in cases

⁵National Commission on Student Financial Assistance. *Guaranteed Student Loans: A Background Paper*. Washington, 1982. p. 14.

⁶Congressional Research Service analysis of data from the 1989-1990 National Postsecondary Student Aid Study (NPSAS).

⁷P.L. 103-66 (OBRA 93) repealed section 428A of the HEA that authorized the SLS program and expanded the unsubsidized Stafford program for independent students.

of borrower death, disability, bankruptcy, and in other limited instances. These loan programs also provide an interest subsidy to lenders (the special allowance), if the borrower's fixed or variable interest rate does not afford a sufficient return given financial market conditions.

The Federal Stafford loan program is the largest of the FFEL programs as measured by loan principal borrowed annually.⁸ Under the subsidized Stafford loan program, which is available only to financially needy undergraduate, graduate, and professional students, the Federal Government pays borrower interest while the student is in school, during a 6-month grace period thereafter, and during periods of loan deferment. Unsubsidized Stafford loans are available to otherwise eligible borrowers, who do not meet the need test, under most of the same terms except there is no Federal interest benefit. Annual and aggregate loan limits vary for dependent undergraduates, independents and graduate students.

Federal PLUS loans, serving borrowers without regard to their financial need, are unsubsidized loans with no interest benefits, and are available to parents of dependent students. After July 1, 1993, there are no annual or aggregate loan limits on PLUS loans.⁹ Consolidation loans are available for borrowers to combine balances due on FFELs, Federal Perkins loans (also authorized by title IV and formerly called National Direct Student Loans (NDSLs)), and Health Professions Student Loans (HPSLs, authorized by the Public Health Service Act) into a single loan at a fixed interest rate with an extended repayment period. There is no minimum balance for a borrower to qualify for a consolidation loan.

SOURCE OF LOAN CAPITAL AND INSURANCE

Federal Family Education Loans are financed by commercial and nonprofit lenders-- **no Federal funds provide capital for FFELs.** Commercial lenders include banks, savings and loans, credit unions, and insurance companies, for example. Nonprofit lenders include postsecondary institutions or agencies designated by States. In addition, a secondary market provides liquidity for lenders to participate in the FFEL program through buying their FFEL loans and lending money to banks and other entities originating loans to enable them to invest in new student loans (called "warehousing").

State or national nonprofit guaranty agencies primarily insure lenders against borrower default on FFELs, but also provide other services to lenders such as assistance in preventing delinquent borrowers from going into default. Under agreements with

⁸For example, the Department of Education (ED) reports that in FY 1993 \$12.4 billion in Stafford loan commitments constituted 75 percent of all loan principal guaranteed (\$16.5 billion). These Federal Stafford loans included \$11.5 billion in subsidized loans, and \$964 million in the unsubsidized loan program, which first became effective for periods of enrollment after Oct. 1, 1992.

⁹Federal SLS loans had similar characteristics to PLUS loans and were available generally to independent undergraduates, graduate, and professional students with annual and aggregate limits on borrowing.

lenders holding the loans, guaranty agencies are responsible for paying the principal and accrued interest on defaulted loans. The Federal Government reinsures the guaranty agencies, and pays guaranty agency claims for their insurance payments to lenders. Federal payments for discharged loans are also made through guaranty agencies.

STUDENT ELIGIBILITY

In general, to be eligible for any new loan under the FFEL programs, a student must be enrolled as a regular student on at least a half-time basis at a participating eligible institution; be maintaining satisfactory academic progress as defined by the school; not owe a refund on a grant under title IV¹⁰ or be in default on a student loan under the title;¹¹ have on file at his or her institution a statement of educational purpose stating that the loan will be used solely for educational expenses; sign a statement that any Selective Service registration requirements were met; and be a citizen or permanent resident alien of the United States.

Non-high school graduates may be eligible for Federal Stafford loans or their parents may be eligible for Federal PLUS loans **only** if the student passes an independently administered examination that has been approved by the Secretary of Education, or undergoes State-established processes approved by the Secretary that establish his or her ability to benefit from the education or training to be provided.

INSTITUTIONAL ELIGIBILITY

Students borrowing FFELs must be enrolled in an eligible postsecondary institution that has signed an agreement with the Department of Education (ED) for participation in the FFEL programs. Institutional eligibility requirements for participation in any title IV HEA student aid program were substantially enhanced by the 1992 amendments to the HEA.¹² There are, in addition, some institutional requirements and definitions that are specific to the FFEL programs. Schools with 300 hour programs (minimum 10 weeks) that are not graduate or professional programs or do not require at least an associate's degree for admission **may** be eligible to participate in the FFEL programs only. To be eligible, these short-term programs must satisfy regulatory criteria prescribed by the

¹⁰Federal Pell grants, Federal Supplemental Educational Opportunity Grants (SEOGs), and State Student Incentive Grants (SSIGs). All are need-based grants. A student would owe a refund on a grant if he or she received an overpayment.

¹¹In addition to the loans under the FFEL programs, title IV authorizes Federal Perkins loans which are need-based loans administered by participating schools. Only students enrolled in those institutions are eligible for such loans. Students who default on FFELs or Federal Perkins loans may have their eligibility for title IV aid restored if they make satisfactory arrangements to repay the loan and have made 6 consecutive monthly payments. Reinstatement is only available once.

¹²For a description of the new institutional eligibility requirements, see: U.S. Library of Congress. Congressional Research Service. *Institutional Eligibility: The Higher Education Amendments of 1992*. CRS Report for Congress No. 93-861 EPW, by Margot A. Schenct. Washington, 1993.

Secretary of ED, including verified completion and placement rates of at least 70 percent. Postsecondary institutions outside the U.S. comparable to certain U.S. colleges and approved by the Secretary of ED may also participate in the FFEL programs. Foreign medical schools must meet additional special standards. Under 1992 program amendments such conditions are that for the year previous to the year for which the loan is sought, at least 60 percent of enrollees and graduates were not U.S. citizens, nationals, permanent residents, or other non U.S. citizens eligible for student aid and at least 60 percent of students or graduates of the school taking examinations administered by the Education Commission for Foreign Medical Graduates passed the test; or, as an alternative, the institution's clinical training program was approved by a State as of January 1, 1992. Students attending foreign schools that lose eligibility to participate in FFEL programs remain eligible to receive FFELs for the academic year succeeding the academic year in which such loss occurred.

In an effort to reduce default costs, Congress enacted provisions linking institutional eligibility and default rates. Institutions with a pattern of high loan default rates are not eligible to participate in FFEL programs. Effective July 1, 1991 through FY 1992, institutions with cohort default rates of 35 percent or higher for each of the most recent 3 fiscal years were ineligible to participate in the FFEL programs for the remainder of the fiscal year through the 2 following fiscal years. For FY 1993, the default rate cutoff dropped to 30 percent and thereafter it is 25 percent. Historically black colleges and universities (HBCUs) and tribally controlled community colleges are exempt from this restriction on eligibility through July 1, 1998.¹³

An institution's cohort default rate is the number of borrowers last attending that institution entering repayment on a Federal Stafford (subsidized or unsubsidized), Federal SLS loan, or the portion of a consolidation loan that is used to repay such loans, in a given year who default (defined as an insurance claim having been paid on their loan) by the end of the succeeding fiscal year *divided by* the total number of those borrowers entering repayment in the given year. For years when fewer than 30 borrowers last attending a school enter repayment, the rate is the total number of that school's defaulters (persons who default by the end of their second year in repayment) over the most recent 3-year period divided by the total borrowers entering repayment over the period. The Secretary of ED is required to report annually on cohort default rates by institutional sector.

Institutions have the right to appeal the loss of eligibility and ED may waive the provision if there are, in the judgement of the Secretary, "exceptional mitigating

¹³As a possible way to control defaults, institutions may now refuse to certify as eligible for FFEL loans certain students believed to be at higher risk of default, if the reasoning for such a refusal is documented and provided to the student. Before 1991, when the default cutoffs were first effective, schools could not refuse such certification, even if they suspected the student would be unable or unwilling to repay a FFEL.

circumstances¹⁴ or if the institution demonstrates that the calculation of its default rate is inaccurate. Institutions may include in their appeal a defense based on improper loan servicing.¹⁵

In a further effort to curb default rates, the SLRA requires States to pay a fee to the Secretary of Education based on new loan volume attributable to institutions with cohort default rates exceeding 20 percent. States, in turn, may assess institutions a fee based on the institution's cohort default rate and the State's risk of loss under the fee requirement.

¹⁴For an interpretation of the conditions for waiver, see: *Federal Register*, v. 56, July 19, 1991, p. 33332-33342.

¹⁵In such cases, the Secretary is required to give institutions access to a representative sample of relevant records for a reasonable time and if the evidence demonstrates inaccuracies, the Secretary must recalculate a reduced rate based on the errors found in the sample. The Higher Education Technical Amendments of 1993 also provide that guaranty agencies must afford schools the opportunity to review and correct records before they are submitted to the Secretary for calculation of the default rates.

CHAPTER 2. FEDERAL FAMILY EDUCATION LOAN PROGRAM CHARACTERISTICS

The various types of FFELs are designed to serve different borrowers and, as a result, the terms of loans vary. This chapter discusses fundamental eligibility and loan terms for Federal Stafford, Federal PLUS, and Federal Consolidation loans.

FEDERAL STAFFORD LOANS (SUBSIDIZED AND UNSUBSIDIZED)

The Federal Stafford subsidized loan program is effectively the original GSL program providing subsidized loans to needy students. The subsidy includes interest benefits--the interest is paid by the Government during in-school, grace, and deferment periods--and the special allowance, which supplements borrower interest under certain conditions.¹⁶

The 1992 program amendments expanded the Federal Stafford loan program to include unsubsidized loans for students who do not have financial need. This policy was adopted to expand the availability of loans to borrowers with limited access to the guaranteed loan programs, primarily dependent students from middle-income families, and the amount of loan aid available to such borrowers. The unsubsidized program provides no Federal interest benefits. Subsequently, the Supplemental Loans for Students (SLS) program which provided similar unsubsidized loans for independent students was repealed and the Stafford unsubsidized loan limits for independent students were correspondingly increased.

Eligibility

Undergraduate, graduate, and professional students attending colleges, community colleges, universities, professional schools, or vocational and trade schools are eligible for Federal Stafford loans. Subsidized Federal Stafford loans are available to financially needy students; unsubsidized loans are available to students who are otherwise eligible for loans under statutory definitions (see chapter 1). Undergraduate students must receive a determination of whether or not they are eligible for a Pell grant prior to being certified by their school as being eligible for a Federal Stafford loan. This is designed to provide maximum grant aid first to needy students before they incur loan debt.

Applicants for Federal Stafford loans must undergo a "need test" through which their family's or their own expected contribution to college expenses is determined. The amount of a **subsidized** Federal Stafford loan for which the student is eligible, up to maximum annual limits, is the total cost of attendance¹⁷ *minus* any other financial

¹⁶While the special allowance is available for all types of FFELs, Stafford loans have characteristically had the lowest borrower interest rate among the programs, implying that the special allowance subsidy has a greater role under this program.

