

August 2004

STUDENT CONSOLIDATION LOANS

Further Analysis Could Lead to Enhanced Default Assumptions for Budgetary Cost Estimates





Highlights of [GAO-04-843](#), a report to House Committee on the Budget.

STUDENT CONSOLIDATION LOANS

Further Analysis Could Lead to Enhanced Default Assumptions for Budgetary Cost Estimates

Why GAO Did This Study

The number of borrowers consolidating their federal student loans has increased substantially in recent years, with the total amount of loans being consolidated rising from \$13 billion in fiscal year 1999 to over \$41 billion in fiscal year 2003. This increase in consolidation loan volume and recent interest rate trends have increased the overall estimated long-term cost to the federal government of providing consolidation loans under the Department of Education's (Education) two major student loan programs—the Federal Family Education Loan Program (FFELP) and the William D. Ford Federal Direct Loan Program (FDLP).

GAO is providing information on (1) the differences that exist between FFELP and FDLP consolidation loans and borrowers, (2) the extent to which borrowers with student loans under one program obtain consolidation loans under the other, and (3) how FFELP and FDLP borrower and loan characteristics and the movement of loans between the two programs are incorporated into Education's budgetary cost estimates for consolidation loans.

What GAO Recommends

GAO recommends that Education consider the type of schools consolidation borrowers attended in developing the risk categories for the department's budgetary cost estimates. Education generally agreed with our recommendation.

www.gao.gov/cgi-bin/getrpt?GAO-04-843.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Cornelia Ashby (202) 512-8403 ashbyc@gao.gov.

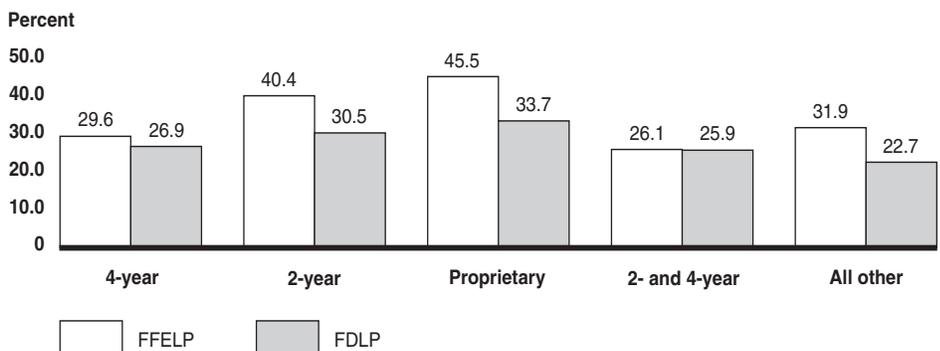
What GAO Found

On average, during the 1995-to-2003 period, FFELP consolidation loan borrowers had higher levels of consolidation loan debt than FDLP consolidation loan borrowers. FFELP borrowers were also more likely than FDLP consolidation borrowers to have attended a 4-year school versus a 2-year or proprietary school. As a group, FFELP borrowers were less likely to default on a student loan prior to consolidation than FDLP borrowers. However, both FFELP and FDLP borrowers who had defaulted prior to consolidation were more likely to default on their consolidation loan than those who did not default prior to consolidation.

Over the 1998-to-2002 period, an increasing share of both FFELP and FDLP underlying loan volume was consolidated into FFELP, while a decreasing share of underlying loan volume was consolidated into FDLP. Defaulted loans, however, whether from FFELP or FDLP, were much more likely to be consolidated into FDLP.

In general, Education incorporates borrower and loan characteristics and movement of loans between programs into its budgetary cost estimates by (1) grouping loans with similar characteristics in risk categories, (2) forecasting loan volume for each risk category, and (3) applying various assumptions to each risk category based on historical and other economic data. Education incorporates the default history of borrowers into its cost estimates by grouping consolidation loans with underlying defaulted loans in a risk category and applying higher default rate assumptions to loans in this category. However, Education has not analyzed whether borrowers with an underlying defaulted loan will default on their consolidation loans at different rates based on the type of school attended. Education does incorporate assumptions based on variations in default rates by school type, but only for nonconsolidation loans. As shown below, our analysis demonstrates that the extent to which borrowers with an underlying defaulted loan default on their consolidation loan varies according to the type of school they attended.

Default Rate of Consolidation Loan Borrowers Who Defaulted on a Loan Underlying Their Consolidation Loan, by Program and School Type, Fiscal Years 1995 to 2001



Source: GAO analysis of Education's National Student Loan Data System data.

