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STATEMENT OF

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BEFORE THE

SUBCOMMITTEE ON EDUCATION, ARTS, & HUMANITIES

SENATE COMMITTEE ON LABOR AND HUMAN RESOURCES

AND THE

SUBCOMMITTEE ON POSTSECONDARY EDUCATION

HOUSE COMMITTEE ON EDUCATION AND LABOR

ON

THE STUDENT LOAN MARKETING ASSOCIATION'S

LOAN CONSOLIDATION PROGRAM

Messrs. Chairmen and Members of the Subcommittees:

We are pleased to be here today to discuss the information you requested us to develop concerning the Student Loan Marketing Association's (Sallie Mae's) loan consolidation program. Specifically, we were requested to develop information on program costs and the program's impact on defaults, and on potential legislative modifications affecting program expansion, interest rates, minimum loan amounts, and interest subsidies.

BACKGROUND

Sallie Mae is authorized by the Education Amendments of 1980 to make new loans and extend the repayment terms of Guaranteed Student Loans (GSL's) and National Direct Student Loans (NDSL's) to borrowers whose aggregate indebtedness exceeds $5,000 from more than one lender, loan program, or guarantor, or exceeds $7,500 from one lender. The act sets the interest rate on consolidated loans at 7 percent. Sallie Mae is paid a special allowance by the Federal Government on the full amount of the loans to compensate for the difference between market and consolidated loan interest rates.

The loan consolidation program is intended to reduce a borrower's repayment burden by providing extended repayment periods and lower monthly payments on relatively high student loan indebtedness. Repayment terms jointly developed by Sallie Mae and the Department of Education can vary from 10 years for loans of up to $7,500 to 20 years for loans totalling more than $16,000. Under the act, only Sallie Mae can provide consolidated loans to student loan borrowers. Sallie Mae is a private for-profit corporation created in 1972 to provide liquidity for student loans by providing a secondary market and related activities for lenders participating in insured student loan programs.

Sallie Mae began consolidating student loans in November 1981, and by December 31, 1982, had consolidated 10,648 loans totalling $66.9 million from 5,473 borrowers. Of these loans, 8,624 totalling $61.9 million were GSLs and 2,024 totalling $5.0 million were NDSLs. The consolidated loans averaged $12,232. The GSL's that were consolidated averaged $7,179 and the NDSLs averaged $2,488. About 70 percent of the consolidated loans exceeded $10,000. By April 1983, loans consolidated by Sallie Mae had reached $107 million.

Sallie Mae offers three repayment options to borrowers participating in the loan consolidation program--a straight line, or constant, monthly repayment schedule, and two types of graduated repayment schedules whereby initial monthly payments are significantly lower than the straight line option but increase every 24 months. However, while repayment periods depend on the aggregate loan amount, the repayment periods for consolidated loans are generally longer than for the original loans and monthly payments are often substantially less than those for the original loans. For example, borrowers with aggregate indebtedness between $11,000 and $16,000 can elect to repay the loan over a period up to 16 years, rather than the 10 year maximum permitted by the GSL and NDSL programs. Typically, a borrower in this range would pay $166 monthly under the original loans and $96 monthly if the loans are consolidated--an average monthly reduction of $70.

COSTS OF CONSOLIDATED LOAN PROGRAM AND ITS IMPACT ON DEFAULTS

Sallie Mae estimates that the consolidation program will cost the Federal Government an additional $2 million, or 5 percent, for every $100 million of loans consolidated. The additional costs would be spread over the life of the consolidated loans, which currently averages about 13 years.

