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Student Loan Issues and the Reauthorization of the Higher Education Act

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Student Loan Issues and the Reauthorization of the Higher Education Act

Summary

The federal government operates two major student loan programs: the Federal Family Education Loan (FFEL) program, authorized by Part B of Title IV of the Higher Education Act (HEA), and the William D. Ford Direct Loan (DL) program, authorized by Part D of Title IV of the HEA. These programs provide loans to undergraduate and graduate students and the parents of undergraduate students to help them meet the costs of postsecondary education. Together, these programs provide more direct aid to support students' postsecondary educational pursuits than any other source. In FY2003, they provided $45.8 billion in new loans to students and their parents.

The HEA is being considered for reauthorization. This report discusses issues concerning the FFEL and DL student loan programs that are likely to be considered during reauthorization.

Issues that are expected to receive attention include borrower interest rates, loan fees, refinance opportunities, and annual and aggregate loan limits. Additionally, it is likely that considerable attention will be devoted to promoting greater comparability between the loan terms and conditions made available to borrowers in the FFEL and DL programs.

In general, helping students by enhancing their benefits is a goal upon which many can agree, but finding offsetting revenues is often a challenge. It is therefore likely that some effort will be made to identify savings in the loan programs' mandatory spending that could be used to offset costs associated with enhancements in borrower benefits, or that could be used to finance other student aid expenditures. This report will be updated as events warrant.

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Student Loan Issues and the Reauthorization of the Higher Education Act

Introduction

The Higher Education Act of 1965 (HEA) is being considered for reauthorization. The HEA was last reauthorized by the Higher Education Amendments of 1998 (P.L. 105-244). Title IV of the act authorizes the major federal student aid programs, including the federal student loan programs, which provide more direct aid to support students' postsecondary educational pursuits than any other source. In FY2003, the federal student loan programs provided $45.8 billion in new loans to students and their parents. This report discusses issues concerning the student loan programs that are likely to be considered during reauthorization.

The report is organized in the following manner. First it provides background information on the student loan programs and their loans. Then it provides an overview of many of the issues likely to receive attention in the reauthorization.[1]

Introduction to the Federal Student Loan Programs

The federal government operates two major student loan programs: the **Federal Family Education Loan (FFEL)** program, authorized by Part B of Title IV of the HEA, and the **William D. Ford Direct Loan (DL)** program, authorized by Part D of Title IV of the HEA.[2] These programs provide loans to undergraduate and graduate students and the parents of undergraduate students to help them meet the costs of postsecondary education.

Under the FFEL program, loan capital is provided by private lenders, and the federal government guarantees lenders against loss through borrower default, death, permanent disability, or, in limited instances, bankruptcy. Under the DL program, operated through the U.S. Department of Education (ED), the federal government provides the loans to students and their families, using federal capital (i.e., funds

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[1] Issues pertaining to loan forgiveness are not discussed here. A separate CRS Report RL32516, *Student Loan Forgiveness Programs*, by (name redacted), addresses loan forgiveness.

[2] There is a smaller, separate, campus-based student loan program (the Federal Perkins Loan Program) that is also authorized by the HEA which will not be discussed here. For information on Perkins loan reauthorization issues see CRS Report RL31618 *Campus-Based Student Financial Aid Programs Under the Higher Education Act*, by David Smole.

from the U.S. Treasury). The two programs rely on different sources of capital and different administrative structures, but essentially disburse the same set of loans.[3]

The DL program, established in 1993, was intended to streamline the student loan delivery system and achieve cost savings. While the DL program was originally introduced to gradually expand and replace the long-standing FFEL program, the 1998 HEA amendments removed the provisions of the law that referred to a "phase in" of the DL program. Currently both programs are authorized and the two programs compete for student loan business. In FY2003, these programs provided $45.8 billion in new loans to students and their parents. In that year the FFEL program provided 8,429,000 new loans averaging approximately $4,009 each and the DL program provided 2,937,000 new loans averaging approximately $4,075 each.

