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ABSTRACT

This report presents the testimony of the Associate Director of Education and Employment Issues of the Health, Education, and Human Services Division of the General Accounting Office (GAO) concerning the participation of postsecondary institutions in the Federal Family Education Loan Program (FFELP), which makes direct student loans to students. It reports on a study of 102 institutions that are participating in the FFELP during its first year of operation, which began July 1, 1994. Representatives of 38 schools that were contacted reported that they were generally very satisfied with the implementation of the direct loan program. They observed that students were able to get their loan proceeds more quickly, the loan process was less complex for parents and students, and the schools had more control over the loan process than under the previous system. A total of 1,420 schools were selected to participate in the second year of the FFELP implementation process. It is estimated that direct loans may make up less than 40 percent of the loan volume at participating schools in 1995, falling short of FFELP goals. Guidelines for school participation in the program, such as loan default rates, are included. (MDM)

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Testimony

Before the Subcommittee on Education, Arts, and Humanities, Committee on Labor and Human Resources U.S. Senate

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DIRECT STUDENT LOANS

Selected Characteristics of Participating Schools

ED 382 076

Statement of Cornelia M. Blanchette
Associate Director
Education and Employment Issues
Health, Education, and Human Services Division

HE028263

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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss our work on the Federal Direct Student Loan Program that we believe will assist you and your Subcommittee in your deliberations on the future of this program.

Federal student loan programs have provided billions of dollars in financial aid to postsecondary education students over the last 25 years, but problems have continually plagued the programs. For example, the guaranteed student loan program--now entitled the Federal Family Education Loan Program (FFELP)--has experienced high student loan defaults and lacks the accurate and timely information required for sound management decisions. This is attributed partly to a complex and costly program structure involving thousands of lenders, guaranty agencies, and other participants. To address these problems the Congress enacted the phase-in of the direct student loan program. As the Department of Education implements the phase-in, several issues and potential pitfalls should be considered involving the selection of schools and administration of the program.

For today's testimony, you asked us to focus on (1) information we have gathered and analyzed on schools that are participating in the first year of the program (referred to as "year one"), which started on July 1, 1994; (2) the preliminary results of a survey we are conducting for the Subcommittee of year-one schools to obtain their views on their experiences with the program; and (3) information on schools selected for year two, which begins on July 1, 1995.

We want to highlight some of the key findings:

-- One hundred and two postsecondary schools are participating in year one. They represent an aggregate of 5 percent of fiscal year 1991 student loan volume.

-- Schools participating in year one are very satisfied with the Department's implementation of the direct loan program.

-- For schools that the Department selected for year two, as of March 21, 1995, the aggregate loan volume is short of that year's 40-percent goal. Part of this shortfall may be attributed to the uncertainty regarding the future of the direct loan program.

BACKGROUND

The federal government, through the Department of Education, has been providing guaranteed student loans to postsecondary students under the Higher Education Act of 1965, as amended. In fiscal year 1994, over $23 billion in student loans were made available to borrowers through programs authorized by this statute. FFELP provides for lenders, mostly from the private sector, to make loans to eligible borrowers, and for state-designated guaranty agencies to guarantee the loans against borrower default or other statutory reasons for nonpayment. Federal costs under FFELP are principally interest subsidy payments to lenders making, holding, and collecting loans, and payments to guaranty agencies to partly reimburse them for loan default claims they paid to lenders and for their administrative expenses.

The Federal Direct Student Loan Program, originally authorized by the Higher Education Amendments of 1992, was established in part because of high student loan default rates and other problems in FFELP (as documented, for example, by our High-Risk Series and other reports). The program is an effort to simplify the student loan process by eliminating private sector lenders and guaranty agencies, and to reduce federal costs mostly by eliminating interest subsidy payments to lenders. Under the direct loan program, the government makes the loans, but the schools actually disburse the funds on behalf of the government. A government contractor is responsible for the day-to-day servicing and collecting of the loans and processing loans that may default. The Department selects schools to participate in the program based on guidelines published in the Federal Register. Schools can then make direct loans to all of their students or to a selected part of their student enrollment, such as first-year students, and allow other students to obtain loans through FFELP.

