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Student Loans: Proposals for Reauthorization

Margot A. Schenet
Specialist in Social Legislation
Education and Public Welfare Division

Summary

The Higher Education Act of 1965 (HEA) is being considered for reauthorization in the 2nd session of the 105th Congress. Title IV of the act authorizes the two major student loan programs, the Federal Family Education Loan (FFEL) program and the Direct Loan program, which are the largest source of aid for students. Proposals for reauthorization assume the continued existence of both programs; issues center around student loan interest rates, other terms and conditions of loans in both programs, and guaranty agency financing in the FFEL. Both House and Senate authorizing committees have marked up HEA reauthorization bills that include student loan provisions. Both H.R. 6 and S. 1882 would, among other things, establish a new interest rate formula that would give students a rate comparable to that which is scheduled in current law to take effect July 1, 1998, while assuring lenders of a higher return. Both bills also include provisions to restructure guaranty agency financing. H.R. 6 passed the House on May 6, 1998. On May 22, 1998, both House and Senate passed the conference report on H.R. 2400 (the Transportation Equity Act for the 21st Century) which includes a provision temporarily authorizing the compromise interest rate formula (as specified in H.R. 6 and S. 1882) for Stafford and PLUS loans from July 1, 1998 to October 1, 1998; the President signed this into law in June. For more information on reauthorization, see *CRS Issue Brief 98004, The Higher Education Act: Reauthorization by the 105th Congress.* This report will be updated periodically.

Background

The Higher Education Act of 1965 (HEA) is being considered for reauthorization during this session of Congress. Title IV of the act authorizes the major federal student aid programs, including the student loan programs, which are the largest source of aid for students. In FY1997, the guaranteed and direct loan programs supported an estimated $30 billion in new loan volume. **Federal Family Education Loan** (FFEL) programs, authorized by Part B of Title IV of the HEA insure and subsidize loans private lenders make to students or their parents to help them meet the costs of postsecondary education. FFELs accounted for about two-thirds of the loan volume in FY1997. Several types of FFELs are available: Federal subsidized Stafford loans (under which the government pays the interest while the borrower is in school, a grace period or deferment);

unsubsidized Stafford loans; Federal PLUS loans (for parents of undergraduate students); and Federal Consolidation loans. A common feature of all these loans is that the federal government guarantees lenders against loss through borrower default, or death, disability, or bankruptcy. Lenders are also provided an interest subsidy (the special allowance), if the borrower's interest rate does not afford a sufficient return given financial market conditions. In addition to the private lenders who provide the capital in the FFEL programs, other important players include the secondary markets that buy loans from lenders and provide liquidity in the program, and the state or national nonprofit guaranty agencies that primarily insure lenders against borrower default and provide other administrative services.[1]

In 1993, a new **Federal Direct Student Loan** (DL) program, authorized under Part D of the HEA, was established; it was scheduled to gradually expand and replace FFEL loans. Currently, Direct Loans account for slightly more than one-third of total student loan volume. Unlike FFEL, Direct Loans are made by the federal government to students through their schools, thus eliminating the need for private capital and the guaranty agencies. Schools may serve as direct loan originators or the loans may be originated as well as serviced by contractors working for the U.S. Department of Education (ED). Loan terms and conditions for Direct Loans are generally the same as those in the FFEL programs; however, students are provided with additional repayment options, including income contingent repayment.[2]

Although the establishment of the Direct Loan program was and continues to be controversial, proposals for HEA reauthorization assume the continued existence of both programs. The main issues have centered on student loan interest rates, other terms and conditions of loans that impact students regardless of which program their school participates in, and restructuring guaranty agency financing in the FFEL program. This report briefly summarizes these issues, followed by a description of the legislation.

