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Report to Congressional Requesters

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PERKINS STUDENT LOANS

Options That Could Make the Program More Financially Independent

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The Honorable Edward M. Kennedy
Chairman, Committee on Labor
and Human Resources
United States Senate

The Honorable William D. Ford
Chairman, Committee on Education
and Labor
House of Representatives

This report, prepared at your request, discusses the financial independence of the Perkins Loan Program. We are making recommendations to the Congress to improve the efficiency of the program, as well as presenting several options for the Congress to consider in making the program more financially independent.

We are sending copies of the report to the Secretary of Education; the Director, Office of Management and Budget; appropriate congressional committees; and other interested parties.

This report was prepared under the direction of Franklin Frazier, Director, Education and Employment Issues, who may be reached on (202) 275-1793 if you or your staffs have any questions. Other major contributors to the report are listed in appendix VIII.

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Purpose

The Perkins Loan Program provides low-interest loans to financially needy students at more than 3,200 colleges, universities, and other postsecondary schools. Each of these schools maintains separate fund accounts to make loans to eligible student borrowers. The federal government provides up to 90 percent of the capital contributions to establish the school-based funds, and the schools provide the remainder. From program inception in 1958 through June 30, 1989, over $13 billion in loans were made to 10 million borrowers. Loans of over $1.5 billion entered default, although the government is recovering some of these funds. The Congress designed the program as a revolving fund—that is, borrower repayments with interest would replenish the schools' loan funds. Annual federal appropriations have helped to reduce the negative effect on the fund caused by the growth in the number of schools and students and the increase in loan size.

At the request of the Chairmen of the Senate Committee on Labor and Human Resources and the House Committee on Education and Labor, GAO examined the program to provide information for use during congressional deliberations on the reauthorization of the Higher Education Act of 1965, as amended, which includes the authority for Perkins loans. GAO's review focused on examining the financial soundness of the Perkins program and on identifying ways to make it less financially dependent on additional federal appropriations to cover operating costs and default losses.

Background

The Perkins Loan Program is one of five federal student loan programs. Under Perkins (formerly the National Direct Student Loan Program), postsecondary schools make 5-percent, 10-year loans to needy students. Each school manages its own revolving loan fund, which it created through federal and school contributions on a 9-to-1 matching share basis. The Department of Education manages federal participation in the program and annually provides funds to the schools' Perkins accounts. These additional funds help the schools adjust for inflation, expand the number of students served, and cover operating losses, primarily from defaults not covered by interest income.

Through June 30, 1989, about $5.7 billion in federal monies had been appropriated for the program. Participating schools are eligible for additional federal funds based partly on their keeping loan defaults within certain statutory thresholds. For example, schools with default rates exceeding 20 percent are not eligible for additional federal Perkins funds.

Under the revolving fund concept, borrowers' payments replenish the school's loan fund, making capital available for loans to other students. For a school's revolving fund to be financially independent, interest income from loan payments needs to be sufficient to cover the costs of administering the program, the costs of inflation, and the costs necessary to serve more student-borrowers. Program costs also include losses of loan capital from loan defaults and loans canceled—forgiven—for statutory reasons, such as loans to borrowers serving in the military or teaching handicapped children.

Results in Brief

Of the 3,230 participating schools, 419 (13 percent) had Perkins program revolving funds in which income exceeded operating costs and losses. The operating costs and losses of the remaining 2,811 (87 percent) exceeded their funds' income. Through June 30, 1989, cumulative operating costs and losses exceeded income by about $1.05 billion. New federal and school capital contributions have been used, in part, to make up operating losses as well as to increase funds available for loans.

Schools with high default rates have avoided funding restrictions by assigning their defaulted loans to the Department. They can maintain funding eligibility in this way because the statutory formula used to calculate default rates excludes loans assigned to the Department—the rates are based only on the loans the schools hold. Using a default rate formula that includes assigned loans would more effectively limit the continued funding of schools with high default rates. This, in turn, could reduce the program's default costs because only schools with default rates below the statutory limits would receive additional funding.

GAO also identified several cost-reduction and revenue-generating alternatives, such as delaying loan disbursements or raising the loan interest rate, that could contribute to the program becoming more financially sound. These alternatives are based on features of other federal student loan programs.

Principal Findings

Operating Costs and Losses Have Exceeded Program Income

The schools' Perkins fund accounts capital has eroded by over $1 billion since the program started. Cumulative interest and other income totaled about $1.24 billion, while administrative costs and operating losses totaled $2.29 billion. Several factors have contributed to these losses; among them are loans that have defaulted, loans canceled by the schools for reasons provided by the law, and program administrative costs. These costs and losses, coupled with the low rate of interest borrowers pay on their Perkins loans, have resulted in the schools, in aggregate, having a net operating loss from their Perkins fund accounts.

Through June 30, 1989, federal appropriations for the program totaled about $5.7 billion. Schools contributed an additional $726 million, which resulted in almost $6.5 billion in capital contributions to the schools' Perkins funds. However, the $1.05 billion net operating loss incurred during the period reduced the schools' aggregate net fund account balance to $5.4 billion.

Default Rate Formula Needs Revision

Loan defaults are a major factor affecting the program's financial soundness. Under the Higher Education Amendments of 1986, schools with default rates between 7.5 and 20 percent (15 percent after fiscal year 1990) receive a reduced allocation of federal funds, and schools with rates exceeding 20 percent (15 percent after fiscal year 1990) are ineligible for additional federal funds.

Schools may remain eligible for additional federal funds, however, although their default rates exceed 20 percent. They can do this by assigning defaulted loans to the Department so it can take collection measures, such as income tax refund offsets, not available to the schools. The statutory default rate formula excludes these assigned loans and computes the rates using only loans schools hold in their portfolios. Therefore, by assigning enough defaulted loans to the Department, schools can keep their default rates below the threshold limits and remain eligible for additional funding. In 1989, 894 schools were eligible for federal funds, although more than 20 percent of their loans were in default.

A formula that computes default rates using all defaulted loans—including assigned loans—would channel more of the annual appropriations to schools with low rates. Schools with high rates would receive less or no additional funding. This could help reduce the program's default costs and would reward schools that maintain low default rates.

If the default formula were revised, schools might be less inclined to voluntarily assign their defaulted loans to the Department. However, the benefits of the Department's additional collection tools could be preserved if schools were required to assign their defaulted loans to the Department within a specified period after the loans go into default.

Options for Making the Program More Financially Sound

Adding some cost-saving and revenue-raising features from the other federal student loan programs could reduce Perkins program operating deficits. GAO identified four options—two directed at reducing default costs and two directed at increasing income. The first would delay the disbursement of Perkins loan proceeds to students until partway into the school term rather than releasing the funds immediately after the loan was made. This could lessen the possibility that a borrower who drops out of school within the first few weeks of the enrollment period would go into default. The second option would require that schools with high default rates, in instances in which their students withdraw from school, (1) provide refunds to borrowers in proportion to the percentage of the school term elapsed and (2) apply refunds toward the repayment of students' Perkins loans. Currently schools can make Perkins loan refunds according to their own policies. If the schools have default rates over 30 percent, they must provide refunds to students leaving school.

Of the options directed to increasing Perkins program income, the first option is to raise the current 5-percent interest rate on Perkins loans. The major federal student loan program—Stafford loans—charges borrowers 8 percent interest during the first 4 years of repayment and 10 percent during the remaining period of repayment. The other option is to charge Perkins loan borrowers a loan origination fee to help cover the cost of defaults and other operating costs. Stafford loan borrowers currently pay a one-time 5-percent origination fee. Either of these options could result in additional income for the schools' Perkins funds and help reduce their program losses. However, both options would increase borrowers' costs as well.

Recommendations to the Congress

GAO recommends that the Congress revise the Higher Education Act

- to provide that the default rate formula include all defaulted Perkins loans, including those assigned to the Department of Education for collection, and
- to require schools to assign their defaulted Perkins loans to the Department of Education after they have been in default for a specified period. (See pp. 25-26.)

Matters for Consideration by the Congress

If the Congress wishes to make the Perkins program more financially sound, it could consider requiring schools to delay loan disbursements to first-time students or raising the loan interest rate. Other matters for consideration appear on page 31.