The direct loan program, as originally authorized, was to operate as a 4-year pilot program. The Department was to select schools, which were to represent 5 percent of the student loan volume, to participate in the program over the 4 years. But that changed with the Student Reform Act of 1993. Under the 1993 legislation, the direct loan program is to be gradually phased in over 5 years, beginning with the 1994-95 academic year. In the first year, direct loan volume is to represent 5 percent of new student loan volume; in the second year, 40 percent; in the third and fourth years, 50 percent; and by the fifth year (the 1998-99 academic year), 60 percent. The Department can exceed the goals for years 3 through 5 if more schools want to participate

The law also specifies that the Department use "the most recent program data available" to estimate student loan volume. The Department used fiscal year 1991 FFELP data for estimating year-one loan volume and fiscal year 1992 data for year-two estimates.

The Department, in its fiscal year 1996 budget request, proposed accelerating the implementation of direct loans to all schools by 1997-98. Several bills have been introduced in the 104th Congress (including S. 495 and H.R. 530) that would, if enacted, cap direct loans at 40 percent of new loan volume.

INFORMATION ON SCHOOLS PARTICIPATING IN YEAR ONE

For the first year of the direct loan program, the Department selected 105 schools from the approximately 1,100 that applied. The Department estimated the direct loan volume for the 105 schools at $729 million, or about 5 percent of student loan volume for the 1994-95 academic year.

After the Department made its original selection of year-one schools, two dropped out. A 4-year private school withdrew because of concerns about the resources it would need to implement direct lending. A proprietary school (that is, a for profit, vocational school) dropped out because it went out of business. Additionally, two 4-year private schools in one university system (the main campus and a branch campus), which the Department initially listed separately, chose to report their direct loan data on a combined basis. As of February 1995, 102 schools were in the program.

As shown in table 1, 56 of the 102 year-one schools are 4-year schools. Of these, 34 are public and 22 are private schools.

Table 1: Kinds of Schools in the First Year of the Direct Loan Program

Kind of school	Number of schools	Percentage
4-year public	34	33.3
4-year private	22	21.6
2-year, or less, public	9	8.8
Proprietary	37	36.3
Total	**102**	**100.0**

Although proprietary schools were the largest portion of year-one schools (36.3 percent), they accounted for only 3.7 percent of the $576 million in direct loan disbursements made during the program's first 6 months, ending on December 31, 1994. Four-year public and private schools, with almost $549 million in direct loans made to their students, accounted for 95 percent of the total loan volume during this period (see table 2).

Table 2: Direct Loans Made at Year-One Schools, July 1 to December 31, 1994

Dollars in millions

Kind of school	Amount of direct loans made	Percentage
4-year public	$439.2	76.2
4-year private	109.7	19.0
2-year, or less, public	6.1	1.1
Proprietary	21.1	3.7
Total	**$576.1**	**100.0**

For year one, the Department selected schools that were widely dispersed around the country. All but five states had at least one year-one school.

Most Year-One Schools Originate Direct Loans

Direct loans can be made by the participating schools themselves or by an alternative originator--an entity that makes loans for schools. On the basis of its assessment of such factors as a school's financial condition, history of loan defaults, and reported audit findings, the Department determines whether a school is permitted to make loans or whether the school must use an alternative originator. A school may choose to use an alternative originator if it wishes.

Of the 102 year-one schools, 59 schools--mostly 4-year public schools--are making direct loans themselves (see table 3). Thirty-one proprietary schools use alternative originators to make direct loans to their students.

