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The Administration of Federal Student Loan Programs: Background and Provisions

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The Administration of Federal Student Loan Programs: Background and Provisions

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 federal student loan programs provide more direct aid to support students' postsecondary educational pursuits than any other source. In FY2004, these programs provided $52.1 billion in new loans to students and their parents.

Under the FFEL program, loan capital is provided by private lenders and the federal government guarantees lenders against loss through borrower default, or death, permanent disability, or in limited instances, bankruptcy. FFEL program loans are originated by private lenders. That is, private lenders work directly with students and families to initiate the loan. Private lenders also are responsible for billing borrowers and collecting loan payments. State and nonprofit guaranty agencies receive federal funds to play the lead role in administering many aspects of the FFEL program. In particular, the guaranty agencies provide many of the administrative services related to the loan guarantee, including providing technical assistance and training to schools on loan certification and lenders on loan procedures, providing credit and loan rehabilitation counseling to borrowers, reimbursing lenders when loans are placed in default, and initiating collections work.

Under the DL program, the federal government provides the loans to students and their families, using federal capital (i.e., funds from the U.S. Treasury), and owns the loans. Under the DL program, schools may serve as direct loan originators or the loans may be originated by contractors working for the U.S. Department of Education (ED). ED hires contractors to service the loans: i.e., to monitor student enrollment and loan repayment status, process loan payments, and initiate collections work for delinquent and defaulted loans.

The DL program was initially introduced to gradually expand and replace the FFEL program. However, the 1998 amendments of the HEA removed the provisions of the law that referred to a "phase-in" of the DL program. Currently both programs are authorized. They draw on different sources of capital and utilize different administrative structures, but essentially disburse the same set of loans: subsidized and unsubsidized Stafford loans for undergraduate and graduate students; PLUS loans for parents of undergraduate students; and Consolidation loans that offer borrowers refinancing options.

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Introduction

The federal government operates two major student loan programs: the **Federal Family Education Loan (FFEL)** program and the **William D. Ford Direct Loan (DL)** program. These programs can trace their roots to the Guaranteed Student Loan (GSL) program, originally enacted in Title IV of the Higher Education Act (HEA) of 1965, to enhance the access students from low and middle income families had to postsecondary education by providing them access to low-interest loans.

The FFEL program, formerly named the GSL program, is authorized by Part B of Title IV of the HEA. Under the FFEL program, loan capital is provided by private lenders, and the federal government guarantees lenders against loss through borrower default. FFEL program loans are originated by private lenders, and state and nonprofit guaranty agencies receive federal funds to play the lead role in administering many aspects of the FFEL program.

The federal government provides lenders a variety of incentives to invest private capital in FFEL student loans. For example, to insure that private capital will be consistently available to support FFEL loans, the program provides private lenders with a loan subsidy known as a "special allowance payment." This loan subsidy, which is tied to a financial market index, insures that private lenders receive, at a minimum, a specified level of return on student loan investments.

In addition, the federal government has helped establish a secondary purchase market for FFEL loans. To help insure the FFEL program would be fully capitalized, the federal government created the Student Loan Marketing Association, also known as Sallie Mae.[1] Sallie Mae was created to purchase loans from lenders seeking to sell them, thereby providing liquidity to help insure the FFEL program is fully capitalized.

The Federal Direct Student Loan program, authorized under Part D of Title IV of the HEA, established in 1993, was intended to streamline the student loan delivery system and achieve cost savings. The DL program was originally intended to gradually expand and replace the FFEL program. The DL program provides the same set of loans as the FFEL program, but uses a different administrative structure and

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[1] Up until very recently, Sallie Mae was a government sponsored enterprise, a federally chartered shareholder owned corporation established for the purpose of creating a secondary purchase market for federally guaranteed student loans. Under the provisions of P.L. 104-208, Sallie Mae has completed the process of fully privatizing.

draws on a different source of capital. Under the DL program, the federal government essentially serves as the banker — the federal government provides the loans to students and their families, using federal capital (i.e., funds from the U.S. Treasury), and owns the loans. Under the DL program, schools may serve as direct loan originators or the loans may be originated by contractors working for the U.S. Department of Education (ED). ED also hires contractors to service the loans.

While the DL program was originally introduced to replace the FFEL program, the 1998 amendments of the HEA removed the provisions of the law that referred to a "phase-in" of the DL program and those which specified the proportion of new student loan volume to be made through the DL program in particular academic years. Currently both programs are authorized. Postsecondary institutions apply to participate in one program or both. Borrowers borrow annually under one program. The program they borrow under is determined by the postsecondary institution they attend.

Together, these federal student loan programs provide more direct aid to support students' postsecondary educational pursuits than any other source. In FY2004, these programs provided $52.1 billion in new loans to students and their parents. In that year, the FFEL program provided 9,550,000 new loans averaging approximately $4,111 each and the DL program provided 3,001,000 new loans averaging approximately $4,279 each.

The loans made through the FFEL and DL programs are low-interest variable rate loans with interest caps that limit the cost to borrowers. Interest rates are determined by statutorily set market-indexed interest rate formulas. The loans disbursed through these programs include subsidized and unsubsidized Stafford loans for undergraduate and graduate students; PLUS loans for parents of undergraduate students; and Consolidation loans that offer borrowers refinancing options.

This report discusses the major provisions of the law pertaining to the administration of the FFEL and DL programs. The primary emphasis is placed on discussing the provisions of the law that outline the roles and responsibilities of participating postsecondary institutions, guaranty agencies, private lenders, and ED contractors. A companion report titled RL30655, *Federal Student Loans: Terms and Conditions for Borrowers* has been prepared to discuss provisions related to borrower eligibility, loan terms and conditions, borrower repayment relief, and loan default and its consequences for borrowers. Both reports provide background information on the FFEL and DL programs. The reports provide updated information through the 1998 reauthorization of the HEA and subsequent amendments enacted through January 26, 2006. These reports will be updated when program changes occur. At the date of this update, the authorization for provisions of the law (lasting through FY2003) had expired, and an extension through March 31, 2006, under P.L. 109-150, is in effect.

