Order Code RS22568
Updated January 30, 2007

CRS Report for Congress

Stafford Loan Interest Rate Reduction: Background and Issues

David P. Smole
Specialist in Social Legislation
Domestic Social Policy Division

Summary

Subsidized and unsubsidized Stafford Loans are the primary sources of federal loan aid available to assist students finance the costs of a postsecondary education. These loans are made available under both the Federal Family Education Loan (FFEL) program and the William D. Ford Direct Loan (DL) program. Through these programs, students may borrow loans with terms and conditions that are generally more favorable than loans from private lenders. Effective July 1, 2006, the interest rate on new Stafford Loans is fixed at 6.8%. For loans made on or after October 1, 1992, and prior to July 1, 2006, interest rates are variable and adjust annually. H.R. 5, as passed by the House, would reduce interest rates on subsidized Stafford Loans that are disbursed to undergraduate students from July 1, 2007, to December 31, 2011. This report provides a brief overview of selected terms and conditions of Stafford Loans, characteristics of borrowers, and a description of how reduced rates proposed under H.R. 5 would compare with current terms and conditions.

Introduction

The increasing desirability of obtaining a postsecondary education, rising college prices, and concerns about financing college costs have increased the visibility of federal student aid programs. Of particular concern is the amount students borrow for college and their resulting debt burden. Also, recently implemented changes to the FFEL and DL programs have resulted in a new interest rate structure for Stafford Loans with loans disbursed on or after July 1, 2006, carrying a fixed interest rate of 6.8%; whereas in prior years, loans were disbursed with variable, annually adjusting interest rates. In the early part of this decade, interest rates had dropped to historic lows, but recently have risen to levels more consistent with historic norms. The combination of recent interest rate changes, rising college prices, and concerns about student loan debt burden have put student loans on the agenda of the 110th Congress.

In the 110th Congress, proposals are being considered to reduce interest rates on student loans to make them less costly to borrowers. On January 17, 2007, the House passed H.R. 5, which would incrementally reduce interest rates on subsidized Stafford

Loans for undergraduate students over a five-year period beginning with academic year (AY) 2007-2008. Under H.R. 5, interest rates would be reduced from the current fixed rate of 6.8% to 6.12% for loans disbursed in AY2007-2008; 5.44% for loans disbursed in AY2008-2009; 4.76% for loans disbursed in AY2009-2010; 4.08% for loans disbursed in AY2010-2011; and 3.4% for loans disbursed in the first half of AY2011-2012 (through December 31, 2011). Rates would then revert back to 6.8% for loans disbursed subsequently, unless the rate reduction was extended through other legislation. Among other things, H.R. 5 would also decrease the special allowance rate (SAP) for larger lenders by 10 basis points (0.10%) and increase loan fees paid by lenders.

FFEL and DL Stafford Loans

Subsidized and unsubsidized Stafford Loans are made to undergraduate and graduate students under both the FFEL and DL programs.[1] Under the FFEL program, loans are made by approximately 3,600 banks and other eligible lenders to students in attendance at more than 5,000 institutions of higher education (IHEs). Loan capital for FFEL program loans is provided by private lenders and the loans are guaranteed by the federal government against loss due to borrower default. State and nonprofit guaranty agencies administer the federal loan guarantee. To help ensure that private capital will consistently be available for lending under the FFEL program, the federal government provides certain incentives to lenders, most notably the SAP. The SAP is a market-indexed loan subsidy payment made by the federal government to compensate lenders for the difference between statutorily established borrower interest rates and a market rate of return.[2]

Under the DL program, the federal government provides loans directly to students using federal capital (i.e., funds from the U.S. Treasury), and owns the loans. DL program loans are originated either by the institution a student attends or by a contractor of the U.S. Department of Education (ED). Loan servicing (i.e., billing borrowers, collecting payments, collecting on defaulted loans) is done by ED contractors. Approximately 1,100 institutions participate in the DL program. The DL program was initially intended to replace the FFEL program, but now both programs operate alongside one another. Each institution chooses whether to participate in the FFEL or DL program.

