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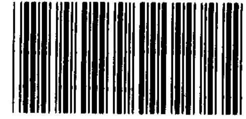

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The Honorable William D. Ford
Chairman, Committee on Education
and Labor
House of Representatives

Dear Mr. Chairman:

In November 1992, we reported that the federal government could save about $4.7 billion in the first 5 years by replacing the Federal Family Education Loan Program with a direct loan program.[1] A December 1992 paper prepared by KMPG Peat Marwick for the National Council of Higher Education Loan Programs and the Consumer Bankers Association criticized our report. Peat Marwick claimed, among other things, that we understated or excluded costs that biased the report in favor of direct lending. Because of the major financial implications of this issue, your staff asked us to respond to Peat Marwick's criticisms.

We believe that our report provided a sound, balanced assessment of the savings achievable through direct lending. As such, it contained numerous cautions about the consequences of several important variables--such as market interest rates, inflation, and loan origination costs--deviating from the values we assumed. We also constructed a range of plausible alternate values for critical variables and showed how substituting different values changed our results, as we reported in appendix II of our report.

After carefully reviewing Peat Marwick's evaluation of our report, we have focused our response on the four key issues discussed. Peat Marwick claimed that we (1) neglected to include the costs associated with future guaranty agency insolvencies and increases in the federal government's overall cost of funds, (2) failed to adequately emphasize that savings from direct lending are predicated on interest rate

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[1] Student Loans: Direct Loans Could Save Billions in First 5 years With Proper Implementation (GAO/HRD-93-27, Nov. 25, 1992).

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margins, (3) failed to adequately address the government's interest rate risk, and (4) skewed our focus group discussion in favor of direct lending. We have also included an enclosure that briefly responds to Peat Marwick's other issues.

FUTURE GUARANTY AGENCIES' INSOLVENCIES ARE NOT RELEVANT TO THE DIRECT LOAN DEBATE

Peat Marwick suggested we should have incorporated the federal costs of phasing out insolvent guaranty agencies into our relative cost analysis. We disagree. Any costs associated with insolvent agencies are properly assigned to the current--guaranteed loan--program, not to a successor program. To the extent they exist, these liabilities will need to be addressed in any event. A lesson learned from the savings and loan disaster is that hidden insolvencies do not go away. Rather, the problems tend to worsen. In this case any insolvencies would be attributable to inadequate financial reserves, high loan default levels, and insufficient loan default recovery. Credit reform rules do not allow the government to assign to a new loan program the unfunded cost of past program commitments. The dependence of some guaranty agencies on the cash flow associated with making new loan guarantees to cover unfunded costs represents a shell game for the federal government.[2] A direct loan program would merely unmask the guaranteed student loan program's hidden costs.

Moreover, Peat Marwick used a flawed methodology to estimate the federal costs associated with future guaranty agency insolvencies. In a memorandum to the Department of Education, Kidder, Peabody & Company estimated that without new loan guarantees, 18 guaranty agencies would fail, at a cost of about $200 million. Peat Marwick concluded that Kidder Peabody's estimate should be revised upward in light of Higher Education Assistance Foundation (HEAF) insolvency.

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[2]If guaranty agencies discontinue making new loan guarantees, they would stop receiving revenue from insurance premiums and administrative cost allowances. Insurance premiums are a fee of up to 3 percent deducted from the borrowers' loan proceeds. Administrative cost allowances are payments from the Department of Education equal to 1 percent of the amount of new loan guarantees (offsetting reinsurance fee payments returned to Education reduce the effective administrative cost allowance rate to about 0.7 percent).

Although we reported that the costs for the first year of HEAF's liquidation alone totaled about $212.4 million, total cost of the liquidation should be a good deal less than $212.4 million.[3] The liquidation agreement requires HEAF to turn over its portfolio of defaulted loans and other assets to Education by December 31, 1993. To the extent that Education collects these defaults more efficiently than HEAF, either by itself or through the IRS income tax refund offset, it will be able to reduce the federal costs of HEAF's insolvency. As we reported, the final federal costs of the liquidation will also depend on the size of the default portfolio that Education receives from HEAF, as well as the additional federal costs or accrued income from HEAF operations after the first year of liquidation.