Postsecondary Institutions

Postsecondary institutions play a central role in administering the federal student loan programs. The role postsecondary institutions play and provisions of the law relating to their role will be discussed within the context of the FFEL and DL programs in subsequent sections of this report. The discussion that follows outlines the provisions of the HEA relating to institutional eligibility to participate in the student loan programs.

Institutional Eligibility

Students borrowing subsidized and unsubsidized Stafford loans must be enrolled in a postsecondary institution that is eligible to participate in the federal student loan programs. Similarly, for parents to take out PLUS loans, their dependent child must be enrolled in an eligible postsecondary institution.

Eligible institutions may include public and private, non-profit colleges and universities, community colleges, and trade and technical schools, most of which are proprietary (private, for profit) schools offering programs of vocational or occupational training lasting less than two years.[2] For an institution to be eligible to participate in the FFEL or DL program, the institution has to meet certain general Title IV eligibility requirements, i.e. the institution must:

- Be accredited by an agency recognized for that purpose by the Secretary of Education,
- Be licensed or otherwise legally authorized to provide postsecondary education in the state in which it is located, and
- Be deemed eligible and certified to participate in federal student aid programs by ED.

There are, in addition, some institutional requirements and definitions that are specific to the federal student loan programs. Schools with 300 hour programs (minimum 10 weeks) that are not graduate or professional programs or do not require at least an associate's degree for admission may be eligible to participate in the student loan programs only. To be eligible, these short-term programs must satisfy regulatory criteria prescribed by the Secretary of ED, including verified completion and placement rates of at least 70%.[3]

Institutional Eligibility and Default Rates. In an effort to reduce default costs, Congress has enacted provisions linking institutional eligibility and default rates. As a result, institutions with a pattern of high loan default rates become ineligible to participate in the FFEL and DL programs.

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[2] Institutions outside of the United States that are approved by the Secretary of Education are also eligible for FFEL program participation.

[3] For more detailed information about institutional eligibility for Title IV assistance see CRS Report RL31926, *Institutional Eligibility for Participation in Title IV Student Aid Programs Under the Higher Education Act: Background and Issues*, by Rebecca R. Skinner.

To determine institutions' rates of default, a cohort default rate is calculated. An institution's cohort default rate is the number of borrowers last attending that institution entering repayment on a Stafford (subsidized or unsubsidized), Supplemental Loan for Students (SLS) loan,[4] or the portion of a consolidation loan that is used to repay such loans, in a given year who default (defined as an insurance claim having been paid on their loan) by the end of the succeeding fiscal year *divided by* the total number of those borrowers entering repayment in the given year. The Secretary of ED is required to report annually on cohort default rates by institutional sector. Schools with few borrowers as determined by a statutory formula (participation rate index) are exempt from sanctions.

Institutions with cohort default rates of 25% or higher for each of the most recent 3 fiscal years are ineligible to participate in the FFEL and DL programs for the remainder of the fiscal year through the 2 following fiscal years. Postsecondary institutions have the right to appeal the loss of eligibility and ED may waive the provision if there are statutorily defined exceptional mitigating circumstances or other exceptional mitigating circumstances as defined by the Secretary.[5] Postsecondary institutions also have the right to appeal the loss of eligibility if the institution demonstrates that the calculation of its default rate is inaccurate. Institutions may include in their appeal a defense based on improper loan servicing.[6]

Historically black colleges and universities (HBCUs) and tribally controlled community colleges were exempt from cohort default rate-based restrictions through July 1, 2004. The 1998 HEA amendments specified that institutions that relied on the exemption to remain eligible to participate in the FFEL and DL programs would be required to submit a default management plan to the Secretary that provided for the reduction of the cohort default rate to less than 25%.[7]

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[4] Prior to July 1, 1994, SLS loans were available for independent students who were not qualified for sufficient financial aid under the FFEL Stafford loan program.

[5] The statutorily defined exceptional mitigating circumstances include cases in which at least two thirds of an institution's students who were enrolled at least half time were eligible to receive at least one half of the maximum Pell Grant award or whose adjusted gross income is less than the Health and Human Services poverty level. In such cases, for an institution to qualify for an "exceptional mitigating circumstances" exemption, a degree granting institution must have a completion rate of at least 70% among full time students scheduled to complete their programs, and a nondegree granting institution must have an employment placement rate of 44%. For the Secretary's definition of these circumstances, see 34CFR, Section 668.17.

[6] In such cases, the Secretary is required to give institutions access to a representative sample of relevant records for a reasonable time and if the evidence demonstrates inaccuracies, the Secretary must recalculate a reduced rate based on the errors found in the sample. The Higher Education Technical Amendments of 1993 also provide that guaranty agencies must afford schools the opportunity to review and correct records before they are submitted to the Secretary for calculation of the default rates.

[7] As a possible way to control defaults, institutions may now refuse to certify as eligible for FFEL loans certain students believed to be at higher risk of default, if the reasoning for such a refusal is documented and provided to the student. Before 1991, when the default cutoffs

(continued...)

FFEL Program: Introduction to How the Program Is Administered

FFEL program loans are financed by commercial and nonprofit lenders. Commercial lenders include banks, savings and loans, credit unions, and insurance companies. Nonprofit lenders include postsecondary institutions or agencies designated by states.

