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Student Loans: Reconciliation Provisions

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Summary

The conference report on the Concurrent Resolution on the Budget for FY1998, H.Con.Res. 84, provides for $1.76 billion in savings over the next 5 years through reforms to the student loan programs: the Federal Family Education Loan programs, and the Direct Loan programs. The savings, to be achieved without increasing costs or limiting benefits or access to loans for students and their families, include: $1 billion from guaranty agency reserves, approximately $603 million from administrative funds for Direct Loans (authorized in Section 458 of the Higher Education Act), and an additional $160 million from elimination of the $10 origination fee to Direct Loan schools. The main issue in carrying out the resolution is the formula to be used to recall funds over the 5-year period from guaranty agency reserves, and its impact on the viability of the guaranty agencies. The House and Senate-passed reconciliation bills (H.R. 2015 and S. 947) include the $1.76 billion in savings in the student loan programs, but use different formulas to recall funds from the guaranty agencies. The conference agreement on H.R. 2015 provides for a compromise formula for the recall of guaranty agency reserves.

Budget Resolution

The Concurrent Resolution on the Budget for FY1998, H.Con.Res. 84, passed the House and the Senate on June 5, 1997; the resolution sets spending limitations for federal budget functions for the period FY1998 through FY2002. Based on the agreement reached earlier between the White House and congressional leadership, the conference report provides for $1.76 billion in savings over the next 5 years through reforms to the student loan programs, to be achieved without increasing costs or limiting benefits or access to loans for students and their families. The House and the Senate passed reconciliation bills (H.R. 2015 and S. 947) that included differing student loan provisions; these differences have been resolved in the conference agreement on H.R. 2015.

Federal Student Loan Programs

Federal Family Education Loan (FFEL) programs, authorized by Part B, Title IV, of the Higher Education Act of 1965 (HEA), as amended, insure and subsidize loans private lenders make to students or their parents to help them meet the costs of postsecondary education. Several types of FFELs are available: Federal subsidized Stafford loans (under which the government pays the interest while the borrower is in school, grace period or deferment); unsubsidized Stafford loans; Federal PLUS loans (for parents of undergraduate students); and Federal Consolidation loans. A common feature of all these loans is that the federal government guarantees lenders against loss through borrower default, or death, disability, or bankruptcy. Lenders are also provided an interest subsidy (the special allowance), if the borrower's interest rate does not afford a sufficient return given financial market conditions. In addition to the private lenders who provide the capital in the FFEL programs, other important players include the secondary markets that buy loans from lenders and provide liquidity in the program, and the state or national nonprofit guaranty agencies that primarily insure lenders against borrower default and provide other administrative services.[1] Guaranty agencies are required to maintain reserve funds to protect against the risk involved in administering the federal guaranty. An agency's reserve level is cumulative revenues minus expenses; its annual *reserve ratio* is calculated in percentage terms as current reserves divided by the original principal of outstanding loans guaranteed. Current law provides for a minimum reserve ratio of 1.1 or 1.1%; the Secretary has established regulations that define reserves above a maximum of 2.0% for 2 fiscal years as excess reserve funds. **Table 1** provides estimates of guaranty agency reserve levels and reserve ratios for FY1996 based on a draft table obtained from the U.S. Department of Education (ED).[2]

In 1993, a new Federal Direct Student Loan (DL) program, authorized under Part D of the HEA, was established; it was scheduled to gradually expand and replace FFEL loans, beginning with 5% of total loan volume in 1994-95, 40% in 1995-6, and up to 60% in 1998-99. Currently, Direct Loans account for slightly more than one-third of total student loan volume. Unlike FFEL, Direct Loans are made by the federal government to students through their schools, thus eliminating the need for private capital and the guaranty agencies. Schools may serve as direct loan originators for which they may receive a fee from the federal government; alternatively, Direct Loans may be originated as well as serviced by contractors working for the ED. Loan terms and conditions for Direct Loans are generally the same as those in the FFEL programs; however, students are provided with additional repayment options, including income-contingent repayment.[3]

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[1] For further information, see: *The Federal Family Education Loan Programs.* CRS Report 94-810, by Margot A. Schenet.

[2] The information in the table is derived from guaranty agency data submitted to ED and was used in debate on the reconciliation recommendations; the final numbers used to implement the reconciliation provisions for recall of reserves may vary.

[3] For further information, see: *The Federal Direct Student Loan Program.* CRS Report 95-110, by Margot A. Schenet.