Subsidized and Unsubsidized Stafford Loans. There are two types of Stafford Loans — subsidized and unsubsidized. Currently, the same interest rate applies to both types of loans — 6.8% for loans disbursed on or after July, 1, 2006. *Subsidized Stafford Loans* are available to undergraduate and graduate students to help them finance their postsecondary education expenses. The federal government "subsidizes" these loans by paying the interest that accrues while the student is enrolled in school on at least a half-time basis, and during grace and deferment periods. Students must establish financial need to qualify for subsidized Stafford Loans. *Unsubsidized Stafford Loans* are also available to both undergraduate and graduate students. The major distinctions between

---

[1] For additional information on the FFEL and DL programs, see CRS Report RL33673, *Federal Family Education Loan Program and William D. Ford Direct Loan Program Student Loans: Terms and Conditions for Borrowers*, by Adam Stoll. (Hereafter, CRS Report RL33673).

[2] For a discussion of the SAP and other aspects of the administration of these loan programs, see CRS Report RL33674, *The Administration of the Federal Family Education Loan and William D. Ford Direct Loan Programs: Background and Provisions*, by Adam Stoll.

the two types of loans are that for unsubsidized Stafford Loans, the federal government does not pay the interest that accrues while the borrower is in school or during deferment and grace periods; and students may qualify for unsubsidized Stafford Loans irrespective of their expected family contribution (EFC) (i.e., they are not need-based).[3]

Interest Rates. Both subsidized and unsubsidized Stafford Loans carry the same interest rate. For loans disbursed on or after July 1, 2006, the interest rate is fixed at 6.8%. For loans disbursed between October 1, 1992, and June 30, 2006, the interest rate is variable and adjusts annually. The formula used to calculate the variable interest rate for those loans is determined by statute and stays in effect from the time the loan is disbursed through the life of the loan, or until the loan is consolidated. The variable rate is calculated based upon the bond equivalent rate of the 91-day Treasury bill, plus a premium which differs depending on when the loan was disbursed; and whether the borrower is in school, a grace period, or deferment, or is in repayment. The interest rate on variable rate loans adjusts each year on July 1. Prior to October 1, 1992, Stafford Loans carried fixed interest rates. **Table 1** presents a history of interest rates in effect during repayment on Stafford Loans disbursed on or after October 1, 1992.[4]

Table 1. Stafford Loan Interest Rates in Effect During Repayment: 1992-1993 through 2006-2007

Date	Disbursement Period				
	Oct. 1, 1992 to June 30, 1994	July 1, 1994 to June 30, 1995	July 1, 1995 to June 30, 1998	July 1, 1998 to June 30, 2006	On or after July 1, 2006
1992-1993	6.94				
1993-1994	6.22				
1994-1995	7.43	7.43			
1995-1996	8.92	8.25	8.25		
1996-1997	8.26	8.25	8.25		
1997-1998	8.26	8.25	8.25		
1998-1999	8.26	8.25	8.25	7.46	
1999-2000	7.72	7.72	7.72	6.92	
2000-2001	8.99	8.25	8.25	8.19	
2001-2002	6.79	6.79	6.79	5.99	
2002-2003	4.86	4.86	4.86	4.06	
2003-2004	4.22	4.22	4.22	3.42	
2004-2005	4.17	4.17	4.17	3.37	
2005-2006	6.10	6.10	6.10	5.30	
2006-2007	7.94	7.94	7.94	7.14	6.80

Sources: U.S. Dept. of Education, Office of Federal Student Aid, FFEL Variable Interest Rates; and CRS Report RL32424, *Consolidation Loans: Redesign Options and Considerations*, by Adam Stoll.

[3] For a thorough discussion of subsidized and unsubsidized Stafford Loans, see CRS Report RL33673.

[4] Lower interest rates apply during in-school, grace, and deferment periods; however, since for subsidized Stafford Loans, this interest is paid by the federal government during these periods, these rates are not shown. Lenders also may make loans at lower interest rates or reduce rates for timely repayment.