Interest Rates. Currently Stafford loan interest rates, which vary annually, are based on 91-day Treasury bill rates plus a premium which varies depending on whether the borrower is in-school(+2.5%) or in repayment (+3.1%). Under current law, the calculation of interest rates is scheduled to change on July 1, 1998 to "the bond equivalent rate of securities with a comparable maturity as established by the Secretary" plus 1.0%, assumed to be the 10 year Treasury note + 1.0.[3] The July 1, 1998 change in the interest rate calculation was adopted in 1993 along with the phase-in to direct loans and was intended to pass on to students some of the savings, under budget scoring rules in effect

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[1] For a more detailed description of the FFEL program, see: CRS Report 94-810*, The Federal Family Education Loan Programs*, by Margot A. Schenet.

[2] For further details of the DL program, see: CRS Report 95-110, *The Federal Direct Student Loan Program,* by Margot A. Schenet.

[3] ED has recently suggested the rate would be a blended rate between the 10 year note and 20 year bond rates.

at that time, attributed to the transition to direct loans. To retain comparability in the programs, the FFEL rates were changed as well.[4]

Two concerns have been raised about the scheduled change for the FFEL program. First, the use of a long term index instead of the 91-day T-bill creates inefficiencies (and thus increases costs) for lenders in raising funds to lend to students; and second, the reduced interest earnings under the new formula are such that profit margins may not be sufficient for some lenders to remain in the program or to make some student loans. To the extent that this is the case, student access to loan funds could be disrupted. While general agreement has been reached that the change to a long term security as the index is inefficient, arguments continue over the scope of the second problem.[5] That is, for any proposed formula, analysts differ on the extent to which lenders may leave the program or refuse to make certain loans. Because returns vary depending on lender costs and efficiencies as well as the size of loans, no one interest rate formula is likely to be best across all sectors and in all financial circumstances.[6] Lenders have proposed accepting a reduction of .15% in the premium (i.e., from T-bill + 3.1% to T-bill + 2.95%). At the other extreme, ED proposed reducing rates to T-bill + 1.7% in school and + 2.3% in repayment; this formula is estimated to yield a rate comparable to the long term index + 1.0%.[7] Recently, the Administration has proposed a somewhat higher rate for lenders, linked to early testing of market-based mechanisms (e.g. auctions) to set the interest rates in the FFEL program.

Other Terms and Conditions. Various proposals have also been made to reduce costs to students in other ways, as well as to eliminate differences that exist between the FFEL and DL programs (thereby achieving the so-called "level playing field"). The Administration has proposed lowering fees which borrowers pay on student loans, as an

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[4] It should be noted that the assumed lower rate for borrowers depends on a continuation of the current low spread between the interest rates of different treasury securities; historically, the use of the 1998 formula would have produced the same or higher interest rates for borrowers most of the time.

[5] See, for example, *The Financial Viability of the Government-Guaranteed Student Loan Program*, U.S. Department of the Treasury, February 1998, and *Impact of Current Law on Profitability and Availability of FFEL Loans*, Testimony by Jonathan Gray, Sanford C. Bernstein &Co., Inc. at House Committee on Education and The Workforce Hearing, March 5, 1998.

[6] Since certain costs are fixed, loans with smaller balances (which tend to be for students in non-degree programs) would likely be the first to be dropped. See CRS Report 97-733 *Student Loans: What is the Problem with Converting to the 10 Year Interest Rate Benchmark?*, by Barbara Miles, as well as CRS Memorandum, *Student Loan Interest Rates*, March 11, 1998 by the same author. Access problems might be dealt with through the "lender of last resort" provisions in FFEL, or through absorption of such schools and students in the DL program.