¹⁷"Cost of attendance," for purposes of the FFEL programs is defined in part F of title IV. It generally includes tuition and fees, an allowance for books, supplies and transportation, room and board, and other expenses related to school attendance.

assistance for which the student qualifies **minus** the expected family contribution (EFC).¹⁸ The higher the EFC determined under need analysis or the greater the amount of other aid for which the student qualifies, the lower the amount of a subsidized Federal Stafford loan the student may receive.

For periods of enrollment beginning on or after October 1, 1992, students are eligible for an **unsubsidized** Federal Stafford loan up to the annual Federal Stafford loan limit without regard to the EFC, that is, only considering the total cost of attendance minus other aid. Students may receive part of their Federal Stafford loan subsidized and part unsubsidized if the calculation of EFC results in a subsidized Federal Stafford loan at less than the annual maximum.

Loan Limits

The FFEL loan principal that may be borrowed annually as well as the aggregate limit on outstanding principal is established by law. Any fees for which the borrower is liable are also included under these limits. Federal Stafford loan limits--the maximum principal that may be borrowed--changed under provisions of P.L. 102-325, and were modified again by P.L. 103-66 and P.L. 103-208. The loan limits now vary by year in school and by dependency status. The following table shows limits on loans for which the first disbursement is made on or after July 1, 1994. Independent students are eligible to receive the amount in the column for dependent students **plus** the additional unsubsidized amount.¹⁹ Prorations of limits for shorter programs apply to fractions of an "academic year," which is defined in the law as a minimum of 30 weeks instruction in which a full-time student is expected to complete a minimum of 24 semester or trimester hours, 36 quarter hours, or 900 clock hours. After the first year, the proration is based on the portion of the academic year that remains to complete a student's program.

¹⁸Other financial assistance includes Federal Pell grants, Federal Supplemental Educational Opportunity Grants, Federal Perkins loans, Federal Work-Study assistance, any veterans' education benefits and any other grants, loans, or scholarships. For more discussion of the need analysis formula and changes made by the 1992 amendments to the HEA, see: U.S. Library of Congress. Congressional Research Service. *Student Aid Application and Need Analysis: The Higher Education Amendments of 1992*. CRS Report for Congress No. 93-385 EPW, by Margot A. Schenet. Washington, 1993.

¹⁹Dependent undergraduates may be eligible to receive the larger unsubsidized Stafford loan limits available to independent students if the financial aid administrator determines that exceptional circumstances would preclude the student's parent(s) from borrowing a Federal PLUS loan to meet the family's expected family contribution to the student's college expenses and if the family is otherwise unable to pay the expected contribution.

TABLE 1. Federal Stafford Loan Limits

Academic level	Dependent student	Independent student	
	Total subsidized & unsubsidized	Plus additional unsubsidized only	Total amount
Annual Limits			
First-year undergraduate			
Full year	\$2,625	\$4,000	\$6,625
2/3 up to full year	\$1,750	\$2,500	\$4,250
1/3 up to 2/3 year	\$ 875	\$1,500	\$2,375
Second-year undergraduate			
Full year	\$3,500	\$4,000	\$7,500
2/3 up to full year	prorated	\$2,500	prorated
1/3 up to 2/3 year	prorated	\$1,500	prorated
Third-year/remainder undergraduate			
Full year	\$5,500	\$5,000	\$10,500
Less than full year	prorated	prorated	prorated
Graduate/Professional Student	\$8,500 subsidized + \$10,000 unsubsidized = \$18,500		
Aggregate Debt Outstanding			
Undergraduate	\$23,000		\$46,000
Graduate/Professional	\$65,000 subsidized + \$73,000 unsubsidized = \$138,500 (including undergraduate loans)		

Interest Rates

Until recently, Federal Stafford loan interest rates have largely depended on whether the borrower had outstanding debt under the program. As a rule, borrowers with outstanding debt retained the interest rate provided under previous Federal Stafford loans. Borrowers with no outstanding debt are considered "**new borrowers**," and received the interest rate effective at the time for new loans. The same rate applies whether or not the loan is subsidized or unsubsidized.

Stafford loan rates before July 1, 1988, were fixed at 7, 8, or 9 percent; between July 1, 1988, and October 1, 1992, the Federal Stafford loan interest rate was 8 percent rising to 10 percent at the beginning of the borrower's fifth year in repayment. Borrowers with existing Federal Stafford loan balances could, therefore, take out new loans at any of the above rates, depending upon the rate of their existing debt.

The 1992 amendments changed the fixed Stafford loan interest rates to a variable rate for new loans to new borrowers after October 1, 1992, to make such interest more responsive to market conditions. This rate, which is determined every June 1 and is

effective July 1 through the following 12-month period, is the bond equivalent rate of the 91-day Treasury bill (T-bill) at the final auction before June 1, plus 3.10 percent. The SLRA provided that **all** new Stafford loans for which the first disbursement is on or after July 1, 1994, have this variable rate (including new loans to borrowers with previous balances).

The current variable interest rate on Federal Stafford loans first disbursed between October 1, 1992, and July 1, 1994, and all new Federal Stafford loans disbursed on or after July 1, 1994, is 7.43 percent through June 30, 1995. The interest rate for the Federal Stafford loans disbursed between October 1, 1992, and July 1, 1994, is capped at 9 percent. New Stafford loans disbursed on or after July 1, 1994, carry a cap of 8.25 percent interest. Since the variable interest rate applies to all new loans, Federal Stafford borrowers may have loans at fixed and variable rates.²⁰

As part of the changes made by the SLRA based on anticipated savings from the phase-in to direct loans, the interest rate calculation was changed again for new Stafford loans first disbursed on or after July 1, 1998, to the "bond equivalent rate of the securities with a comparable maturity as established by the Secretary" plus 1.0 percent.

Borrower Fees

When a student borrows under the FFEL programs, he or she may be liable for certain fees, which the borrower pays to the lender. Origination fees offset Federal subsidy costs and the lender, in turn, pays them to the Federal Government; loan insurance premiums defray default costs and the lender pays them to the guaranty agency or the Federal Government. Therefore, the lender does not keep any of the fees paid by the borrower but passes them on to the appropriate entity. Borrower fees, which are calculated as a proportion of loan principal borrowed, are added to loan principal and subsequently deducted proportionately and forwarded to the Federal Government or guaranty agency as the loan is disbursed (see below regarding multiple disbursement requirements).

The SLRA reduced these borrower fees and made them the same for both subsidized and unsubsidized Stafford loans. Effective July 1, 1994, borrowers pay²¹ a 3 percent loan origination fee. Guaranty agencies may require a loan insurance premium of not more than 1 percent on subsidized and unsubsidized Stafford loans. Previously, the maximum

²⁰The Higher Education Technical Amendments required holders of fixed rate loans subject to the excess interest provisions (see chapter 3) to convert these loans to a variable rate not later than January 1, 1995; 10-percent loans are converted to a variable rate equal to the rate of the 91-day T-bill at the final auction before June 1 plus 3.25 percent, fixed rate loans made between July 23, 1992, and July 1, 1994, are to be converted to a variable rate of the T-bill calculation plus 3.10 percent.

²¹Technically lenders are authorized, but not required, to collect such a fee, but the amount the lender receives from the Federal Government in interest and special allowances *is required to be reduced by the amount the lender is authorized to collect* as an origination fee, effectively requiring lenders to charge the fee.

insurance premium, allowed on subsidized Stafford loans only, was 3 percent, and the national average charged was about 1.5 percent.

Repayment

Subsidized Stafford loan borrowers do not have to repay principal on their loans while they are in school, and for a 6-month "grace" period thereafter.²² The Federal Government pays a student's interest during this period. For unsubsidized Stafford loans, the borrower must pay the interest either monthly or quarterly, or it is added to the loan principal quarterly (i.e., capitalized), increasing the borrower's debt until repayment of principal begins.²³

The Stafford loan borrower's repayment period begins the day following the expiration of the grace period, which is 6 months after he or she ceases to be enrolled at an eligible institution on at least a half-time basis, unless the borrower requests and is granted a repayment schedule that begins earlier. New borrowers with new loans first disbursed on or after July 1, 1993 must be offered a choice of repayment schedules to include standard, graduated, and income-sensitive repayment options. See chapter 4 below. The loan must be repaid within 10 years after repayment commences excluding any periods during which the loan is in deferment or forbearance. The minimum annual payment on the total balance of all FFELs owed by the borrower is \$600, but may not be less than the total interest due. For loans with variable interest rates, the lender may change the monthly payment amount annually or adjust the length of repayment to reflect changes in the interest rate.

FEDERAL PLUS LOANS

The Federal PLUS Loan program provides guaranteed loans at variable market interest rates to the parents of dependent students. These loans do not require a test of financial need but, like unsubsidized Federal Stafford loans, do not provide interest benefits to borrowers. Characteristics of the Federal PLUS loans are discussed below.

Eligibility

After July 1, 1993, Federal PLUS loans are only available to parents who have no adverse credit history. Before that time, lenders were not prevented from requiring parents to meet certain credit standards to receive Federal PLUS loans and many lenders required this. Federal PLUS loans are authorized to be used to help parents meet the expected family contribution for the Federal need-tested student aid programs.²⁴

²²An exception is for 7 percent loans when the grace period may be between 9 and 12 months.

²³P.L. 103-66 reduced the interest rate paid during in-school, grace, and deferment periods for new Stafford loans made on or after July 1, 1995, to the 91-day T-bill plus 2.5 percent with a cap of 8.25 percent.

²⁴Such need-tested assistance includes Federal subsidized Stafford loans, Federal Pell grants, Federal Perkins loans, Federal SEOGs and Federal Work-Study assistance.

Loan Limits

Prior to July 1, 1993, PLUS loans were limited to \$4,000 annually and an aggregate of \$20,000. Federal PLUS loan limits changed under provisions of P.L. 102-325. Effective with loans for which the first disbursement was made on or after July 1, 1993, the yearly loan limit is the cost of attendance minus any other financial assistance for which the student qualifies. There is no longer an aggregate limit on Federal PLUS loans.

Interest Rates

Federal PLUS interest rates do not depend on the rate of existing debt, but simply reflect the interest established by law for the period in which the loan is made. Since 1987, the interest rate on Federal PLUS loans has been variable for each 12-month period beginning on July 1 and ending June 30 the following year. For loans for which the first disbursement occurs on or after October 1, 1992, the variable rate is based on the bond equivalent rate of the 52-week T-bill (auctioned at the final auction prior to June 1) plus 3.1 percent; before then the rate was the same T-bill standard plus 3.25 percent. Between October 1, 1992, and July 1, 1994, the borrower interest rate is capped at 10 percent for Federal PLUS loans; after July 1, 1994, the cap is reduced to 9 percent. After July 1, 1998, the interest rate on new Federal PLUS loans is reduced again to the "bond equivalent rate of the securities with a comparable maturity" plus 2.1 percent.