H.R. 5 would reduce interest rates only for undergraduate borrowers of subsidized Stafford Loans. The interest rate on unsubsidized Stafford Loans and on subsidized Stafford Loans borrowed by graduate students would remain at 6.8%. As shown in **Table 1**, for loans disbursed on or after October 1, 1992, interest rates during repayment on Stafford Loans have been at or lower than 3.4% only during the period from July 1, 2004, to June 30, 2005, and only for loans that had been disbursed on or after July 1, 1998. For most of the history of the Stafford Loan program, interest rates on variable rate loans have been at or above 6.79% during repayment.[5] (For purposes of comparison, under the Federal Perkins Loan program — the other major subsidized student loan program — all loans disbursed on or after October 1, 1981, carry a fixed interest rate of 5.0%.) The proposed interest rate reduction would result in increased costs to the government under the FFEL program due to larger SAP payments to lenders; and under the DL program due to receipt of reduced revenue from interest payments.[6]

Loan Volume and Characteristics of Borrowers

Loan Volume. Borrowing under the subsidized and unsubsidized Stafford Loan programs constitutes the largest single source of direct federal student aid to help students finance their postsecondary education expenses. In academic year FY2006, more than $36 billion in subsidized and unsubsidized Stafford Loan aid was made available to undergraduate students under the FFEL and DL loan programs. The number of undergraduate borrowers and committed loan volume for FY2006 is presented in **Table 2** for both programs.

Table 2. FFEL and DL Undergraduate Borrowers and Committed Loan Volume: FY2006

Loan Type	FFEL Borrowers	FFEL Loan Volume	DL Borrowers	DL Loan Volume	Total Loan Volume
Subsidized	4,394,000	$15,537,000,000	1,148,000	$4,113,000,000	$19,650,000,000
Unsubsidized	3,345,000	$13,505,000,000	778,000	$2,949,000,000	$16,454,000,000

Source: U.S. Dept. of Education, Office of Postsecondary Education, National Student Loan Data System.

Income Distribution of Borrowers. Data on the distribution of undergraduate Stafford Loan borrowers in AY2003-2004, by 2002 income percentiles are presented in **Table 3**. The table shows total 2002 income for the parents of dependent students and for independent students and their spouses at selected percentile point breaks. For instance, column B shows incomes for various categories of students at the 25th percentile (i.e., 25% of students have lower incomes); and column C shows median incomes.

---

[5] However, interest rates have also been lower on federal student loans. For example, Guaranteed Student Loans (GSLs) were originally made at a fixed interest rate of 6%; and borrowers whose income was below a certain threshold at the time of disbursement were eligible to have 3 percentage points of their interest paid by the federal government (P.L. 89-329, § 428(a)(2)).

[6] An examination of the cost to the government of this proposal, and issues such as its effect on student access to and persistence in postsecondary education are beyond the scope of this report.

Table 3. Income Percentile Distribution of Undergraduate Stafford Loan Borrowers: AY2003-2004

	10th percentile (A)	25th percentile (B)	50th percentile (C)	75th percentile (D)	90th percentile (E)
Dependent					
All students	$16,305	$32,370	$59,443	$91,754	$130,485
Stafford borrowers total	$17,519	$31,842	$55,827	$85,540	$117,266
Subsidized Stafford	$14,553	$26,353	$44,681	$67,373	$91,468
Unsubsidized Stafford	$24,862	$45,885	$75,837	$104,201	$141,376
Independent					
All students	$3,500	$11,214	$25,415	$49,415	$77,031
Stafford borrowers total	$3,519	$9,355	$20,052	$35,394	$57,533
Subsidized Stafford	$3,335	$8,924	$19,034	$32,272	$51,228
Unsubsidized Stafford	$4,000	$10,272	$21,483	$37,855	$61,020

Source: U.S. Dept. of Education, National Postsecondary Student Aid Study, 2004 (NPSAS:2004); CRS calculations.

Notes: Income data are 2002 total income. Data on borrowers of subsidized Stafford Loans and unsubsidized Stafford Loans are not mutually exclusive. Since students qualify for subsidized Stafford Loans on the basis of need, it is not uncommon for students whose subsidized Stafford Loan amounts are less than the statutory maximum to borrow the difference between their subsidized Stafford Loan eligibility amount and the statutory maximum through unsubsidized Stafford Loans. Thus, many students borrow both types of loans.