The estimated increase in costs is based on several assumptions. Sallie Mae's estimate assumes that investors incur no expenses associated with the purchase of Sallie Mae securities which are to provide funds for consolidated loans, and therefore pay Federal income taxes on the full amount of interest earned. To the extent that investors' expenses reduce taxable income, Sallie Mae's estimate of Federal costs for the program would increase. The estimated cost increase is also based on the expectation that the added special allowance payments resulting from extended repayment periods will exceed savings resulting from fewer defaults. Sallie Mae used a 2 percent default rate for consolidated loans in its estimate of total program costs, a figure they believe is conservative. The cost estimates can change with variations in a number of factors affecting special allowances including,

--Treasury Bill yields that are the basis for setting special allowances which rise or fall with changes in the yields;

--volume of consolidated NDSLs which are not eligible for special allowances until they are consolidated; and

--aggregate borrower indebtedness which affects the length of the repayment periods and thus special allowance payments.

With respect to Sallie Mae's default experience, as of December 1982, three consolidated loans totalling about $32,000 went into default--less than one tenth of one percent of Sallie Mae's consolidated loan portfolio of about $66.9 million at that time. However, because the program has been operating for only about one year, it is too early to assess the program's impact on loan defaults. The annual default rate for the GSL program is 10 percent of the outstanding loan value and for the NDSL program it is 11 percent.

Department of Education and State student loan program officials expect the consolidation program to reduce defaults. However, a Department official indicated it would be misleading to compare consolidation default rates with GSL and NDSL default rates because default rates tend to decline as the level of borrower indebtedness increases. According to a 1982 study prepared for the National Commission on Student Financial Assistance, borrowers with cumulative GSL debts of over $9000--

the cumulative debt of most borrowers at the time of repayment is less than $3,000--default less often than borrowers with smaller loan amounts.

ASSESSMENT OF PROGRAM ALTERNATIVES

We reviewed the potential legislative modifications to Sallie Mae's loan consolidation program in terms of four issues: (1) extending loan consolidation authority to States, (2) determining individual loan interest rates by averaging the rates of the loans being consolidated, (3) revising or eliminating the aggregate qualifying loan balance requirements, and (4) limiting special allowance payments to the consolidated loans that were eligible for the allowance prior to consolidation.

We developed information on the administrative and financial capability of State programs to administer loan consolidations, the administrative and financial capability of Sallie Mae and State programs to administer consolidations with the potential legislative modifications, and the impact of the potential legislative modifications on Federal costs.

Extending loan consolidation authority to State programs

With the assistance of the National Council of Higher Education Loan Programs, Inc., we identified 33 programs within the States with secondary market or direct student loan authority.

According to a council official, these programs would be the most likely to participate in loan consolidations because they have established funding mechanisms and the authority to buy, sell, and/or make student loans. We contacted officials of the 33 programs by phone to determine their interest in participating in the student loan consolidation program. Officials from 20 of the State programs indicated that their programs would participate in the loan consolidation program if authority was extended to the States. We visited 8 of the 20 State programs to obtain additional information on their interest in the consolidation program and on their programs' administrative and financial capability to administer consolidated loans. These 8 programs provide a balance in terms of loan volume, funding levels, and geographic locations.

We sent letters to the remaining 12 programs requesting similar information, and received responses from four. Because the information they provided was more general than we were able to obtain through personal discussions, their responses are not included in our analysis. However, they generally agreed with the views expressed by officials of the 8 programs we visited.

Six of the eight programs visited had issued tax-exempt bonds to fund their secondary market and direct loan programs. Of the remaining two, one was considering issuing such bonds to fund a secondary market program which had been authorized but not yet implemented, and the other used state pension funds to finance its operations but had authority to issue bonds if necessary to meet funding requirements. Recent bond issues by the programs have ranged from $92 million to $140 million, and in early 1983 the outstanding bonds totalled about $800 million. Officials from each of the programs we visited believed that necessary funds could be raised to meet demand for loan consolidations.

According to Department of Education and State program officials, adequate information is not readily available to identify borrowers who are eligible for loan consolidation in order to develop accurate estimates of the potential volume of loans that would be consolidated. However, a preliminary estimate provided by Sallie Mae indicates a potential nationwide market for loan consolidations of between $300 million and $500 million, and $300 million in new consolidations annually after a few years.

