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United States Government Accountability Office
Washington, DC 20548

February 25, 2005

The Honorable John A. Boehner
Chairman
Committee on Education and the Workforce
House of Representatives

Subject: Consolidation Loan Borrower Interest Rates

This letter responds to your question related to the recommendation we made in our October 31, 2003, report *Student Loan Programs: As Federal Costs of Loan Consolidation Rise, Other Options Should Be Examined* (GAO-04-101), which we completed at your request. As you know, we reported that then recent trends in interest rates and consolidation loan volumes had affected the federal costs of consolidations in the Department of Education's two major student loan programs—the Federal Family Education Loan Program (FFELP) and the William D. Ford Federal Direct Loan Program (FDLP)—in different ways, but in the aggregate, estimated federal subsidy costs[1] for consolidation loans had increased. In light of these increased costs, we recommended in our report that the Secretary of Education assess the advantages of consolidation loans for borrowers and identify options for reducing federal costs, taking into consideration how best to distribute program costs among borrowers, lenders, and the taxpayers. Among the options we suggested for the Secretary's consideration was changing the borrower interest rate on consolidation loans from a fixed to a variable rate.[2] Given that some time has passed since we issued our report, you asked for our perspective on whether economic circumstances—such as current and projected interest rates--are such that a variable interest rate remains a viable option for reducing federal costs of student consolidation loans. On the basis of the information discussed below, we believe a variable interest rate remains a viable option for reducing federal costs.

VARIABLE BORROWER INTEREST RATE FOR CONSOLIDATION LOANS IS A VIABLE OPTION FOR REDUCING FEDERAL SUBSIDY COSTS

Changes in market interest rates affect the costs of the FFELP and FDLP in different ways due to differences between how the programs operate. Under FFELP, private lenders make loans to students, with Education guaranteeing the lenders loan repayment and a rate of return on the loans they make. Under FDLP, the federal government makes loans to students using federal funds. A change in the borrower interest rate on consolidation loans from a fixed to a variable rate would affect

[1] Subsidy costs are the net present value of cash flows to and from the government, excluding administration costs, that result from providing loans to borrowers.
[2] The borrower interest rate on consolidation loans is currently calculated as the weighted average of the interest rates in effect on the loans being consolidated rounded up to the nearest one-eighth of 1 percent, capped at 8.25 percent.

federal subsidy costs for FFELP and FDLP consolidation loans in the ways discussed below.

FFELP

As we previously reported, increased federal subsidy costs of FFELP consolidation loans were due in part to the fact that the government-guaranteed rate of return to lenders was projected to be higher than the fixed interest rate consolidation loan borrowers pay. When the interest rate paid by borrowers does not provide the full guaranteed rate to lenders, the federal government must pay lenders the difference—an interest subsidy called a special allowance payment (SAP).[3] If the borrower's rate exceeds the guaranteed lender yield, Education does not pay a SAP, and the lender receives the borrower rate. As was the case when we issued our prior report, the Administration currently projects that interest rates and the guaranteed lender yield will continue to rise over the next several years. As a result, in future years, when the guaranteed lender yield is expected to increase, Education would have to make up any difference between the higher lender yields and the fixed rate paid by current consolidation loan borrowers.

Since we issued our report, Education has developed several proposals, presented in the President's Fiscal Year 2006 Budget, that are intended to reduce federal costs of consolidation loans, including the introduction of a variable borrower interest rate. The proposal would replace the current fixed rate interest formula for consolidation loans with the variable rate formula currently used for Stafford student loans—loans that underlie consolidation loans.[4] The interest rates that borrowers currently pay on Stafford loans adjust annually, based on a statutorily established market-indexed rate setting formula, and may not exceed 8.25 percent.[5] Figure 1 shows how, when interest rates are projected to increase in the future, a change to a variable borrower interest rate would reduce federal SAP costs for FFELP consolidation loans originated in fiscal year 2006.