The variable interest rate on Federal PLUS loans disbursed between October 1, 1992, and July 1, 1994, and on or after July 1, 1994, is 8.38 percent through June 30, 1995. The variable interest rate on PLUS loans disbursed prior to October 1, 1992, is 8.53 percent through June 30, 1995.

Borrower Fees

Prior to October 1, 1992, Federal PLUS borrowers did not pay a loan origination fee. For loans made between October 1, 1992, and July 1, 1994, borrowers paid a loan origination fee equal to 5 percent of loan principal borrowed. P.L. 103-66 reduced the origination fee for new loans on or after July 1, 1994, to 3 percent. Federal PLUS borrowers are also liable for the guaranty agency's loan insurance premium, which is limited to a maximum of 1 percent, also effective July 1, 1994.

Repayment

Repayment on Federal PLUS loans must begin within 60 days after the last disbursement. Repayment of principal may be deferred subject to the parent meeting the grounds for deferment (see chapter 4 below), but interest must either be paid by the borrower or capitalized (added to the principal). The repayment "period" for Federal PLUS loans begins the day of the last disbursement of the loan proceeds. The length of the Federal PLUS repayment period is the same as that for Federal Stafford loans: 10 years, excluding periods of deferment and forbearance.

Refinancing

Borrowers may request lenders from whom they obtained a loan under the old PLUS program to reissue a loan or loans so that the borrower may secure the variable interest rate. A lender may charge up to \$100 to cover administrative costs of reissuing a loan, half of which is paid by the guaranty agency and half by the borrower. The insurance on the loan is unaffected by the reissuance, and borrowers may not be charged any additional insurance fee.

Borrowers unable to refinance their loan to secure a variable interest rate from the original lender may seek a new loan from another lender in order to have the original loan discharged. The new loan would have the variable interest rate for Federal PLUS loans, but its repayment period would not extend beyond that of the original discharged loan. Borrowers may be subject to an insurance premium on the new loan but not the \$100 administrative cost fee.

FEDERAL CONSOLIDATION LOANS

In order to simplify the repayment of a number of loans or to lower monthly payments, borrowers may consolidate their student loans. The basic requirement for consolidation is that the borrower has outstanding loan principal from one or more of the following programs: Federal Stafford loans, Federal SLS loans (or ALAS loans), Federal PLUS loans, Federal Perkins Loans (or NDSLs), Health Professions Student Loans (HPSLs), and Public Health Service Act Nursing Loans.²⁵

Eligibility

Applicants for consolidation loans must either be in repayment status or in the 6-month grace period after they leave school, and may not be more than 90 days delinquent in loan repayment. After January 1, 1993, defaulted borrowers who have already made arrangements to repay their obligations satisfactory to the guaranty agency or the Secretary of Education, are eligible for consolidation loans. Married persons, each of whom has eligible loans, are also eligible for a single consolidation loan even if only one meets the full eligibility requirements if each agrees to become jointly and severally liable for repayment of the note.

Potential borrowers must first seek consolidation through lenders holding their loans. If the borrower is not able to obtain a consolidation loan with income-sensitive repayment terms from his or her originating lender, the individual may seek consolidation through any lender having a consolidation insurance agreement with the Federal Government or with a guaranty agency.

²⁵The eligibility of Public Health Service Act Nursing Loans for inclusion in FFEL Consolidation Loans was added to the HEA by P.L. 103-382. P.L. 102-408, the Health Professional Education Extension Amendments of 1992, amends the Public Service Act (but not the HEA) to **not preclude** consolidation of Health Education Assistance Loans (HEAL) in a FFEL consolidation loan, if borrower and lender agree.

Generally, eligibility for a consolidation loan ceases upon its receipt, but the borrower may be eligible for another consolidation of new loans received thereafter. Effective January 1, 1993, loans received before the date of consolidation may be added to the loan up to 180 days after it is made.

Interest Rate

For consolidation loans made before July 1, 1994, the interest rate was fixed at the greater of the weighted average of the loans being consolidated, or 9 percent. For consolidation loans made on or after July 1, 1994, the interest rate is fixed at the weighted average of the loans being consolidated, rounded up to the nearest whole percent.

Repayment Terms

Repayment of the consolidation loan begins within 60 days after all holders of the loans being consolidated discharge the borrower's liability for the original loans. Lenders are required to offer income-sensitive repayment terms to borrowers of consolidation loans made on or after July 1, 1994. Income-sensitive repayment adjusts the borrower's monthly payment based on their income, most commonly on an annual basis.²⁶

The repayment schedule on consolidation loans is determined by the consolidation loan balance plus the outstanding balance of any other student loans held by the borrower (the amount of other student loans may not exceed the amount being consolidated). The schedule is:

Up to \$7,500	10 years
\$7,500 up to \$10,000	12 years
\$10,000 up to \$20,000	15 years
\$20,000 up to \$40,000	20 years
\$40,000 up to \$60,000	25 years
\$60,000 and over	30 years

Borrower Fee

Borrowers consolidating loans are not subject to insurance premiums or loan origination fees.

²⁶Borrowers unable to obtain a FFEL consolidation loan with income sensitive repayment terms satisfactory to the borrower may obtain a Federal Direct Consolidation Loan from the Secretary. For more information on Federal Direct Loans, see forthcoming CRS report.

CHAPTER 3. PROGRAM ADMINISTRATION BY LENDERS AND GUARANTY AGENCIES

Two key players in the administration of FFEL programs are lenders and State-level guaranty agencies. Lenders provide the loan capital, originate and service the loans under federally prescribed guidelines. They are most commonly banks, savings and loans, credit unions and other private lenders. They may also be pension funds, insurance companies, State agencies or nonprofit private agencies designated by States, eligible educational institutions, the Rural Rehabilitation Corporation or, under limited circumstances, guaranty agencies.

Originating lenders often sell their FFEL loans on the secondary market in order to secure new capital to make more loans. The largest of these secondary market purchasers, holding about one-third of outstanding FFEL paper, is the Student Loan Marketing Association (Sallie Mae), which is a federally sponsored private for-profit corporation. Other loan purchasers are banks, and nonprofit State level agencies or institutions dealing exclusively in student loans and often only buying loans from lenders in their own State or region. Lender-related provisions of the law apply to any holder of a FFEL loan, regardless of whether the lender originated the loan or bought it.

Guaranty agencies are State agencies created by State governments, or private nonprofit agencies operating only within a State or nationally. Each State has a guaranty agency selected to serve as the "designated" guarantor of FFELs for students going to schools in the State or State residents going to schools elsewhere. Other guarantors, however, may serve State students and residents also.

The primary function of the guaranty agency is to provide direct insurance to lenders on FFELs to protect them against losses due to borrower default. Through a reinsurance agreement with the Federal Government, the guaranty agency is reimbursed for direct insurance claims it pays to lenders for such losses.²⁷ These agencies also administer the loan discharges available for borrower death, disability, bankruptcy, and the new discharges available for school closures. Guaranty agencies also recruit lenders to participate in the FFEL programs to assure the access of students in the State to the loans, provide assistance to lenders in collecting loans before they enter default (preclaims assistance), may act as a lender of last resort, and may provide technical assistance to lenders.²⁸

²⁷For much of its first two decades of existence, the Federal Stafford loan program (then the Guaranteed Student Loan program) operated under both State agency guarantees and direct Federal guarantees through the Federally Insured Student Loan (FISL) program. At times, fewer than half of the loans made each year in this program were directly guaranteed by State guaranty agencies with Federal reinsurance. Legislative changes in 1976 (Education Amendments of 1976, P.L. 94-482) made it more attractive for States and others to establish guaranty agencies. The last FISLs were made during FY 1984.

²⁸See: National Council on Higher Education Loan Programs. *Guaranteed Student Loan Handbook*. NCHELP, Inc., 1987. p. 3.

This chapter discusses major provisions of law affecting lenders and guaranty agencies operating under the FFEL programs. The first section summarizes lender-related provision.; the second, provisions relating to guaranty agencies.

PROVISIONS AFFECTING LENDERS

Special Allowance Payment

A key component of the FFEL program for lenders is the special allowance. It is a payment of additional interest on a student loan that is made by the Federal Government when the borrower's interest rate does not meet a certain level of return to the lender. The provision dates to the early days of the GSL program when the return on student loans was low compared to what lenders could receive from other types of consumer credit, and Congress wanted to provide an incentive for them to put their capital in GSLs.

The special allowance rate is determined quarterly under a statutory formula. Effective for most loans for which the first disbursement is on or after October 1, 1992, the special allowance rate is the sum of the average bond equivalent rates of the 91-day T-bills auctioned during the quarter and 3.10 percent, minus the borrower's interest rate, divided by four (for a quarterly payment).²⁹ If the result of this calculation is positive,³⁰ the lender receives a payment of this additional interest from the Federal Government, by multiplying the result times the outstanding principal on the loan.³¹

The special allowance is available for all types of FFELs, but is only paid on variable interest rate Federal SLS and PLUS loans if the calculation for the program interest exceeds a cap. For Federal PLUS loans the cap is 10 percent; for Federal SLS loans it is 11 percent. For Federal Consolidation loans, the borrower's new interest rate on the consolidation loan is the basis for the special allowance calculation, **not** the original interest rates of the individual loans that were consolidated.

Several exceptions apply to the calculation of the special allowance. For loans made by the South Carolina direct lender or held by the Maine secondary market, the special allowance rate is calculated by adding 3.5 percent to the T-bill rate.³² Additionally, the

²⁹Between Nov. 16, 1986, and Oct. 1, 1992, the special allowance rate was 15 basis points (i.e., 0.15 percent) higher (T-bill calculation plus 3.25 percent) and other special allowance rates apply for earlier loans.

³⁰It is negative if the borrower's variable interest rate, determined annually, is higher than the quarterly average T-bill plus 3.1 percent.

³¹During in-school, grace, and deferment periods on new Stafford loans made on or after July 1, 1995, the special allowance rate is lower (T-bill calculation plus 2.5 percent) and it is changed for all new Stafford loans after July 1, 1998, to parallel the changes in Stafford loan rates after those dates (see previous chapter).

³²The exceptions for these entities were related to their 1984 and 1985 taxable bond issues, according to the conference report on P.L. 99-498 (H. Rept. 99-861).

special allowance rate is halved for holders of loans made or purchased with the proceeds of tax exempt bonds issued before October 1, 1993, but the annual rate of return must be a minimum of 9.5 percent on these loans. For holders of loans made or purchased with the proceeds of tax exempt bonds issued on or after October 1, 1993, the special allowance rate is the same as that provided for other student loans.

The Federal Government pays the special allowance from the time the loan is disbursed through the entire repayment period.

Excess Interest

In contrast to the special allowance, the "excess interest" provision was crafted to keep lenders from making unreasonable profits on Stafford loans with fixed interest rates. The excess interest provisions established a ceiling of return for lenders under a statutory formula effectively producing the same quarterly return that would be achieved through the special allowance. One formula to determine "excess interest" applies to 8/10 percent Federal Stafford loans made after July 1, 1988, but before the enactment of the Higher Education Amendments of 1992 (July 23, 1992); another applies to Stafford loans with fixed interest rates made between July 23, 1992, and July 1, 1994, to borrowers with an outstanding balance on a part B loan.