Table 3: How Year-One Schools Originate Loans

Dollars in thousands

Kind of school	Schools making their own loans		Schools using alternative originators	
	Number of schools	Loan volume	Number of schools	Loan volume
4-year public	30	$406,633	4	$32,601
4-year private	20	108,643	2	1,086
Proprietary	6	10,163	31	10,954
2-year public	3	4,596	6	1,461
Total	**59**	**$530,035**	**43**	**$46,102**

VIEWS OF YEAR-ONE SCHOOLS ON THEIR DIRECT LENDING EXPERIENCES

To get a sense of how the direct loan program has been working so far, we conducted telephone interviews with a judgmentally selected sample of 17 year-one schools. In addition, using a short questionnaire on the Internet, we asked school financial aid officials at selected year-one schools to comment on their experiences with the direct loan program. We will report to the Subcommittee on the complete results of this survey in the future, but we want to share with you a brief summary of what the schools had to say about their experiences with this new program.

Overall, representatives of the 38 schools we contacted were very pleased with direct lending and with the assistance and guidance provided by the Department of Education's Direct Loan Task Force (the Department unit formed to implement the direct loan program) and the loan servicing contractor. In general, the schools preferred direct lending over FFELP because they believed the program benefits both students and schools. Some of their comments were as follows:

-- Students get their loan proceeds much faster.

-- The direct loan process is less complex and confusing than FFELP for students and their parents.

-- Schools have more control over the loan process.

Representatives of 20 schools said that the direct loan program did not have any disadvantages when compared with FFELP.

But nine schools recounted difficulties they experienced in reconciling their records of direct loan disbursements with those of the loan servicer. Schools were drawing down funds from the government and disbursing loan proceeds to students but were delaying--in part because of software interface problems--the reporting of these actions to the direct loan servicer, which requires periodic reconciliation. This has been a very time-consuming and tedious experience, and has contributed to difficulties in reporting accurate financial information. The Department's Office of Inspector General's (OIG) fiscal year 1994 audit report of the direct loan program, issued on March 17, 1995, identified this as an internal control weakness. OIG representatives said that the Department has acknowledged the problem and has been working on resolving it for some time.

Even though some schools had experienced problems, representatives from the 38 schools said they would recommend the direct loan program to other schools and said they intend to continue in the program beyond the first year.

INFORMATION ON SCHOOLS SELECTED TO PARTICIPATE IN YEAR TWO

On July 1, 1995, the direct loan program will begin its second year. On December 29, 1994, the Department published a list of 1,495 schools it had selected to participate in year two. The Department estimated that the selection of these schools would result in direct loans representing about 40 percent of student loans for the 1995-96 academic year.

However, Department data, as of March 21, 1995, showed that 104 of the 1,495 schools had withdrawn from the program, 74 of which were 4-year schools. Two of these were among the five largest schools selected to participate in year two, with a combined fiscal year 1992 student loan volume of $121 million. As shown in table 4, the 104 schools that withdrew had a combined 1992 loan volume of $620 million, nearly 11.5 percent of the $5.4 billion the Department estimated for year-two schools.

Table 4: Year-Two School Withdrawals and Additions, from December 29, 1994, through March 21, 1995

Dollars in millions

	Withdrawals		Additions		Net changes	
Kind of school	Number of schools	FY 1992 loan volume	Number of schools	FY 1992 loan volume	Number of schools	FY 1992 loan volume
4-yr public	26	$281.5	8	$30.5	-18	$-251.0
2-yr public	14	15.6	6	4.0	-8	-11.6
Proprietary	16	15.4	13	10.3	-3	-5.1
4-yr private	48	307.3	1	3.1	-47	-304.2
2-yr private	0	0	1	0.1	+1	+0.1
Total	**104**	**$619.8**	**29**	**$48.0**	**-75**	**$-572.0**

To compensate for the withdrawal of the 104 schools, the Department began adding schools for year two. As of March 21, 1995, the Department had added 29 schools with an aggregate fiscal year 1992 loan volume of $48 million for a net reduction of 75 schools and a 1992 loan volume of $572 million. According to a Department official, the Department is continuing the process of selecting replacement schools.