The FFEL and DL programs provide the following types of loans to students and their parents:

> **Stafford loans (subsidized and unsubsidized):** Low interest, variable rate loans available to undergraduate and graduate students. The interest rates on subsidized and unsubsidized Stafford loans adjust annually, based on a statutorily established, market-indexed, rate setting formula, and may not exceed 8.25%.
>
> To qualify for a subsidized Stafford loan, a student must establish financial need. The federal government pays the interest on the borrower's behalf on the subsidized Stafford loans while the borrower is in school (on at least a half-time basis) and during grace periods and deferment periods.
>
> **PLUS loans:** Variable rate loans available to parents of dependent undergraduate students. The interest rates on these loans adjust annually, based on a statutorily established, market-indexed, rate-setting formula, and may not exceed 9%.
>
> **Consolidation loans:** Loans that provide borrowers refinancing options. A consolidation loan may be comprised of one underlying loan or multiple underlying loans. Consolidation provides borrowers with multiple loans the opportunity to simplify the repayment of loans by combining multiple loans into one. Consolidation loans also enable borrowers to lower monthly payments by extending the repayment period. Additionally, consolidation loans afford borrowers the opportunity to pursue a more favorable long term interest rate through locking in a fixed interest rate on their student loans, based on the weighted average of the interest rates in effect on the loans being consolidated rounded up to the nearest one-eighth of 1%, capped at 8.25%.[4]

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[3] For detailed information on the array of FFEL and DL program loans, see CRS Report RL30655, *Federal Student Loans: Terms and Conditions for Borrowers*, by (name redacted). For a thorough discussion of how the loan programs operate, see CRS Report RL30656, *The Administration of Federal Student Loan Programs: Background and Provisions*, by (nam e redacted).

[4] For a comprehensive description of consolidation loans' terms and conditions see CRS Report RL31575, *Consolidation Loan Provisions in the Federal Family Education Loan and Direct Loan Programs*, by (name redacted).

Underlying Tensions

Prior to discussing individual reauthorization issues, it may be helpful to note that there are certain underlying tensions inherent in the current design of the loan programs that affect many of the reauthorization issues considered in this report. One pertains to program cost. It is generally the case that enhancements to borrower benefits increase federal subsidy costs. For instance, in the FFEL program, where the government insures and subsidizes loans made by private lenders, federal subsidy costs increase when less revenue is derived from borrower fees and when interest subsidy payments to lenders are increased (lenders receive a subsidy payment that ensures they receive the difference between the statutorily set borrower rate and a fair market rate). In the DL program, where the government acts as lender, federal subsidy costs are increased when borrower fees or repayment revenues paid to the government are reduced.

Another tension stems from dissimilarities in FFEL and DL program loan terms and conditions. The two programs disburse the same set of loans, but loan terms and conditions are not perfectly parallel across the two programs. Each program has its supporters. Some favor promoting more parallel terms and conditions, others do not if parallel terms and conditions are achieved by reducing a benefit currently available in only one of the two programs.[5]

Reauthorization Issues

Loan Terms and Conditions

Interest Rates on Stafford and PLUS Loans. The Stafford and PLUS loans currently being disbursed are variable rate loans. As of July 2006, under current law, new Stafford and PLUS loans will carry fixed interest rates. The desirability of this planned switch has been the subject of considerable debate.

Student loan interest rates were a focal issue in the 1998 reauthorization. The statutory rate setting formulas, which are used to establish rates for loans disbursed from July 1, 1998 through June 30, 2006, were initially enacted in June 1998 and extended in the HEA amendments of 1998.

The formula for calculating interest rates on Stafford loans is based on the 91-day Treasury bill rate plus 1.7% while the borrower is in school, and plus 2.3% when the borrower is in repayment. Stafford rates are capped at 8.25%. The formula in effect for calculating interest rates on PLUS loans is based on the 91-day Treasury bill rate plus 3.1%, and the PLUS rates are capped at 9%.[6]

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[5] In instances where the terms and conditions differ across programs it will be noted. Otherwise the reader should assume terms and conditions being discussed apply in both programs.