For Federal Stafford loans made between July 1988 and July 1992, with an interest rate of 10 percent, if the quarterly average of 91-day T-bills **plus 3.25 percent** is less than 10 percent, the lender must either credit the "excess interest" that quarter to the Federal Government, if it is paying the interest (on subsidized Stafford loans during in school, grace, and deferment periods), or credit a Federal Stafford loan borrower's outstanding principal. The borrower's principal is reduced by an amount equal to the "excess" interest rate (10 percent minus the sum of the T-bill average plus 3.25 percent) multiplied by his or her outstanding principal, divided by four (calculations are made quarterly).

For Stafford loans made to old borrowers between July 23, 1992, and July 1, 1994, if the quarterly average of 91-day T-bills **plus 3.1 percent** is less than the loan's interest rate, the lender must either credit the "excess" interest that quarter to the Federal Government, if it is paying the interest (on subsidized Federal Stafford loans during in-school, grace, and deferment periods), or reduce the borrower's outstanding principal under a formula similar to the one mentioned above.³³ As noted above (chapter 2), lenders/holders of loans subject to these provisions are required to convert these loans to a variable interest rate not later than January 1, 1995.

Lender Fees

The reconciliation act passed in 1993 (P.L. 103-66) included numerous provisions designed to reduce Federal costs in the FFEL program including new fees on lenders and

³³For any loan subject to these provisions for which the borrower is delinquent for more than 30 days in making a required payment, the excess interest is credited to the Secretary and not the borrower's account.

holders of FFEL loans. All lenders/holders are required to pay to the Secretary a **loan fee** (subtracted by the Secretary from the quarterly interest and special allowance payments due to lenders) equal to 0.50 percent of loan principal on FFEL loans for which the first disbursement was on or after October 1, 1993. In addition, holders of consolidation loans for which the first disbursement was made on or after October 1, 1993, must pay to the Secretary, on a monthly basis, a **rebate fee** calculated on an annual basis, equal to 1.05 percent of the loan principal plus accrued interest.

Sallie Mae is required to pay the Secretary, on a monthly basis, an **offset fee** calculated on an annual basis of 0.30 percent of the principal amount of each part B loan held that was acquired after August 10, 1993. If the Secretary determines that Sallie Mae has not complied with the new lender of last resort requirements (discussed below), the fee rises to 1 percent of loans held.

Loan Disbursement

Disbursement requirements are generally designed to prevent fraud by assuring that the school has some control over the distribution of the loan proceeds for student expenses. Lenders must send Federal Stafford loan proceeds directly to the institution of higher education. The check or other instrument used to deliver the loan proceeds to the institution must require the endorsement of the student and be payable directly to him or her, and may not be made co-payable to the institution and borrower. If the student is studying abroad in a program approved for credit by his or her home institution in the U.S., funds may be delivered directly to the student upon request, and may be endorsed or a fund transfer authorized through a power-of-attorney.

Federal PLUS loans must be disbursed by means of an electronic funds transfer (EFT) from the lender to the institution or in a check **co-payable** to the institution and parent borrower.

Multiple disbursement provisions are designed to lower defaults among students who never attend the school in which they are enrolled or drop out of educational programs shortly after enrollment. The lender must disburse any Federal Stafford loan in two or more installments, none of which exceeds one-half the loan amount. The interval between installments is required to be at least half the period of enrollment unless this interferes with disbursement at the beginning of a semester, quarter, or similar academic division. If borrowers cease to be enrolled at the institution prior to the second disbursement, the disbursement must be withheld and credited to the borrower's principal as a prepayment. Further, if a student receives an overaward the institution must return it to the lender and the lender must credit the funds to the borrower's principal as a prepayment. Lenders may not sell loans to secondary markets or other entities before the final disbursement of loan proceeds unless the sale of the loan does not change the identity of the party to whom payments are made and the first disbursement has been made. Federal consolidation loans, and loans for attendance at an eligible institution outside the U.S. are not subject to these disbursement requirements.

Also, as a default reduction measure, disbursement to first-time, first-year Federal Stafford borrowers must be delayed until 30 days after the borrower begins his course of study. For other students, loans may not be disbursed prior to 30 days before the beginning of the period of enrollment for which the loan is made.

The law authorizes lenders other than the holder of the loan, as well as guaranty agencies, to act as escrow agents for loan disbursements.

Credit Checks and Endorsement

As a general rule lenders are neither prohibited from evaluating nor required to evaluate a prospective student borrower's financial condition through a credit check and make a decision regarding the size of the loan based on such information. Until July 23, 1992, provisions of P.L. 102-164 (November 15, 1991) required lenders to secure a credit report on all FFEL applicants 21 years of age or older and require endorsement if there was evidence of an adverse credit history. This provision was repealed by P.L. 102-325. The 1992 program amendments, however, do require credit checks for parents applying for Federal PLUS loans, because these amendments restrict program eligibility to those parents with no adverse credit history.

Lenders may not require endorsement on loans made under the currently inactive Federally Insured Student Loan (FISL) program, but no such prohibition applies to other FFELs.

Conditions Relating to Interest Charges

Under the 1992 program amendments, lenders may not receive interest on loans until they are delivered to the borrower beyond 10 days if proceeds are disbursed by check or 3 days if proceeds are issued by electronic funds transfer (EFT). Loan holders may not receive interest or a special allowance payment on a loan unless the loan check is cashed by the borrower (the loan is "consummated").

Disclosures

The law requires lenders to make certain disclosures to borrowers before disbursement of the loan proceeds and at the beginning of the repayment period. Upon approval of a Federal Stafford or Federal PLUS loan, lenders must issue a statement to the borrower on his or her rights and responsibilities with respect to the loan and the consequences of defaulting on the loan, including that the defaulter will be reported to credit bureaus. Before disbursement, the lender must disclose to the borrower certain detailed information such as the principal owed, any additional charges made, the interest rate, an explanation of the repayment requirements, the total cumulative balance of the loans owed the lender by the student, and the projected monthly balance (given the cumulative balance), prepayment rights, default consequences, and any collection costs for which the borrower may become liable. This disclosure, which must be in a written form, must contain a statement in bold print that the borrower is receiving a loan that must be repaid.

The lender must provide other written information to the borrower not less than 30 days or more than 240 days (these limits do not apply to Federal PLUS and consolidation loans) before the repayment period begins. This information generally relates to loan repayment information such as who is to receive the payments, total interest charges, what monthly payments will be, what repayment options may be available such as consolidation or refinancing, prepayment rights, fees, etc. For Federal SLS, Federal PLUS and unsubsidized Federal Stafford loans, lenders may project monthly payments with or without capitalization.

Notifications

Lenders or loan holders are required to notify Federal Stafford borrowers 120 days after they leave school of the date their repayment period begins.

Upon the sale or transfer of any part B loan when the borrower is either in a grace period or in repayment, the old and new holders, either jointly or separately, are required to notify borrowers of the sale or transfer within 45 days from the date the new holder will have an enforceable right of repayment from the borrower. The notification must include such information as the identity of the new holder, the address where payment must be sent and the telephone numbers of the original and new holders. The new holder must also notify the guaranty agency and, if requested, the institution the student attended, of the sale/transfer.

Lenders are required to report to national credit bureaus on the amount of a FFEL loan made to an individual and the loan's status.

Prohibitions

The law prohibits lenders from offering inducements for loan applications, conducting unsolicited mailings for applications, using FFEL loans as an inducement to a prospective borrower to buy life insurance, or engaging in fraudulent or misleading advertising. Lenders are also prohibited from practicing discrimination in their FFEL credit practices on the basis of race, national origin, religion, sex, marital status, age, or handicapped status.

Exceptional Performance

Lenders, loan servicers, and guaranty agencies are all required to pursue delinquent or defaulted student loan accounts with "due diligence" as prescribed by Federal regulation. If irregularities are found in complying with these regulations, the insurance payment on a default to a lender or a reinsurance payment to a guarantor is jeopardized. Regular reviews associated with servicing and collection requirements may be conducted on any loan.

Under the 1992 program amendments lenders, loan servicers, and guaranty agencies who the Secretary of Education finds have a 97 percent or greater compliance with due diligence requirements may be designated as having "exceptional performance," and

relieved from regular review for compliance with servicing and collection requirements. With this designation, lenders and servicers receive 100 percent reimbursement for their default claims and guaranty agencies receive the appropriate level of reimbursement from the Federal Government with no added review. The designation lasts for a 1-year period or until revoked by the Secretary, and annual audits of the lenders, services and guarantors are required specific to the designation.

Audits

With the enactment of the 1992 amendments, lenders are required to have an annual audit for compliance with FFEL law. Guaranty agencies must have both a financial and compliance audit annually.

PROVISIONS AFFECTING GUARANTY AGENCIES

Insurance Against Borrower Default

The guaranty agency insures lenders against borrower default for 98 percent of the loan principal for loans first disbursed on or after October 1, 1993. For loans first disbursed prior to that date, as well as exceptional performance lenders and lender of last resort loans, the lender receives 100 percent insurance. The course of a loan through default is described in greater detail in chapter 5. In summary, once a loan has been delinquent for 180 days, the lender files a default claim. If the guarantor determines that the lender exercised the required diligence in attempting to collect on the loan, the guaranty agency pays the claim. The guarantor subsequently files a claim with the Federal Government for a reinsurance payment covering 98 percent of the cost of the claim plus certain administrative costs. The reinsurance rate drops to 88 percent or 78 percent if the guarantor has default claims that are high compared to the volume it insured in a given fiscal year. For lender of last resort loans, the reinsurance rate is 100 percent. These reinsurance rates are effective for loans first disbursed on or after October 1, 1993.

After the guaranty agency is reimbursed by the Federal Government for a defaulted loan, it must continue collection efforts. The guaranty agency is authorized to retain 27 percent of any collections it makes to pay for its costs associated with the collection, with the remaining 73 percent being paid to the Federal Government. For loans resold through rehabilitation (see chapter 5), the guaranty agency must pay the Federal Government 81.5 percent of the outstanding principal balance of the loan at the time of resale.

Assignment of Defaulted Loans to the Federal Government (Subrogation)

At any time, the Secretary of Education may require a guaranty agency to assign the defaulted loan to the Federal Government for collection under the assumption that the Federal Government will have more success in collection on a particular loan or group of loans than the guaranty agency. This becomes an issue for the guaranty agency because once a loan is assigned to the Federal Government, the guaranty agency receives no

further payment resulting from collections on that loan (i.e., it ceases to get 27 percent of collections).

ED has established certain categories of loans for mandatory assignment such as aged accounts and defaulted loans of Federal employees. Also, loans that may be collectable through the offset of the defaulter's Federal tax refund are temporarily assigned to the Federal Government.