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Abbreviations

FDLP	William D. Ford Direct Loan Program
FFELP	Federal Family Education Loan Program
NSLDS	National Student Loan Data System

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G A O

Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

August 20, 2004

The Honorable Jim Nussle
Chairman, Committee on the Budget
House of Representatives

Dear Mr. Chairman:

Consolidation loans—available under both of the Department of Education’s (Education) two major student loan programs, the Federal Family Education Loan Program (FFELP) and the William D. Ford Direct Loan Program (FDLP)¹—allow borrowers who have multiple student loans, possibly from different lenders and from different loan programs, to combine their loans into a single new loan and extend their repayment period. Consolidation loans can reduce borrowers’ monthly repayments, which may lower default risk and thereby reduce federal costs of loan defaults. Current provisions of the program also allow borrowers to lock in a fixed interest rate on their consolidation loans, unlike other FFELP and FDLP student loans, which carry an interest rate that varies from year to year. As we reported in October 2003 and in March 2004,² the number of borrowers consolidating their federal student loans has increased substantially, with the total amount—or volume—of loans being consolidated rising from \$13 billion in fiscal year 1999 to over \$41 billion in fiscal year 2003. This increase in consolidation loan volume and the lower interest rates available to borrowers in recent years have increased the

¹Under FFELP, private lenders make consolidation loans to borrowers, with Education guaranteeing lenders loan repayment and a minimum rate of return. Under FDLP, Education uses federal funds to make direct student loans.

²GAO, *Student Loan Programs: As Federal Costs of Loan Consolidation Rise, Other Options Should Be Examined*, [GAO-04-101](#) (Washington, D.C.: October 31, 2003) and *Student Loan Programs: Lower Interest Rates and Higher Loan Volume Have Increased Federal Consolidation Loan Costs*, [GAO-04-568T](#) (Washington, D.C.: March 29, 2004).

overall estimated long-term cost to the federal government of providing consolidation loans.³

This report addresses your request that we expand upon the information provided in our earlier reports on consolidation loans by determining (1) what differences exist between FFELP and FDLP consolidation loans and borrowers, (2) the extent to which borrowers with student loans under one program obtain consolidation loans under the other, and (3) how FFELP and FDLP borrower and loan characteristics and the movement of loans between the two programs are incorporated into Education's budgetary cost estimates. Our work is based on an analysis of a representative sample of borrowers from Education's National Student Loan Data System (NSLDS), a national database of student loan recipients. Our analysis primarily focused on FFELP and FDLP borrowers in the sample who originated consolidation loans from 1995, the first full year in which loans were available under FDLP, through June 2003. On May 20, 2004, we briefed your staff on the results of our work. This report transmits the slides we used to brief your staff and conveys additional school type information requested by your staff at the briefing. Our key findings provided at the briefing are summarized below, followed by the additional information we are reporting in response to your staff's request. At the end of this letter, we provide additional details on the scope and methodology of our work.

Summary of Key Findings

In determining differences that exist between FFELP and FDLP consolidation loans and borrowers, we found that on average, FFELP consolidation loan borrowers, during the 1995-to-2003 time period, had higher levels of consolidation loan debt than did FDLP consolidation loan borrowers. The average consolidation loan amount among FFELP borrowers was about \$26,400 versus about \$20,000 for FDLP borrowers. FFELP consolidation borrowers were less likely than FDLP consolidation borrowers to have attended a proprietary (for profit) school prior to consolidation and were more likely to have borrowed while attending

³Lower interest rates available to borrowers have increased the cost to the federal government because FFELP consolidation loans carry a government-guaranteed rate of return to lenders that is projected to be higher than the fixed interest rate consolidation borrowers pay. Higher loan volumes in the FFELP program also add to the estimated costs of consolidation loans. FDLP consolidation loans are made by the government and thus carry no interest rate guarantee to lenders, but changing interest rates and loan volumes affect the costs in this program as well.

graduate school. Overall, FDLP borrowers had higher default rates in 4 out of the 7 years between fiscal years 1995 through 2001. Additionally, for borrowers who had defaulted prior to consolidation, borrowers from both FFELP and FDLP were more likely to have defaulted on their consolidation loan than those who did not default prior to consolidation.