DIRECT LENDING WILL NOT AFFECT CAPITAL MARKETS

Peat Marwick contended that the federal borrowing needed to support direct lending would increase the cost of financing the federal debt (by $200 to $440 million for the 5 year period). Its underlying assumption is that any increase in government borrowing for direct lending would increase the federal cost of borrowing.

Any resulting increase in the cost of funds to the federal government is likely to be negligible. Eliminating the need for banks and secondary market purchasers, such as the Student Loan Marketing Association (Sallie Mae), to raise funds to make and purchase guaranteed student loans should reduce much of any upward pressure on interest rates that might accompany increased government borrowing. Additionally, the extent that the federal government is able to realize savings from a direct loan program would--in the long term--lead to reduced federal spending and deficit borrowing. This could possibly reduce the cost of funds to the government.

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[3] Guaranty Agency Solvency: Can the Government Recover HEAF's First-Year Liquidation Cost of $212 Million? (GAO/HRD-93-12BR, Nov. 13, 1992).

SAVINGS FROM NOT PAYING INTEREST SUBSIDIES CAN MATCH THOSE DERIVED FROM THE INTEREST MARGIN

Peat Marwick implied that savings from direct lending depend on the existence of interest rate margins. However, given the interest rates assumed in our baseline analysis, the interest margin--the difference between the interest rate charged to student borrowers (8.4 to 9.1 percent) and government's cost of borrowing (7.1 percent)--provided an important source of savings.

Under most plausible alternative interest rate scenarios, the savings associated with eliminating the interest subsidy to lenders--the special allowance payments (SAP)--would counterbalance a narrowing of interest margins.[4] This occurs because of the inverse relationship between the interest margin revenues and SAP expenditures; as interest margin revenues decline, SAP savings rise. For example, interest rates 1.5 percent above those assumed in our baseline estimate would have reduced the interest rate margin for Stafford loans to 0.4 percent, thereby reducing interest margin revenues by about $3.1 billion.[5] Education, therefore, would be required to pay guaranteed student loan program lenders--assuming, for example, a 1.36 percent SAP for Stafford loans--an additional $3.1 billion.[6] The net effect of substituting these interest rates would have increased our savings estimate from $4.7 to $4.8 billion.

THE FEDERAL GOVERNMENT CAN USE RISK MANAGEMENT STRATEGIES TO MINIMIZE INTEREST RATE RISK

Peat Marwick incorrectly implied that the interest rate risk inherent to direct lending makes our savings estimate improbable. Maintaining a

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[4]For most new loans, the SAP is set equal to the bond equivalent rate on 91-day Treasury bills plus an additional interest supplement of 3.10 percent. If the borrower's interest rate is below this guaranteed yield, Education pays the difference.

[5]The 9 percent rate paid by Stafford borrowers less the government's cost of borrowing--8.6 percent (7.1 + 1.5 percent).

[6]For Stafford loans the SAP would be 1.36 percent: 5.76 percent baseline T-bill yield + 1.5 percent + 3.1 percent SAP factor - 9 percent paid by students.

conservative posture, we assumed that the federal government would finance direct loans with securities with an average yield equal to the forecast rate on 10-year Treasury notes. In actual practice, the funds for a direct loan program would come from the Treasury and would not be earmarked for a particular program or use. Also, the government is not precluded from managing a direct loan portfolio in ways that minimize interest rate risk. For example, it could substantially reduce interest rate risk by using T-bills to finance direct loans. Had we assumed that the government would use T-bills to finance a direct loan program, our baseline savings estimate would have increased from $4.7 to about $11 billion.

OUR RESULTS ON THE FOCUS GROUP DISCUSSIONS PRESENTED BOTH SIDES OF THE DIRECT LOAN DEBATE

Peat Marwick gave an inaccurate picture of our focus group results. Focus group discussions are designed so that participants can share a range of thoughts and experiences on many topics. We conducted our focus groups to explore the variety of "opinions and insights of postsecondary school officials on the acceptability and impact of replacing guaranteed student loan programs with a direct loan program" (see p. 23 of our report). We did not report our focus group results in such a way as to take a specific position for or against direct lending. Our report made clear that "both financial aid administrators and business officers were divided over the advisability of switching to a direct loan program" (p. 7). Furthermore, the balanced nature of our presentation was epitomized in our finding that "the majority of participants expressed little or no confidence in Education's ability to manage a direct loan program" (p. 9). Our report also concluded that "any potential federal savings will require substantial effort on both schools' and the federal government's part" (p. 10).