In 1991, ED established specific conditions for the mandatory assignment of aged loans, generally those over 3 years old with no repayment activity. Many guarantors believed these standards did not take the value of their total collection efforts into account. The 1992 program amendments required the Secretary to establish individual criteria to judge an agency's record of collections before requiring assignment. However, this provision was repealed by the SLRA. In addition, guaranty agencies must promptly assign loans to the Federal Government if the Secretary deems it necessary for the orderly transition to direct loans.

Lender of Last Resort (LLR)

Guaranty agencies must act as a "lender of last resort" (LLR) to serve otherwise eligible applicants for subsidized Federal Stafford loans who have been unable to secure a loan. In this capacity, the guaranty agency may make loans itself or choose banks, credit unions, savings and loans, or other private lenders at their request to act as lenders of last resort.³⁴ Guaranty agencies must respond to an LLR loan application within 60 days and may not require students to have more than two rejections from lenders.

Several new provisions on lender of last resort loans were added by the SLRA in view of the potential increase in demand for such loans during the transition to the new direct loan program. The Secretary is authorized to provide additional advances to guarantors to ensure they will make LLR loans. Guaranty agencies are to be paid a fee for making such loans in lieu of interest and special allowance subsidies. Such loans are assigned to the Secretary on demand, which serves as repayment of the portion of the advances used to make the loans. As an additional incentive to make LLR loans, guaranty agencies receive 100 percent reinsurance for defaulted LLR loans.³⁵

The Secretary is also authorized to enter into new agreements with guarantors for lender referral services in specified geographic areas **to ensure loan access during the transition to direct loans**. The SLRA authorized the use of direct loan administrative funds to pay the guaranty agency fee for such services.

³⁴A provision enacted in 1992 potentially limits the guaranty agency's LLR responsibility by authorizing it to limit the total number or volume of FFEL loans to a particular school during any academic year. See section 428(b)(1)(T) of the HEA.

³⁵An amendment to the HEA included in P.L. 103-382 clarified that lender of last resort loans are not included in calculating the guaranty agency reinsurance rate described above.

Finally, Sallie Mae is now **required** to serve as a lender of last resort for any part B loan, at the request of the Secretary whenever the Secretary determines that borrowers are unable to obtain loans, either within a particular geographical area or for attendance at particular institutions. These loans are directly insured by the Secretary. Sallie Mae may also be required to act as lender of last resort for loans insured by a particular guaranty agency if that agency, the secondary market players, and the Secretary agree that students in a particular State or area are unable to obtain loans. These Sallie Mae LLR requirements cease when the Secretary determined the condition which led to the activity has ceased to exist.

Fees

Prior to October 1, 1993, guaranty agencies were required to pay the Federal Government a **reinsurance fee** annually equal to 0.25 percent of the FFEL loan volume newly insured (not refinanced or consolidated loans) by the agency during the fiscal year, or 0.5 percent of such volume if the agency's default claims exceed 5 percent of total principal insured. This fee was eliminated by the SLRA. At the same time, the **administrative cost allowance (ACA)**, an annual fee that the Federal Government paid to guaranty agencies to offset costs resulting from their administration of FFEL programs, was eliminated as an entitlement effective October 1, 1993. This payment was equal to 1 percent of the principal amount of all FFELs insured by that agency during the fiscal year.³⁶ However, report language in P.L. 103-66 directed ED to pay "on a timely basis . . . an amount equivalent to that . . . received under the ACA . . ." ED is directed to use Direct Loan program administrative funds for these payments.³⁷

Advances

The Federal Government is authorized to issue interest-free "advances" to guaranty agencies to help them meet start-up costs, or, in emergencies, to meet immediate cash needs and ensure uninterrupted payment of claims when the Secretary is seeking to terminate a guaranty agency agreement (see below). The agencies are liable to repay these advances at some future time.³⁸ The SLRA expanded this provision to include authorization of emergency advances for LLR activities in the transition phase to direct loans.

³⁶The ACA provided about 3.9 percent of funds to operate guaranty agencies at the end of 1992. Their primary source of funding--61.3 percent--was through reinsurance claims. (U.S. Department of Education. *FY 1992 Loan Programs Data Book*. Washington, 1994. p. 59. (Hereafter cited as ED, *FY 1992 Loan Programs*))

³⁷For FY 1994 and FY 1995, ED paid the guaranty agencies an annual fee calculated on the same basis as the ACA, while reviewing the financial condition of the guaranty agencies to determine the "appropriate basis for providing funds in the future." While some guaranty agencies would prefer continued use of the previous formula, ED is concerned about limiting the fees so as not to deplete administrative funds for the direct loan program.

³⁸As of March 31, 1993, about \$40.1 million in advances was outstanding. (ED, *FY 1992 Loan Programs*, p. 63.)

Reserves and Solvency Requirements

In order to pay insurance claims on defaulted loans, guaranty agencies must maintain a certain level of reserves. In 1990, the largest student loan guarantor, the Higher Education Assistance Foundation (HEAF) became insolvent because it did not have funds to meet its insurance obligations. At that time, the law had no provisions prescribing the course of action in such situation, so new provisions were included in the 1992 program amendments to: 1) establish a mechanism for the Federal Government to oversee the financial conditions of guaranty agencies, and 2) prescribe actions that may be taken in the event of guaranty agency insolvency. The SLRA made additional changes to deal with the anticipated impact on guarantors of the transition to direct loans.

Guaranty agencies are required to have certain levels of reserves. For the agency's fiscal year beginning in 1993, the minimum level was 0.5 percent of outstanding loans guaranteed by the agency.³⁹ The minimum level rose to 0.7 percent for the agency's fiscal year beginning in 1994; 0.9 percent for the fiscal year beginning in 1995; and 1.1 percent for the fiscal year beginning in or after 1996. The SLRA directed ED to set a maximum reserve level through the negotiated rulemaking process; the Secretary may require a guaranty agency to return any portion of reserves above that level.

Although reserve funds are held by guaranty agencies to pay program expenses and contingent liabilities, such funds and assets derived from such funds are considered "property of the United States" to be used for part B or part D (the new Federal Direct Loan program). The Secretary is authorized to terminate contracts made by guarantors to ensure the preservation of reserves or to cease activities involving the fund if the Secretary determines that such expenditures would be misapplied, misused, or improper. The Secretary may direct a guarantor to suspend or stop activities carried forth under contracts begun after January 1, 1993, if the Secretary determines that misuse or improper use of funds under the contracts provide improper benefits to the agency's officers or directors. The Secretary is also authorized to require the return of reserves if it is in the best interest of part B or part D programs, is necessary for maintenance of an agency's funds or assets, or ensures an orderly termination of a guarantor's operations. Returned reserve funds are to be available for use in administration of the new direct loan program.

To assess guaranty agency financial solvency, the Secretary is required to collect annual information on the agencies' financial condition. Certain financial indicators may trigger a requirement that the guaranty agency submit a management plan to the Secretary to either restore its financial soundness or to ensure the orderly termination of operations. The Secretary may seek to terminate a guaranty agency agreement to administer the FFEL programs for any of the following reasons: failure to submit the required management plan acceptable to the Secretary; failure to improve its financial condition; danger of financial collapse; to protect the Federal fiscal interest; to ensure continued availability of loans to student and parent borrowers; to ensure an orderly transition from FFEL to the direct loan program.

³⁹Does not include loans that were transferred to the agency from another because the latter agency was financially unstable.

If the guaranty agency agreement is terminated, the Secretary of Education assumes the responsibility for any of the guaranty agency's functions and is authorized to take actions to dissolve the agency and transfer its guarantees elsewhere, to restore its viability, or any other actions necessary to ensure an orderly transition from guaranteed to direct loans. The Secretary is also authorized to use all of the guarantor's funds or assets to assist in such termination/assumption of functions including the return of funds from contracts, notwithstanding any State court orders or provisions of State law. The liability of the Secretary with respect to the outstanding liabilities of the guarantor is limited to the fair market value of the guaranty agency's reserves minus liquidation and other administrative costs.

The ED is required to report annually to congressional authorizing committees on the fiscal soundness of the guaranty agency system and the progress of transition to direct loans.

CHAPTER 4. BORROWER REPAYMENT RELIEF

Features of the FFEL programs provide repayment relief to borrowers who may have or are having difficulty in making payments on their student loans. This chapter discusses provisions under which borrowers may reduce, temporarily or permanently cease, or otherwise alter the monthly repayments that would be required under the amortization schedule for the loan under its original terms. Such provisions authorize:

- repayment adjustments relating to income, such as income-sensitive and income-contingent repayment;
- deferments and forbearance;
- discharge and forgiveness.

Most of these features are designed to prevent loans from going into default. Defaults on student loans are costly to the Federal Government and have significant consequences for borrowers, which will be addressed in the next chapter.

REPAYMENT ADJUSTMENTS RELATED TO INCOME

A series of provisions first enacted in P.L. 102-325 offer alternative loan repayment terms for borrowers who *anticipate* having problems meeting loan payments because of post-school earnings. Two such alternatives are graduated or income-sensitive repayment; the other alternative, for selected borrowers and defaulters, is an income-contingent payment plan. The difference between these options is that the first two change monthly payments from what they would be under the regular amortization schedule but retain the same maximum repayment period: 10 years for Federal Stafford and Federal SLS loans, and up to 30 years for Federal Consolidation loans. Income-contingent repayment establishes installment payments according to the borrower's annual income over an indefinite period of time. Under the income-contingent repayment provisions relating to FFEL loans, the maximum repayment period would be 25 years with any remaining amount owed on the loan discharged after that time by the Federal Government.

Graduated or Income-Sensitive Repayment Schedules

For Federal Stafford or Federal SLS loans disbursed on or after July 1, 1993 to new borrowers, lenders are required to offer graduated or income-sensitive repayment schedules, approved by the Secretary of Education, as alternatives to regular amortization. For Federal Consolidation loans, lenders must offer such schedules after July 1, 1994; before this time, they were offered at lender option. These repayment schedules assume that a borrower's income will increase over the repayment period. Under a graduated repayment plan, fixed payment amounts established at the beginning of repayment, are smaller at first and larger during later years of repayment. Under an income-sensitive scheme, the payment amounts may be adjusted annually to reflect changes in borrower's

income.⁴⁰ These repayment schedules increase the total costs of the loan (in increased interest payments) to the borrower, and unlike income-contingent repayment, do not result in a discharge, reducing the borrower's total debt.

Income-Contingent Repayment

The SLRA established the new Federal Direct Student Loan program (FDSL), one of the important provisions of which is alternative repayment plans, including income-contingent repayment. Under the income contingent repayment option, students would repay based on annual income for up to 25 years with any remaining amount owed on the loan discharged at that time.

At the same time, several provisions for income-contingent repayment were added to the FFEL program. The Secretary of ED must mandate income contingent repayment for at least 10 percent of defaulters whose notes have been assigned to the Secretary for collection via subrogation. The income-contingent repayment plan must be the same or similar to that available to borrowers under the new FDSL program.⁴¹ In addition, the Secretary of ED is authorized to buy up to \$200 million in loans to high-risk student borrowers⁴² who request alternative repayment options, which must include income-contingent repayment as previously described. Other alternative payment schedules could include graduated repayment or an extended repayment period.