Agency Comments

The Department and an association representing schools participating in the Perkins program agreed with GAO's recommendation to revise the default rate formula and mandatorily assign defaulted loans to the Department after a specified period but disagreed with GAO's suggestion to charge Perkins borrowers a loan origination fee. The Department also agreed with GAO's suggestions for delaying loan disbursements to students, making pro rata refunds to students who do not complete their scheduled education, and increasing the interest rate charged borrowers. The association did not comment on the interest rate changes but disagreed with the other suggestions. In addition, both the Department and the association provided technical comments that GAO incorporated in the report, as appropriate. (See apps. VI and VII.)

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COHEAO	Coalition of Higher Education Assistance Organizations
GAO	General Accounting Office

Introduction

The Perkins Loan Program, the oldest federal student loan program, provides funds to postsecondary schools that make low-interest loans to needy students. From its inception in 1958 through June 30, 1989, Perkins loans provided 10 million borrowers about $13 billion to finance their postsecondary education. The program is different from other federal student loan programs because the Congress designed it to be operated by schools on a revolving fund basis. Loan payments—principal and interest—replenish the schools' revolving funds, thereby making loans available to other students. Annual federal appropriations have helped defray inflationary education cost increases and increase the number of schools and students participating in the program. The other federal loan programs rely on capital from commercial lenders, such as banks, which make loans that are guaranteed by the federal government in cases of nonrepayment.

The Perkins Loan Program is to be reauthorized after the end of fiscal year 1991. We examined the program's ability to operate in a more financially independent manner in order to provide the Congress with information for its deliberations during the upcoming reauthorization.

The Perkins Loan Program

Created by the National Defense Education Act of 1958 (P.L. 85-864), the Perkins Loan Program gave special consideration to students who demonstrated superior academic performance in such areas as math and science.[1] Amendments in 1964 broadened coverage to all academic disciplines, and amendments in 1968 expanded eligibility for students enrolled in proprietary (for-profit) schools. The Higher Education Amendments of 1986 (P. L. 99-498) provided that schools restrict loans to students who demonstrate exceptional financial need. Those amendments also renamed the program in honor of the late Representative Carl D. Perkins, former Chairman of the House Education and Labor Committee.

The Perkins program provides low-interest loans to qualifying students. The amount of the loan depends on several factors, including the borrower's financial need, his or her education level, the availability of funds, and statutory annual loan limits. The original legislation limited a student to loan amounts of $1,000 in any fiscal year and $5,000 for a lifetime. That legislation also set the maximum annual interest rate at 3 percent. Subsequent legislation modified the interest rate and lifetime

[1]The Perkins Loan Program was originally called the National Defense Student Loan Program and later the National Direct Student Loan Program.

maximum loans. The current interest rate is 5 percent. The current lifetime maximum loan amounts are

- $4,500 for vocational programs or for students who have not successfully completed 2 years of undergraduate study,
- $9,000 for undergraduate study, and
- $18,000 for undergraduate and graduate or professional study.

Students do not begin repaying their Perkins loans—principal or interest (and interest does not accrue)—until 9 months after they leave school or drop below half-time status. After this 9-month grace period, borrowers have up to 10 years to repay, depending on the amount borrowed. However, schools can establish a $30-per-month minimum payment arrangement if the monthly payment amount over a 10-year payment period would be less than $30. Payments can be on either a monthly, bimonthly, or quarterly basis, and some borrowers can postpone or defer repayment under certain statutory circumstances. All or part of a borrower's Perkins debt—principal and accrued interest—can be canceled by the school if the borrower serves in an area of hostilities while in the military, teaches students who are handicapped or from low-income families, or works in the Head Start Program or for certain volunteer organizations, such as the Peace Corps. Loans are also canceled for borrowers who die, become totally and permanently disabled, or in some instances are declared bankrupt by a bankruptcy court.

Program Is Administered by Participating Institutions

Perkins loans differ from the other federal student loans authorized by title IV of the Higher Education Act of 1965, as amended. The other programs, which fall under the umbrella of guaranteed student loan programs, include: (1) Stafford loans, (2) Parent Loans for Undergraduate Students, (3) Supplemental Loans for Students, and (4) Consolidated Loans. Capital for guaranteed student loans comes from private sources, such as commercial lenders, which make loans to borrowers. The loans are guaranteed against nonpayment by state or private nonprofit guaranty agencies, which are in turn reinsured by the federal government for up to 100 percent of the unpaid principal and accrued interest. The reinsurance payment depends on the agency's rate of loan default. Total guaranteed student loans outstanding were over $55 billion as of September 30, 1989.

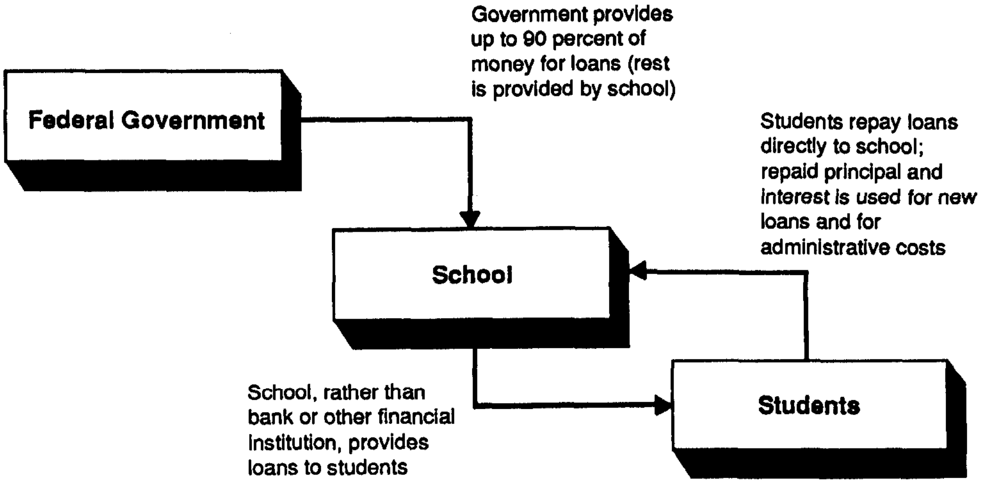
In contrast to the guaranteed student loan programs, the Perkins Loan Program is much smaller—about $5 billion in outstanding loans—and is one of three "campus-based" programs in which federal student aid is administered directly by a participating school.[2] The Department of Education allocates federal funds—capital contributions—to participating schools through a formula provided by the Higher Education Act. Under the formula, schools participating in the program in the 1990-91 award year,[3] and which also participated during 1985-86, are guaranteed to receive an amount equal to the allocation they received in 1985-86. Schools entering the program after 1985-86 are guaranteed to receive the greater of $5,000 or 90 percent of the amount they received in their first year of participation. After schools have been allocated these amounts, 25 percent of any remaining funds are allocated to all participating schools on a pro rata share basis. The remaining 75 percent of the funds are allocated to the schools based on their relative need. In addition, schools may receive reduced or no allocations if their loan default rate exceeds certain "default penalty" limits. Participating schools are required to contribute at least $1 for every $9 in federal funds allocated to their Perkins loan fund.

Participating schools make loans to eligible students and are repaid starting when the repayment period begins. The students' payments—principal and interest—are deposited in the schools' Perkins loan fund and are used to make new loans and to help pay the schools' cost of administering the program. (See fig. 1.1.)

[2]The other two campus-based programs are the College Work Study Program, which provides federally subsidized part-time jobs for low-income students, and the Supplemental Educational Opportunity Grant Program, which provides grants to qualifying low-income undergraduate students.

[3]The financial aid award year begins on July 1 and ends on the following June 30.