Using the assumption that demand for loan consolidation would be related to outstanding GSLs because they comprised over 90 percent of the consolidations, we computed each State's percentage share of total outstanding GSLs at September 30, 1982. By applying the percentages to the preliminary market estimates, we estimate that potential consolidations for the eight States, based on Sallie Mae's lower nationwide estimate of $300 million, range from about $3 million to about $31 million and total about $84 million. At Sallie Mae's higher estimate of

$500 million, the range would be about $4 million to $51 million and total $140 million.

Because these ranges are well within the ranges of recent bond issues by the State programs we visited, it appears that--as State officials indicated--the programs could raise the funds needed to consolidate loans. In any event, borrowers encountering unanticipated funding limitations at the State programs could consolidate their loans with Sallie Mae.

All of the State programs we visited used automated systems to service student loans. Four had developed their own systems and four contracted with organizations that had student loan processing systems available to interested servicers. These systems maintain demographic and loan history data, provide for merging multiple loans to establish single monthly payments over terms based on loan amounts, generate monthly billings, account for collections, initiate delinquency followup actions, and produce information needed to prepare special allowance billings to the Department of Education.

Of the eight State programs we visited: four operated secondary markets whereby they purchased student loans from lenders to improve lender liquidity; two operated direct loan programs under which loans were made to students who otherwise could not obtain them; one operated both a secondary market and direct loan program; and one had the authority to operate a secondary market but had not exercised it. In addition to servicing the loans in their portfolios, four of these programs had contracts to service GSLs in Sallie Mae's secondary market portfolio.

According to officials of the eight State programs, their program functions for servicing, purchasing, and making student loans are similar to those required to consolidate loans, and any modifications to allow for extended repayment periods could be readily implemented. The officials pointed out that

--their practice of merging borrowers' multiple loans (many students receive more than one loan during their education) to provide a single monthly repayment over periods which vary with loan amounts is a form of consolidation similar to that practiced by Sallie Mae, and

--their secondary market and direct loan activities involve procedures similar to those needed to consolidate loans whereby loan payoff amounts are obtained, checks are prepared and forwarded to lenders to repay student loans, and new loans are established.

None of the State programs offer borrowers graduated repayment schedules--options that have been selected by about 75 percent of those who obtained consolidated loans from Sallie Mae. However, each of the programs expressed the opinion that the technical expertise to develop and implement such options is available. On the other hand, an official observed that if states did not offer graduated repayment schedules--which would generally increase borrower interest costs and Federal special allowance payments--students wanting graduated repayments could obtain consolidated loans from Sallie Mae.

Whether the functions involved in the State secondary market or direct loan activities are similar to those required for loan consolidation is, according to Sallie Mae, questionable. In any event, on the basis of our discussions with the State programs and Sallie Mae, it would seem that the programs could obtain the administrative and technical capability to operate a loan consolidation program.

We attempted to estimate the potential net impact on Federal costs of extending loan consolidation authority to States. We were unable to come up with anything near a precise figure because of the difficulty in obtaining reliable information on several of the elements needed to compute relative costs. There is a cost factor that would need to be addressed, however, if consolidation authority is extended to the States; that is, the administrative cost allowance on GSLs that would be paid to the State guaranty agency by the Department of Education. Since the Federal Government has already paid the 1 percent administrative cost on the face value of the original loans, the desirability of having the Goverment pay a second fee for the consolidation of these same loans is something the Congress may wish to consider.

State program officials agreed that if consolidation authority is extended, criteria should be established to ensure borrowers full access to consolidations and to limit repayment periods based on aggregate loan amounts.

According to officials of three of the State programs we visited, if consolidation authority is extended some State guaranty agencies may be unwilling to insure loans offered for consolidation which were originally insured by another guarantor because they did not receive insurance fees on the original loans. Of the $66.9 million of loans consolidated by Sallie Mae through December 1982, $33.4 million (49.9 percent) were made with borrowers consolidating multiple loans insured by more than one guarantor.