[6] Variable rates for Stafford and PLUS loans adjust annually. For Stafford and PLUS loans, (continued...)

The current rate setting formulas were adopted as a result of deliberations that centered on how to replace so called "comparable maturity rates" that were set to take effect July 1, 1998. The comparable maturity rate-setting formula was initially enacted in the Student Loan Reform Act (SLRA) of 1993, the legislation that created the DL program. The formula afforded the Secretary of Education a great deal of latitude in establishing borrower rates.[7]

The decision to move toward a comparable maturity rate was made in 1993 within the context of the assumption that the DL program would be phased in over a series of years and ultimately replace the guaranteed loan system. In years following the enactment of the SLRA, Congressional support emerged for sustaining both loan programs and, within this context, considerable attention was devoted to replacing the comparable maturity rate structure before it took effect. This led to the adoption of the rate setting formulas currently in effect. However, due to cost considerations under prevailing budget scoring rules, the HEA amendments of 1998 were only able to install the current formula until June 30, 2003, after which the comparable maturity rates were once again set to take effect.

The interest rate issue was revisited in 2002 with the passage of P.L. 107-139. This measure extended the existing variable rate setting formulas through June 30, 2006. Additionally, it installed fixed interest rates of 6.8% for Stafford loans and 7.9% for PLUS loans disbursed thereafter.

In the upcoming reauthorization of the HEA it is likely that borrower interest rates will once again receive consideration. Some feel that the 6.8% fixed rate set to take effect for new loans made on or after July 1, 2006 is a good rate in comparison to historical borrower rates in the program, and that a fixed rate provides the borrower with a set of predictable monthly payments which many borrowers desire. Others feel that a borrower is better served under a variable rate formula where the borrower is able to take advantage of low market rates when available (such as the 3.37% repayment rate being charged this year) but still receive protection against high rates thanks to the 8.25% interest cap.

It is likely that student loan interest rates will be hotly debated. Part of the debate is likely to focus on enhancing or preserving borrower benefits. There will also likely be concerns about the federal subsidy cost. This is because, in the FFEL program, lenders are provided a federal interest subsidy payment (discussed later) when the statutorily set borrower rate fails to provide lenders a market rate of return. In the DL program, where the federal government acts as lender, federal subsidy costs increase when repayment revenues are reduced. Across both programs, more generous borrower benefits generally increase federal costs.

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[6] (...continued)
the T-bill rates used in establishing the annual borrower rate are the bond equivalent rates from the last auction prior to June 1. Rates take effect from July 1 through the following June 30.

[7] The statute states that the borrower rate would adjust annually, but does not specify the index upon which the variable rate will be established. The selection of the security to serve as the index would be left to the Secretary.

Borrower Fees. Several proposals have been forwarded recently that call for reductions in borrower fees. Currently, Stafford borrowers in the DL program pay a 3% origination fee that goes to the federal government to help offset program costs. Statutory provisions call for DL borrowers to pay a 4% origination fee, but ED reduced the fee for Stafford DL borrowers effective August 15, 1999. DL PLUS borrowers pay a 4% origination fee.

In the FFEL program, the origination fee for PLUS and Stafford borrowers is 3% which goes to the federal government. Lenders may opt to pay the fee or a portion of the fee on the borrower's behalf in order to secure loan business. Additionally, FFEL borrowers may be required to pay a 1% insurance premium. This fee goes to guaranty agencies to help offset loan insurance costs. Guarantors may wave the fee, and if the fee is assessed lenders may opt to pay the fee or a portion of the fee on the borrower's behalf.