Figure 1.1: Basic Structure of the Perkins Loan Program



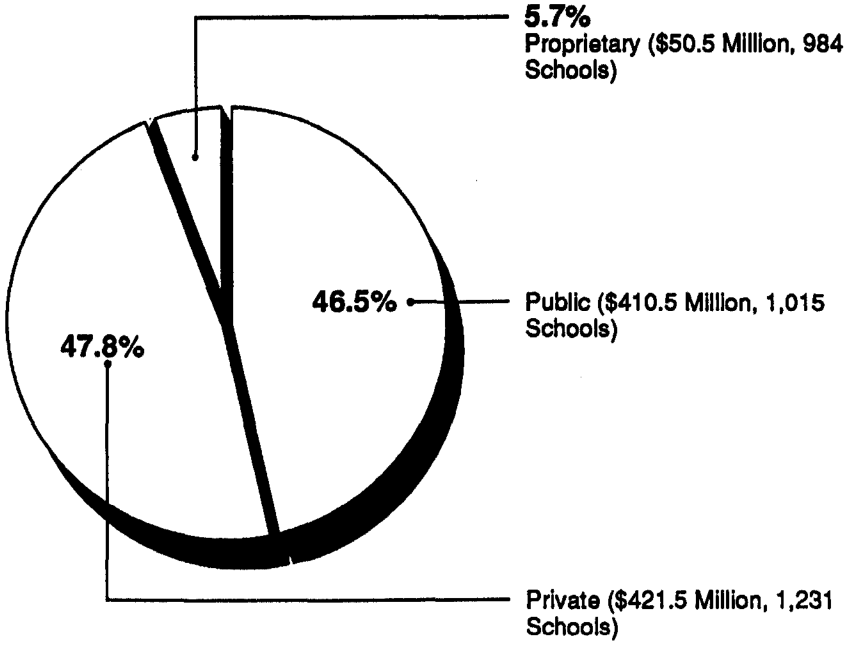
The federal government reimburses schools for loans that are canceled for statutory reasons: serving in the military, working in the Head Start Program, teaching, or serving in a volunteer organization. Schools are not reimbursed for loans that are canceled due to death, disability, and bankruptcy.

Perkins Loan Program Designed as a Revolving Fund

When the Congress established the program in 1958, it was designed to operate as a revolving fund; that is, the principal and interest payments made by borrowers would provide schools capital to make new loans. To the degree the income of a school's revolving fund equaled or exceeded operating costs and losses, the school's fund would have no need for further federal capital contributions to remain solvent. Additional federal contributions could be used to expand the program (such as by increasing loan amounts), adjust for inflation, and help cover losses from defaulted loans.

The Congress has made appropriations to the program every year since its inception. As of June 30, 1989, federal capital contributions totaled nearly $6 billion, and the 3,230 participating institutions had contributed about $750 million to the program. The schools—1,015 public, 1,231 private, and 984 proprietary (for-profit trade and technical) schools—made $883 million in Perkins loans during the 1988-89 award year. As shown in figure 1.2, most of these loans were made to students enrolled in public and private schools.

Figure 1.2: Perkins Loan Program Activity (1988-89 Award Year)



Objectives, Scope, and Methodology

We made our review at the request of the Chairmen of the Senate Committee on Labor and Human Resources and the House Committee on Education and Labor. They asked for information for their deliberations on the reauthorization of the Higher Education Act. We focused our work on determining whether schools can operate their revolving funds through loan principal and interest repayments, or whether they need capital contributions to maintain their programs. We made our analysis on a cash accounting basis, not in present value terms.

For participating schools whose cumulative—from program inception in 1958 through June 30, 1989—costs and losses exceeded their income, we looked at ways to make them more financially independent. We also assessed the effect of loan defaults on the program's financial soundness.

We analyzed cumulative financial and other data on the program from the Department of Education for the 1988-89 award year—the most current information available at the time of our review. We held discussions with Department officials responsible for program policy, administration, and monitoring. We reviewed the legislation and regulations, as well as the Department's policy and procedural guidelines for the program.

To determine the program's cumulative income, costs, and losses, we obtained and analyzed nationwide fiscal operations data. The Department gave us computer tapes of fiscal data compiled from the participating schools' annual reports. We used these data, along with the Department's financial aid accounting reference manual, to measure and compare the program's aggregate income, costs, and losses. We did not verify the accuracy of these data.

We analyzed financial and statistical information to evaluate the extent to which loan defaults are affecting the program. We used data from the Department's computer tapes to make our analyses. We also reviewed legislation and regulations to identify the measures that address loan defaults. In addition, we compared the default measures for the Perkins program with those for the Department's other student loan programs.

Our field work was conducted from February through October 1990. Our review was conducted in accordance with generally accepted government auditing standards.

The Department and the Coalition of Higher Education Assistance Organizations (COHEAO), which represents schools participating in the Perkins Program, provided comments on a draft of this report (see apps. VI and VII). We have revised our report as necessary to improve its accuracy. We did not make some of the suggested changes to the numerical data, however, because our data were more current.

Financial Condition of the Revolving Fund as of June 30, 1989

For the 3,230 participating schools as of June 30, 1989, cumulative costs and losses exceeded loan interest and other income by about $1 billion. At 419 of the schools (13 percent), revolving fund income exceeded costs and losses. At the remaining 2,811 schools (87 percent), income was insufficient to cover costs and losses. Federal and school contributions have offset the fund losses.

Operating Costs and Losses Have Exceeded Program Income

As of June 30, 1989, cumulative costs and losses for the 3,230 schools were about $2.29 billion (see table 2.1). In contrast, cumulative income for these schools totaled about $1.24 billion. The difference, nearly $1.05 billion, represents a net loss to the schools' revolving funds.

Table 2.1: Cumulative Perkins Fund Costs and Losses Exceeded Income
(As of June 30, 1989)

Dollars in millions		
Income		
Interest on loans		$1,132.7
Other income		109.6
Total income		1,242.3
Costs and losses		
Administrative costs	$489.1	
Collection costs	267.7	
Defaulted loans[a]	822.7	
Canceled loans	693.7	
Other costs and losses	15.5	
Total costs and losses		2,288.7
Net operating difference		**$−1,046.4**

[a]Defaulted loans assigned to the Department; schools were holding an additional $737 million in defaulted loans that they do not report as costs until assigned to the Department. Thus, total loans in default were over $1.5 billion.

Program Income

Income from program operations came from the following sources:

- Interest income on loans. Interest that Perkins borrowers paid on outstanding loans is the major source—about 91 percent—of income.
- Other income. Other income includes (1) interest earned on cash reserves the schools hold in their Perkins funds and (2) receipt of incidental charges to borrowers for such items as late loan payments and returned checks. Department regulations require schools to hold their cash reserves in interest-bearing bank accounts; the cash balances for all

participating schools' Perkins funds totaled about $246 million as of June 30, 1989.

Program Costs and Losses

Operating costs and losses shown in table 2.1 are:

- Administrative costs. Schools participating in campus-based programs such as Perkins loans are authorized—by the Higher Education Act—an administrative cost allowance to help offset salaries, furniture, travel, supplies, and equipment expenses. The amount of the allowance is based on the schools' expenditures related to all three campus-based programs and cannot exceed 5 percent of total expenditures. Although certain restrictions apply, schools can use all or none of the allowance for their Perkins loan funds. The amount the schools allocated to their Perkins funds is shown in table 2.1.
- Collection costs. Schools can use their Perkins funds for allowable collection costs, including the costs for address searches, collection agencies, credit bureau reports, and litigation. Schools charge the borrowers these costs, but if their collection attempts are unsuccessful, the costs are usually charged to the fund.
- Loan defaults. When schools are unable to bring defaulted loans into repayment, they can transfer (assign) the loans to the Department of Education for further collection. Collections the Department makes on these loans are deposited in the U.S. Treasury and are not returned to the schools or the program. Thus, the loan principal and accrued interest represented by these defaults are treated as costs and are shown on table 2.1 as loan defaults.
- Loan cancellations. Principal and accrued interest associated with loans canceled are counted as program costs. As of June 30, 1989, about $873.7 million in loan principal and accrued interest had been canceled. Cumulative reimbursements from the federal government totaled about $180 million, leaving a net loss of $693.7 million, as shown in table 2.1. The Department treats these reimbursements as income to the schools' funds. However, because these payments are, in essence, a replacement of program capital rather than income generated by program assets, we view them as an offset or reduction in costs. Appendix I contains more detailed information on canceled loans.
- Other costs and losses. This cost element includes the defaulted loans of $200 or less that the schools write off and other miscellaneous program costs and losses. These small dollar loans can be written off if, after

regulatory collection procedures were followed, the schools were unsuccessful in getting the borrower into repayment. Schools are also permitted to write off loans discharged by bankruptcy. Amounts written off can include loan principal, interest, penalties, and late charges.

Most Schools' Program Funds Have Net Operating Losses

As of June 30, 1989, 2,811 (87 percent) of the 3,230 participating schools had revolving funds with cumulative net operating losses. As table 2.2 shows, these schools' costs and losses collectively exceeded income by about $1.07 billion. The other 419 schools had income exceeding costs and losses by about $24.9 million.