Officials of all the programs indicated that requirements should be established to ensure that borrowers are able to consolidate all eligible loans with a participating program. An official of one program suggested that participating programs offer consolidation only to those borrowers who obtained at least one of the original loans in that program's jurisdiction. In those instances when a guaranty agency is unwilling to insure all of a borrower's eligible loans, the Department of Education could offer to insure the loans directly as it now does with Sallie Mae.

With regard to loan repayment periods based on aggregate loan amounts, according to Sallie Mae and Department of Education officials such limits are needed to prevent unreasonable increases in special allowance payments which could result if borrowers with relatively low loan amounts could extend repayment periods up to the 20 year maximum. State program officials agreed with this.

Averaging interest rates

Because all consolidated loans made by Sallie Mae currently carry a 7 percent interest rate, borrowers who consolidate NDSL loans made at 3, 4, or 5 percent experience an interest rate increase, while those who consolidate 9 percent GSL loans experience a decrease.

Both Sallie Mae and officials of most State programs we visited indicated that their programs have or could acquire the capability to determine consolidated loan interest rates by averaging, on a weighted basis, the interest rates of the underlying loans. However, Sallie Mae and Department of Education officials stated that such a modification would cause administrative problems with the special allowance billing process and limit the Department's ability to assure itself that lenders' billings are accurate. Billings for special allowances are submitted to the Department quarterly for verification and payment. The loans are summarized by the statutory interest rates, and the categories would have to be expanded if consolidated loans are grouped by the average interest rates.

According to Sallie Mae, ninety-three percent of their consolidated loans through December 1982 were GSLs and 7 percent were NDSLs. The average weighted interest rate of the GSLs and NDSLs was 6.7 percent. At this rate, Federal costs on a consolidated loan volume of $100 million would increase by about $300,000--or about 4 percent--in the first year because special allowances will increase to make up for reduced interest payments by borrowers. Sallie Mae estimates that special allowance payments on such a portfolio would increase by $2.9 million--or about 5 percent--over the life of the loans. The modification would be likely to induce more borrowers to consolidate NDSLs, but we cannot estimate how much.

Determining consolidated loan interest rates by averaging the original loan rates would decrease special allowances associated with 9 percent GSLs because these loans are now consolidated at 7 percent. Sallie Mae and the Department of Education favor a change to prevent borrowers from receiving "windfall" interest rate reductions by consolidating 9 percent loans at 7 percent.

In addition to GSLs and NDSLs, the law authorizes Auxilliary Loans to Assist Students and Health Education Assistance Loans, which carry higher interest rates than GSLs, to be consolidated. While these loans do not now participate in the consolidation program, their consolidation would affect the weighted average interest rate of loans being consolidated and thus special allowance payments.

Revising qualifying loan amounts

As I mentioned earlier, to qualify for a consolidated loan borrowers must have loans totalling more than $5,000 from more than one lender, or totalling more than $7,500 from one lender. While borrowers with more than $7,500 can choose extended repayment periods, those with less are limited to the same 10 year maximum as provided for GSLs. However, the monthly payments to Sallie Mae by a borrower with less than $7,500 will usually be lower than they would have been without consolidation because--due to loan servicing costs--each of the original lenders would usually require at least the $50 minimum payment provided for GSLs.

The $5,000 qualifying level is approximately consistent with the current GSL requirements that provide for a minimum monthly repayment of $50 and a maximum term of 10 years. For example, a borrower would have to have loans of about $4,300 in order to pay off the principal and interest over 10 years at $50 a month. Providing more liberal repayment terms to lower indebtedness borrowers by eliminating or reducing the qualifying amounts would increase Federal special allowance payments. For example, the special allowance payments on a $4,000 consolidated loan with a 10-year repayment period would be about 14 percent greater than the allowances paid on a similar loan with a required minimum monthly repayment of $50 which would limit the repayment period to 9 years. Similarly, special allowance payments on a $3,000 consolidated loan with a 10 year repayment period would be about 84 percent greater than special allowances paid on a similar loan that would be paid off in 6 years under a minimum monthly payment requirement of $50.