It is likely that a reduction in borrower origination fees (particularly for student borrowers) will be considered in reauthorization. Helping students by reducing charges is a goal upon which many can agree, but finding offsetting revenues from other sources is often a challenge. In FY2003, borrower origination fees generated approximately $1.3 billion in revenue across the two programs. Additionally, attention may be devoted to examining the comparability of borrower fees charged across and within the two loan programs.

Loan Limits. To limit the federal government's subsidy costs, and to limit the amount of debt incurred by borrowers, annual and aggregate Stafford borrowing caps have been established. Considerable interest has surfaced in the adequacy of the existing loan limits. The current caps for undergraduate students, which were enacted in the Higher Education Amendments of 1992 (P.L. 102-325), are as follows.

Table 1. Annual and Aggregate Stafford Loan Limits

Dependent undergraduate students		Independent undergraduate students	
Annual limits:		Annual limits:	
1st year	$2,625	1st year	$6,625
2nd year	$3,500	2nd year	$7,500
3rd year and beyond	$5,500	3rd year and beyond	$10,500
Aggregate limit	$23,000	Aggregate limit	$46,000

Source: HEA, Section 428 (20 U.S.C. 1078).

As **Table 1** shows, dependency status is a key determinant of a student's personal borrowing limits.[8] It is assumed that dependent students and the parents of dependent students will co-finance the postsecondary education of the dependent students. Dependent students are therefore afforded lower personal borrowing limits than independent students. At the same time, parents of dependent students are afforded the opportunity to take out federal PLUS loans to support dependent students.[9] Some have questioned, however, whether dependent students in particular are being provided adequate borrowing opportunities if they have to self finance their studies.

In general, those in favor of expanding loan limits suggest loan limits have not kept pace with tuition increases and thus constrain students' ability to finance their education, adversely affecting student access, choice, and persistence. Those opposed suggest it is undesirable for students to incur more debt, and question whether the expansion of borrowing opportunities will have any positive effect on access, choice or persistence — particularly for lower income students. Also at issue are federal subsidy costs, because as borrowing opportunities are expanded so are federal subsidy costs.

Repayment Plans. Issues concerning repayment plans that surface with some regularity relate to differences between options made available to borrowers in the DL program and those made available to borrowers in the FFEL program. A brief summary of the repayment options available in each program is offered below.

All FFEL borrowers are allowed to choose among standard, graduated, and income sensitive repayment plans. For new borrowers on or after October 7, 1998, who accumulate (after such date) outstanding loans totaling more than $30,000, a fourth repayment option is available — an extended repayment plan.

Like FFEL borrowers, all DL borrowers are allowed to choose among standard and graduated repayment plans. In addition, **all** DL borrowers are allowed to choose extended repayment (there are no restrictions similar to those in FFEL). Income contingent repayment (as opposed to income sensitive repayment) is available to all DL unsubsidized and subsidized Stafford borrowers.[10]

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[8] For federal student aid, a student is considered independent of his or her parents if the student is at least 24 years old by December 31 of the award year, is an orphan or ward of the state (or was until age18), is a veteran of the armed forces, is a graduate or professional student, is married, has dependents other than a spouse, or is deemed independent by a financial aid officer for "other unusual circumstances."

[9] Parents are actually provided quite flexible borrowing limits through PLUS loans. PLUS borrowers may borrow any amount up to the dependent student's cost of attendance minus certain other types of aid (i.e., grants, scholarships, Federal Work Study, and Perkins loans).

[10] PLUS borrowers are not eligible for income contingent repayment. The main difference between income sensitive and income contingent repayment plans are the 10-year repayment term and prohibition on negative amortization in income sensitive repayment. Negative amortization refers to a situation where the borrower's required monthly payment does not cover the interest due on the loan.

One of the things likely to garner some attention is the difference in the repayment terms available in each program. In FFEL, all repayment plans offer a 10-year repayment term with the exception of extended repayment under which repayment must occur within a time period not to exceed 25 years. In DL, standard repayment offers a 10-year term. Under the income contingent repayment plan, repayment must occur over a period not to exceed 25 years. Repayment periods for DL extended and graduated repayment plans vary with the size of the loan.