[7] A Congressional Budget Office (CBO) study, released March 30, 1998, *The Profitability of Federally Guaranteed Student Loans*, indicates that for the interest rate proposed by ED "returns would be unattractively low for all loans with the possible exception of loans to students attending graduate or professional schools". The report also concluded that current rates provide more than sufficient rates of return on all types of loans.

additional way to help students in both programs.[8] Helping students by reducing charges is a goal on which many can agree, but finding offsetting revenues from other sources is a problem. Level playing field issues include eliminating the differences between consolidation loans in the two programs (and allowing DL borrowers to consolidate in FFEL), differences in the repayment options available, and differences concerning delivery system rules and procedures (such as applications and disbursements).[9]

Guaranty Agency Structure. Guaranty agencies range widely in the size and scope of their activities, and the relationship between their financing and the functions they perform in the FFEL program is not always clear. The agencies maintain reserves to pay lender default claims, for which they are reimbursed by ED at 98%.[10] They receive income from interest on reserves, the insurance premium from students, payments from ED for administrative expenses (.85% of new loan volume) and for "supplemental preclaims assistance" (1% of principal and interest, to help lenders prevent defaults), and retention of 27% of collections on defaulted loans. These revenues are used to pay for activities that include administering the federal guarantee, providing assistance to lenders to prevent defaults, monitoring student loan status and enrollments, and undertaking collection efforts.

Changes being considered during reauthorization focus on strengthening the relationship between revenues and activities, and improving efficiency. ED has proposed eliminating the reinsurance function, recalling most reserves; having lenders pay for default prevention; reducing collections retained; and paying agencies separate fees: one for origination of new loans, and one for maintenance on outstanding loans, to replace the administrative expense allowance.

An alternative model, supported by most guaranty agency representatives, would essentially trade greater risk-sharing by the guaranty agencies for increased responsibility and freedom from ED oversight. This model would separate guaranty agency financing into two streams, maintaining reserves, but restricting the use of reserve funds to pay default claims and fees for default prevention. In contrast, separate fees paid by ED for loan origination and maintenance would go to pay agency operating expenses and could be used not only for loan program activities, but other student aid activities as well, at the discretion of the guarantor.

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[8] Currently, DL Stafford borrowers pay a 4% origination fee; in FFEL, the origination fee is 3%, but borrowers also pay a 1% insurance premium which goes to guaranty agencies to defray their costs.

[9] FFEL consolidation loan interest rates are set by statute, DL consolidation rates by regulation; in addition, DL borrowers could not consolidate in the FFEL program. Most consolidation loan differences were essentially eliminated on an emergency, short-term basis last year, with passage of the Emergency Student Loan Consolidation Act, part of P.L. 105-78. For more information, see CRS Report 97-916, *Student Loan Consolidation,* by Margot A. Schenet. For other level playing field issues, see *Student Loan Issues in Reauthorization of the Higher Education Act*, Congressional Distribution Memorandum, July 3, 1997 by the same author.

[10] Guaranty agency reserves equal accumulated income minus expenditures.

Student Loan Provisions in H.R. 6 and S. 1882

The House Committee on Education and the Workforce marked up H.R. 6 on March 19, 1998. For H.R. 6, CBO estimated additional costs of $1.02 to $3.6 billion, depending on the model used for scoring purposes. H.R. 6 passed the House on May 6, 1998. As passed, the bill includes offsets for slightly more than half the lower CBO estimate.[11] The Senate Committee on Labor and Human Resources marked up S. 1882 on April 1, 1998. CBO cost estimates were not released for S. 1882. Both bills include a number of changes to the student loan programs, the most important of which are summarized below:

- Students will pay interest on new loans made on or after July 1 based on a formula of the 91-day T-bill + 1.7% in schools and + 2.3% in repayment. This is a reduction of .8 in the premium and is the formula ED proposed to hold students harmless. Lenders will receive a special allowance for these loans based on a higher premium: +2.2% in school and + 2.8% in repayment. Lender of last resort loans may also be made, if access problems develop; the House bill clarifies ED's ability to pay guaranty agencies advances for making such loans. Both bills also call for study of market-based mechanisms (such as auctions)to establish federal subsidies for student loans.

