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Direct Student Loans Could Save Money and Simplify Program Administration

Statement of
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Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss our recent report that compared the relative federal cost of guaranteed and direct student loans.[1] The Stafford Student Loan Program, also known as the guaranteed student loan programs, constitutes the largest form of federal financial assistance to students seeking postsecondary education. In recent years these programs have been the subject of great scrutiny. Administrative complexity, high costs, and lack of accountability in the Stafford program have spurred the search for an alternative loan delivery system. The Federal Credit Reform Act of 1990 (P.L. 101-508) allows direct lending to be an alternative to the current loan guarantee system.

I will focus my comments today on the portions of our report that pertain to (1) the potential federal savings associated with substituting Stafford loans with direct loans and (2) the effect that a direct loan program could have on the administrative functions of the Department of Education and postsecondary educational institutions.

STAFFORD LOAN PROGRAM

The Stafford program is a complex, multilayered delivery system. This system involves over 8,000 educational institutions, 10,000 commercial lenders, 45 state or nonprofit agencies, and 35 secondary market institutions. Students typically apply through their school to borrow from a commercial bank or other lender.

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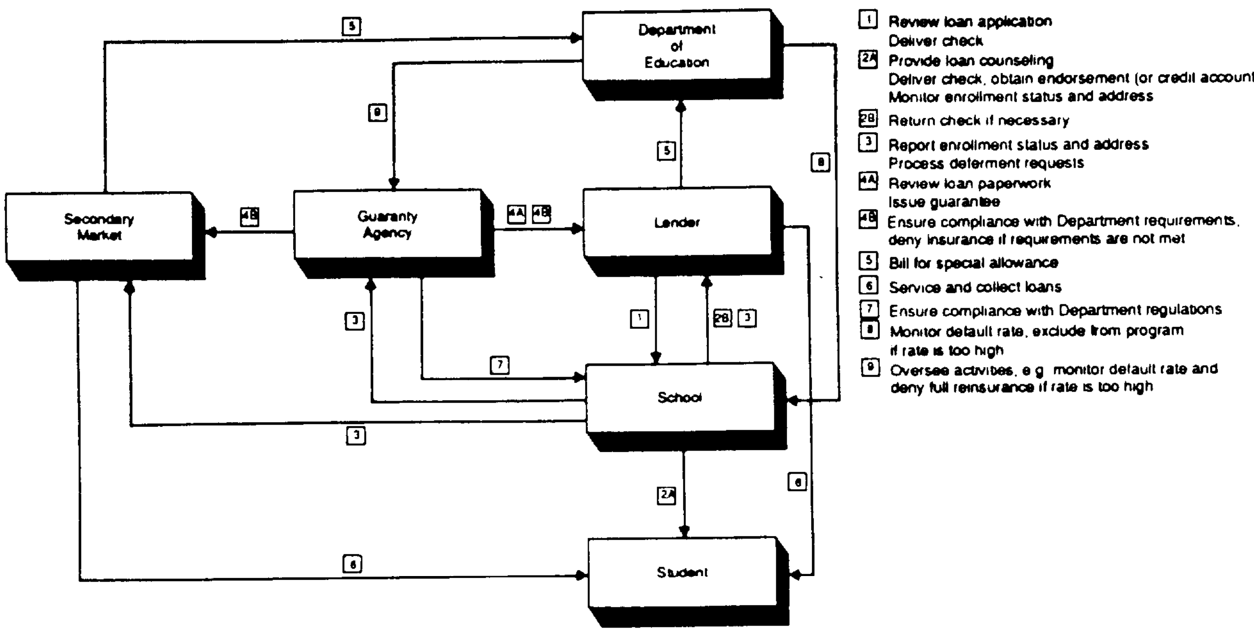
[1] Student Loans: Direct Loans Could Save Money and Simplify Program Administration (GAO/HRD-91-144BR, Sept. 27, 1991).

The original lender may hold the loan throughout its lifetime or sell it to a secondary market purchaser. Each state establishes or designates a guaranty agency to guarantee student loans under its jurisdiction. Guaranty agencies insure lenders against default and in turn are reinsured by the Department of Education. Guaranty agencies also monitor school and lender compliance with program rules.

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

Figure 1 illustrates the flow of responsibilities under the Stafford program.