The SLRA also authorized the Secretary to offer Federal Direct Consolidation loans to borrowers of FFELs unable to obtain a consolidation loan with income-sensitive repayment terms acceptable to the borrower from a FFEL lender. (FFEL Consolidation loans are described in chapter 2 above.) Federal Direct Consolidation loans will offer the borrower a variety of repayment options, including income-contingent repayment.

DEFERMENTS AND FORBEARANCE

Deferment and forbearance are the primary means through which a borrower is temporarily relieved of his or her obligation to make scheduled loan payments. Any period during which a borrower is in deferment or forbearance is *excluded* from the calculation of the repayment period.

⁴⁰These repayment plans are limited in the amount of adjustment that can be made by statutory requirements that the loan be repaid within the 10-year maximum and that monthly payments are, at a minimum, sufficient to cover interest (i.e., no negative amortization).

⁴¹For a general discussion of the issues involved in designing an income-contingent plan, see: Congressional Budget Office. *Issues in Designing a Federal Program of Income-Contingent Student Loans*. CBO Memorandum. Washington, Jan. 1994. For a discussion of the implementation of income-contingent repayment under the new FDSL program, see forthcoming CRS report.

⁴²Applies to all FFEL loans except PLUS loans. The Secretary of Education determines what borrowers are at high risk of default under indicators, which must include the ratio of part B debt to income, established in regulation.

Deferments

A deferment is the temporary cessation of the borrower's obligation to repay loan principal, usually limited by law to a specific period of time, because he or she meets certain conditions. Because of frequent amendments, the types of deferment for which borrowers are eligible can vary according to when the loan is taken out, what type of loan it is, and whether the borrower has an outstanding balance in other FFEL loans.⁴³ As a general rule, until July 1, 1993, one set of conditions for deferments applied and after that time new conditions apply to **new borrowers**, who have no outstanding balance in FFEL loans. For subsidized Federal Stafford loans and Federal Consolidation loans⁴⁴ made up entirely of subsidized Stafford loans, the Federal Government pays the interest during the deferment period; for all other part B loans, the borrower is responsible for the payment of accrued interest, either by making such payments monthly or quarterly or by having the interest added to their principal balance (i.e., capitalized).

The 1992 program amendments made a major change in deferments by consolidating the terms under which borrowers qualify. These deferments only apply to new borrowers with the first disbursement of their loan proceeds on or after July 1, 1993. These new deferments and their time limits are:

- 1) any period during which the borrower is pursuing at least a half-time course of study as determined by the eligible institution he or she attends, is pursuing a course of study pursuant to a graduate fellowship program approved by the Secretary of ED, or is pursuing a course of study pursuant to a rehabilitation training program for disabled individuals approved by the Secretary;⁴⁵
- 2) no more than 3 years during which the borrower is unemployed; and
- 3) no more than 3 years for economic hardship.

The law defines economic hardship as: 1) the borrower earning an amount not exceeding the greater of the minimum wage or 100 percent of the poverty level for a family of two; 2) the borrower having a Federal educational loan debt burden that equals or exceeds 20

⁴³For example, after July 1, 1993 PLUS borrowers with no outstanding FFEL balance are eligible for any deferment as long as the **parent** meets the condition; for other PLUS borrowers--those borrowing before that date or those with outstanding balances as of that date--the parent is eligible not only for in-school, disability, or unemployment deferments, but the parent may also receive a deferment as long as the dependent **student** is attending school. Deferments are borrower specific, i.e., once a borrower has received a deferment for the period specified in law, he or she is not eligible to receive additional deferments for the same condition.

⁴⁴Effective for applications received on or after Jan. 1, 1993, borrowers of Federal Consolidation loans are eligible for any of the deferments of principal authorized for Federal Stafford loans (see above). For Federal Consolidation loans made before Jan. 1993, other deferment rules apply.

⁴⁵The law specifically precludes Stafford or SLS borrowers from eligibility for this deferment if they are serving in a medical internship or residency program.

percent of adjusted gross income **and** the borrower's income is not more than 220 percent of the amounts in "1" above after subtracting the debt payments; and 3) other regulatory criteria established by the Secretary of ED, who must consider as primary factors the borrower's income and debt-to-income ratio.⁴⁶

For those borrowers who have outstanding balances under the FFEL programs as of July 1993, other deferments apply.⁴⁷ They include:

- 1) effectively the same in-school, fellowship, and rehabilitation deferments cited above;
- 2) no more than 3 years during which a borrower is a member of the U.S. Armed Forces, an active duty member of the National Oceanic and Atmospheric Administration Corps, or is an officer in the Public Health Service;
- 3) no more than 3 years during which a borrower serves as a volunteer in the Peace Corps;
- 4) no more than 3 years during which a borrower serves as a full-time volunteer under the Domestic Volunteer Service Act of 1973 (VISTA program);
- 5) no more than 3 years during which a borrower serves in a volunteer capacity comparable to service in the Peace Corps or VISTA for a tax-exempt nonprofit organization;
- 6) no more than 3 years during which a borrower is a full-time teacher in an elementary or secondary school in a "teacher shortage area" established by the U.S. Secretary of Education pursuant to the HEA;
- 7) no more than 2 years during which a borrower serves as an intern as part of a requirement for professional practice or serves in an internship or residency program leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility that offers postgraduate training;
- 8) no more than 3 years during which a borrower is temporarily totally disabled or the borrower is unable to secure employment because of having to care for a disabled dependent;
- 9) no more than 2 years during which a borrower is unemployed and unable to find employment;

⁴⁶The second definition of economic hardship was added to the HEA by P.L. 103-382.

⁴⁷Of the deferments listed, the following are effective only for new borrowers after July 1, 1987: for half-time students, for service in the National Oceanic and Atmospheric Administration Corps, for teaching in shortage areas, for having to care for a disabled dependent, for parental leave, and for mothers of preschoolers.

- 10) no more than 6 months during which a borrower is pregnant or caring for his or her newborn child or adoptive child as long as the borrower is not in school (but within 6 months of when the borrower was in school at least half-time) and not employed; and
- 11) no more than 1 year for mothers with preschool age children who are entering or reentering the workforce with a wage rate no more than \$1 above the minimum wage.

The legislative history indicates Congress intended that at least some of these "old" deferment conditions--medical residencies and internships and low-paid community service and volunteer work--would qualify for deferment under the new broader economic hardship condition.⁴⁸

Forbearance

Forbearance is the practice under which lenders grant borrowers temporary relief from their obligation to repay because the borrower is willing but unable to meet regular payment obligations. Forbearance can constitute lower monthly payments than would otherwise be expected, or total cessation of payments ("complete" forbearance). Forbearance for the FFEL programs (except administrative forbearance) must be "complete" unless the borrower chooses to make smaller payments or extend the time period of repayment. Unlike deferments for subsidized Federal Stafford loans, when the interest is paid by the Federal Government, any borrower under forbearance is liable for all accrued interest during the forbearance period. Also unlike deferments, forbearance is granted at the option of the loan holder, under most circumstances (exceptions are noted below), rather than mandated.

Forbearance is usually used to prevent a loan from defaulting, but under the 1992 program amendments guaranty agencies holding defaulted loans may also use forbearance during collection on a defaulted loan. These amendments also authorize administrative forbearance (not requiring the borrower's permission) under limited conditions as authorized by the Secretary of ED.⁴⁹

⁴⁸A colloquy on the House floor between Representative Dale Kildee and the floor manager of the reauthorization legislation, Representative William Ford, clarified that volunteers such as VISTA and Peace Corps workers and medical residents and interns meeting the debt-to-income standard set by the Secretary of ED would qualify for an economic hardship deferment. (*Congressional Record*, Daily Edition, v. 138, Mar. 26, 1992. p. H1898.) Further, the House committee report on the legislation stated that it was the committee's intent that persons working in community service jobs at wages below the poverty level, and other low-paid volunteers, be included in the Secretary's definition of "economic hardship." (U.S. Congress. House. Committee on Education and Labor. Higher Education Amendments of 1992. Report to Accompany H.R. 3553. House Report 102-447, 102d Cong., 2d Sess. Washington, GPO, 1992. p. 44.)

⁴⁹Under final regulations published June 29, 1994, these include up to 3 years if variable interest rate changes preclude a borrower's ability to repay the loan in 10 years under the standard or graduated repayment plans, and up to 5 years if a borrower's income precludes the ability to repay in 10 years under the income-sensitive repayment plan.

The law establishes three conditions under which lenders are *required* to forbear loans. One is any year when the borrower is serving in a medical or dental residency or internship and does not qualify for a deferment; the second condition is for up to 3 years when the borrower's title IV, HEA debt burden equals or exceeds 20 percent of income. Third, forbearance is required for any year when the borrower is serving in a national service position for which the borrower receives a national service educational award under the National Service and Community Service Trust Act of 1993.

LOAN DISCHARGE AND FORGIVENESS

Borrowers may have all or a portion of their FFEL debt repaid by the Federal Government under certain circumstances through discharge or "forgiveness." The authority for discharge of borrower liability for the loan is confined to instances when any repayment would appear unreasonable. Forgiveness, which only will be available under a limited new demonstration program, is typically used as an incentive for borrowers to be employed in certain activities or professions.

Loan liability is discharged if the borrower dies or becomes permanently and totally disabled. Federal PLUS loans may also be discharged if the student for whom the parent borrower received the loan dies. FFEL loans are generally not dischargeable through personal bankruptcy actions brought either under chapter 7 or chapter 13 of the bankruptcy code.⁵⁰ If, however, the loan repayment began more than 7 years before the date of the filing of the bankruptcy action or the exception of the debt from discharge would, in the judgment of the bankruptcy court, cause undue hardship on the debtor and his or her dependents, the entire student loan or a portion thereof may be discharged. When a FFEL loan is discharged in bankruptcy, the Federal Government pays the debt.⁵¹

The 1992 program amendments additionally provided for the discharge of a borrower's liability for a FFEL loan (including any interest and collection fees owed by the borrower) under either of two circumstances if the student received the loan on or after January 1, 1986. The first is that the student was unable to complete his or her educational program because the school closed. The second is that the school falsely certified the student's eligibility to borrow. Any period of the student's attendance at the institution at which the student was unable to complete the course of study because of closure is not counted against the total period of the student's eligibility for additional student aid. Also, if the borrower had defaulted on the loan discharged under these circumstances, his or her eligibility for further student aid is restored.

The 1992 amendments also authorized a small demonstration program under which Federal Stafford loans borrowed by students during their last 2 years of undergraduate education may be forgiven. This program would repay proportions of such debt for the

⁵⁰Sec. 11 U.S.C. 523; 11 U.S.C. 1328.