It is likely that some attention may be devoted to adopting more comparable repayment options across the two programs. Additionally, some interest exists in adding a new "interest only" repayment option. Under such an option, a borrower would have low "interest-only" payments in their initial years after graduation, but would also delay the point at which they begin paying down loan principal.

Loan Consolidation

Consolidation Loan Interest Rates. In recent years, several congressional hearings have focused on the fixed rate benefit on consolidation loans. In general, the debate pertaining to the fixed rate benefit centers on its cost.

Consolidation loans were originally introduced in the HEA Amendments of 1986 (P.L. 99-498). They were initially intended to simplify repayment for borrowers, simplify loan repayment servicing for lenders, and offer relief in the form of extended repayment to those borrowers seeking lower monthly payments. As the consolidation loan interest rate formula has been modified by Congress, consolidation loans have evolved into a refinance benefit as well (i.e., a benefit that enables a borrower to pursue a better interest rate).

The current consolidation loan interest rate formula affords borrowers the opportunity to secure a fixed rate equal to the weighted average of the rates in effect on underlying (variable rate) loans being consolidated rounded up to the nearest one eighth of 1%. In the recent low interest rate environment consolidation volume has grown dramatically as borrowers have sought to lock in as permanent the favorable rates currently in effect on their variable rate loans. This has enabled a large number of borrowers to secure a valuable refinance benefit. Currently, a borrower who consolidates while in the grace period can secure a 2.88% interest rate. Over the last two years, in which very low rates have been available, an estimated $63 billion in loan volume has been consolidated. When borrowers exercise their option to lock in low rates permanently the federal government is potentially exposed to high subsidy costs. In the FFEL program, this is so because the government has guaranteed the lenders a market rate of return, and must make up the difference between the rate the borrower is paying and the rate the lender is guaranteed. In the DL program, subsidy costs increase when repayment revenue is reduced.

Those in favor of the existing fixed rate setting formula assert that in the current low interest rate environment the fixed rate amounts to a valuable benefit to borrowers. At a time of escalating student loan debt it provides important repayment relief and sends a signal to students and potential students that repayment will be manageable. Further, proponents of the existing rate setting formula suggest that eliminating the opportunity to lock in a fixed rate would be tantamount to taking

away a benefit that was available when borrowers received their Stafford loans and that they are counting on utilizing once they enter repayment. The removal of this benefit in a low interest environment would amount to dropping a large share of the interest subsidy currently available to borrowers.

Those opposed to sustaining the existing rate setting formula suggest it offers an overly generous borrower benefit that is costly to the point of placing future aid in jeopardy. They also question whether it is necessary to offer a refinance benefit when the rate is already subsidized on Stafford loans. Further they question whether a benefit received in the years after postsecondary schooling contributes in any way to students' postsecondary access, persistence, or choice. They note the repayment period subsidy is provided without regard to need, over a lengthy period potentially extending up to 30 years beyond schooling, and disproportionately benefits students who attended four-year private institutions and/or graduate programs.

Reconsolidation. In many ways the debate on "reconsolidation" is an extension of the debate on the fixed rate benefit. Borrowers who have locked in fixed rates through consolidation in high interest periods sometimes miss out on more advantageous variable rates that they would have had on underlying loans. This introduces a facet of the fixed rate benefit some find troubling — some borrowers fare worse under the high fixed rates they lock in. This raises concern, particularly with regard to those using consolidation for repayment relief (i.e., extended repayment), because these borrowers may have to consolidate in years in which the fixed rate is disadvantageous.

One way to address this situation is through offering borrowers multiple refinance opportunities (i.e., offering borrowers with relatively high fixed rates the prospect of securing a better rate). Any added interest benefit for a borrower, however, would likely expand federal subsidy costs. Another way to address this is to eliminate consolidation loans' fixed rate benefit. This would prevent borrowers from locking in disadvantageous rates in the future, but would not offer assistance to those having already done so.