Table 2.2: Most Schools' Perkins Loan Funds Had Operating Losses (Cumulative, as of June 30, 1989)

Dollars in millions

Number of schools	Income	Costs and losses	Net income or losses
419	$137.4	$112.5	**$24.9**
2,811	1,104.9	2,176.2	**−1,071.3**
3,230	$1,242.3	$2,288.7	**$−1,046.4**

Collectively, public, private, and proprietary schools' costs and losses exceeded their income (see table 2.3). In terms of total dollars, aggregate net losses were largest for public and private schools. This is not surprising, because public and private schools' Perkins funds are much larger than those of proprietary schools. However, as shown in table 2.3, when aggregate costs and losses are compared dollar-for-dollar with income, proprietary schools' costs and losses were $3.89 for every $1.00 of income—much greater than the ratio for public and private schools.

Table 2.3: Operating Income or Losses Varied by Type of School (Cumulative, as of June 30, 1989)

Dollars in millions

	Type of school			
	Public	Private	Proprietary	Total
Income	$647.9	$547.6	$46.7	**$1,242.3**
Costs and losses	1,212.4	895.0	181.6	**2,288.7**
Net operating difference	$−564.5	$−347.4	$−134.9	**$−1,046.4**
Costs and losses per $1.00 of income	$1.87	$1.63	$3.89	**$1.84**

Appendix II contains more detailed income, cost, and loss information for each type of school.

Capital Contributions Have Offset Net Operating Losses

The continued influx of federal and school capital contributions has more than offset the schools' net operating losses. As shown in table 2.4, through June 30, 1989, cumulative contributions totaled $6.4 billion—$5.7 billion from the federal government and $726 million from the schools. This funding, along with income, was offset by operating costs and losses, reducing the loan fund to an aggregate balance of about $5.4 billion at June 30, 1989. Appendix III displays this information for each type of school.

Table 2.4: Cumulative Capital Contributions Exceeded Costs of Operations (As of June 30, 1989)

Dollars in millions		
Capital contributions		
Federal		$5,696
School		726
Total		6,422
Funds from operations		
Income	$1,242	
Costs and losses	−2,289	
Net loss from operations		−1,047
Fund net balance[a]		**$5,375**

[a]Consists mostly of outstanding loans and funds in interest-bearing accounts.

Conclusions

The cumulative costs of operating the Perkins program, including loan cancellations and defaults, exceeded interest and other income by about $1.05 billion as of June 30, 1989. As a result, a portion of the federal and school contributions has been needed to offset net losses rather than provide additional funds for loan capital. Unless costs and losses are reduced or income increased, the program will continue to need capital contributions to make up for operating losses, or schools will have less funds available to make Perkins loans.

Agency Comments and Our Evaluation

Both the Department and representatives of COHEAO commented on a draft of this report. (See apps. VI and VII.) The Department questioned whether our characterization of the original congressional intent that the program operate on a self-sustaining basis was relevant. It said that legislative actions since the program's enactment have been directed to encouraging students to become educated in critical areas. As such, several congressional actions, such as authorizing the cancellation of certain types of borrowers' loans and keeping interest rates low, are not consistent with making the program self-sustaining.

We agree that the Congress has furthered some of the program's social goals at the expense of making it financially self-sufficient. We have revised our report to focus on the cumulative financial condition of the revolving fund rather than on the Congress' intent to make the program self-sustaining. The suggestions we make on page 31 can help make the program more financially sound without significantly affecting congressional goals for the Perkins program.

Operating Losses Could Be Reduced by Revised Default Rate Formula

The program's largest operating cost relates to defaulted loans. In the Higher Education Amendments of 1986, the Congress revised the capital contribution formula used to fund schools by penalizing schools with default rates over certain limits. However, schools can manage their default rates to avoid these restrictions and may receive additional federal funds. Defaulted loans that schools retain in their portfolios are factored into the formula, but loans assigned to the Department of Education for collection are not.

We estimate that 894 of the 3,296 schools participating in the program in 1988 received $26 million in funds they would not have received if default penalties had been applied to all of their loans. Had all the schools' defaulted loans been factored into the formula, more funds could have been allocated to schools with lower rates of defaulted loans or to schools not currently participating in the program. Using a different formula—one used for calculating default rates in guaranteed student loan programs since 1989—could better allocate federal funds to schools with lower rates.

Revised Measures for Controlling Defaulted Perkins Loans

The 1986 amendments and Department regulations placed additional requirements on schools to better control losses from defaults. Under these requirements, schools must counsel borrowers on their loan repayment responsibilities and exercise "due diligence" in making, servicing, collecting, and recovering delinquent or defaulted loans. For example, schools are required to follow such procedures as sending borrowers overdue notices, reporting delinquent accounts to credit bureaus (if permitted by state law), and initiating litigation. Regulations require that schools take certain collection actions within specified time frames. For example, a school must send the first overdue notice within 15 days of the due date, a second notice 30 days after the first notice, and a final demand for payment within 15 days of the second notice. Department officials said that completing due diligence for a defaulted loan may take about 2 years.

If a loan remains in default after these due diligence efforts, the school has the option of assigning it to the Department for collection. The Department has additional collection tools that can be used to increase recoveries. For example, the Department can have the Internal Revenue Service offset a borrower's income tax refund toward the repayment of his or her student loan, and it has authority to garnish wages of defaulters.

The 1986 amendments incorporated a Department regulation that provided a default control penalty for the Perkins program. This penalty influences the allocation of additional federal contributions to participating schools by specifying that the allocation is to be

- lowered for schools with default rates between 7.5 and 20 percent (maximum of 15 percent after 1990) and
- eliminated entirely for schools with default rates above 20 percent (above 15 percent after 1990).

The allocation is reduced by the same percentage as the default rate. For example, a school with a 10-percent default rate would have its allocation reduced by 10 percent.

Default Rate Formula Excludes Many Defaulted Loans

The legislatively mandated default formula underreports defaults. Because the formula establishes a default rate using only those loans schools hold in their program portfolios, it excludes the defaulted loans schools assign to the Department for collection.[1] As a result, even though a school may have a high number of defaulted loans, if it has assigned enough of them to the Department so that its default rate does not exceed 7.5 percent, it will not be subject to the penalty and may continue to receive federal funds.

For example, one school had about $5 million in outstanding loans in repayment status as of June 30, 1988. About half of these loans—about $2.5 million—were in default. The school assigned about $2.2 million to the Department and retained the remaining $300,000 in its own portfolio. Using the formula, the school's default rate was about 6.2 percent—computed on $300,000 of defaulted loans—and the school was eligible for full funding for 1989. Department records show the school was allocated $200,500 in federal Perkins funds for 1989. However, if the defaulted loans assigned to the Department were included in the formula, the school's default rate would have been 50 percent and the school would have been ineligible for continued funding. The $200,500 could have been allocated to schools with default rates below the penalty limits.

For an indication of the extent that this is occurring, we computed two 1988 default rates for all participating schools—the first excluded loans

[1] The formula also excludes defaulted loans that have been repaid, brought back into repayment, canceled, or discharged in bankruptcy.

assigned to the Department, and the second included such loans. The results of this analysis, as tabulated in table 3.1, show that:

- When Perkins loan default rates are calculated without assigned loans, as currently done under the formula, 493 (about 15 percent) of the 3,296 participating schools had default rates above 20 percent. These schools would have been ineligible for program funding in 1989 under current provisions.
- When assigned loans are factored into the calculations, 1,387 (about 42 percent) of the 3,296 schools exceeded the 20-percent limit. Compared with the results using the existing formula, an additional 894 schools would have been ineligible for federal funding in 1989.

Table 3.1: Assigning Defaulted Loans to the Department Increases Eligibility for Additional Program Funding

	Schools with default rates above 20 percent[a]		
Type of school	**Without assigned loans**	**With assigned loans**	**Difference**
Public	84	416	332
Private	91	219	128
Proprietary	318	752	434
Total	**493**	**1,387**	**894**

[a]As of June 30, 1988.

Funding schools with higher default rates places program funds at a greater risk of loss. The 894 additional schools that had default rates above 20 percent—with assigned loans included in the formula—received about $26 million in federal capital contributions in 1989. If these funds had been allocated to schools that had default rates below 20 percent, such schools would have received about 16 percent more in federal capital contributions than they did in 1989.