⁵¹As soon as a bankruptcy action is filed, the Federal Government pays off the lender. Once the action is concluded, either the loan is resold to the original lender or another lender and collection resumes, or the loan is discharged.

borrower's employment as a teacher in certain special fields (math, science, foreign language, etc.), or in schools with high concentrations of economically disadvantaged students, as a Peace Corps or VISTA volunteer, or as a full-time nurse or medical technician in certain facilities. Eligibility for the program is extended only to *new borrowers* (those with no outstanding FFEL balance) after October 1, 1992. Appropriations are authorized for FY 1993 through FY 1997 for the forgiveness demonstration program, however Congress has not appropriated funds for this program through FY 1995.⁵²

⁵²The FY 1994 disaster assistance legislation, P.L. 103-211 permitted ED to request reprogramming of up to \$3 million from the Corporation for National and Community Service for the Stafford Loan Forgiveness Demonstration program. ED did not request such reprogramming and the FY 1995 budget request from the Department did not request funding for the demonstration.

CHAPTER 5. LOAN DEFAULT AND ITS CONSEQUENCES

Defaults are a significant problem both for the Federal Government and for borrowers. Currently, defaults constitute the greatest single Federal cost in the FFEL program. Gross obligations for defaults in FY 1993 were about \$2.6 billion but collections that fiscal year resulted in net default costs of about \$1.6 billion.⁵³ From the borrower's perspective, default on a student loan can ruin credit and otherwise present a major obstacle to future well-being. This chapter outlines the course of a loan into default, and the consequences of default for borrowers.

WHAT IS A DEFAULTED LOAN AND WHAT HAPPENS TO IT?

As defined for purposes of the FFEL program, a defaulted loan is one on which the borrower has failed to make a required payment or otherwise violated the terms of the promissory note for 180 days⁵⁴ and it is reasonable to conclude that the borrower does not intend to repay the obligation. Guaranty agencies must insure loans made under the conditions of the FFEL programs against default for at least 98 percent of the unpaid principal.⁵⁵

Under the insurance agreement, lenders are primarily responsible for enforcing the repayment of loans they hold. If a borrower misses a payment and a loan becomes delinquent, the lender must undertake certain federally prescribed "due diligence" efforts to collect on the loan over a 180-day period.⁵⁶ At the request of a lender, guaranty agencies must assist the lender in pursuing borrowers with delinquent FFEL accounts prior to the lender filing a default claim. Between the 90th and 120th days of delinquency, such efforts are called "preclaims assistance;" after the 120th day they are "supplemental preclaims assistance." ED reimburses the guaranty agency at the rate of 1 percent of the unpaid principal and accrued unpaid interest on each delinquent account on which it performs *supplemental preclaims assistance* but only if no default claim has been filed on the account within 150 days after the 120th day of delinquency. The guaranty agency receives no specific reimbursement for its preclaims assistance efforts.

If the loan is not collectable after 180 days of delinquency, the lender, within 90 days, must submit a default claim to the guaranty agency for the insurance payment for the outstanding principal plus accrued interest. Once this claim is paid, the lender ceases to have an interest in the loan.

⁵³For additional statistics on defaults, see appendix B.

⁵⁴Two hundred forty days if the loan is repayable in installments less frequent than monthly.

⁵⁵Under certain circumstances, lenders may receive 100 percent insurance. For more details, see chapter 3.

⁵⁶Due diligence is following procedures specified in 34 C.F.R. 682.411 in an attempt to secure repayment of a loan.

After the guaranty agency pays an insurance claim, the note is assigned to it and the agency becomes responsible for making efforts to collect on the defaulted loan. As part of its reinsurance agreement with the Federal Government a guaranty agency is, like the lender, required to exercise diligence in pursuing defaulters for repayment of principal and accrued interest due on their loans under many of the same procedures required for lenders during loan delinquency.⁵⁷

To receive reimbursement of its losses for its insurance payment to the lender on the defaulted loan, the guaranty agency must file a claim with ED no later than 45 days after it pays the insurance claim to the lender. Such reimbursement includes a payment for unpaid principal and accrued interest (that is, the amount it paid the lender), and certain administrative costs minus any payments the guarantor may have collected from the borrower on the defaulted loan. Generally, the Federal Government reimburses the agency at 98 percent. If the agency's annual default claims exceed 5 percent of the agency's insured principal, claims over that level are reimbursed at an 88-percent rate until the end of the fiscal year, when reimbursement reverts to 100 percent again; if such claims exceed 9 percent, the amount over 9 percent is reimbursed at a 78-percent rate until the end of the fiscal year.⁵⁸

CONSEQUENCES OF DEFAULT FOR BORROWERS

When a loan goes into default, the borrower effectively loses all rights and privileges associated with the loan and the guaranty agency can demand payment in full of all principal and interest due. As part of its due diligence requirements, the guaranty agency must apprise the defaulter of some of the major consequences of defaults. This section summarizes these and other elements of the law designed to improve collections on defaulted loans. It is important to note that there is **no statute of limitations on student loan collections.**

Report to Credit Bureau

By law, loan holders and guaranty agencies are required to enter into agreements with national credit bureaus to exchange information relating to student borrowers. Such agreements **require** the guaranty agency to report a loan default and the status of collections on that note. Credit bureaus are authorized to report information on the status of a defaulter's account for 7 years from the date the default claim is paid or, if the borrower reenters repayment after defaulting and subsequently defaults, 7 years from the date of the subsequent default.

⁵⁷34 CFR 682.410(b)(6)

⁵⁸See chapter 3 for more information on the guaranty agencies responsibilities and reinsurance rates. In FY 1992, six guaranty agencies had annual default claims exceeding 5 percent. (ED, *FY 1992 Loan Programs*, p. 61.)

Offset of Tax Refund

Defaulters are liable for any Federal tax refund due them to be attached by the Internal Revenue Service (IRS) as repayment on their student loan. A number of States also attach refunds due on State income taxes to collect student loans.

Wage Garnishment

Notwithstanding any State law to the contrary, 10 percent of a defaulter's disposable pay may be garnished to repay a defaulted student loan. "Disposable pay" is defined as that part of compensation remaining after deducting amounts required by law to be withheld. Defaulters must be given written notice of the intent to garnish and have rights to examine the debt record, have a hearing concerning the existence and amount of the debt or repayment terms, and to establish a repayment schedule before garnishment begins. In the past, garnishment has particularly been used as a tool against defaulters who are Federal employees.⁵⁹

Ineligibility for Student Aid

As previously mentioned in chapter 1, students who have defaulted on a title IV loan are ineligible for student aid. Under the 1992 program amendments, defaulters having made 6 consecutive monthly payments on their defaulted loans may have eligibility restored, but a borrower may only benefit from this provision once.

Lawsuit

The ultimate tool used to collect on a defaulted student loan is litigation under which the guaranty agency sues the defaulter to compel repayment of the loan. Such civil suits are required to be instituted under the due diligence regulations unless the note is assigned to ED for collection through the IRS offset program, the lawsuit costs would exceed those of the likely recovery or the borrower does not have the funds to satisfy the judgment on the debt or a large portion of it.

LOAN REHABILITATION

Loan rehabilitation offers defaulted borrowers an opportunity to have their loan reinstated as an active loan and restore benefits and privileges they have as borrowers. If the defaulter makes 12 consecutive monthly payments under a payment plan agreed to by the borrower and guaranty agency, the loan may be sold at which time the individual is again eligible for full borrower privileges, such as deferments. In implementing these provisions, the guarantor may not require a monthly payment that is not "reasonable and affordable" based on the borrower's financial circumstances.

⁵⁹Applicants for Federal employment are also screened to prevent defaulters from being hired.

APPENDIX A: BASIC PROGRAM DATA

RECIPIENTS

The following table displays the characteristics of undergraduate Stafford loan recipients in the 1989-90 academic year, which are the most recent data available. As noted above, approximately 16 percent of all undergraduates (2.568 million students) received Stafford loans; a similar percentage of graduate and professional students also were Stafford loan borrowers. Data are not available for the proportion of students receiving SLS loans or whose parents received PLUS loans. Data for the table are from CRS analysis of the U.S. Department of Education, National Postsecondary Student Aid Survey, NPSAS90 database.

TABLE A.1. Characteristics of Undergraduate Stafford Loan Recipients (1989-90)
(in percents)

Type of School	
Public 4-year	32.9
Private 4-year	24.7
Community college	10.2
Proprietary school	29.5
Other	2.7
Total	100.0
Income and Dependency	
Dependent students	
Less than \$10,000	9.7
\$10,000 - 29,999	17.2
\$30,000 - 39,999	8.6
\$40,000 or more	12.2
Total	47.8
Independent students	
Less than \$10,000	29.8
\$10,000 - 29,999	18.4
\$30,000 - 39,999	2.6
\$40,000 or more	1.4
Total	52.2
Race/Ethnicity	
White	71.5
Black	16.2
Hispanic	8.4
Asian	3.3
Native American	0.6
Total	100.0

PROGRAM OPERATION

Statistics on the operation of the FFEL programs are generally available through FY 1994 (academic year 1993-94), although the FY 1994 numbers are estimated. This section summarizes some major program indicators. The following tables provide information on loan volume, number of loans, and the average loan size based on the amount of loan principal actually disbursed in a given fiscal year. Similar data are available for loan commitments, but the disbursement data are a better indicator of actual program use. As the tables indicate, there have been significant increases as a result of the 1992 amendments. The source of the data is *The Budget of the United States Government, Fiscal Year 1994, Appendix*, p. 554, and *Fiscal Year 1995, Appendix*, p. 383, Washington, 1993, 1994:

TABLE A.2. FFELS Disbursed, FY 1992-FY 1994
(in billions of \$)

	FY 1992	FY 1993	FY 1994
Stafford Loans (subsidized)			
Undergraduates	\$8.196	\$8.976	\$9.242
Graduates	2.179	2.532	2.607
Unsubsidized Stafford	n.a.	0.964	3.050
SLS	2.020	2.811	1.863
PLUS	1.202	1.241	1.487
Total	13.597	16.524	18.249

TABLE A.3. Number* Of FFELS Disbursed,
FY 1992-FY 1994
(in thousands)

	FY 1992	FY 1993	FY 1994
Stafford Loans (subsidized)			
Undergraduates	3,281	3,431	3,430
Graduates	405	424	424
Unsubsidized Stafford	n.a.	404	885
SLS	676	742	473
PLUS	365	325	316
Total	4,727	5,326	5,528

*These data indicate the number of loans, not borrowers in a given year. A student could borrow more than one loan during the year.