Borrowers' Ability to Choose Among Consolidators. A complex set of provisions has been enacted to regulate competition for consolidation loan refinance business among loan holders within the FFEL program and across the DL and FFEL programs and to protect borrowers — ensuring they are afforded equitable refinancing options. In effect, some of these provisions constrain borrowers' ability to choose among consolidators.

FFEL borrowers whose loans are held by one holder must first attempt to consolidate their loans with that holder.[11] If a consolidation loan is unavailable from

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[11] If a FFEL lender secures an insurance agreement to make consolidation loans, the lender may offer consolidation loans (upon request) to all borrowers for whom the lender is the sole loan holder. Also, if FFEL lenders opt to make consolidation loans, the lenders may not discriminate against borrowers seeking a consolidation loan, based upon: a) the number and type of eligible student loans the borrower seeks to consolidate; b) the type of institution (continued...)

that lender or the lender does not provide the borrower with an income sensitive repayment plan acceptable to the borrower, then the borrower may pursue other FFEL consolidation loans. Other FFEL borrowers, with loans from more than one FFEL lender, may seek a consolidation loan through any FFEL lender. If FFEL borrowers certify that they are unable to secure a consolidation loan through FFEL lenders, or that they are unable to secure a FFEL consolidation loan with income sensitive repayment terms (deemed to be acceptable by the borrower),[12] the borrower may pursue a DL consolidation loan.[13]

DL borrowers may pursue consolidation loans within the DL program. DL borrowers are also able to consolidate their loans through FFEL lenders.

It is likely that proposals calling for the elimination of provisions that constrain borrowers' choice among consolidators will receive consideration during reauthorization. Those in favor of such changes suggest it is important to afford all borrowers, not just some, the opportunity to shop among consolidators. Some FFEL lenders object to making a change in this area, asserting they offer some up front discounts on Stafford and PLUS loans based on the assumption they will be able to hold the loan over its life, and their anticipated level of income from the loan will be jeopardized if the borrower can consolidate elsewhere.

Comparable Consolidation Loan Benefits Across the FFEL and DL Programs. Interest is often expressed in promoting greater comparability among FFEL and DL consolidation benefits. There are several ways in which consolidation loan benefits differ across the FFEL and DL programs. One of the primary ways (discussed above) pertains to constraints placed on a borrower's ability to choose among consolidators. Some of the other principal differences are as follows.

In School consolidation: Borrowers seeking a FFEL consolidation loan are eligible to pursue consolidation when the borrowers have entered the repayment or grace period on each loan they are seeking to consolidate. In contrast, borrowers seeking a DL consolidation loan may consolidate any eligible loans that have been fully disbursed even if the borrowers have not yet entered a repayment or grace period (i.e., the borrower may still be in their in-school period when consolidating). In practical terms this affords DL consolidation borrowers a broader time period in which they can lock in as permanent an in-school rate which is lower than the repayment rate (T-bill + 1.7% as opposed to T-bill +2.3%). This affords borrowers

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[11] (...continued)
the borrower attended; c) the interest rate to be charged to the borrower (which varies in accordance with when the loans being consolidated were initially disbursed). Additionally, FFEL lenders may not discriminate with regard to the types of repayment schedules they make available to borrowers.

[12] For all FFEL consolidation loans made on or after July 1, 1994, lenders have been required to offer borrowers income sensitive repayment plans, established by the lender, in accordance with regulations promulgated by the Secretary.

[13] For FFEL borrowers who also have outstanding DL program loans, this certification is not required. Such borrowers are free to pursue consolidation in the DL program.

greater opportunity to lock in as permanent favorable variable rates in effect in years when the borrowers are still in school.

Repayment term: Borrowers with less than $7,500 in outstanding loans seeking to consolidate in FFEL may receive a maximum repayment term of 10 years. A 12-year repayment term is available to borrowers with that level of debt in DL.