From fiscal year 1998 to fiscal year 2002, the share of underlying FFELP and FDLP loan volume consolidated into FFELP increased, while the share of underlying loan volume consolidated into FDLP decreased.⁴ In fiscal year 2002 alone, 84 percent of FFELP loan volume that was consolidated was done so under FFELP, while 16 percent was consolidated under FDLP. With regard to FDLP loan volume consolidated, 58 percent was consolidated under FFELP, while 42 percent was consolidated under FDLP. Defaulted loans, however, whether from FFELP or FDLP, were much more likely to be consolidated into FDLP. For example, in fiscal year 2002, 87 percent of defaulted underlying FFELP loan volume and 92 percent of defaulted underlying FDLP loan volume were consolidated under FDLP. According to Education officials, it is not surprising that a larger share of defaulted underlying FFELP and FDLP loan volume is consolidated into FDLP because requirements for consolidating defaulted loans under this program are often less stringent than those imposed by FFELP lenders. For example, FFELP lenders may chose not to offer repayment plans based on income levels, while FDLP is required to offer such a plan to eligible borrowers. In addition, an FFELP lender may require that the borrower be employed, while FDLP does not have such a requirement.

Education incorporates FFELP and FDLP borrower and loan characteristics, and the movement of loans between the two programs, into its budgetary cost estimates by (1) grouping loans that share similar characteristics in risk categories, (2) forecasting loan volume for these categories, taking into account the movement of loans between the two programs, and (3) applying various assumptions to the categories, such as rates of interest, estimates of loan prepayment, and rates of default. Among the risk categories Education uses to estimate costs, for example, is one that includes consolidation loans with underlying defaulted loans. Education forecasts the expected loan volume for this risk category and

⁴The combination of declining interest rates and increased consolidation loan marketing efforts by lenders has likely contributed to the increase in the share of underlying loans consolidated into FFELP.

then applies various assumptions to derive an estimated budget cost for the loans. For example, Education assumes that a certain proportion of loans placed in this risk category will eventually go into default, thus increasing the federal government's cost of the loans. Education sometimes makes different assumptions for different groups. For example, Education assumes that consolidation borrowers who have defaulted on an underlying loan will default on their consolidation loans at a higher rate than will consolidation loan borrowers who have not previously defaulted. In estimating the costs of nonconsolidation loans—those that borrowers may ultimately consolidate—Education groups loans based on the type of schools borrowers attended (2-year, 4-year, proprietary, and so forth) because experience has shown that these borrowers default on their loans at different rates. However, Education does not group consolidation loan borrowers in this way because consolidation loans could reflect multiple underlying loans with different risk categories, and it believes that other differences, such as default rates of underlying loans, are more likely to significantly affect the estimated costs of consolidation loans. For consolidation loans, however, Education has not analyzed whether borrowers who consolidate a defaulted loan default again, or redefault, at different rates based on the type of school they attended. Because of data limitations, Education was, until recently, unable to link consolidation loans to borrowers' underlying loans. Education can now do this, making it possible to determine whether redefault rates vary by type of school. As a result of the additional analysis we conducted after the briefing, we are making a recommendation to the Secretary of Education that he direct Education's Director, Budget Service, to consider the type of schools consolidation borrowers attended in developing the risk categories for the department's budgetary cost estimates.

Further Analysis Could Lead to Enhanced Default Assumptions for Consolidation Loan Cost Estimates

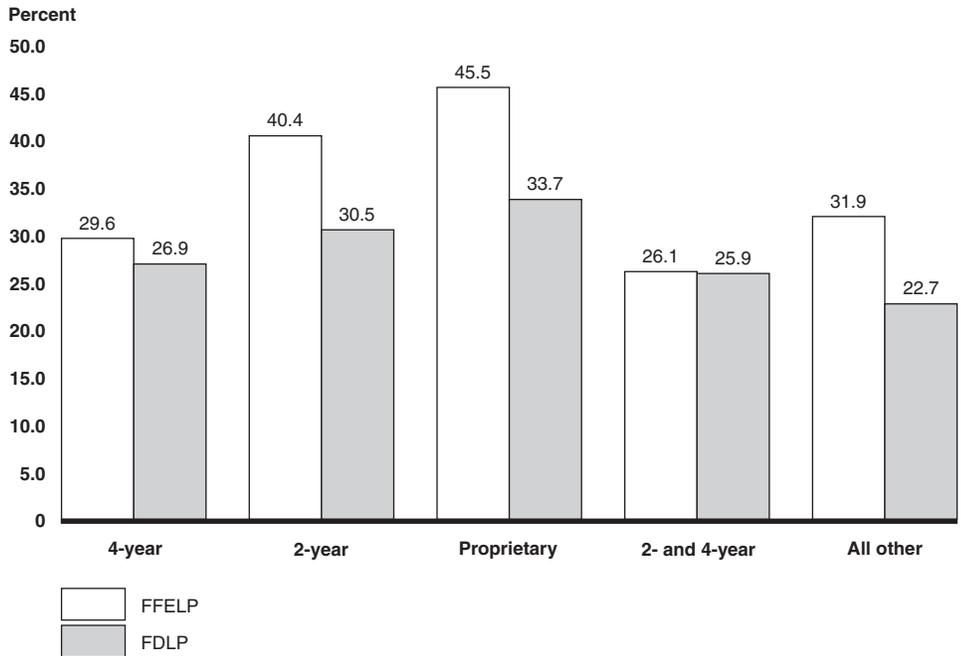
Education's recently acquired ability to link consolidation loans to borrowers' underlying loans allows it to conduct additional analyses, which could be used to refine its budgetary cost estimates. In particular, Education could expand its risk categories that currently segregate consolidation loans by whether they have an underlying default to also segregate by the type of schools borrowers attended. Our analysis demonstrates that the extent to which borrowers redefault on consolidation loans varies according to the type of school they attended. By analyzing the extent to which borrowers will default on their consolidation loans based on the type of school attended, Education could determine the resulting impact on budgetary cost estimates. This could be important since the proportion of consolidation loan borrowers by type of