Table 1. Guaranty Agency Reserve Levels, FY1995

Agencies	Cash reserves ($ in 100s)	Reserve ratios (%)
Arkansas	6,885	1.01
California	265,734	2.52
Colorado	39,662	2.02
Connecticut	14,758	1.04
Florida	74,747	2.97
Georgia	13,512	1.00
Illinois	55,155	0.90
Iowa	47,019	2.58
Kentucky	48,316	1.40
Louisiana	12,336	1.82
Maine	11,810	1.78
Massachusetts	51,079	0.88
Michigan	55,462	2.08
Minnesota	43,284	1.09
Missouri	46,902	2.81
Montana	9,549	1.78
Nebraska	16,719	0.58
New Hampshire	5,420	0.74
New Jersey	40,389	1.49
New Mexico	5,944	1.30
New York	131,220	1.47
North Carolina	35,932	3.62
North Dakota	8,540	1.90
Oklahoma	13,317	0.87
Oregon	17,657	2.07
Pennsylvania	214,733	1.55
Rhode Island	8,408	1.30
South Carolina	13,217	1.34
South Dakota	17,018	2.84
Tennessee	38,418	2.27
Texas	75,688	0.94
USA-Funds	423,866	1.45
Utah	22,776	2.29
Vermont	5,260	1.00
Washington	29,160	1.34
Wisconsin	84,965	0.75

Loan Program Costs

Loan volume for both FFEL and Direct Loans in FY1996 was $30 billion. Federal outlays were approximately $4.4 billion for the two programs combined. The main components of FFEL annual federal *expenditures* are the in-school, grace period and deferment interest payments to lenders on behalf of borrowers of subsidized loans, special allowance payments to lenders, and reimbursements to guaranty agencies for losses due to borrower defaults; guaranty agencies also receive allowances from the federal government for administrative expenses. Given a stable default rate, the main influences on these costs are changes in loan volume and market interest rates. In the Direct Loan program, the main components of annual federal costs are the foregone interest payments for subsidized loans while students are in school, during the grace period and deferments; defaults; and administrative costs of contracts for loan origination, servicing and collections, and fees to schools who perform origination functions themselves.[4] In both programs, there are also certain annual *revenues* that offset some of these costs, including fees that students or parents pay when borrowing, and collections on defaulted loans. In FFEL, other offsets include fees that are assessed on lenders/loan holders, guaranty agencies, and the Student Loan Marketing Association (Sallie Mae), a government-sponsored enterprise established to provide liquidity in the loan program and currently the largest secondary market purchaser of FFELs.

The Clinton Administration FY1998 budget request had originally proposed the recall of all guaranty agency reserves (an estimated $2.5 billion over 5 years) and the assumption of the insurance function directly by the federal government. The budget request did not spell out the formula for spreading the return of reserves over the 5-year period. The Administration proposal appeared to assume elimination of some of the remaining guaranty agencies and the adoption of a more contractual relationship with the rest; ED would continue to pay the agencies for administrative costs, but the basis for the payment was not spelled out in the proposal.[5] It was believed at the time the budget request was submitted to Congress that some smaller state guaranty agencies would be unable to survive under the new rules proposed in the budget. ED also proposed some savings (more than $450 million) in administrative costs for Direct Loans, as well as elimination of the $10 per loan fee for schools. Part of the savings from the Administration's proposals would be used to reduce student borrowers' origination fees.

Reconciliation Provisions

The House and Senate-passed reconciliation bills (H.R. 2015 and S. 947) include student loan program savings of $1.76 billion, derived as follows: $1 billion from guaranty agency reserves, approximately $603 million from administrative funds for Direct Loans (authorized in Section 458 of the HEA), and an additional $160 million from elimination of the $10 origination fee to Direct Loan schools. The bills establish different formulas to determine each guaranty agency's share of the $1 billion in recalled reserves and the allocation of the return over the 5-year period. The Senate reconciliation bill, passed June 25, 1997, contains the following provisions:

- the determination of each guaranty agency's share of the total $1 billion to be returned to ED in 2002 (based on agencies' reserve levels in FY1996); first, agencies with reserve ratios above 1.12 would contribute the amount above 1.12

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[4] Both the FY1996 and FY1997 appropriations acts prohibited ED from paying the $10 per loan fee to schools for origination.

[5] Under current law, ED pays the guaranty agencies an administrative expense allowance out of the funds for Direct Loan administration and transition authorized in Section 458 of the HEA; FY97 appropriations language set the payment at 0.85% of new loan volume.

and those amounts combined would be subtracted from the $1 billion, then each agency would be assessed an equal percentage reduction in remaining reserves to reach the total combined $1 billion. Their "equitable share" equals any amount above 1.12, plus the equal percentage reduction.