Originating lenders — the lenders who make the loans — often sell their FFEL loans on the secondary market in order to secure new capital to make more loans. The largest of these secondary market purchasers, holding about one third of outstanding FFEL paper, is Sallie Mae, which up until very recently was a federally sponsored private for-profit corporation or government-sponsored enterprise (GSE).[8] Other loan purchasers are banks, and nonprofit state level agencies or institutions dealing exclusively in student loans and often only buying loans from lenders in their own state or region.

Originating lenders or the secondary market loan purchasers who hold a loan, work with postsecondary institutions to track students' enrollment and loan eligibility status. Once loans are in repayment, loan holders bill borrowers and collect loan payments.

State or national nonprofit guaranty agencies administer the federal insurance which protects lenders against loss stemming from borrower default, death or disability. Guaranty agencies also provide other services to lenders such as assistance in preventing delinquent borrowers from going into default. Guaranty agencies are state agencies created by state governments, or private nonprofit agencies operating only within a state or nationally. Each state has a guaranty agency selected to serve as the "designated" guarantor of FFELs for students going to schools in the state or state residents going to schools elsewhere. Other guarantors, however, may serve state students and residents also.

The primary function of the guaranty agency is to service the federal loan insurance that is provided to lenders in the FFEL program. Under agreements with

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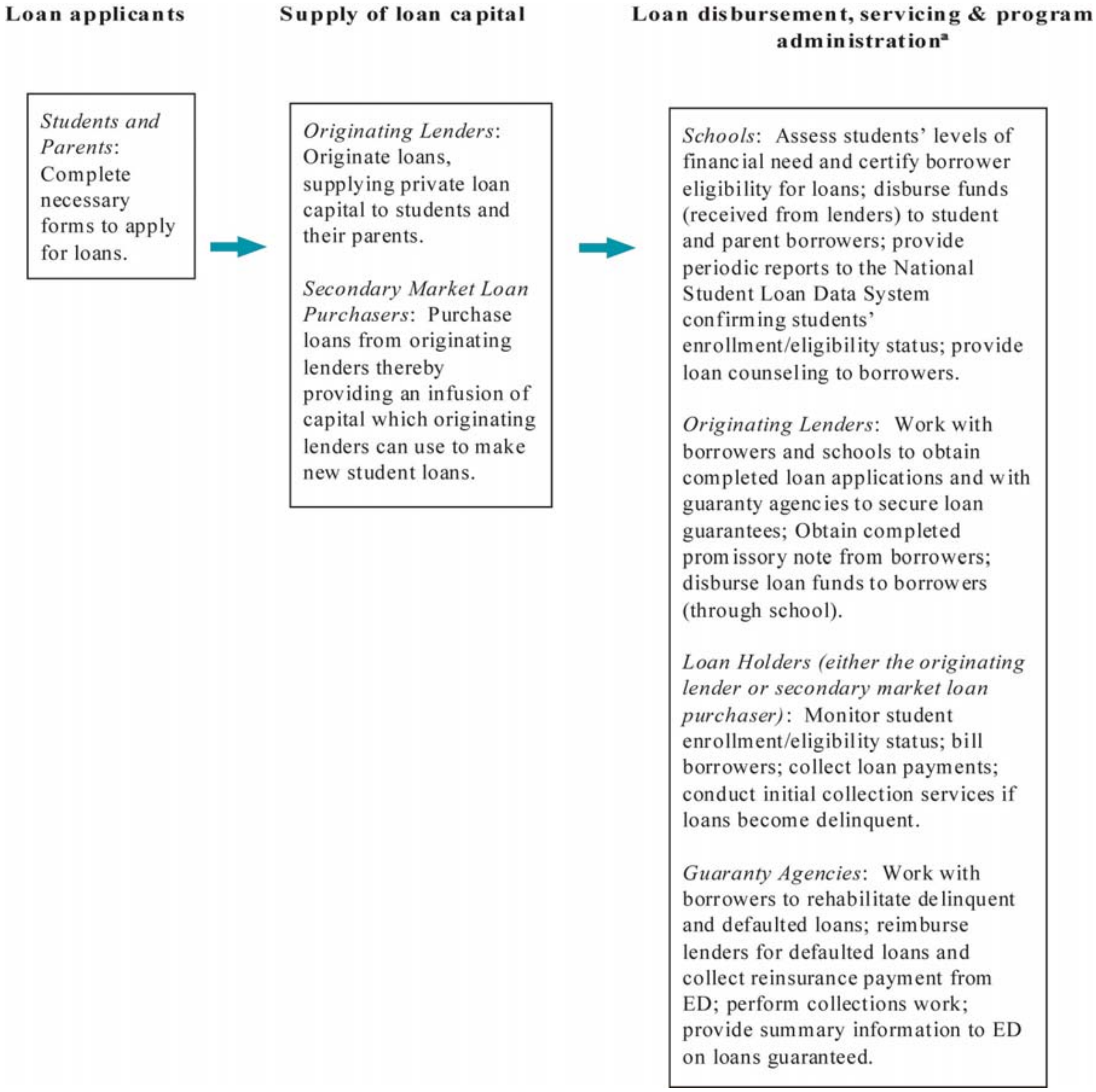
[7] (...continued)
were first effective, schools could not refuse such certification, even if they suspected the student would be unable or unwilling to repay a FFEL.