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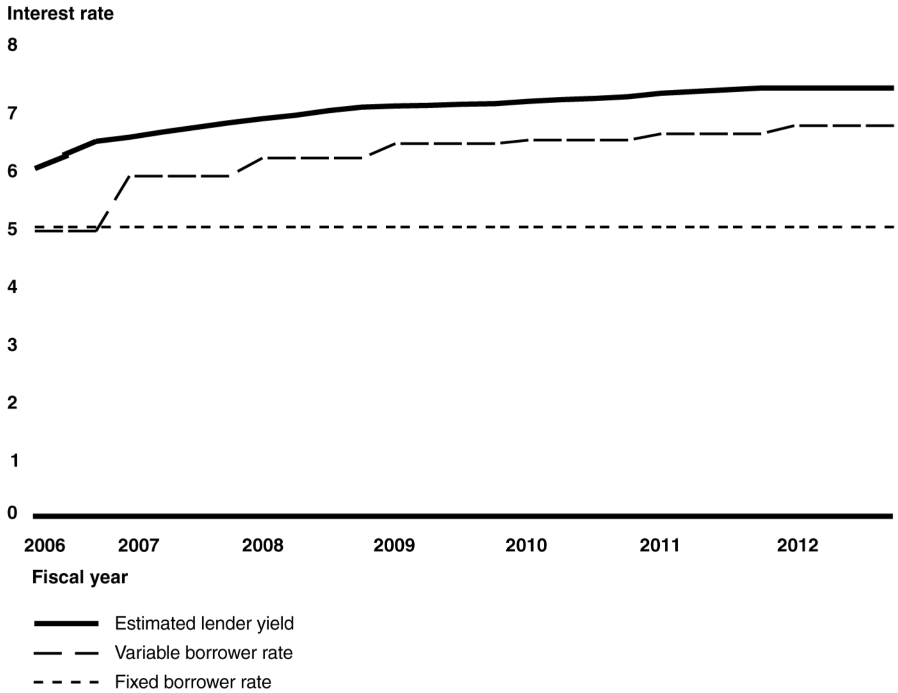
[3] The SAP is based on a formula specified in law and paid by Education to lenders on a quarterly basis when the "guaranteed lender yield" exceeds the borrower rate. This guaranteed lender yield is currently based on the average 3-month commercial paper interest rate plus 2.64 percent. The amount of quarterly SAP paid to loan holders equals the difference between the guaranteed lender yield and the borrower rate divided by 4 and multiplied by the average unpaid principal balance for all loans the lender holds.
[4] Borrowers may also consolidate other types of student loans, including PLUS loans, Perkins loans, Health Professions Student Loans, Nursing Student Loans, and Health Education Assistance Loans.
[5] For Stafford loans originated between July 1, 1998 and June 30, 2006 the borrower interest rate is the bond equivalent rate of the 91-day Treasury bill at the final auction held prior to June 1 (rates become effective July 1 through the following 12-month period) plus 1.7 percent during in-school, grace, and deferment periods and 2.3 percent during repayment periods, capped at 8.25 percent. Under current law, borrower rates on Stafford loans are scheduled to become a fixed rate of 6.8 percent on July 1, 2006. Among the Administration's other student loan program proposals is one to retain the variable borrower interest rate on Stafford loans.

Figure 1: Illustration of Estimated SAP Paid to Holders of FFELP Consolidation Loans Originated from October to June of Fiscal Year 2006



Source: GAO analysis.