A Department official said the legislated formula excludes assigned loans for two reasons. First, including all defaulted loans in the default rates would unfairly penalize schools for loans they no longer control—the ones assigned to the Department. Since default rates are based on cumulative data, an assigned loan would always count as a default for a school even if the Department brings it back into repayment. Second, this arrangement encourages schools to assign older, uncollectible loans to the Department, although they are not required to do so.

The Department's views on these practices have some merit. However, allowing schools to avoid the default penalties by assigning loans reduces their incentives to prevent borrowers from defaulting or to bring defaulted loans back into repayment. Also, the continued funding of schools with high default rates places federal funds at a higher risk of loss. A formula that reflects schools' total defaults—including assigned loans—could make the default penalties serve more as incentives for schools to reduce defaults. Such a formula could also reduce federal vulnerabilities to losses from defaults because only schools with total defaults below the threshold limits would remain eligible for additional federal funds. In addition, if available federal moneys were not being allocated to schools with high default rates, schools with low default rates could receive higher allocations.

A Revised Default Formula Could Reduce Program Default Costs

The default rate mechanism for the Perkins Loan Program is different from that used by the guaranteed student loan programs, which is designed to provide better default management and reduce defaults at participating schools. The 1989 Omnibus Budget Reconciliation Act (P.L. 101-239) established restrictions on the eligibility of students to receive loans to attend schools whose Supplemental Loans for Students default rates exceed certain thresholds. It also established sanctions for schools with default rates above the specified limits—somewhat similar to the default penalty provisions of the Perkins program.

The Supplemental loan default rates are computed using a "cohort" formula. This formula measures the default rates of a group, or cohort, of borrowers entering repayment in a particular year. These borrowers' repayment activities are tracked for a specified period, and the default rate is computed by dividing the total number of borrowers in the cohort into the number of these borrowers who default on their loans during the period. We believe this kind of formula is a more meaningful measure of current default trends since it reflects more recent activities.

The Department has expanded the use of a cohort default rate formula beyond that specified for the Supplemental Loan Program. In 1989, the Secretary of Education initiated a default reduction initiative for the guaranteed student loan programs. It specified that sanctions could be levied against schools with default rates above certain thresholds, and that the rates would be computed using a cohort formula.

A similar formula could be used for Perkins loans. Using a cohort-based default rate formula that includes all defaulted loans, including those assigned to the Department, would remove loan assignments as factors in the funding allocation process. Using this formula would make the default penalties work more effectively: Schools that kept their default rates below the penalty limits could be rewarded by being eligible for additional federal contributions, and schools with rates above the limits could be subject to the sanctions, including loss of eligibility for additional federal funds. We believe that using the cohort default rate formula would also make student loan default information among all federal student loan programs more comparable.

The removal of loan assignments as a factor in the funding allocation process could reduce the incentive for schools to assign loans and lead to fewer collections by the Department. To preserve the benefits of the assignment process, the Higher Education Act could be amended to require schools to assign defaulted loans to the Department if due diligence efforts fail to bring the loan into repayment within a specified period, such as 2 years.

Conclusions

The current method of calculating loan default rates may limit the effectiveness of the default penalty provision in reducing loan defaults. The formula has resulted in schools' being able to remain eligible for additional federal funding by assigning their defaulted loans to the Department, rather than reducing Perkins loan defaults.

Calculating a Perkins loan default rate on a basis similar to that used for Stafford student loans would more accurately reflect schools' default rates and provide a better basis for allocating federal Perkins capital contributions to schools with lower rates. The use of such a default rate formula could also eventually lead to the program operating on a more financially sound basis because schools with the lowest default rates would get more funds. In addition, if schools were required to assign all their defaulted loans to the Department after they were in default for a specified period, such as 2 years, the benefits of the Department's additional collection methods could be maintained.

Recommendations to the Congress

To make the default penalties more effective in limiting the distribution of federal funds to schools with high default rates and thereby more effective as tools for reducing the program's default costs, we recommend that the Congress revise the Higher Education Act, as amended, to require that Perkins loan default rates be computed on a basis similar to that used for the Stafford loan program.

To ensure that the benefits of the Department's additional collection methods on defaulted loans are maintained if the default rate formula is revised, we recommend that the Congress further revise the Higher Education Act to require that schools assign their defaulted Perkins loans to the Department for collection after they have been in default for a specified period, such as 2 years.

Agency Comments and Our Evaluation

Both the Department and COHEAO concurred in our recommendations to revise the default rate formula and to require schools to assign defaulted loans to the Department after some specific number of days. COHEAO suggested that the maximum time schools are allowed to hold defaulted loans before assigning them to the Department should include allowances for loans in litigation or prelitigation.

How Could the Perkins Loan Program Become More Financially Sound?

For the Perkins Loan Program to continue serving needy students and to become more financially sound, program costs need to more closely mirror operating income. This would require legislative changes to reduce costs or increase income, or more probably a combination of the two. Also, maintaining the primary purpose of Perkins loans—to provide subsidized low-interest loans to the most needy students—will require balancing any additional costs to borrowers with the congressional objective of giving eligible students easy access to low-cost loans.

In chapter 3, we discussed how revising the default rate formula could better target federal funding to schools with fewer defaults. Such a change would make the program more financially sound and would help it operate more efficiently.

To help get the Perkins program to rely less on additional capital contributions, from both the federal government and the schools, several features of the guaranteed student loan programs could be applied to the Perkins program to help reduce costs or increase income.

- Options for reducing costs: Delaying loan disbursements to borrowers until they have attended school for a specified time and requiring that schools with high defaults give pro rata refunds to students who drop out, so that part of the loan can be repaid.
- Options for increasing income: Raising the loan interest rate and charging borrowers a loan origination fee.

Options for Reducing Operating Costs

The best opportunities for reducing costs in the Perkins program are in the area of reducing loan defaults. We compared the legislative and regulatory provisions for loan defaults in the Perkins program with those in the guaranteed student loan programs. Two measures recently established for guaranteed loans appear suitable for Perkins: (1) the timing of when lenders disburse loan funds to borrowers and (2) the amount of refunds borrowers receive if they discontinue their course of study before the end of the term.

Delay Loan Disbursements to Borrowers

Department regulations specify that schools can disburse Perkins loan proceeds to enrolled students no more than 10 days before their first day of class. Delaying loan disbursements to borrowers until they have been in attendance for a specified time—such as 30 days—could help reduce default costs. Typically, students who drop out of school do so within the first few weeks of enrollment, and delaying receipt of loan proceeds is one way of reducing loan defaults.

In our 1988 report on potential default reduction options for the guaranteed student loan program,[1] we suggested that delaying loan disbursements to students until sometime after school starts could help reduce default costs. Borrowers who default may fail to complete their course of study and drop out shortly after beginning classes. If loans have already been disbursed to such students, the likelihood of recovering the loan is reduced. Delaying loan disbursements—particularly to students attending schools with high default rates—until students have been in attendance for a specified period could reduce federal default costs.

The 1990 Omnibus Budget Reconciliation Act (P.L. 101-508) established a provision for the guaranteed student loan programs that specifies that first-time borrowers are not allowed to obtain their loan funds until they have completed their first month of school. Since this legislation became effective after the start of our review, data were unavailable for analysis. We believe a delayed loan disbursement provision for the Perkins program, similar to the one now in effect for guaranteed student loan programs, has potential for reducing defaults and the subsequent loss of capital.

Provide Pro Rata Refunds to Borrowers

Another option to help curb default losses would be to require participating schools with high default rates to provide pro rata refunds to borrowers who drop out of school.[2] The refunds could be used to pay some or all of their Perkins loans. In its 1989 default reduction initiative regulations for the guaranteed student loan programs, the Department established such a requirement for schools with default rates above certain thresholds. This provision does not apply to the Perkins program.

Under the guaranteed student loan programs, schools with default rates at 30 percent or above must provide pro rata refunds of tuition, room, and board costs to borrowers who leave school before the enrollment period is half over or before 6 months, whichever comes first. The refund amount is to be equal to a percentage of costs, depending on how many weeks of the enrollment period were completed (less reasonable

[1] Guaranteed Student Loans: Potential Default and Cost Reduction Options (GAO/HRD-88-52BR, Jan. 7, 1988).

[2] In general, a pro rata refund is one that is based on how much time has elapsed in the term when the student drops out.

administrative costs). The primary purpose of this provision is to remove the incentive for high default schools to enroll students who are likely to drop out and default on their loans.