[8] Sallie Mae was established to correct for market failures that existed in the early years of the GSL program during which participating lenders experienced difficulty in selling their student loans. Sallie Mae was given certain tax exemptions and borrowing privileges (from the U.S. Treasury) that enabled it to profitably purchase and market loans even during times when secondary market demand for student loans may not have been high. This has helped originating lenders who need to be able to sell loans in order to raise capital to originate new loans. P.L. 104-208, the Student Loan Marketing Association Privatization Act of 1996, authorized Sallie Mae to fully privatize. Under the act, the GSE could continue to function as a subsidiary of a private holding company through Sept. 30, 2008, after which the GSE would cease to exist. On Dec. 29, 2004 Sallie Mae completed the process of fully privatizing.

lenders holding the loans, guaranty agencies are responsible for paying the principal and accrued interest on defaulted loans. Through a reinsurance agreement with the federal government, the guaranty agency is reimbursed for direct insurance claims it pays to lenders for such losses.[9] These agencies also administer the loan discharges available for borrower death, disability, bankruptcy (in limited instances), and the new discharges available for school closures. Guaranty agencies also recruit lenders to participate in the FFEL programs to assure the access of students in the state to the loans, provide assistance to lenders in collecting loans before they enter default (preclaims assistance), may act as a lender of last resort, and may provide technical assistance to lenders.

[9] For much of its first two decades of existence, the federal Stafford loan program (then the Guaranteed Student loan program) operated under both state agency guarantees and direct federal guarantees through the Federally Insured Student loan (FISL) program. At times, fewer than half of the loans made each year in this program were directly guaranteed by state guaranty agencies with federal reinsurance. Legislative changes in 1976 (Education Amendments of 1976, P.L. 94-482) made it more attractive for states and others to establish guaranty agencies. The last FISLs were made during FY1984.

Figure 1. Basic Elements of the FFEL Program Model



a. Many of the administrative jobs performed in the FFEL program are handled via subcontracts. This is particularly true with regard to loan servicing tasks (i.e., many of the administrative tasks identified above as work originating lenders and loan holders are responsible for completing). Several guaranty agencies and secondary market loan purchasers have developed large servicing operations and typically secure many of the servicing contracts from loan holders.

Lender Provisions

The lender-related provisions of the law discussed below apply to any holder of a FFEL loan, regardless of whether the loan holder originated the loan or bought it.

Lender Responsibilities

Loan Disbursement. Disbursement requirements are generally designed to prevent fraud by assuring that the school has some control over the distribution of the loan proceeds for student expenses. Lenders must send Stafford loan proceeds directly to the institution of higher education. The check or other instrument used to deliver the loan proceeds to the institution must require the endorsement of the student and be payable directly to him or her, and may not be made co-payable to the institution and borrower. If the student is studying abroad in a program approved for credit by his or her home institution in the U.S. or at an eligible foreign institution, funds may be delivered directly to the student upon request, and may be endorsed or a fund transfer authorized through a power-of-attorney.

PLUS loans must be disbursed by means of an electronic funds transfer (EFT) from the lender to the institution or in a check co-payable to the institution and parent borrower.

Multiple disbursement provisions are designed to lower defaults among students who never attend the school in which they are enrolled or drop out of educational programs shortly after enrollment. The lender must disburse any Stafford loan in two or more installments, none of which exceeds one-half the loan amount. The interval between installments is required to be at least half the period of enrollment unless this interferes with disbursement at the beginning of a semester, quarter, or similar academic division. If a borrower ceases to be enrolled at the institution prior to the second disbursement, the disbursement must be withheld and credited to the borrower's principal as a prepayment. Further, if a student receives an over-award the institution must return the excess funds to the lender and the lender must credit the funds to the borrower's principal as a prepayment.[10] Lenders may not sell loans to secondary markets or other entities before the final disbursement of loan proceeds unless the sale of the loan does not change the identity of the party to whom payments are made and the first disbursement has been made. Consolidation loans, and loans for attendance at an eligible institution outside the United States are not subject to these disbursement requirements.

Also, as a default reduction measure, disbursement to first-time, first-year Stafford borrowers must be delayed until 30 days after the borrower begins his or her course of study. For other students, loans may not be disbursed prior to 30 days before the beginning of the period of enrollment for which the loan is made. Provisions in the 1998 HEA amendments made postsecondary institutions with very low default rates exempt from many of these disbursement requirements. However, these exemptions expired on September 30, 2002.

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[10] An over-award is an award in excess of the amount for which the student is eligible.

The law authorizes lenders other than the holder of the loan, as well as guaranty agencies, to act as escrow agents for loan disbursements.

Credit Checks and Endorsement. As a general rule lenders are neither prohibited from evaluating nor required to evaluate a prospective student borrower's financial condition through a credit check and make a decision regarding the size of the loan based on such information. Lenders are required, however, to do credit checks for parents applying for PLUS loans, because program eligibility is restricted to those parents with no adverse credit history.

Disclosures. The law requires lenders to make certain disclosures to borrowers before disbursement of the loan proceeds and prior to the beginning of the repayment period. Upon approval of a Stafford or PLUS loan, lenders must issue a statement to the borrower on his or her rights and responsibilities with respect to the loan and the consequences of defaulting on the loan, including that the defaulter will be reported to credit bureaus. Before disbursement, the lender must disclose to the borrower certain detailed information such as the principal owed, any additional charges made, the interest rate, an explanation of the repayment requirements, the total cumulative balance of the loans owed the lender by the student, and the projected monthly balance (given the cumulative balance), prepayment rights, default consequences, and any collection costs for which the borrower may become liable. This disclosure, which must be in a written form, must contain a statement in bold print that the borrower is receiving a loan that must be repaid.

The lender must provide other written information to the borrower not less than 30 days or more than 240 days (these limits do not apply to PLUS and consolidation loans) before the repayment period begins. This information generally relates to loan repayment information such as who is to receive the payments, total interest charges, what monthly payments will be, what repayment options may be available such as consolidation or refinancing, prepayment rights, fees, etc. For PLUS and unsubsidized Stafford loans, lenders may project monthly payments with or without capitalization.

Notifications. Loan holders are required to notify Stafford borrowers 120 days after they leave school of the date their repayment period begins.