We contacted officials of seven large schools and two smaller schools that left the program to learn their reasons for withdrawing. Officials at eight schools said they withdrew primarily because of computer-related or other resource concerns at their schools. For example, an official at a large 4-year public school said the school was working on a major computer upgrade and could not free up the staff needed to revise systems to operate under the direct loan program. The official said the school was undergoing staff cuts and would assess its resources before deciding whether to enter the direct loan program in year three.

An official at another 4-year public school said that after talking to representatives from year-one schools, the school realized that it did not have the resources to start direct lending because its staff was fully occupied with implementing other new software. But the official said the school expects to participate in year three.

An official of a small 4-year private school said the school withdrew primarily because its guaranty agency and loan servicer under FFELP began providing improved service last fall and helped the school fully implement new software and an electronic funds transfer system. As a result, its day-to-day administration of FFELP is no longer unwieldy, and its error rates and processing time have been cut dramatically, making the direct loan program less attractive compared with FFELP.

Officials we spoke with at several of the schools that withdrew were also concerned about the future of the Federal Direct Student Loan Program. They were concerned that the program might not be fully funded in the future or that it might be rescinded.

Year-Two Loan Volume May Be Below 40-Percent Goal

The direct loan volume generated by year-two schools may be substantially less than 40 percent of student loans--the goal specified in the law. This may occur because (1) some of the schools originally selected to participate subsequently withdrew, as we discussed previously, and (2) the Department's estimates of direct student loan volume for year-two schools were based on its assumption that all student loans at participating schools would be direct loans. That is, the Department estimated that year-two schools no longer would make any new loans under FFELP. A Department official said that this was done as a precaution to avoid exceeding the 40-percent goal.

Using its assumption that all year-two schools would make direct loans exclusively, and using fiscal year 1992 student loan data, the Department estimated loan volume for the original list of 1,495 year-two schools at $5.4 billion. This represented 36.7 percent of the $14.7 billion in fiscal year 1992 student loan volume. But some schools specified a lesser percentage of direct loan participation in their applications.

Using the Department's March 21, 1995, revised list of 1,420 schools selected for year two, we found that 925 schools (65.1 percent) intended that direct loans would be 100 percent of their new loan volume. We adjusted the Department's estimate of the percentage of direct loans that the schools planned to make in year two, and estimated that direct loan volume for year two could be about $4.2 billion (see table 5). This is about 28.7 percent of fiscal year 1992 student loan volume, a shortfall of 11.3 percentage points--about $1.7 billion--from the 40-percent goal.

Table 5: Extent of Direct Loan Program Participation for Year-Two Schools, as of March 21, 1995

Dollars in millions

Direct loan percentage of new loan volume	Number of schools	Percentage of total schools	Estimated direct loan volume
100 percent	925	65.1	$3,402.0
75 to 99 percent	153	10.8	389.4
50 to 74 percent	223	15.7	274.7
30 to 49 percent	119	8.4	173.4
Total	**1,420**	**100.0**	**$4,239.5**

If year-two direct student loan volume fails to approximate the 40-percent goal stated in the Student Reform Act, the government may fail to fully achieve the cost savings anticipated for direct loans. The cost saving estimate is predicated on the phased-in implementation of direct lending as provided by the statute. Department officials said that they are confident that enough schools will participate in years two and three to achieve the cost savings target.

Characteristics of Schools Selected for Year Two

Table 6 shows the kinds of schools the Department selected to participate in year two. Similar to the distribution of schools in year one, proprietary schools will make up the largest number of the schools in year two.

Table 6: Kinds of Schools Selected for Year Two, as of March 21, 1995

Kind of school	Number	Percentage
4-year public	231	16.3
4-year private	238	16.8
2-year public	160	11.3
2-year private	63	4.4
Proprietary	728	51.3
Total	**1,420**	**100.1[a]**

[a]Does not total 100 percent because of rounding.