- H.R. 6, but not S. 1882, changes consolidation loan interest rates after October 1, 1998 in both the FFEL and DL programs to the weighted average of the loans being consolidated rounded up to the nearest 1/8th of a percent, with a cap of 8.25%. H.R. 6, but not S. 1882, also allows two way consolidation, and FFEL consolidation loan borrowers would retain interest subsidies.

- The House bill changes several loan terms to provide partial offsets (i.e. savings) to pay for the interest rate compromise: the definition of default is changed to extend the period of delinquency, prior to default claims being filed by a lender, by an additional 90 days (from 180 days to 270 days for most loans); accrued interest on FFEL unsubsidized and PLUS loans is capitalized when the loans enter repayment; and the dischargeability in bankruptcy after 7 years of student loans is repealed for loans obtained to attend degree-granting institutions.

- Most other loan terms and conditions are unchanged. S. 1882 provides a new extended repayment option for FFEL borrowers with balances greater than $30,000; it also gives ED authority to establish additional PLUS loan eligibility requirements. H.R. 6 excludes periods of active military duty from calculation of the grace period. Both bills include provisions to simplify FFEL delivery, facilitate electronic exchanges of information, and relax disbursement rules for schools with low default rates. H.R. 6 requires and S. 1882 allows the federal student aid application to be used as the loan application. Both bills also allow ED to offer discounts to DL borrowers for good repayment behavior, but only if it is cost neutral.

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[11] The rule under which the bill was considered on the House floor included a provision that the bill could not take effect without offsets that included, in addition to those in the bill, the sale of sufficient commodities from the National Defense Stockpile to generate $480 million in revenues.

- Both bills give ED authority to enter into "voluntary flexible agreements" with a limited number of guaranty agencies (6) to experiment with new financing arrangements; S. 1882 allows expansion of this number after the third year.

- H.R. 6 recalls an additional $215 million in reserves over 5 years, while S. 1882 recalls $200 million. Under both bills, all current reserves will be placed in a federal fund to be used only for default claims and to pay a default prevention fee of 1% (the existing supplemental preclaims fee is repealed). Federal reinsurance, reduced to 95%, would go into this fund, as would students' insurance premiums. Both bills also reduce the required minimum reserve level from 0.5 to 0.25.

- Both H.R. 6 and S. 1882 set up a separate operating fund that would be under guarantor control, for use in FFEL program and possibly other student aid activities. The Senate bill provides the fund can be used for other activities "as determined by the Secretary"s. Revenues for this fund would include 24% of default collections, and two fees from ED to replace the administrative expense allowance: a .65% issuance fee on new loans; and a .12% maintenance fee on outstanding loans (reduced to .10% in 2001 and thereafter). Under the House bill, but not the Senate, ED may also permit a limited number of agencies to transfer interest on federal reserves to their operating fund for the first 3 years.

- Both bills add slightly different loan forgiveness provisions for teachers, after they have persisted in teaching for 3 years. Both also include a discretionary demonstration program of loan forgiveness for child care providers. Both bills repeal the current discretionary loan forgiveness demonstration program under FFEL.[12]

A temporary interest rate provision, for loans made between July 1, 1998 and October 1, 1998, that changes the formula for Stafford and PLUS loans in both the FFEL and DL programs to the compromise formula specified in H.R. 6 and S. 1882 (see above), was added in conference to H.R. 2400 (the Transportation Equity Act for the 21st Century), which subsequently passed both House and Senate on May 22, 1998.[13] The President signed the bill into law in June.

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[12] For further details on loan forgiveness for teachers, see *Teacher Quality and Quantity: Proposals in the 105th Congress*, CRS Report 98-156, by Jim Stedman.

[13] The Emergency Student Loan Consolidation Act established FFEL consolidation loan interest rates at the 91-day T-bill + 3.1% through October 1, 1998. DL consolidation loan rates are established by regulation and were the same until July 1, 1998. ED has announced that the new rates, beginning July 1, 1998, will match the temporary rates for new Stafford loans, i.e. the 91-day T-bill + 2.3%.