Upon the sale or transfer of any FFEL loan when the borrower is either in a grace period or in repayment, the old and new holders, either jointly or separately, are required to notify borrowers of the sale or transfer within 45 days from the date the new holder will have an enforceable right of repayment from the borrower. The notification must include such information as the identity of the new holder, the address where payment must be sent and the telephone numbers of the original and new holders. The new holder must also notify the guaranty agency and, if requested, the institution the student attended, of the sale/transfer.

Lenders are required to report to national credit bureaus on the amount of a FFEL loan made to an individual and the loan's status.

Prohibitions. The law prohibits lenders from offering inducements for loan applications, conducting unsolicited mailings for applications, using FFEL loans as an inducement to a prospective borrower to buy life insurance, or engaging in fraudulent or misleading advertising. Lenders are also prohibited from practicing discrimination in their FFEL credit practices on the basis of race, national origin, religion, sex, marital status, age, or disability status.

Collections. Under the insurance agreement, lenders are primarily responsible for enforcing the repayment of loans they hold. If a borrower misses a payment and a loan becomes delinquent, the lender must undertake certain federally prescribed "due diligence" efforts to collect on the loan over a 270-day period.[11] At the request of a lender, guaranty agencies must assist the lender in pursuing borrowers with delinquent FFEL accounts prior to the lender filing a default claim.

Lenders, loan servicers, and guaranty agencies are all required to pursue delinquent or defaulted student loan accounts with "due diligence" as prescribed by federal regulation. If irregularities are found in complying with these regulations, the insurance payment on a default to a lender or a reinsurance payment to a guarantor is jeopardized. Regular reviews associated with servicing and collection requirements may be conducted on any loan. Once a loan being repaid in monthly installments has been delinquent for 270 days, the lender files a default claim.[12] If the guarantor determines that the lender exercised the required diligence in attempting to collect on the loan, the guaranty agency pays the claim. Once this claim is paid, the lender ceases to have an interest in the loan.

Lender of Last Resort. Borrowers in certain geographic areas and borrowers seeking loans that are less appealing to lenders (such as low-balance loans) sometimes encounter difficulty securing loans. To ensure that qualified borrowers will be able to secure FFEL loans, the law provides for "lenders of last resort" (LLR). Guaranty agencies must act as a lender of last resort to serve otherwise eligible applicants for subsidized Stafford loans who have been unable to secure a loan. The Secretary is authorized to provide advances to guarantors to ensure they will make LLR loans.

Sallie Mae is also required to serve as a lender of last resort for any FFEL loan, at the request of the Secretary whenever the Secretary determines that borrowers are unable to obtain loans, either within a particular geographical area or for attendance at particular institutions. These loans are directly insured by the Secretary.

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[11] Due diligence is following procedures specified in 34 C.F.R. 682.411 in an attempt to secure repayment of a loan.

[12] For loans being repaid in less frequent than monthly installments, a default claim is filed after 330 days of delinquency.

Payments to Lenders

Interest Payments. Lenders receive interest payments on loan principal from borrowers (or from the federal government, during in-school periods, grace periods, and deferment periods, in the case of subsidized Stafford loans). Loan interest rates are determined by statute.[13]

Special Allowance Payment. A key component of the FFEL program for lenders is the special allowance payment. It is a payment of additional interest on a student loan that is made by the federal government when the borrower's interest rate does not meet a statutorily specified level of return to the lender. The provision dates to the early days of the GSL program when the return on student loans was low compared to what lenders could receive from other types of consumer credit, and Congress wanted to provide an incentive for lenders to put their capital in GSLs. The special allowance compensates the lender for the difference between the statutorily set interest rate charged to borrowers and the market rate of return. In essence, the Special Allowance Payment is in place to keep student loan investments appealing to private lenders during periods when the statutorily capped interest rates for borrowers would provide a lower rate of return than other investments. The special allowance payment has been sustained to ensure that the program is consistently fully capitalized.

The special allowance rate is determined quarterly under a statutory formula. The special allowance paid for each loan is dependent on the formula in effect when the loan was disbursed. The federal government pays any special allowance due lenders from the time the loan is disbursed through the entire repayment period.

Effective for Stafford, PLUS and Consolidation loans for which the first disbursement was on or after January 1, 2000,[14] the special allowance rate is determined by the following formulas, each of which is based on a market index — three-month Commercial Paper (CP) rates[15] — to keep the special allowance payment sensitive to market conditions.

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[13] For additional information on the interest rates for various types of loans and loan repayment responsibilities see CRS Report RL30655, *Federal Student Loans: Terms and Conditions for Borrowers*, by Adam Stoll.

[14] The Ticket to Work and Work Incentives Improvement Act of 1999 (P.L. 106-170, December 17, 1999) included an amendment to the HEA enacting these formulas for calculating the special allowance for loans disbursed on or after January 1, 2000 and before July 1, 2003. P.L. 107-139, adopted February 8, 2002, included provisions that extend these formulas to loans disbursed on or after July 1, 2003.

[15] The "CP rate" used in the special allowance calculation is based on the average bond equivalent rates of the daily quotes of the three-month commercial paper rates for each of the days in a quarter.

Quarterly Special Allowance Formulas

Stafford loans

$$\frac{\text{3-month CP rate} + \text{a premium (1.74 in school, 2.34 in repayment)} - \text{borrower's interest rate}}{4}$$

PLUS and Consolidation loans

$$\frac{\text{3-month CP rate} + \text{a premium (2.64)} - \text{borrower's interest rate}}{4}$$

In these formulas, the CP rate represents the cost of borrowing to banks (i.e., banks borrow the funds that are used to make loans at roughly this rate); the premium reflects other costs associated with making and servicing loans as well as a return rate subsidy (i.e., an agreed upon minimum profit margin deemed to be appropriate to keep the loans appealing to lenders); the borrower's interest rate reflects the interest rate the borrower is paying the bank on the loan; and the denominator (4) reflects the fact that the calculation is done to derive a quarterly payment.