Under the Perkins program, the Department does not regulate student refunds, and any policy is left up to the schools. Data were not available for us to analyze the extent to which a pro rata refund policy could affect loan default costs in the Perkins program. However, a policy that requires schools providing Perkins loans that have high default rates to have a pro rata refund policy similar to that for guaranteed student loans could help reduce Perkins default costs. Also, recognizing that students borrow funds from different sources, such a refund policy could provide that a borrower with a Perkins loan would receive a refund equal to the amount that the Perkins loan is in proportion to the total amount borrowed from all sources.

Options for Increasing Program Income

The opportunities for increasing Perkins loan funds' income involve increased costs to the borrower, and any attempts to increase income need to be considered in light of the program's objective of providing low-interest loans to eligible students.[3]

Two options, currently part of other federal student loan programs, could increase schools' Perkins loan funds. These options are increasing the borrowers' interest rate and charging borrowers a loan origination fee. For purposes of illustration, we developed several examples of how these options could change the program's financial condition. These estimates assumed that an increase in the interest rate would not influence the demand for Perkins loans—that is, students would have borrowed the same amount without regard to the interest rate. Also, the dollar figures are simple summaries of the estimates and are not shown in present value terms.

Increase the Borrower's Interest Rate

Raising the interest rate on Perkins loans above the current 5 percent would put it more in line with rates for guaranteed student loans:

[3] As we discussed in chapter 2, the program's major sources of income are revenue from money in program bank accounts and revenue from money loaned to students. Because schools hold a relatively small of amount of program capital in their bank accounts, there is little opportunity for significantly increasing program income from these funds.

- Stafford loan borrowers are charged 8 percent for the first 4 years of repayment and 10 percent for the remaining years. In general, repayment terms for Stafford loans can be no longer than 10 years.
- Borrowers with Supplemental Loans for Students and Parent Loans for Undergraduate Students are charged interest rates that vary with Treasury bill rates, with a statutory 12-percent maximum. The rate for these loans was 11.49 percent for the 12-month period ending June 30, 1991.
- Consolidated loan borrowers are charged an interest rate that is the greater of 9 percent or the weighted average of the loans consolidated.

To illustrate how raising the borrowers' interest rate could increase program income, we computed the interest income that could be generated if all Perkins loans in repayment in 1989 were made with an 8-percent interest rate. A 3-percent increase in the interest rate on the approximately $1.71 billion in Perkins loans being repaid would have increased Perkins loan fund income by about $51.3 million in 1989. (In app. IV, we estimated the impact of alternate interest rates on the program's income.)

Raising the interest rate would in turn increase either borrowers' monthly payments or the length of their repayment term, or both. For example, if the interest rate was increased from 5 to 8 percent, a borrower of a $1,000, 10-year, maximum-term Perkins loan would pay $183 more in interest ($456 vs. $273) over the life of the loan. The borrower's monthly payments would increase by $1.52—from $10.61 to $12.13. If the borrower was repaying under the $30 minimum payment arrangement, total interest costs would increase by about $56 ($135 vs. $79), and the repayment term would be extended by 2 months (from 36 to 38).

Charge Borrowers a Loan Origination Fee

A loan origination fee, similar to the 5-percent fee charged Stafford loan borrowers to help cover program costs, could be added to the principal balance of the borrower's loan or deducted from the loan proceeds. Income from these fees would help offset the schools' cost of operating their Perkins funds by adding income to the funds.

For example, if a 5-percent origination fee had been charged to borrowers of the approximately $875 million in Perkins loans made during the 1989 school year, about $44 million in fees would have been generated. (App. V includes the amount of funds raised with a fee of 1, 2, 3, and 4 percent.) This fee, along with the other options available, could result in more closely aligning the Perkins program's income and costs.

The cost to a borrower of a 5-percent origination fee on a $1,000, 10-year loan would be $50. If capitalized—added to the loan's principal—this fee would increase a borrower's interest costs by about $14 over the life of the loan and increase his or her payments by about 53 cents monthly. Under the $30 minimum payment plan, a borrower's total interest costs would increase by $8 and the repayment term would be extended by 2 months.

Conclusions

The Perkins program's revolving fund could be made more financially sound through a combination of default cost reduction and income enhancement measures. These alternatives would require legislative changes.

Matters for Consideration by the Congress

To make the Perkins Loan Program more financially sound and less reliant on additional capital contributions, the Congress may wish to consider:

- Requiring schools to delay for 30 days the disbursement of Perkins loan proceeds to first-time borrowers.
- Requiring schools with high default rates to provide pro rata refunds to borrowers who drop out of school before the scheduled completion of their period of enrollment and to apply the refunds toward the repayment of their Perkins loans. The amount of a borrower's refund should be in proportion to the amount of Perkins loans borrowed when compared to funds borrowed from all sources.

The Congress may also wish to consider additional alternatives to increase revenues; these options, however, would require student borrowers to absorb more of the costs. These options are to

- increase the interest rate Perkins loan borrowers pay and
- charge borrowers a loan origination fee.

Agency Comments and Our Evaluation

The Department agreed with our suggestions to delay the disbursement of Perkins loan proceeds to first-time borrowers, require schools to provide pro rata refunds for borrowers who drop out of school before completion, and increase the interest rate borrowers pay. However, it disagreed with charging borrowers a loan origination fee. It said such a fee would add to the cost of attendance, creating a need for additional loan assistance.

COHEAO did not agree with our suggestions to require delaying loan disbursements and charging loan origination fees because these provisions would add to the student-borrower's costs. It also disagreed with our suggestion for pro rata refunds, in part because such a requirement would remove the schools' judgment on how to handle refunds.

Delayed Disbursement of Loan Proceeds

COHEAO said that requiring the delayed disbursement of loan proceeds would cause hardships on students who may need funds sooner to pay for rent, food, and books. We recognize that such a policy may have its drawbacks. However, the government's funds are at the highest risk of loss through loan defaults during the initial days of a student's post-secondary education. We believe that schools with high Perkins loan default rates—as are schools with high Stafford loan defaults—should be expected to share some of the risk. To help students in immediate need of funds, the schools could either advance their own funds to these students or extend the due dates for receipt of tuition payments.

Pro Rata Refund Policy

COHEAO raised several concerns regarding our suggestion for a uniform pro rata refund policy. It interpreted our draft as implying that the pro rata refund policy should be applied to all schools, not just the ones with high default rates, as is the current policy in the Stafford program. We have revised our report so that it more clearly reflects our position that the refund policy should be applied only to schools with high default rates.

COHEAO also interpreted our draft as suggesting that refund monies be first applied to the Perkins program before being used to refund other sources of student aid funds. It also believes that schools should have the discretion on how to distribute refunds when students may have several forms of aid, including Pell grants and Perkins and Stafford loans. We believe that when a student has obtained aid from more than one source, the monies should be returned to the respective programs in the same proportion as the amount borrowed or granted. We have revised our report to explain our position more clearly. We also believe that schools should not be allowed the discretion to distribute refunds. Doing so could lead to less money being available to serve the most needy students—the target population of the Perkins program.

In its comments, COHEAO said that a pro rata refund policy is unnecessary because the 1990 appropriations act (P.L. 101-166) established such a policy for all schools authorized by title IV of the Higher Education Act. We disagree. The provisions in the 1990 act pertain to programs authorized by part B of the Higher Education Act. The Perkins program is authorized by part E.

Loan Interest Rate

The Department concurred with the suggestion to increase the interest rate on Perkins loans. COHEAO did not comment on this option.

Loan Origination Fees

Neither the Department nor COHEAO agreed with our suggestion to charge borrowers a loan origination fee. They both believe that it would make education for the neediest students more costly. We recognized in our report that charging Perkins borrowers an origination fee would add to their education costs. However, as our analyses on pages 30 and 31 show, charging Perkins loan borrowers such a fee is likely to be considerably less costly to them than raising their loans' interest rate—an option the Department supported.

The extent to which these additional costs are borne by the primary beneficiaries—Perkins borrowers—or taxpayers is an issue subject to congressional debate. As a result, we are not recommending one option over another, but are providing information on the available options should the Congress consider revising the financial structure of the Perkins program.

COHEAO also said that charging Perkins loan borrowers an origination fee would make these loans too similar to Stafford loans and destroy a primary reason for the Perkins program to exist—that is, to serve the lowest income borrowers. We do not believe that charging a loan origination fee would change this. The Congress could set the origination fee for Perkins borrowers at a lower percentage rate than that charged Stafford loan borrowers to maintain the unique nature of the Perkins program.