- a procedure for calculating the amount of each agency's 'equitable share" that is deposited in a restricted account **annually**; for FY1998 agencies with reserve ratios in excess of 2.0 would first deposit that excess in a restricted account and then each agency would contribute an equal additional amount to reach an aggregate one-fifth of the total to be recalled or $200 million; for each of the succeeding 4 years, each agency would contribute an amount equalling one-fourth of its total remaining equitable share. In 2002, the total in the restricted accounts would be returned to ED.

- the minimum reserve ratio is lowered from 1.1 to .5, the level it was in FY1993; the Secretary may not recall *excess* reserves other than the amounts determined by the above formulas; any other reserve funds recalled for other reasons under current law can only be used for purposes of meeting the agency's equitable share and not for administration of direct loans.

- agencies may only use the earnings on funds in the restricted accounts for"activities to reduce student loan defaults".

- administrative funds authorized under Section 458 are to be used for direct loan administrative costs, and to pay guaranty agency administrative expense allowances calculated on the basis of 0.85% of new loan volume. Total Section 458 funds are capped at a reduced level; in addition, total annual administrative payments to guaranty agencies are capped at $170 million in FY1998 and FY1999 and at $150 million in FY2000-02.

- the school fee for origination of direct loans is eliminated.

The House reconciliation bill, passed June 25, 1997, differs in several ways. The House formula for calculation of guaranty agencies' equitable share is based on return of excess reserves from agencies with ratios above 2.0 and then an equal percentage share from each agency to reach the total recalled; each agency would deposit one-fifth in the restricted account annually, although agencies that might be most affected (i.e., those with reserve ratios of 1.1% or less) could delay the start of their return until 1999, and could establish a different repayment schedule developed by the Secretary. Guaranty agencies could use earnings on funds in the restricted accounts for any operating expenses. Finally, the House bill includes a provision that the guaranty agencies' share of collections on loans that were consolidated out of default is 18.5%.[6]

The conference agreement establishes a compromise formula for the recall of guaranty agency reserves. First, guaranty agencies with reserve ratios above 2.0 are assessed the excess above 2.0, this amount is subtracted from the total to be recalled and

[6] ED has interpreted current law to allow guaranty agencies to retain only 18.5% on such consolidations since 1992; guaranty agencies have disputed that interpretation.

the remainder is calculated as a percentage of total remaining reserves; each agency is then assessed this percentage of their remaining reserves, except that no agency can be required to go below a reserve ratio of 0.58. Third, if an additional amount is still needed to reach the $1 billion, the remainder is calculated as a percentage of excess reserves of agencies with ratios above 0.58 and collected from their remaining reserves. The House provision on delaying return until 1999 for guaranty agencies with reserve ratios of 1.1 or less was retained. Earnings from restricted accounts can only be used for "improving, strengthening, and expanding" default prevention activities. Section 458 funds are to be used for administrative costs of Part B and direct loans, including an administrative expense allowance calculated on the basis of 0.85% of new loan volume with annual caps. The House provision regarding the guaranty agency share of collections on loans consolidated out of default was dropped.

Impact

Guaranty agencies reserves have increased recently, as defaults have declined; from a total of $600 million in FY1991 to an estimated $2 billion in FY1996. Nevertheless, as **Table 1** indicates, the agencies vary greatly in the size of their reserves and their reserve ratios; the main question in assessing the impact of the recall is the extent to which it could impair the financial viability of those guaranty agencies with smaller reserve ratios. The conference formula recalls only the excess above 2.0 from the agencies with higher ratios, before taking a percentage reduction from all; however, it adds a floor of 0.58 that protects agencies with the smallest reserves. The conference agreement also clarifies the uses of restricted account funds for default prevention activities; it does not change current law with respect to collections on consolidation of defaulted loans.

Schools that participate in the Direct Loan program will be affected because of the elimination of the loan origination fee; since this fee has been eliminated through appropriations language for the last 2 years, any effects have presumably already been absorbed. Finally, the provisions will reduce the funds available for *ED administration* of the direct loan program more than proposed in the original FY1998 Administration budget request, and ED's flexibility in using the funds will be further limited. The Administration has argued that the provision to pay the administrative cost allowance at .85% creates a new entitlement; it is within Section 458, which currently is mandatory spending. However, the provision would prevent the Administration from pursuing plans such as those suggested in its original budget submission to convert the guaranty agency payments to a contractual basis per loan serviced. None of the recommendations are likely to have any direct impact on students or their families.

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