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We hope this provides additional perspective to the direct loan debate. Copies of this letter will be provided to the Secretary of Education, the Director, Office of Management and Budget, other congressional

committees, and other parties. If you have any further questions, please contact me at (202) 512-6806.

Sincerely yours,

Lawrence H. Thompson

Lawrence H. Thompson
Assistant Comptroller General

Enclosure

GAO Response To Selected Peat Marwick Comments

Loan servicing costs

Peat Marwick claimed that we severely understated servicing costs, thereby overstating the savings potential of direct lending. As such, it suggested that we would improve our analysis by using the average servicing costs determined in our 1990 review of secondary market lenders.[1] In fact, the 1-percent figure used in our direct loan report was slightly higher than average servicing costs found in the earlier report. While the simple average of servicing costs was 1.41 percent for 10 selected secondary markets, the weighted average--the more germane data element--was about 0.95 percent. Our savings estimate would have increased from $4.7 billion to $5.0 billion by using a 0.95-percent servicing cost assumption.

Loan defaults

Peat Marwick took exception to our assumption that default rates under direct lending would equal those of guaranteed loan programs--it assumed that default rates will increase with direct lending. We cautioned our report readers that poor management by the Department of Education could trigger more defaults, which could erode potential cost savings (p. 10). On the other hand, for several reasons, the net default costs--the critical issue--could well be lower than our estimate indicated because of the increased collections possible from a direct loan program. Since the federal government rather than guaranty agencies would hold defaulted loans, it is reasonable to assume that a more widespread use of the IRS income tax refund offset program would occur under direct lending; about $500 million was recovered from defaulted borrowers last year. If the portion of collections obtained through the IRS offset increased from 34 percent (as was the case in fiscal year 1991) to 50 percent, direct loans could have saved the government an additional $200 million.

Costs transferred to institutions

Peat Marwick said that our analysis did not consider cost transfers to higher education institutions. It assumed that these costs emanate from the expanded administrative role required to accommodate direct lending. Though our analysis

[1]Guaranteed Student Loans: Profits of Secondary Market Lenders Vary Widely (GAO/HRD-90-130BR, Sept. 28, 1990).

did not focus on indirect costs, some evidence suggests that institutions' administrative burdens may actually decline under direct lending. For example, Harvard's and Colorado State's financial aid administrators concluded from a functional analysis that the numbers of administrative tasks that schools perform in connection with the origination of loans would decline under direct lending.[2] Nevertheless, we assumed that the federal government would cover institutions' costs to originate loans--estimated at $35 per loan adjusted for inflation, and included this additional payment as part of our estimate of the cost of a direct loan program (p. 18). Currently, schools receive no compensation for administering guaranteed loan programs.

Effect on students

Peat Marwick said that our analysis did not explore the effect of direct lending on students. Our focus group participants extensively discussed their perceptions about how direct lending would affect students. In the current program students must interact with a confusing array of players in the system--the institutions' financial aid office, a lender, and, in many cases, a secondary market participant and one or more loan servicers. Many focus group participants felt confident that a direct loan program would be more user friendly to students. In their opinion, the advantages of direct lending would include (1) a simplified loan process that students should more easily understand, (2) a single set of rules for students to master, and (3) automatic loan consolidation.

Impact of Higher Education Amendments of 1992

Peat Marwick implied that our analysis did not adequately address the impact of the Higher Education Amendments of 1992. To the contrary, appendix VIII of our report discusses the effects of the amendments on our savings estimate (p. 30). The net effect was a decrease in our savings estimate from $4.8 billion to $4.7 billion. The improvements the amendments call for in the operation and oversight of the guaranteed student loan program do not, in our judgment, materially affect the potential cost savings that could be achieved through direct lending.

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[2] G. Kay Jacks and Elizabeth M. Hicks, "Comparison of Administrative Functions for Schools Under the Stafford Loan Program and A Direct Loan Program."