If the result of this special allowance calculation is positive, the lender receives a payment of this additional interest from the federal government, by multiplying the result times the outstanding principal on the loan. If it is negative the lender receives no quarterly special allowance payment.

For Stafford loans first disbursed on or after July 1, 1998 and before January 1, 2000, the special allowance rate is the sum of the average bond equivalent rates of the 91-day T-bills auctioned during the quarter and 2.2% in school, and 2.8% in repayment. The PLUS and Consolidation loan rate for loans disbursed during that time period is based on the 91-day T-bills auctioned during the quarter plus 3.1%.

The special allowance is available for all types of FFELs. For the most part, it is only paid on variable interest rate PLUS loans if the calculation of borrower's interest exceeds the interest cap (the cap is 9% for loans disbursed on or after October 1, 1998 and before July 1, 2006).[16] For Consolidation loans, the borrower's new interest rate on the consolidation loan is the basis for the special allowance calculation, not the original interest rates of the individual loans that were consolidated.

Default Claims. Lenders are insured against borrower default for 98% of the outstanding loan principal. Lenders, loan servicers, and guaranty agencies who the Secretary of Education finds have a 97% or greater compliance with due diligence requirements may be designated as having "exceptional performance," and relieved from regular review for compliance with servicing and collection requirements. With this designation, lenders and servicers also receive 100% reimbursement for their default claims and guaranty agencies receive the appropriate level of reimbursement

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[16] The one exception to this is PLUS loans disbursed on or after July 1, 1994, and before July 1, 1998 for which the rate cap restrictions do not apply.

from the federal government with no added review. The designation lasts for a one-year period or until revoked by the Secretary, and annual audits of the lenders, services and guarantors are required specific to the designation.

Lender Fees

In recent years, numerous provisions designed to reduce federal costs in the FFEL program have been enacted. These include fees charged to lenders and holders of FFEL loans. In essence, these fees pass along some of the federal costs associated with insuring and subsidizing student loans to lenders.

All lenders/loan holders are required to pay to the Secretary a loan fee (subtracted by the Secretary from the quarterly interest and special allowance payments due to lenders) equal to 0.5% of loan principal on FFEL loans for which the first disbursement was on or after October 1, 1993. In addition, holders of consolidation loans for which the first disbursement was made on or after October 1, 1993, must pay to the Secretary, on a monthly basis, a rebate fee calculated on an annual basis, equal to 1.05% of the loan principal plus accrued interest.[17]

Guaranty Agency Provisions

Guaranty Agency Responsibilities

Loan Insurance. A central function of guaranty agencies is administering loan guarantees. When loans are in default, and when loans are eligible for a discharge (e.g., in instances of death or permanent disability), the guaranty agency pays the lender's insurance claim. The guaranty agency subsequently files a claim with the federal government for a reinsurance payment.

Default Aversion Assistance. Upon receiving a request from a lender, not earlier than the 60th day after a loan has become delinquent, a guaranty agency is required to provide the lender with default aversion assistance. This assistance is aimed at preventing default by the borrower.

Collections. After the guaranty agency pays a lender's insurance claim on a defaulted loan, the note is assigned to it and the agency becomes responsible for making efforts to collect on the loan. As part of its reinsurance agreement with the federal government a guaranty agency is, like the lender, required to exercise diligence in pursuing defaulters for repayment of principal and accrued interest due on their loans under many of the same procedures required for lenders during loan delinquency.[18] When a guarantor is assigned a loan it can convert the loan from

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[17] The 1998 HEA amendments reduced the lender rebate fee on FFEL consolidation loans based on applications received from October 1, 1998 through January 31, 1999 from 1.05% to .062% of principal and accrued interest on student loans.

[18] 34 CFR 682.410(b)(6).

defaulted status by rehabilitating it through loan rehabilitation or consolidation or the guarantor can collect on the loan.

Assignment of Defaulted Loans to the Federal Government (Subrogation). At any time, the Secretary of Education may require a guaranty agency to assign the defaulted loan to the federal government for collection under the assumption that the federal government will have more success in collection on a particular loan or group of loans than the guaranty agency. Once a loan is assigned to the federal government, the guaranty agency receives no further payment resulting from any collections on that loan.

ED has established certain categories of loans for mandatory assignment such as aged accounts and defaulted loans of federal employees. Also, loans that may be collectable through the offset of the defaulter's federal tax refund are temporarily assigned to the federal government.

Payments to Guaranty Agencies

Administrative Payments. Guarantors receive payments as compensation for the varied administrative tasks they perform as intermediaries within the FFEL program. For loans originated in fiscal years on or after October 1, 1998 and before October 1, 2003, the Secretary paid guaranty agencies a loan processing fee equal to 0.65% of the total amount of loan principal for the loans on which insurance was issued in each fiscal year. The loan processing fee, which is paid quarterly, dropped to 0.40% for insured loans originated on or after October 1, 2003. In addition, the 1998 HEA amendments established an account maintenance fee that is paid quarterly by the Secretary to guaranty agencies. For fiscal years 1999 and 2000, the payment equaled .12% of outstanding loan principal. For fiscal years thereafter through 2003, the payment equals .10% of outstanding principal.