**TABLE A.4. Average FFEL Loan Size,
FY 1992-FY 1994**
(in whole dollars)

	FY 1992	FY 1993	FY 1994
Stafford Loans (subsidized)			
Undergraduates	\$2,498	\$2,616	\$2,695
Graduates	5,374	5,972	6,149
Unsubsidized Stafford	n.a.	2,388	3,447
SLS	2,986	3,786	3,938
PLUS	3,288	3,822	4,699

CUMULATIVE LOAN VOLUME

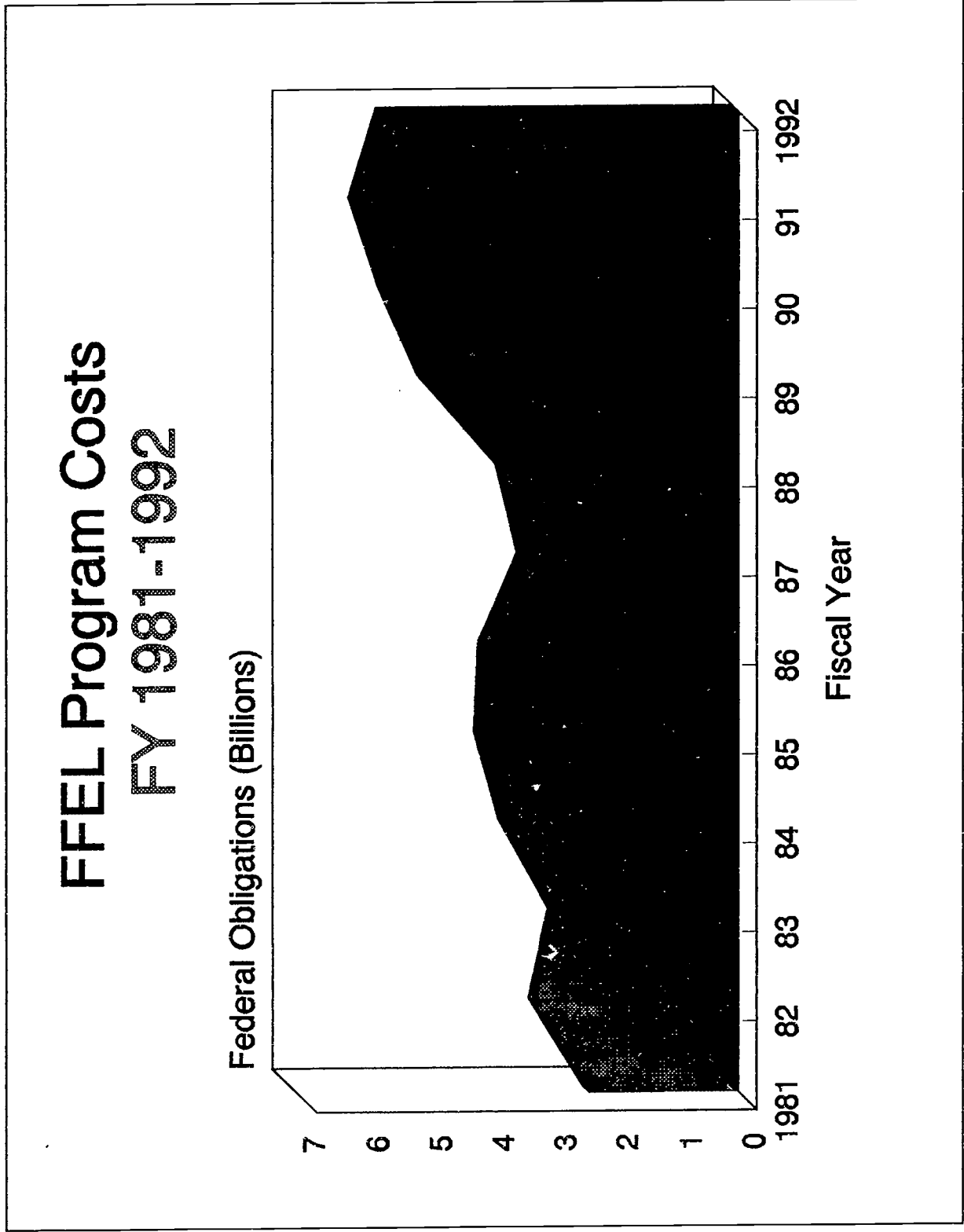
From the inception of the FFEL programs through FY 1993, total loan principal disbursed was over \$143 billion. About \$7 billion of this amount was guaranteed directly by the Federal Government under the FISL program. The remainder was guaranteed through State and national guaranty agencies. As of the end of FY 1993, about \$119 billion in loans had matured, or ever entered repayment; approximately \$41 billion was in repayment. Generally, about \$12-13 billion enters repayment annually and about \$6-7 billion is repaid by borrowers.

ANNUAL FEDERAL EXPENDITURES

The following graph illustrates the growth in annual Federal expenditures for the GSL programs from FY 1981 through FY 1992. The data are from the U.S. Department of Education, *FY 1992 Loan Programs Data Book*, Washington, 1994. The three main components that affect Federal expenditures are the special allowance payments to lenders, in school interest payments to lenders on behalf of borrowers of subsidized loans and reimbursements to the guaranty agencies for losses due to borrower default. Reflecting the significant program expansion in FY 1979 under the Middle Income Student Assistance Act, program expenditures had increased significantly at the end of the 1970s. Since then, changes in interest rates which affect the special allowance, and the growth in default costs have been the two most important factors affecting the trend in the graph. Federal expenditures for GSLs were particularly affected by the costs of special allowance payments in FY 1981 and FY 1982, when the T-bill quarterly averages ranged from 13 to nearly 16 percent. A considerable decrease in expenditures occurred in FY 1983, when the T-bill average fell to between 8 and 10 percent. A rise in the T-bill rate in FY 1984 produced a corresponding rise in expenditures that year to \$3.7 billion. Special allowance costs stabilized in FY 1985 but dropped by \$500 million in FY 1986 and in FY 1987 acting as a primary influence on the reduction in total GSL expenditures those 2 fiscal years.

By FY 1990, GSL program expenditures had reached \$5.6 billion. Two major influences on this increase were large increases in special allowance payments and payments for defaults after FY 1988. Expenditures for special allowance payments had risen to \$1.425 billion and reinsurance payments for defaults had increased to \$2.484 billion. Since then, special allowance payments have declined precipitously, paralleling the drop in T-bill rates, to only \$0.231 billion in FY 1992, while default costs peaked at \$3.245 billion in FY 1991 and were \$3.031 billion in FY 1992. Appendix B provides some default statistics for the FFEL programs.

GRAPH 1. FFEL Program Costs FY 1981-1992



APPENDIX B: DEFAULT STATISTICS

A defaulted loan is one on which the borrower has not made required payments for at least 180 days. At this time the State-level guaranty agency insuring the loan pays the lender principal and interest due; this agency is subsequently reimbursed for most of these costs by the Federal Government under its reinsurance agreement.

ANNUAL DEFAULT COSTS AND OFFSETS

Federal default costs reached an all time high of \$3.3 billion in FY 1991. Contributing to this level was the significant rise in FFEL borrowing in the 1980s, increasing the loan volume in repayment exposed to default. Another factor was increased program participation by borrowers at high risk of default: students attending proprietary schools with short-term programs. New Federal laws limiting the participation of schools with high default rates in FFEL programs have apparently begun to lower default costs; in FY 1992 and FY 1993, costs were approximately \$2.7 billion each year. Collections on defaulted loans have also increased in the 1980s, particularly due to the attachment of defaulter's Federal tax refunds after 1986. In FY 1993, collections amounted to \$1.05 billion. It should be noted that annual default costs are less useful in assessing trends because of annual flows into and out of repayment. The most useful indicators of long term default trends are the cumulative default rate measures.

CUMULATIVE DEFAULT RATES

The gross default rate is the total dollars in default claims paid lenders since the inception of the FFEL programs (FY 1966) divided by the total loan principal that ever entered repayment. The net default rate reduces the claims by funds recovered through collections. Cumulative FFEL defaults were \$22.4 billion as of the end of FY 1993; cumulative collections were \$6.4 billion; matured loans totalled \$119 billion. The gross default rate for the FFEL programs has increased from 11.6 percent in FY 1985 to 18.8 percent in FY 1993. The net default rate has also increased from 8.9 percent in FY 1985 to 13.4 percent in FY 1993.

Aside from volume increases, much of the increases in default costs have been attributed to the growth in program participation by students of proprietary schools. Separate cumulative default rates by institutional sector are not available; however, the ED has calculated the percentage of cumulative default costs for Stafford Loans only (\$15.2 billion for FY 1966 through FY 1992) attributable to borrowers who attended various types of postsecondary institutions. These percentages are as follows:

Cumulative Stafford Default Rate

4-Year Public Institutions	20.9%
4-Year Private Institutions	17.7
2-Year Public Institutions	10.7
2-Year Private Institutions	02.1
Proprietary Schools	48.6
	100.0

A more useful measure of trends in the default behavior of borrowers attending different types of institutions is the cohort default rate which indicates the defaults among a selected group of borrowers or loans. ED has calculated cohort default rates (defined as a group of borrowers who entered repayment in Fiscal Year X whose default status was determined at the end of Fiscal Year X + 3) for the Stafford Loan program by type of institution for FY 1985 through FY 1989. Tables B.1 and B.2 provide these rates for borrowers and dollars respectively.

TABLE B.1. Stafford Borrower Default Rates, FY 85-89

FY Cohort	Public 4-year	Private 4-year	Public 2-year	Private 2-year	Proprietary	All
1985	13.4	15.2	34.7	15.4	51.5	26.7
1986	12.8	11.7	34.6	17.9	48.4	26.5
1987	12.9	13.5	32.3	23.4	48.0	28.7
1988	14.0	14.8	33.3	26.7	53.1	34.0
1989	12.8	13.3	30.7	29.4	58.4	35.5

TABLE B.2. Stafford Dollar Default Rates, FY 85-89

FY Cohort	Public 4-year	Private 4-year	Public 2-year	Private 2-year	Proprietary	All
1985	11.7	10.8	28.6	11.0	45.1	18.0
1986	10.8	9.3	34.5	14.3	43.8	18.9
1987	10.7	9.9	30.5	18.0	44.9	20.0
1988	11.7	11.3	29.7	21.2	50.3	25.1
1989	10.5	9.3	29.5	22.4	55.2	23.3

Institutional Eligibility and Cohort Default Rates

For purposes of linking institutional eligibility and cohort default rates, (see chapter 1 above) an institution's default rate is defined as the number of borrowers last attending that institution entering repayment on a Federal Stafford (subsidized or unsubsidized), Federal SLS loan, or the portion of a consolidation loan that is used to repay such loans, in a given year who default by the end of the succeeding fiscal year *divided by* the total number of those borrowers entering repayment in the given year. Note that this definition is different from that used by ED's analysis branch in tables 1 and 2 above. ED has recently published cohort default rates for FY 1990, 1991 and 1992 by institutional sector using the statutory definition. Table B.3 provides that data.

**TABLE B.3. Federal Family Education Loans Cohort Default Rates,
FY 1990, FY 1991, FY 1992**

FY Cohort	Public 4-year	Private 4-year	Public 2-year	Private 2-year	Proprietary	All
1990	7.0	6.5	17.2	18.5	41.2	22.4
1991	6.6	5.9	14.8	14.9	36.2	17.8
1992	7.0	6.4	14.5	14.3	30.2	15.0