Cumulative Loan Cancellations by Type of School (As of June 30, 1989)

Dollars in millions

	Type of school			
Kind of cancellation	**Public**	**Private**	**Proprietary**	**Total**
Bankruptcy	$51.1	$27.8	$3.7	$82.6
Death and disability	37.8	24.8	2.4	65.0
Teacher and military service before 1972[a]	298.5	217.2	.6	516.3
Teacher service after 1972	132.5	76.2	.2	209.0
Military service after 1972	.1	.3	.4	.7
Volunteer service	0	.1	0	.1
Total cancellations	520.0	346.4	7.3	873.7
Less reimbursements	115.1	64.7	.2	180.0
Net cancellations	**$404.9**	**$281.7**	**$7.1**	**$693.7**

[a]Cancellations of loans made before and those made on or after July 1, 1972, are reported separately in the program's fiscal operations reports. Different federal reimbursement policies apply to these two categories of canceled loans.

Cumulative Operating Income, Costs and Losses by Type of School (As of June 30, 1989)

Dollars in millions

	Type of school			
	Public	**Private**	**Proprietary**	**Total**
Operating income				
Interest on loans	$579.1	$511.5	$42.0	**$1,132.7**
Other income	68.8	36.1	4.7	**109.6**
Total income	647.9	547.6	46.7	**1,242.3**
Operating costs and losses				
Administrative costs	230.0	238.2	20.9	**489.1**
Collection costs	142.3	106.6	18.9	**267.7**
Defaulted loans[a]	428.6	261.1	133.1	**822.7**
Loan cancellations[b]	404.9	281.7	7.1	**693.7**
Other costs and losses	6.6	7.4	1.6	**15.5**
Total costs and losses	1,212.4	895.0	181.6	**2,289.7**
Net operating loss	**$−564.5**	**$−347.4**	**$−134.9**	**$−1,046.4**

[a]Defaulted loans assigned to the Department; schools were holding an additional $737 million in defaulted loans that they do not report as costs until assigned to the Department.

[b]Loan cancellation figures are net of federal reimbursements.

Cumulative Capital Contributions Plus Operating Income Have Exceeded Operating Costs and Losses (As of June 30, 1989)

Dollars in millions		
Public schools		
Funds from capital contributions:		
Federal	$2,815	
School	361	
Total capital contributions		$3,176
Funds from program operations:		
Operating income	648	
Operating costs and losses	−1,212	
Net loss from operations		−564
Fund net balance		**$2,612**
Private schools		
Funds from capital contributions:		
Federal	$2,516	
School	322	
Total capital contributions		$2,838
Funds from program operations:		
Operating income	548	
Operating costs and losses	−895	
Net loss from operations		−347
Fund net balance		**$2,491**
Proprietary schools		
Funds from capital contributions:		
Federal	$364	
School	43	
Total capital contributions		$407
Funds from program operations:		
Operating income	47	
Operating costs and losses	−182	
Net loss from operations		−135
Fund net balance		**$272**

Impact of Various Interest Rates on Aggregate Operating Income (As of June 30, 1989)

Dollars in millions

Alternative interest rate	Amount	Current 5% rate	Difference
6	$102.66	$85.55	**$17.11**
7	119.77	85.55	**34.22**
8	136.88	85.55	**51.33**

Note: Based on the average balance of $1.71 billion in loans in repayment during the 1988-89 program year.

Income Could Be Generated by Charging Borrowers Loan Origination Fees at Various Rates

Dollars in millions

	Fee (percent)				
	1	2	3	4	5
Additional capital[a]	$8.75	$17.50	$26.25	$35.00	$43.75

Note: Stafford loan borrowers currently pay a 5-percent loan origination fee.

[a]Fees are based on the $875 million in loans made during the 1988-89 program year.

Comments From the Department of Education

Note: Page references in this appendix may not correspond to page numbers in the final report.

UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF THE ASSISTANT SECRETARY FOR POSTSECONDARY EDUCATION

JUL 29 1991

Franklin Frazier, Director
Education and Employment Issues
Human Resources Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Frazier:

Thank you for the opportunity to review the GAO Draft Report, "Perkins Student Loans: Options that Could Make the Program More Financially Independent," GAO/AC 104649, issued May 31, 1991.

Enclosed are the Department of Education's comments on the subject draft report. In addition to addressing the specific recommendations and matters for consideration by the Congress made by the GAO, we have provided comments or suggested technical corrections and changes to clarify information presented in the narrative portion of the report.

We believe that while the Congress originally may have intended for the program to be self-sustaining or may have intended that the program at least maintain a revolving fund, subsequent Congressional actions have not carried out that intent. Also, we are not aware that the Congress has ever explicitly stated such an intent, and in fact, Congressional actions imply something quite different. That is, all of the types of costs and losses that GAO specifies in Table 2.1 as the primary causes of the overall program loss are the direct result of provisions of the Higher Education Act (HEA), as it has been amended. For example, the law encourages borrowers to teach in low-income schools in order to receive a partial or full loan cancellation.

The Perkins Loan Program was originally designed to attract superior students to the teaching profession for service at all academic levels by virtue of the partial or full loan cancellation provisions. Further, to encourage students to enter professions where the service is most needed, the Congress most recently has expanded the cancellation losses to include those for volunteer and law enforcement service. In the Higher Education Amendments of 1986, the Congress authorized institutions to take funds for their College Work-Study and

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Supplemental Educational Opportunity Grant programs' administrative cost allowance from cash-on-hand in their Perkins Loan Fund. And, the Congress has intentionally kept the interest rate low for this program, raising it only from 3 to 4 to 5 percent over the 32-year history of the program.

These actions definitely do not support or are not consistent with any overall intent to make the program self-sustaining. The originally stated legislative intent of the program was a declaration that the security of the Nation required the fullest development of the mental resources and technical skills of its young men and women. Conditions were deemed to be an emergency that demanded that additional and more adequate educational opportunities be made available.

Congress believed that the defense of the Nation depended upon the mastery of modern techniques developed from complex scientific principles as well as the discovery and development of new principles, new techniques and new knowledge. The purpose of the higher education programs was to provide substantial assistance to individuals through institutions of higher education in order to ensure trained manpower of sufficient quality and quantity to meet the national defense needs of the United States. The loan program was intended not only to provide for some of the financial assistance needed by students, but also to provide for cancellations and other benefits in the event that critical manpower needs were served by the borrowers.

If you have further questions, please contact Valerie Hurry of the Division of Quality Assurance on 708-9453.

Sincerely,

Michael J. Farrell

Michael J. Farrell
Acting Assistant Secretary

Enclosure

U.S. Department of Education Comments on the
General Accounting Office Draft Report,
"Perkins Student Loans: Options that Could Make the
Program More Financially Independent," GAO/AC 104649

GAO RECOMMENDATION #1:

GAO recommends that the Congress revise the Higher Education Act to provide that the Perkins loan default rate formula include all defaulted loans, including those assigned to the Department of Education for collection and that the default rates be computed on a basis similar to that used for the Stafford Loan Program.

ED Comments:

ED concurs. We share the GAO concern in regard to a need to revise the legislated definition of the default rate. We agree that the default rate calculation should include all defaulted loans, including those which have been assigned to the Department. We agree that the use of the cohort formula will be especially practical in that this calculation will assure that assignments made prior to the cohort year will not have a continual cumulative negative effect on an institution's default rate.

GAO RECOMMENDATION #2:

GAO recommends that the Congress further revise the Higher Education Act to require schools to assign their defaulted Perkins loans to the Department of Education for collection after they have been in default for a specified time period.

ED Comments:

ED concurs. We agree that schools should be mandated to assign defaulted Perkins Loans to the Department after a specified period of time in default.

MATTERS FOR CONSIDERATION BY THE CONGRESS:

A. To make the Perkins Loan Program more financially self-sustaining and relying less on additional capital contributions, the Congress may wish to consider:

-- Requiring schools to delay for 30 days, the disbursement of Perkins loan proceeds to first-time borrowers.

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-- Requiring schools to provide pro rata refunds to borrowers who drop out of school before the scheduled completion of their period of enrollment and to apply the refunds towards the repayment of their Perkins loans.

ED Comments:

ED concurs.