Default Aversion Payments. The 1998 HEA amendments established a default aversion fee, that is intended to provide added incentive for guarantors to work with borrowers to rehabilitate loans in danger of going into default. Under the provisions, guaranty agencies are paid a default aversion fee equal to 1% of unpaid principal and accrued interest on a loan for which a default claim is not paid within 300 days after the loan is 60 days delinquent — because the loan has been successfully brought into "current status." It should be noted that statutory and regulatory provisions offer divergent guidance with regard to how default aversion fees are calculated and paid.[19]

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[19] Regulatory provisions, developed in response to concerns raised at negotiated rule-making, created a "netting out process" whereby guarantors may transfer default aversion fees from their Federal Fund to their Operating Fund equal to 1% of principal and accrued interest owed on all loans submitted by lenders to the guaranty agency for default aversion assistance during a period (e.g., that quarter) minus 1% of unpaid principal and accrued interest on loans for which default claims were paid during that time period (i.e., on those loans for which default aversion fees have previously been paid). See HEA Section 428(l) and 34 CFR 682.404(k).

Insurance Premiums. The HEA authorizes guaranty agencies to charge lenders an insurance premium equal to not more than 1% of loan principal. Lenders may in turn require FFEL borrowers to pay the loan insurance premium. This fee helps defray some of the federal cost of insuring loans.

Reinsurance Payments. When a loan has gone into default, and a guaranty agency has paid a lender's insurance claim, the guaranty agency files a claim with the federal government for a reinsurance payment. For loans disbursed on or after October 1, 1998, reinsurance payments cover 95% of the cost of the claim plus certain administrative costs, provided that overall reimbursements don't exceed 5% of the loans (in repayment) that are insured by the guaranty agency. The reinsurance rate drops if the guarantor has default claims that are high compared to the loans in repayment. If more than 5% of the guarantor's loans (in repayment) are in default in any fiscal year, the reimbursement rate drops to 85%; and if default claims exceed 9% of loans in repayment status, the reimbursement rate drops to 75%. For lender of last resort loans, the reinsurance rate is 100%.

Collection Payments. The guaranty agency is authorized to retain the complement of the reinsurance percentage in effect when the reinsurance payment was made plus a percentage of any collections it makes to pay for its costs associated with the collection.[20] The remaining amount collected is paid to the federal government. Prior to October 1, 2003, the percentage of collections the guaranty agency was authorized to keep was 24%. On or after October 1, 2003, the guaranty agency is authorized to keep 23%. For defaulted loans resold through rehabilitation, the guaranty agency may retain 18.5% of the proceeds from the loan sale. The guarantor may keep an additional amount equal to up to 18.5% of principal and accrued interest from collection fees assessed to the borrower. For a loan that is consolidated out of default, the guaranty agency may retain an amount equal to up to 18.5% of principal and accrued interest from collection fees assessed to the borrower.

Reserves and Solvency Requirements

In order to pay insurance claims on defaulted loans, guaranty agencies must maintain a certain level of reserves. Provisions in the HEA specify:

- the level of reserves a guaranty agency must maintain;
- the actions that may be taken in the event of guaranty agency insolvency;[21]
- the mechanisms the federal government will use to oversee the financial conditions of guaranty agencies;
- and the terms under which "excess reserves" may be recalled by the federal government.

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[20] For example, the complement of the reinsurance percentage in effect when the reinsurance payment was paid would be 5%, if the reinsurance percentage in effect was 95%.

[21] In 1990, the largest student loan guarantor, the Higher Education Assistance Foundation (HEAF) became insolvent because it did not have funds to meet its insurance obligations.

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 its 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 ratio of 0.25%, and under current law, reserves above 2.0% are considered "excess reserves" which are subject to being recalled by the federal government.

Guaranty agencies reserves are property of the federal government. In an effort to create clear separation between reserve funds and operating funds, the 1998 HEA amendments required all guaranty agencies to establish two funds: a Federal Fund; and an Operating Fund. All of the funds from the guaranty agencies' reserve funds were to be transferred into the Federal Fund. Additionally, after the enactment of the 1998 HEA amendments, the following payments are to be placed in the Federal Fund: insurance premiums from borrowers, reinsurance payments from ED, and the reinsurance complement from collections and rehabilitations.

The law specifies that the Federal Fund, including its earnings, is the property of the United States. The Federal Fund may be used to pay lender claims and to pay default aversion fees into the guaranty agency's Operating Fund. Also the HEA authorizes guaranty agencies to transfer funds from the Federal Fund to the Operating Fund to support normal operating expenses (not including claim payments) during the first three years in which the Operating Fund is being established.

The Operating Fund is to be used to support operating expenses and may also be used by the guarantor to support discretionary student aid activities. The Operating Fund, with the exception of funds temporarily transferred in from the Federal Fund to support the fund's establishment, is the property of the guaranty agency. Guaranty agencies are authorized to deposit loan processing and issuance fees into the Operating Fund, account maintenance fees, the agency's percentage of any collections on defaulted loans, compensation for defaulted loan rehabilitations and consolidations, and default aversion fees transferred from the Federal Fund.

In years leading up to the 1998 amendments, student loan defaults had declined, and consequently guaranty agency reserves had grown. Hence there has been increased interest in recalling reserves. The Balanced Budget Act of 1997, required the return of $1 billion from guaranty agency reserves by 2002. The 1998 HEA amendments required the recall of an additional $250 million by FY2007. The ED is required to report annually to congressional authorizing committees on the fiscal soundness of the guaranty agency system.

Voluntary Flexible Agreements

The 1998 HEA amendments included provisions that allow for up to six guaranty agencies to enter into voluntary flexible agreements (VFAs) with the Secretary in fiscal years 1999, 2000, 2001 to pilot new ways for guaranty agencies to operate and receive fees for their services.[22] As of FY2002 any guaranty agency may enter into a VFA. Under the provisions of the HEA, the Secretary is afforded considerable discretion in awarding statutory and regulatory waivers for VFAs and establishing fees for services, except that the cost of the agreement "reasonably projected" cannot exceed the cost as similarly projected in the absence of the agreement.