Joint Consolidation. Married persons, each of whom has eligible loans, are eligible for a joint consolidation loan. Only one of the borrowers must meet the full set of individual eligibility requirements for a new consolidation loan. However, each agrees to become jointly and severally liable for repayment of the note regardless of any changes in marital status. It is likely that proposals to eliminate joint consolidations will receive consideration in the reauthorization.

While joint consolidation can simplify repayment for a married couple, concerns have been raised in recent years about disadvantages that may be associated with joint consolidation for some borrowers. For instance, borrowers with a joint consolidation loan must both meet the requirements for a deferment or forbearance in order to receive those benefits. Had the loans not been joined, each borrower could qualify for these benefits based upon their own status. Additionally, concerns have been raised about complications that may ensue for unsuccessful marriages given that both parties agree to be liable for the total repayment of the joint consolidation loan. Also, in instances involving a spouse who becomes permanently disabled, a disability discharge is provided for that spouse (covering the proportion of the loan attributable to their underlying debt), but each spouse remains liable for repayment of the remaining loan amount.

FFEL Financing and Structure

Guaranty Agencies. Guaranty agencies administer the federal government's loan guarantee. The role guarantors play within the FFEL program has evolved a good deal since the program's inception. Initially, the federal government intended to encourage the growth of state loan insurance programs. Over time the federal government assumed the role of providing the insurance and now guaranty agencies service the federal guarantee and perform various program administrative tasks. In the 1998 reauthorization of the HEA considerable attention was devoted to more clearly defining the role guaranty agencies play within the FFEL program and insuring clear linkages exist between financing streams and tasks performed. Changes adopted during the 1998 reauthorization focused on strengthening the relationship between revenues and activities, and improving efficiency.

The 1998 amendments adopted a "risk sharing" approach. Under this approach, uses of reserves are restricted, and guarantors are afforded flexibility in the use of their operating funds. There is a clearer distinction between reserves and operating funds, and clearer direction about where various revenue streams are to be deposited — and ultimately about how these sources of revenue are to be used. Under this arrangement reserves are held in a guarantor's Federal Fund which is the property of the federal government, and other funds are held in a guaranty agency's Operating Fund which is the property of the guarantor.

It is likely that some attention will be devoted to the solvency of Federal Funds (i.e., locally held federal reserve funds) and the size of Operating Funds — which can be used to support agency operations and also for discretionary student financial aid expenditures. An overarching issue here pertains to the adequacy of revenues flowing into each fund. Some concerns have been raised about shrinking reserves and robust Operating Funds. Some proposals have already called for mandating insurance premiums to strengthen reserves. Some observers have suggested guarantor fees for loan collections and defaulted loan rehabilitation work may be too high thus inflating Operating Funds.

Excess Interest Provisions. As has been noted, the federal government provides lenders with a loan subsidy known as a special allowance payment (SAP). The SAP amount is determined on a quarterly basis by a statutory formula which is tied to a financial index and ensures lenders receive, at a minimum, a specified level of interest income on loans. The SAP is designed to compensate lenders for the difference between the below-market, statutorily set interest rate charged to borrowers and a market set interest rate that is intended as fair market compensation on the loan asset.[14]

In some instances lenders receive interest income from borrowers exceeding the amount called for by the SAP calculation. The amount of income lenders receive above the government SAP rate is often called "floor income."

The SAP affords lenders necessary protection in high interest environments during which the statutorily established borrower rate may provide lenders insufficient below-market rate returns. However, in low interest environments, the statutorily established borrower rate has the potential of providing lenders with above-market rate returns (i.e., returns above the market-indexed SAP rate). Some argue that since the SAP is designed to approximate fair market compensation it is unnecessary to compensate lenders at levels that exceed the SAP rate. It is often noted that in an earlier period, "excess interest provisions" were adopted that essentially installed the SAP rate as the sole lender reimbursement rate for loans. Several recent proposals have called for reducing federal subsidy costs by establishing the SAP rate as the sole lender reimbursement rate and having lenders' floor income refunded to the federal government.