Both dependent and independent Stafford Loan borrowers are distributed across a slightly lower income range than undergraduate students overall. However, for dependent students, there is considerable variation between the income distribution of borrowers of subsidized Stafford Loans and borrowers of unsubsidized Stafford Loans. Dependent student borrowers of subsidized Stafford Loans had a median 2002 income of $44,681, compared with a median income of $75,837 for borrowers of unsubsidized Stafford Loans. There was less variation among undergraduate independent borrowers, with the median income of borrowers of subsidized Stafford Loans being $19,034, compared with $21,483 for borrowers of unsubsidized Stafford Loans.

Subsidized Stafford Loan Borrowing. During AY2003-2004, 27.7% of undergraduate students borrowed subsidized Stafford Loans, and these students borrowed an average amount of $3,232.[7] Borrowers who graduated that year, had borrowed an average cumulative amount of $10,842 in subsidized Stafford Loans.[8] Loan limits on Stafford Loans vary by class level, with annual loan limits rising as students progress through college. The amount students actually borrow also tends to increase as they become eligible for larger loan amounts. **Table 4** presents information on current loan limits for subsidized Stafford Loans and average amounts borrowed by undergraduate students during AY2003-2004.

[7] U.S. Dept. of Education, NPSAS:2004; CRS calculations.

[8] *Ibid.*

Table 4. Subsidized Stafford Loan Limits and Average Borrowing by Undergraduate Students: AY2003-2004

Statutory Loan Limits		Borrowing by class level		
Class Level	**Loan Limit**	**Class Level**	**Percent who borrowed**	**Average amount borrowed**
1st year	$2,625	1st year	27.4	$2,190
2nd year	$3,500	2nd year	24.4	$2,932
3rd year and beyond	$5,500	3rd year	37.8	$4,360
		4th year	35.8	$4,288
		5th year	32.3	$4,138

Sources: HEA, § 428(b)(1)(A); U.S. Dept. of Education, NPSAS:2004; CRS calculations.

Interest Amortization. The amount of interest a borrower pays over the life of a subsidized Stafford Loan is a function of the amount borrowed, the interest rate, and the duration of the repayment period. Reduced interest rates on subsidized Stafford Loans could substantially affect the amount of interest borrowers pay over the life of their loans. **Table 5** presents case simulations of two types of borrowers under current law and H.R. 5. Case A is a borrower who first enrolls in AY2007-2008 and over five years borrows $2,000 in year 1; $3,000 in year 2; and $4,000 in each of years 3 through 5. Case B is a borrower who begins enrollment in AY2008-2009 and over four years borrows $2,000 in year 1; $3,000 in year 2; and $4,000 in each of years 3 and 4. Both borrowers consolidate their loans and select a standard 10-year repayment period. (For loans of these amounts, unless consolidated, fixed interest rates below 6.8% would result in less total interest paid over a shorter repayment period, but no decrease in monthly payments due to the required minimum monthly payment of $50 under the standard repayment plan.)

Table 5. Case Simulations of Monthly Payments and Total Interest on Subsidized Stafford Loans: Current Law and H.R. 5

Case	Cumulative borrowed	Consolidation rate	Monthly payment	Total interest	Total repayment
Borrower A					
Current law	$17,000	6.875	$196.29	$6,555	$23,555
H.R. 5	$17,000	4.625	$177.21	$4,265	$21,265
Savings			$19.08	$2,290	$2,290
Borrower B					
Current law	$13,000	6.875	$150.10	$5,012	$18,012
H.R. 5	$13,000	4.250	$133.17	$2,980	$15,980
Savings			$16.93	$2,032	$2,032

Source: CRS calculations using U.S. Dept. of Education, Office of Federal Student Aid interest calculator.

Notes: The interest rate for a Consolidation Loan is the weighted average of the interest rates on the loans being consolidated, rounded to the nearest higher one-eighth of one percent.

Table 5 shows that compared with current law, under H.R. 5, Borrower A would save $2,290 in total interest over a 10-year repayment period, while Borrower B would save $2,032. However, each would have his or her monthly payments reduced by less than $20. Under H.R. 5, Borrower A would pay 34.9% less in total interest over the duration of the loan, and would pay 9.7% less per month and in total payments. Borrower B would pay 40.5% less in total interest, and 11.3% less overall.