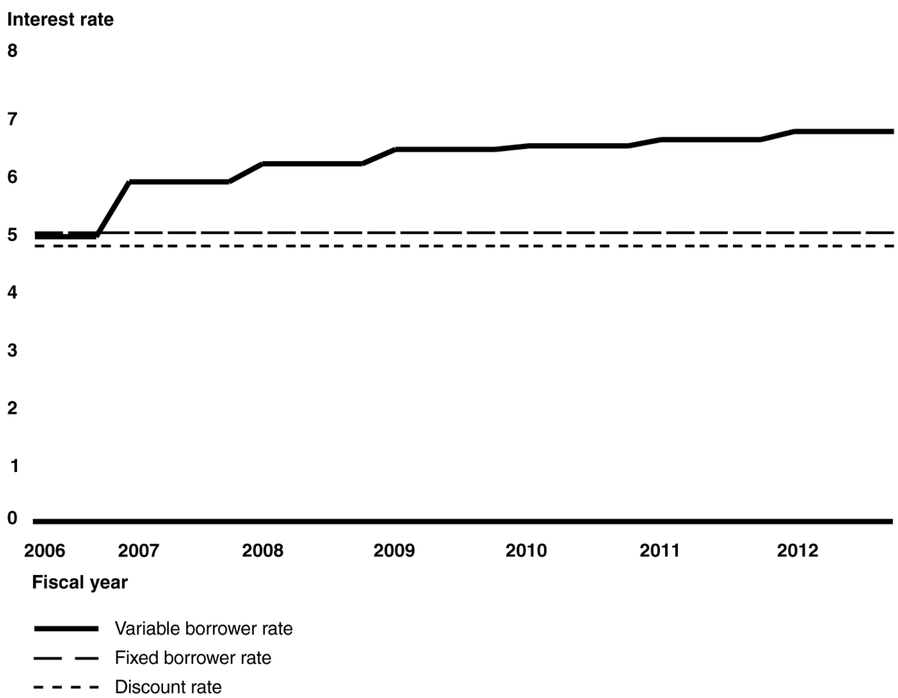
Note: The estimated lender yield and variable borrower interest rate do not vary after fiscal year 2011 because the Administration's interest rate projections do not vary after fiscal year 2011. The estimated fixed borrower rate is for a consolidation loan originated from October to June of fiscal year 2006, whose underlying loans are Stafford loans disbursed after July 1, 1998, and in repayment at time of consolidation. Under current law, borrower rates on Stafford loans are scheduled to become a fixed rate of 6.8 percent on July 1, 2006.

As the figure shows, based on current interest rate projections, lenders would receive a SAP in fiscal year 2006 and beyond for consolidation loans made in fiscal year 2006. The amount of the SAP would be determined based on the difference between the lender's yield and the borrower interest rate and the amount of the consolidation loan. As the figure also shows, the difference, or spread, between the lender yield and the variable borrower interest rate proposed by Education is less than the spread between the lender yield and the fixed borrower interest rate. This is due to the fact that, as interest rates rise in the future, the variable borrower rate would increase along with the lender yield. As a result, federal SAP costs would be reduced. The amount by which SAP costs would be reduced would be determined by the difference between the fixed borrower rate and the variable borrower rate shown above. If market interest rates were to decline, rather than increase as projected, SAP cost reductions would be smaller because the spread between the projected variable and fixed borrower interest rates would decrease. Further, if market interest rates were to decline to the point that a variable borrower rate would be less than the fixed rate shown, SAP would continue to be paid on loans with a variable interest rate, but would not be necessary for loans with the fixed rate shown.

FDLP

We also previously reported that, as a direct loan program, the FDLP consolidation program involves no guaranteed yields to private lenders and the subsidy cost of this program is determined in part by the relationship between the interest rate Education earns from borrowers--the borrower rate--and the rate Education pays Treasury to finance its lending. The government's cost of capital is determined by the interest rate Education pays Treasury to finance direct student loans, which is equivalent to the discount rate.[6] When the borrower rate is greater than the discount rate, Education receives more interest from borrowers than it pays to Treasury. In calculating the subsidy costs of FDLP loans made in a given year, the discount rate is generally fixed for the life of the loans. Because current borrower interest rates on consolidation loans are also fixed, the subsidy costs of FDLP consolidation loans made in a given fiscal year do not vary in the way the subsidy costs for FFELP consolidation loans do. However, changing the borrower rate from a fixed to a variable rate would affect the subsidy costs of FDLP consolidation loans. Figure 2 shows the relationship, for a FDLP consolidation made in fiscal year 2006, between the discount rate, a fixed borrower interest rate, and a variable borrower interest rate based on the Administration's interest rate projections.

Figure 2: Illustration of Assumed Discount Rate and Fixed- and Variable Borrower Interest Rates on a FDLP Consolidation Loan Originated from October to June of Fiscal Year 2006



Source: GAO analysis.

Note: The estimated variable borrower rate does not vary after fiscal year 2011 because the Administration's interest rate projections do not vary after fiscal year 2011. The estimated fixed borrower rate is for a consolidation loan originated from October to June of fiscal year 2006 and whose underlying loans are Stafford loans disbursed after July 1, 1998, and in repayment at time of consolidation. Under current law, borrower rates on Stafford loans are scheduled to become a fixed rate of 6.8 percent on July 1, 2006.