schools attended has varied over time. As these proportions vary, the total rate of default on consolidation loans will likely vary as well, given that the type of school borrowers attended affects default rates. In its report on internal control, Education's auditor recently recommended that the department better monitor consolidation loan activity and conduct studies of the assumptions used in estimating the budgetary costs of consolidation loans.

**Extent to Which
Consolidation Loan
Borrowers Redefault
Varies by Type of School
Attended**

According to our analysis, the extent to which borrowers consolidated loans that included at least one loan on which they had defaulted, and then subsequently defaulted on their consolidation loan, varies by the type of school borrowers attended. For both FFELP and FDLP consolidation loans originated from fiscal years 1995 to 2001, the overall default rate for consolidation loan borrowers with an underlying default was higher for borrowers who had attended a 2-year or proprietary school than for those who had attended a 4-year school. As figure 1 shows, for FFELP, the rate of default was 45.5 percent for borrowers who had attended proprietary schools, compared with 29.6 percent for borrowers who had attended a 4-year school. We observed similar relative default rates with respect to FDLP consolidation loans. The lower rate of redefault among consolidation loan borrowers who attended a 4-year school is consistent with the lower risk of nonconsolidation loan borrowers who attended a 4-year school, compared with borrowers who attended other types of schools.

Figure 1: Default Rate of Consolidation Borrowers Who Defaulted on a Loan Underlying Their Consolidation Loan, by Program and School Type, Fiscal Years 1995 to 2001



Source: GAO analysis of NSLDS data.

Notes:

(1) Analysis based on borrowers in the NSLDS sample who originated a consolidation loan from fiscal years 1995 through 2001, plus any underlying loans these borrowers originated from January 1, 1980, through September 2001.

(2) Four-year, 2-year, and proprietary represent borrowers whose underlying loans were obtained exclusively while attending these types of schools. Two-and 4-year category represents borrowers whose underlying loans were obtained while attending both 2-and 4-year schools. All other represents borrowers whose underlying loans were obtained while attending some combination of 4-year, 2-year, proprietary, and foreign schools other than the categories listed above.

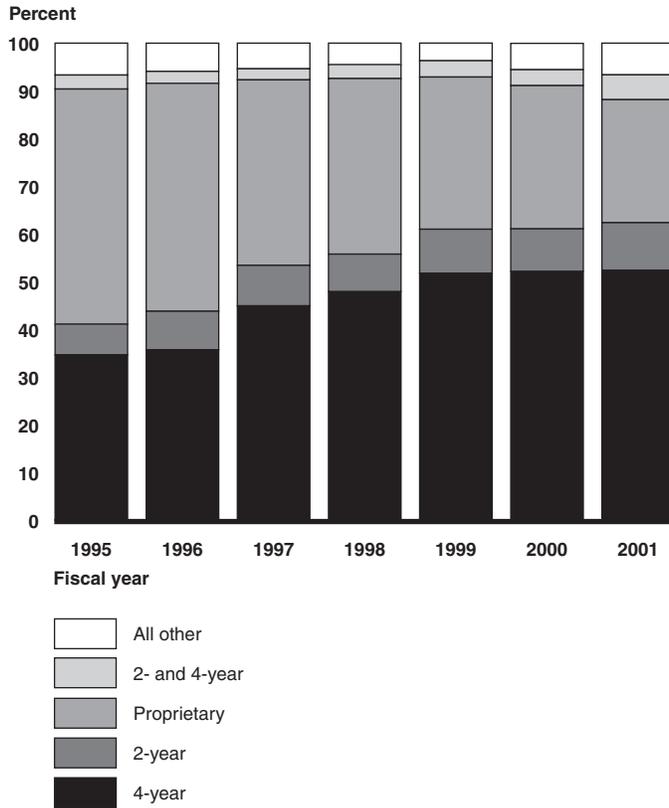
While figure 1 presents borrower rates of redefault, by school type, we also analyzed borrowers' default rates by year of consolidation, by school type. On this basis, we also observed differences by school type. Moreover, we observed different borrower default rates by school type for consolidation loans without an underlying loan default, and we observed different dollar volume default rates by school type for both consolidation loans with and without an underlying loan default. Because Education assumes a similar rate of default among consolidation loan borrowers without regard to the type of school borrowers attended, Education's cost estimates may be excluding important risk factors associated with specific