9.5% Floor Loans. Some FFEL program loans which are made or purchased with tax exempt funds provide lenders a guaranteed interest rate of at least 9.5% (hereafter, these loans are referred to as 9.5% floor loans). This guarantee is provided in the SAP formula applied to these loans, which requires the federal government to supplement borrower interest payments so as to insure a minimum 9.5% rate for lenders. There seems to be broad Congressional support for curbing

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[14] The "lender rate" in SAP calculations, which serves as a proxy for fair market compensation to lenders, is based on the average of daily quotes of the three-month commercial paper rates plus 2.34% for Stafford loans in repayment. The lender rate is intended to be sensitive to lender borrowing and servicing costs and the need for a profit margin.

this rate guarantee for future loans. The legislative developments that led to the enactment of the guarantee are briefly described below.

As part of an effort to ensure the FFEL program would be fully capitalized in the program's early years, provisions that served to encourage the issuance of tax-exempt student loan bonds were included in the Tax Reform Act of 1976. Such bonds are exempt from federal taxation, and are used by states to finance below market interest rate loans for students.[15] In essence, through the issuance of bonds with low tax-exempt interest rates, state authorities are able to raise "low cost" funds, and then re-lend the funds at higher rates.

Soon after these provisions were passed, student bond volume began to grow rapidly, and concerns about the profitability of tax exempt student loans surfaced. The 1980 HEA amendments took steps to curb the profitability of tax-exempt loans by reducing by half the SAP rate on loans originating from the proceeds of tax-exempt bonds. However, to ensure that student loan authorities were always able to cover their operating costs, the amendments also established minimum SAPs, for loans disbursed on or after October 1, 1980, which ensure a minimum return of 9.5% on these loans.[16]

The discourse on the profitability of tax-exempt student loans continued through the 1980s on into the early 1990s. The Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) contained a provision eliminating the floor on tax-exempt loans supported through tax-exempt financing for issuances on or after October 1, 1993. These loans were afforded the same SAP rates as were available for taxable loans. However, different provisions were retained with regard to loans made or purchased with tax-exempt funds obtained by holders from obligations originally issued on or after October 1, 1980 and prior to October 1, 1993. These loans retained the 9.5% floor reimbursement structure.

The statutory provisions adopted in P.L. 103-66 and ensuing regulatory guidance from ED have served to establish funds (derived from debt originally issued in the aforementioned period) that can be used by holders to finance 9.5% floor loans on an ongoing basis. In recent years lenders have been using a variety of refinancing techniques, and also invested earnings from existing 9.5% floor loans to make or purchase new ones.

While 9.5% floor loans comprise a relatively small percentage of all outstanding loans, in recent years they have accounted for a very large proportion of federal SAP subsidies. There appears to be a general consensus that no federal policy objective is served now by continually guaranteeing lenders a minimum return of 9.5%. However, there is some debate about how best to phase out the guarantee for

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[15] Investors in tax-exempt bonds do not pay taxes on the interest they earn, and are thus willing to accept a lower interest rate on their investment.

[16] It should be noted that this decision was made within the context of a high interest rate environment. In 1979, SAPs averaged 6.5% meaning a 13.5% return (6.5% SAP plus 7% interest rate) constituted "fair market compensation in the prevailing interest rate environment."

nonprofit lenders. The Taxpayer-Teacher Protection Act of 2004 (P.L. 108-409); signed October 30, 2004, curbs growth in 9.5% loans, for one year, by eliminating the 9.5% guarantee on new loans stemming from any new refinancing of obligations originally issued on or after October 1, 1980 and prior to October 1, 1993. However, it does not curtail the 9.5% guarantee on new loans stemming from "recycling"of proceeds from outstanding 9.5% loans. These proceeds can be used to finance new 9.5% loans.

A phase out of the 9.5% guarantee would produce savings in mandatory spending. These savings could be used to offset new expenditures.

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