Officials at most of the eight State programs we visited agreed that minimum qualifying criteria is needed to prevent excessive increases in special allowance payments. Officials of six programs indicated that the current $5,000 level is reasonable, and the other two believed the specific criteria should be dropped but that minimum loan requirements should be consistent with the repayment requirements of the GSL program of $50 per month.

Because the total monthly payments of borrowers with multiple loans who do not qualify for consolidation can be inordinately high because of lenders' minimum payment requirements, several States had established procedures to alleviate the burden. Two State programs generally require borrowers to obtain all of their loans from the same lender, which enables the lender to merge the loans at the beginning of the repayment period to provide for a single monthly repayment. Because loan servicing costs are relatively constant regardless of loan amounts, the resulting monthly payment will usually be lower than the total of the payments which would have been required by multiple lenders. Similarily, four State programs have been successful in encouraging lenders to buy loans from one another so that all of a borrower's loans are held by one lender.

While Sallie Mae accepts all eligible loans of borrowers who meet the qualifying levels, relatively few borrowers with lower indebtedness levels have chosen to consolidate their loans. Of the consolidated loans made to 5,473 borrowers through December 1982, 729--or about 13 percent--were less than

$8,000, and 3,901--or about 71 percent--were greater than $10,000.

We do not believe the current qualifying loan amounts are unreasonable, and some State programs have demonstrated that means other than reducing the levels can be developed to prevent high payment burdens of borrowers with low indebtedness obtained from multiple lenders. If the specific levels are eliminated, one way to limit Federal costs would be to require a minimum monthly payment similar to that in the GSL program.

Limiting special allowances on consolidation loans

NDSL loans are made by educational institutions and are funded in part by the institution (10 percent) and in part by the Department of Education (90 percent). The interest rate on these loans was 3 percent prior to 1980, 4 percent in 1980, and is currently 5 percent. While lending institutions are not eligible for Federal special allowances on the original NDSL's, Sallie Mae receives such allowances when the loans are consolidated.

Based on past experience, Sallie Mae estimates that by eliminating Federal special allowances on the NDSL portion of consolidated loans, the allowances paid on a $100 million consolidated loan portfolio would decrease by $500,000 in the first year and by $4.3 million over the life of the loans. If original loan interest rates were averaged and special allowances on the NDSL portion were eliminated, the savings would be about

$200,000 in the first year and about $1.6 million over the life of the loans.

According to Sallie Mae and Department of Education officials, there are certain benefits to the Federal Government of consolidating NDSLs which should be considered when assessing the equity of paying special allowances on these loan amounts, including probable reduction of NDSL defaults and reduced Federal contributions needed to replenish college revolving funds as a result of early repayment of NDSLs.

While paying special allowances on the NDSL portion of consolidated loans may be inequitable to the Federal Government, officials of the eight State programs we visited indicated that eliminating such payments would give State programs little incentive to consolidate these loans. The officials pointed out that the cost of money and operating expenses associated with consolidating NDSLs would probably exceed borrower interest payments, in which case they would not be willing to accept the loans.

Thus, if special allowances are eliminated on the NDSL portion of consolidated loans and borrower interest rates are not increased to compensate for the lost Federal payments, borrowers may be unable to consolidate all of their loans. Of the 5,473 borrowers who consolidated their loans through December 1982, 1,601 included NDSL loans totalling $5 million. If NDSLs were not eligible for consolidation, 442 of these borrowers would not have qualified for loan consolidation.

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Messrs. Chairmen, this concludes my statement. We will be happy to answer any questions you or members of your Subcommittees may have.