[6] While the discount rate is the interest rate used to calculate the present value of the estimated future cash flows to determine subsidy cost estimates, it is also generally the same rate at which interest is paid by Education on the amounts borrowed from Treasury to finance the direct loan program.

As figure 2 shows, based on current interest rate projections, the discount rate is projected to be less than the fixed borrower rate for a consolidation loan made in fiscal year 2006. As a result, Education would receive more interest from borrowers than it would pay in interest to Treasury. As figure 2 also shows, the spread between the discount rate and the variable borrower rate the Administration proposes would result in Education receiving an even greater amount of interest from borrowers, thereby decreasing the subsidy cost of, or increasing the gain to the government from, an FDLP consolidation loan. If, however, market interest rates were to decline, rather than increase as projected, a variable borrower rate would also decline, resulting in Education receiving less interest from borrowers than shown above. If interest rates declined below the discount rate, such a scenario could result in Education paying more in interest to Treasury than it receives from borrowers.

ADMINSTRATION ESTIMATES THAT A VARIABLE BORROWER RATE WOULD RESULT IN SAVINGS OF $2.6 BILLION OVER FISCAL YEARS 2006-2015

The proposal in the President's Budget for Fiscal Year 2006 to replace the current fixed-rate interest formula for consolidation loans with a variable rate formula is one of several proposals in a package of proposed changes for the consolidation loan program designed to reduce overall program costs. Compared to its baseline estimates of FFELP and FDLP subsidy costs, which assume no changes are made in the loan programs, the Administration estimates that implementing a variable borrower interest rate would reduce subsidy costs by about $2.6 billion for consolidation loans originated in the 2006-2015 period. The Administration's estimates of the change in estimated subsidy costs for both FFELP and FDLP consolidation loans, by fiscal year, are shown in table 1.

Table 1: Change in Estimated Costs of Consolidation Loans from Implementing Variable Borrower Interest Rate Proposal, by Program and Fiscal Year ($ in millions)

Fiscal Year	Change in FFELP Subsidy Costs	Change in FDLP Subsidy Costs	Total
2006	(166)	(71)	**(238)**
2007	(451)	(76)	**(527)**
2008	(403)	(46)	**(449)**
2009	(361)	(16)	**(377)**
2010	(373)	(12)	**(384)**
2011	(297)	18	**(279)**
2012	(186)	45	**(141)**
2013	(161)	48	**(113)**
2014	(88)	55	**(33)**
2015	(100)	57	**(43)**
Total	**(2,586)**	**2**	**(2,584)**

Source: Department of Education.
Notes:
These estimated savings are based on the assumption that several Administration policy proposals concerning student loans are enacted. Because certain proposals may impact others, these estimated savings may vary depending on the specific proposals enacted.
Totals may not add due to rounding.
We did not examine the reasonableness of the Administration's estimates.

As shown in table 1, the estimated savings over the 10-year period would vary by program and fiscal year. Actual savings will be affected by a number of factors, including the extent to which forecasted interest rates vary from actual interest rates. Additional factors include the extent to which actual consolidation loan volume and characteristics of loans underlying consolidation loans, and rates of loan repayment and default vary from assumptions Education used in making its estimates.

In closing, the Department of Education's proposal to change from a fixed to a variable rate the interest charged to borrowers on consolidation loans, as well as its other consolidation loan reform proposals included in the President's Budget for Fiscal Year 2006, is consistent with the recommendation we made in our October 31, 2003, report that the Secretary of Education identify options for reducing federal costs.

In providing updated information for this letter, we reviewed the President's Budget for Fiscal Year 2006, obtained and reviewed additional information from Education concerning the assumptions used in preparing the President's budget and the Administration's student loan program policy proposals, and interviewed knowledgeable Education officials. We conducted our work in February 2005 in accordance with generally accepted government auditing standards. We provided Education with a copy of our draft letter for review and comment. Education provided a technical comment, which we incorporated.

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As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this letter until 30 days after its date. At that time, we will send copies of this letter to the Secretary of Education and other interested parties. The letter will also be available on GAO's home page at http://www.gao.gov. If you have any questions about this letter, please contact me at (202) 512-8403 or Jeff Appel, Assistant Director, at (202) 512-9915. You may also reach us by e-mail at ashbyc@gao.gov or appelc@gao.gov. Susan Chin and Chuck Novak were also key contributors to this letter.

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