Table 7 shows the distribution of estimated direct loan volume for the different kinds of schools for year two. Based on our review of the Department's data, direct loans at proprietary schools will comprise 15.4 percent of loan volume.

Table 7: Fiscal Year 1992 Student Loan Volume for Schools Selected for Year Two, as of March 21, 1995

Dollars in millions

Kind of school	FY 1992 volume	Percentage
4-year public	$2,386.8	56.3
4-year private	985.7	23.3
2-year public	147.4	3.5
2-year private	65.9	1.6
Proprietary	653.7	15.4
Total	**$4,239.5**	**100.1[a]**

[a]Does not total 100 percent because of rounding.

Schools selected to make direct loans in year two are located in every state, except Alaska, and are also located in the District of Columbia, Guam, Puerto Rico, and the Virgin Islands. California will have the largest number of direct loan schools (203 schools), with direct loans estimated to total $369.9 million.

Department records show that as of March 21, 1995, 22.2 percent of all schools in FFELP (1,420 of 6,403) planned to participate in year two of the direct loan program. Arizona will have the largest percentage of schools participating in the direct loan program in year two, with 38.4 percent of schools in the state (36 of 94 schools) participating. Appendix I shows a tabulation, based on Department data, of the number of schools that will be participating in FFELP and the direct loan program, by state, in academic year 1995-96, as of March 21, 1995.

Of the 104 historically black colleges and universities (HBCU), 74 will participate in year two. Six HBCUs are currently participating in year one.

Ninety-two schools that the Department selected to participate in year two of the direct loan program had no FFELP borrowers in repayment in fiscal years 1990 through 1992, and thus may have had little or no FFELP experience. Seventy-three of these schools are proprietary schools.

FFELP Default Rates of Direct Loan Schools

In selecting schools for year two, the Department stated that to be eligible, a school (1) must have a cohort default rate of less than 25 percent for at least one of the three most recent fiscal years for which data are available and (2) must not be prohibited from participating in FFELP because its default rates exceed statutory limits. In general, the cohort default rate is the percentage of a school's FFELP borrowers who enter repayment status in a fiscal year and default by the end of the following fiscal year. We examined the default rates of the 1,420 schools selected for year two to determine the extent to which they met the Department's eligibility criteria.

Overall, the fiscal year 1992 aggregate FFELP default rate (the latest data available) of the schools selected for year two was 11.3 percent. This is 3.7 percentage points lower than the 15-percent aggregate default rate of all schools nationwide, including direct loan schools (see table 8).

Table 8: Aggregate Default Rates for Fiscal Years 1990-1992: Year-Two Schools Versus All Schools in FFELP

Percentages

Kind of school	1992		1991		1990	
	All schools	Year two	All schools	Year two	All schools	Year two
4-year public	7.0	7.3	6.6	6.8	7.0	7.2
4-year private	6.4	7.8	5.9	7.2	6.5	7.0
2-year public	14.5	15.3	14.8	14.7	17.2	17.2
2-year private	14.3	15.0	14.9	14.4	18.5	14.8
Proprietary	30.2	20.0	36.2	19.6	41.2	19.2
Total	**15.0**	**11.3**	**17.8**	**10.6**	**22.4**	**11.0**

Although most schools had fiscal year 1992 FFELP cohort default rates below statutory thresholds, several schools had default rates above the thresholds. Ten schools (nine proprietary and one 2-year public) had default rates that exceeded 40 percent. Although these schools could be subject to the loss of all title IV program eligibility, the Department had not initiated action against these schools as of March 21, 1995.

Three schools (all proprietary) had default rates of 25 percent or higher for fiscal years 1990, 1991, and 1992. These schools--if they do not successfully appeal--could lose their eligibility for FFELP. According to a Department official, all three schools had appeals pending with the Department as of March 7, 1995, and remain eligible to participate in FFELP until their appeals are resolved.