Figure 1: Flow of Responsibilities for Guaranteed Loans



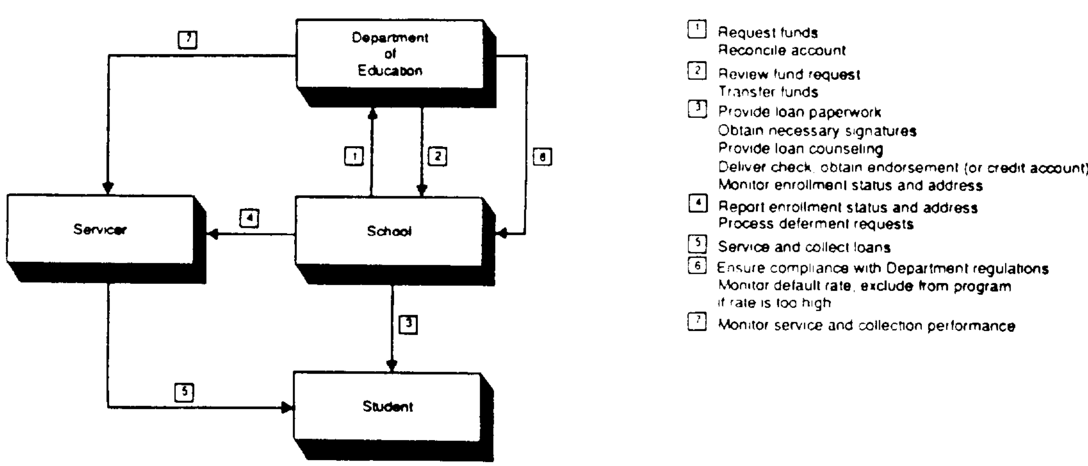
DIRECT LOAN PROGRAM

Our report contains a comparative analysis of a 1-year cohort of Stafford loans with a similar cohort of direct loans, as proposed by the National Association of State Universities and Land Grant Colleges. Under the Association's proposal, a direct student loan program could reduce the complexity and federal costs involved in delivering student loans. The Association's proposed program would eliminate commercial lenders, guaranty agencies, and secondary markets. Educational institutions would act as agents of the Department and use federal funds to make loans to students. The Department would contract with private firms to service and collect the loans. The federal government would raise loan capital by issuing Treasury securities rather than paying interest subsidies to commercial lenders.

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

Figure 2 illustrates the flow of responsibilities under a direct loan program.

<u>Figure 2: Flow of Responsibilities for Direct Loans</u>

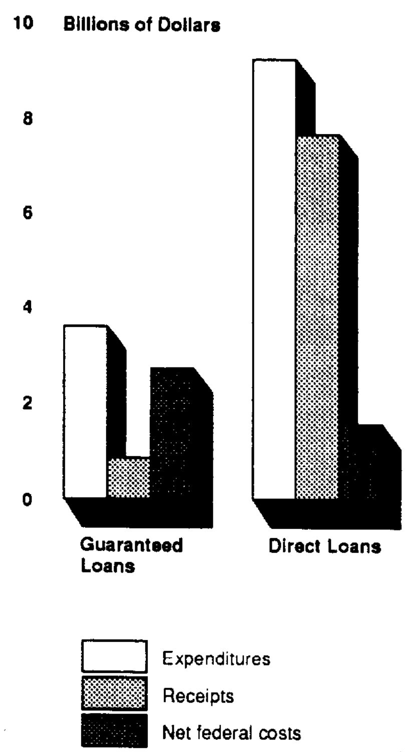


WHAT WE FOUND

Switching to Direct Loans
Could Save up to $1.4 Billion

Our analysis suggests that a direct loan program operating in place of the Stafford program in fiscal year 1992 could save over $1 billion--in present value. Our baseline estimate of the budgetary cost for a 1-year cohort of Stafford loans is $2.71 billion, compared with $1.55 billion for direct loans. Depending on the assumptions made, our estimated savings range from $620 million to $1.47 billion. These savings result primarily from the absence of interest subsidy (in-school interest and special allowance) payments to lenders. (See fig. 3.)

Figure 3: Direct Loans Reduce Federal Costs



Note: Figures represent present value for a 1-year cohort of loans.

Layers of Oversight Should be Reduced Under Direct Lending

Under a direct loan program, the focus of the Department of Education's administrative burden would shift from an indirect to a direct oversight role. For example, rather than relying on guaranty agencies, the Department would need to ensure that loan papers are properly executed and documented. In addition, instead of depending on banks to service loans, the Department would monitor the performance of its servicers to ensure that loan repayments are collected and credited promptly.

In other ways, however, a direct loan program would reduce some of the Department's administrative burden, and it could improve accountability. The Department would no longer monitor lenders or guaranty agencies, make interest subsidy payments to lenders, or reconcile special allowance and origination fee accounts with lenders. With fewer participants, the Department could focus its oversight effort on schools and servicers. As such, its ability to monitor the flow of funds in the program should improve.

Many School Administrative Functions Simplified With Direct Lending

Educational institutions would engage in different activities in a direct loan program. At the beginning of each year, schools would perform new tasks, such as (1) forecasting loan volume, (2) drawing down funds from the Department as they make student loans, and (3) reconciling student loan accounts at designated intervals. Schools that participate in the Perkins loan and Pell grant programs[2] currently perform tasks similar to those required to operate a direct loan program.

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[2]Federal programs administered by educational institutions on behalf of their students.

A direct loan program could simplify schools' administrative functions in the areas of loan disbursement, reporting, record-keeping requirements, and cash management. For example, schools probably would work with one servicer rather than hundreds of lenders and multiple guaranty agencies. In addition, the standardization that would accompany direct lending would eliminate problems associated with the multiplicity of policies, procedures, computer systems, and deferment forms. For example, lenders typically have their own requirements--procedures and forms--for students requesting a deferment. Under a direct loan program, the Department of Education would be the sole "lender," with its uniform procedures and forms.

GAO'S ONGOING WORK

We recognize that uncertainties about the specific features of a direct loan program and how it might be implemented could lower our estimated savings. For example, we did not account for the costs that the transition from a guaranteed to a direct loan program would entail. Also, the Department may encounter unforeseen additional costs in administering the program, such as an inability to negotiate servicing contracts as favorable as those reflected in our assumptions. These costs would reduce the anticipated savings.

The House Education and Labor Committee's Postsecondary Education Subcommittee requested that we: (1) refine the estimated savings--including transition costs--expected from a direct loan program, and (2) determine whether postsecondary institutions have the administrative infrastructure to meet their responsibilities under the program.

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