Direct Loan Program: Introduction to How the Program Is Administered

Capital for the DL program is provided by the federal government and disbursed to borrowers through schools. Schools seeking to participate in the DL program apply to the Secretary. Participating schools — either individually or as part of a consortium — choose whether to originate loans for their students and must be specifically approved by ED for this purpose. For students attending schools not choosing to originate direct loans or not approved for that purpose, loans would be originated by an "alternative originators" under contract with the federal government. ED has hired one contractor to serve as the program's Loan Origination Center.

ED has also hired a contractor to serve as the DL program's Loan Servicing Center. It performs much of the DL program's servicing, accounting and collections work. However, ED staff play an important monitoring role in relation to the disbursement of funds to schools, ensuring that schools "drawdown" appropriate sums.

In general, schools participating in the DL program assume more direct administrative duties related to loan origination and servicing than they would have as participants in the FFEL program. At the same time, they are freed of many tasks associated with finding lenders for their students and working with an assortment of lenders and guaranty agencies.

[22] The VFAs are being piloted in an attempt to find new ways to tie guaranty agency reimbursement to default prevention activities.

Figure 2: Basic Elements of the DL Program Model

Loan applicants

Students and Parents: Complete necessary forms to apply for loans.

Supply of loan capital

The Federal Government: ED secures funds from the U.S. Treasury and supplies federal loan capital to students and their parents.

Loan disbursement, servicing & program administration

Schools: Assess students' levels of financial need and certify borrower eligibility for loans; disburse funds (received from ED) to student and parent borrowers and notify ED of those disbursements; provide periodic reports to the National Student Loan Data System confirming students' enrollment/eligibility status; provide loan counseling to borrowers.

Loan Originators (either the school or the Loan Origination Center): Obtain completed promissory notes from borrowers; request loan funds from ED; perform fund management tasks — including reconciling all accounts on a monthly basis;

Loan Servicing Center: Monitors student enrollment/eligibility status; bills borrowers; collects loan payments; conducts initial collection services if loans become delinquent; transfers defaulted loans to ED's debt collection system.

ED: Reviews requests for federal loan capital and transfers funds; monitors loan servicing and collection activities; ensures compliance with the law and program regulations; monitors institutional default rates.

Provisions Related to DL Program Administration

Under the HEA, the Secretary is authorized to contract for origination, servicing, default collections, data systems and sundry services connected with the implementation of direct loans.

Loan Origination. To enhance financial controls and accountability, ED has set up three levels of loan origination: standard origination, under which schools have the least responsibility and control over funds; and two levels of school origination. Schools must meet additional criteria beyond those for participating in the DL program to have full authority to originate loans. Any school eligible to participate in the Direct Loan program may operate under the standard origination option, in which case the Loan Origination Center, not the school, is responsible for preparing the promissory note, obtaining the completed note from the borrower, and initiating the drawdown of funds for the school to disburse to the student. To be eligible for either of the two school origination options, which allows schools greater control over funds, institutions must meet additional criteria that include participating in the Pell Grant program; not being on the reimbursement system in the Pell Grant, Work Study, or Perkins loan program; and demonstrating fiscal responsibility, as determined by the Secretary. The Secretary has the authority under the final regulations, based on evaluation of a school's performance, to require a change to standard origination.

Under school origination option 1, the school would be responsible for the promissory note, but the contractor would continue to be responsible for initiating drawdown of funds. Under school origination option 2, the school would have full responsibility for all aspects of the origination function, including determining funding needs and initiating funds drawdown.

Federal funds for direct student loans are delivered to participating schools and students in essentially the same manner as Pell Grants,[23] and other fiscal control and record keeping practices by schools are the same for all HEA Title IV programs. ED has developed loan origination software and training for schools, as well as entrance and exit counseling materials.

Disbursement of Funds to Borrowers. Direct loans are disbursed to students by first applying the loan to the student's account with any remainder being disbursed to the student. The requirement of the FFEL programs for a 30-day delay in the distribution of loan proceeds to first-year first-time borrowers also applies to Direct Loans. Direct PLUS loans to parents of dependent students are also subject to multiple disbursement, which has been required to date only for the Stafford and SLS loans under the FFEL programs.

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[23] For a description of the Pell Grant delivery system, see CRS Report RL31668, *The Federal Pell Grant Program of the Higher Education Act: Background and Reauthorization,* by Charmaine Mercer.

Loan Servicing and Default Collections. Under the DL program, loan servicing and collections are handled by a contractor, the Loan Servicing Center. The Loan Servicing Center bills borrowers whose loans are in repayment and processes loan payments.

If DL borrowers fail to make any installment payments on a loan, the loan becomes delinquent and the Loan Servicing Center is responsible for exercising due diligence in attempting to locate borrowers to initiate loan rehabilitation efforts. Ultimately, if a DL loan becomes 270 days delinquent, the loan goes into default and the Loan Servicing Center is responsible for conducting collections on the defaulted loan. If ED determines a borrower does not intend to honor their obligation to repay a loan, the Department may take any action authorized by law to collect a defaulted loan, including garnishing the borrower's wages; requesting the IRS to offset the borrower's federal income tax refund; filing a lawsuit against the borrower; reporting the default to national credit bureaus.

Payments for Administration

Under the HEA, funds for federal administrative costs (program operations by ED, servicing contracts, etc.) for Direct Loans are mandatory spending with a permanent appropriation. Spending for administrative costs has specific annual authorizations under the HEA; over the five-year period (FY1999-FY2003). The specific annual authorization for FY1999 is $617 million, rising to $735 million in FY2000, $770 million in FY2001, and $780 million in FY2002, and $795 million in FY2003.[24]

[24] Section 458 of the Higher Education Act, which authorizes these funds, also requires ED to use a specified portion of these funds to pay account maintenance fees to the FFEL program guaranty agencies. Some Section 458 funds are also used for general Office of Student Financial Assistance operating expenses.