Forty-nine schools (46 proprietary schools, one 4-year private school, and two 2-year public schools) had default rates of 25 percent or higher for both fiscal years 1991 and 1992. While these schools' default rates do not exceed the eligibility criteria, the schools could lose FFELP eligibility next year if their fiscal year 1993 default rates are 25 percent or higher. In addition, another 99 year-two schools (81 proprietary schools) had fiscal year 1992 default rates of 25 percent or higher.

CONCLUSION

Because of problems in FFELP, the direct loan program was enacted in part to minimize the number of participants in the delivery of student loans and to strengthen financial information. The phase-in of the direct loan program established a balance between FFELP and the new program that provides opportunities for schools and students to select options that best meet their needs. At the same time, the Congress and the administration can evaluate the costs and benefits of both programs.

For year one of the direct loan program, the Department is meeting its legislative goal that direct loans will represent 5 percent of student loan volume. Also, the schools participating in year one are very satisfied with the Department's performance in implementing the program and responding to problems as they surface.

As of March 21, 1995, the Department has not selected enough schools to meet the legislative goal that direct student loans comprise 40 percent of student loan volume in year two. Part of this shortfall is due to the withdrawal of schools that the Department originally selected to participate in year two. These schools' principal reason for withdrawing was insufficient resources to implement direct lending. Our sense is that the schools might be more concerned about the uncertainty surrounding the future of the Federal Direct Student Loan Program.

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

For more information on this testimony, please contact Joseph J. Eglin, Jr. at (202) 512-7009. Other major contributors included Susie Anschell, Charles M. Novak, Meeta Sharma, Charles H. Shervey, and Dianne L. Whitman.

COMPARISON OF THE NUMBER OF DIRECT LOAN SCHOOLS WITH ALL FFELP SCHOOLS BY STATE AS OF MARCH 21, 1995

State or territory	Direct loan schools	All schools	Direct loan schools as a percentage of all schools
Alabama	19	77	24.7
Alaska	0	11	0.0
Arizona	36	94	38.3
Arkansas	7	89	7.9
California	203	586	34.6
Colorado	29	104	27.9
Connecticut	17	107	15.9
Delaware	4	13	30.8
Dist. of Columbia	2	27	7.4
Florida	34	217	15.7
Georgia	42	128	32.8
Guam	1	1	100.0
Hawaii	1	19	5.3
Idaho	7	27	25.9
Illinois	74	296	25.0
Indiana	26	128	20.3
Iowa	37	106	34.9
Kansas	17	85	20.0
Kentucky	38	151	25.2
Louisiana	17	120	14.2
Maine	7	46	15.2
Maryland	31	97	32.0
Massachusetts	50	193	25.9
Michigan	52	186	28.0
Minnesota	26	127	20.5
Mississippi	8	65	12.3
Missouri	34	183	18.6
Montana	2	34	5.9
Nebraska	11	58	19.0
Nevada	5	23	21.7
New Hampshire	4	36	11.1
New Jersey	49	160	30.6
New Mexico	9	42	21.4
New York	90	472	19.1
North Carolina	31	149	20.8
North Dakota	3	31	9.7
Ohio	49	280	17.5
Oklahoma	10	96	10.4
Oregon	18	89	20.2

Pennsylvania	70	445	15.7
Puerto Rico	31	83	37.3
Rhode Island	10	27	37.0
South Carolina	19	75	25.3
South Dakota	1	34	2.9
Tennessee	18	148	12.2
Texas	61	335	18.2
Utah	8	38	21.1
Vermont	7	31	22.6
Virgin Islands	1	1	100.0
Virginia	41	147	27.9
Washington	15	101	14.9
West Virginia	16	70	22.9
Wisconsin	20	101	19.8
Wyoming	2	14	14.3
Total	1,420	6,403	22.2

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