B. The Congress may also wish to consider additional alternatives to increase revenues, however, these options would require student borrowers to absorb more of the costs. These options are:

-- increase the interest rate Perkins loan borrowers pay, and

-- charge borrowers a loan origination fee.

ED concurs with the option of increasing the Perkins loan interest rate.

ED does not concur with the suggestion that a loan origination fee should be charged to a Perkins Loan borrower. Such a provision would add to the cost of attendance which would create a need for additional loan assistance. Efforts should be extended to reduce or hold costs of attendance increases to a minimum.

Comments and/or Technical Corrections to the GAO Report

Page 1, paragraph 1, line 5 -- "about" should be replaced by "no more than";

Page 2, paragraph 1, line 9 -- Insert "Perkins Federal capital" after "additional";

Page 2, paragraph 1, line 12 -- Insert "Federal capital" after "Perkins";

Page 2, paragraph 2, line 6 -- Add "administrative cost allowances," after "from";

Page 2, paragraph 2, line 7 -- "entering" should be "serving in";

Page 4, paragraph 2, line 5 -- "1001" should be "108766";

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Page 6, "RECOMMENDATIONS TO THE CONGRESS," -- "(See p. 33.)" should read "(See p. 32.)."

Page 10, paragraph 3, line 7 -- After "loans." add ", after appropriated funds exceeded $190 million. This occurred in the 1971-72 award year.";

Page 10, Footnote, line 2 -- Add ", in 1972," after "later";

Page 12, paragraph 2, -- The Income Contingent Loan Program should be noted as another title IV loan program;

Page 12, paragraph 3, line 8 -- "school year 1985" should be "award year 1985-86";

Page 13, line 1 -- "received in 1985." should be "expended in the 1985-86 award year.";

Page 15, paragraph 1, line 2 -- "1,015" should be "878"; "1,231" should be "1,203";*

Page 15, paragraph 1, line 3 -- "984" should be "1,132";*

Page 15, paragraph 1, line 4 -- "$883" should be "$873.7";

Page 15, Figure 1.2, -- "$410.5" should be "$431.1"; "$421.5" should be "$396.0"; "1,015" should be "878"; "1,231" should be "1,203"; "$50.5" should be "$46.5"; and "984" should be "1,132";

Page 18, paragraph 1, line 2 -- "3,230" should be "3,213";*

Page 18, paragraph 1, lines 4 and 6 -- "419" and "2,811" should be "210" and "3,003," respectively;*

Page 18, paragraph 2, line 2 -- "3,230" should be "3,213";*

Page 18, paragraph 2 -- Should include the statement: "The $1.05 billion indicated as a net loss includes defaulted loans assigned to the Department and subsequently collected. It also includes reimbursements for Defense Loan cancellations, all of which were returned to institutions as institutional funds. Therefore, the actual loss to the Federal government as of June 30, 1989 was considerably less than $1.05 billion."

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Page 20, paragraph 1, line 3 -- The term "administrative cost allowance" has not been specified to this extent in the statute or regulations but rather in general terms as a payment in lieu of reimbursement for an institution's expenses in administering its Perkins Loan Program.

Page 20, paragraph 2, line 2 -- Insert "allowable" between "for" and "collection";

Page 21, "Other costs and losses" -- New regulations will reduce this write-off authority to $25; amounts above $25 will be assigned to the Department for collection through the IRS offset provisions;

Page 21, paragraph 3, line 1 -- "2,811" should be "3,003" and "3,230" should be "3,213"; line 5 -- "419" should be "210";*

Page 22, Table 2.2 -- "419" should be "210," "2,811" should be "3,003," and "3,320" should be "3,213";*

Page 25, paragraph 3, line 1 -- "new" should be "additional";

Page 26, paragraph 3 -- This paragraph implies that prior to the 1986 amendments the Department had no procedures for reducing or eliminating new Federal capital contributions to institutions because of high default rates. It would be more appropriate to modify the statement to indicate that the 1986 amendments changed the procedures for determining a default penalty.

Page 27, paragraph 1, line 3 -- "hold" should be "held";

Page 27, paragraph 1, line 4 -- "assign" should be "assigned";

Page 36, paragraph 3, line 5 -- "income" should be "interest";

Appendix II -- Military service before 1972, proprietary, ".6" should be ".3" and military service after 1972, proprietary, ".4" should be ".006."

* **Note:** Differences in the numbers of participating institutions, type and control categories, and self-sustaining institutions is attributable to the use of different sets of data bases. The Analysis Section of the Campus-Based Programs Branch/DPPD figures are derived from data taken from September 1988 files which will not reflect edits and other changes after that date.

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The GAO data base was provided on or about January 1991 which would have included edits and other changes made after September 1988. One of these changes that would account for the difference in the number of participating institutions stems from the fact that allocations for some institutions were on hold pending actions relative to eligibility determinations; therefore, they were not in the September 1988 data files.

Also, as used by the Department, the definition of "self-sustaining" refers to those institutions which have, for the year involved, (1) an approved LOE greater than zero, (2) a Federal capital contribution of zero, and (3) a default rate of less than 20 percent (a default rate of greater than 20 percent would have resulted in the default penalty application, i.e., denial of an approved LOE).

Comments From the Coalition of Higher Education Assistance Organizations

Note: Page references in this appendix may not correspond to page numbers in the final report.

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MEMORANDUM

TO: Jay Eglin

FROM: Ellin Nolan

RE: GAO Study on Perkins Loan Fund

DATE: July 1, 1991

Comments from Reviewers:

1. With the 1987 regulations, there is important new income for the fund, i.e. late charges, internal collection costs, and outside agency collection costs. This should generate more revenue and help make the program more self sustaining.

2. With the 1987 regulations due diligence and pre-assignment requirements (IRS skip-tracing, referrals to 2 collection agencies, credit bureau reports) abuses noted by GAO and random dumping of loans back on the government will be reduced.

3. Since the government has both the IRS tax offset and garnishment available to them, they have an advantage over institutions in collection. If an assigned loan is ultimately collected by the government or government designee, some adjustment should be made to the schools default or assignment rate.

4. As an advocate of performance based regulations, I would support inclusion of assignment into the calculation of default. The default rates for Perkins should have some consistency with GSL cohort concepts.

5. If assigned loans were included in the default rate calculations, it might encourage some institutions to pursue collections more diligently.

6. Requiring institutions to assign within a certain period (three years) is a good idea. However, allowances must be made for loans in pre-litigation or litigation (3-5 years at times).

7. Delaying disbursements can cause real hardships for students. They need to pay rent, eat, buy books and may not have other aid to cover these costs.

8. Charging a loan origination fee doesn't make sense with a need based program targeted toward the lowest income students. Student budgets are already increased to cover the loss of GSL origination and insurance fees and there are just not enough grant funds available. Perkins is a unique program which should serve a unique student--the lowest income borrower. If you make it identical to Stafford you destroy its reason to exist.

9. Page 19. What is "other income" from "returned checks"? Its confusing and mysterious. We certainly wouldn't want a new regulation requiring institutions to charge borrowers for returned checks and then credit the fund!

EJN\B\6

Notes on GAO paper

On page 2, the paper indicates that there are losses to loan capital because of loan defaults and loans cancelled. Loans cancelled are reimbursed by the Federal government in most cases; therefore, cancelled loans do not represent losses of loan capital. See page 13.

On page 5, GAO suggests delaying the disbursement of Perkins loans for a few weeks into the enrollment period. However, schools must now delay the disbursement of GSL and SLS loans to first time borrowers who are first year students. By delaying the disbursement, another source of funding to the student, then he/she may not have sufficient funding to even begin his/her program.

Also on page 5, GAO suggest that schools pro rate refunds for Perkins borrowers and apply refunds first toward the repayment of the Perkins loans. First, schools with default rates over 30% now are subject to pro rata. It would seem to be a rather punitive measure to require it of all institutions if they participate in the Perkins Loan program. Further, under 34 CFR 668.22(e), the institution is required to develop its own policy as to how to apply the refunds back to the Federal accounts. Generally, schools return refunds first to the lenders because of the higher interest rates and larger loan balances. There is no logical reason for removing an institution's judgement as to how to return funds, and it certainly is not in the student's interest to refund to Perkins before refunding to GSL/SLS.

Just a point of clarification, see page 35. Schools with over 30% default rates were subject to pro rata refunds for all Title IV programs, including Perkins Loans, under the FY 1990 appropriations act (P.L. 101-166).

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