school types. However, the impact of this exclusion will not be known until Education performs an analysis of the sensitivity of the cost estimates to different school types.

Share of Consolidation Loan Borrowers by Type of Schools Attended Varied over Time

Overall, the number of borrowers consolidating their student loans has increased significantly in recent years, while the proportion of borrowers by type of school attended has varied over time. As these proportions vary, the overall rate of default on consolidation loans will likely vary as well, given that the type of school borrowers attended affects default rates. As shown in figure 2 for FFELP and figure 3 for FDLP, generally there was an increasing share of consolidation loan borrowers with an underlying defaulted loan who had attended a 4-year school. At the same time there was a decreasing share of consolidation loan borrowers with an underlying defaulted loan who had attended a proprietary school. For example, for FFELP, the percentage of consolidation loan borrowers with an underlying default who had attended a 4-year school increased from over 30 percent in fiscal year 1995 to almost 50 percent in fiscal year 2001. In contrast, the percentage of consolidation loan borrowers with an underlying default who had attended a proprietary school dropped from almost 50 percent in fiscal year 1995 to about 26 percent in fiscal year 2001. Similar patterns are also observed with regard to FDLP consolidation loans beginning in fiscal year 1996.

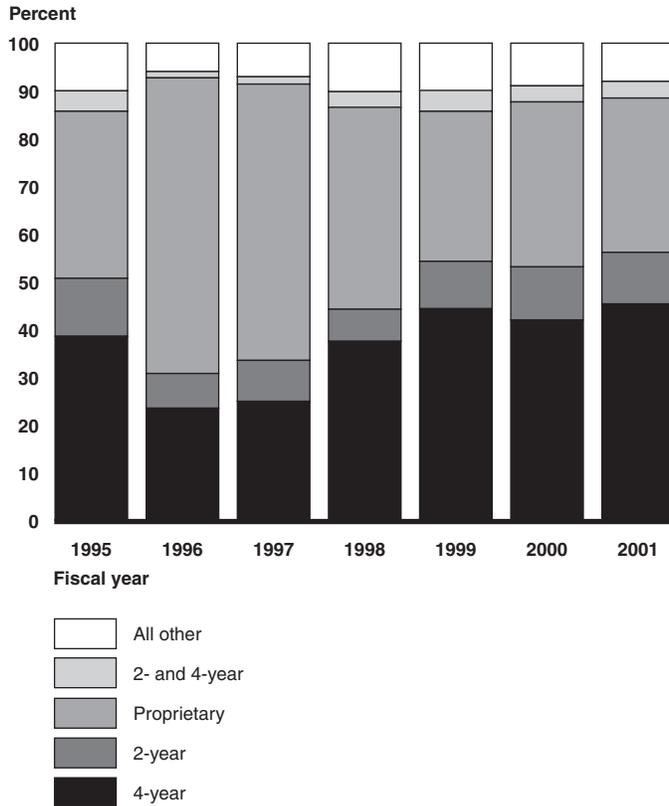
Figure 2: Percentage of FFELP Consolidation Loan Borrowers with an Underlying Default by School Type



Source: GAO analysis of NSLDS data.

Note: Analysis based on borrowers in the NSLDS sample who originated a FFELP consolidation loan from fiscal years 1995 through 2001, plus any underlying loans these borrowers originated from January 1, 1980, through September 2001.

Figure 3: Percentage of FDLP Consolidation Loan Borrowers with an Underlying Default, by School Type



Source: GAO analysis of NSLDS data.

Note: Analysis based on borrowers in the NSLDS sample who originated a FDLP consolidation loan from fiscal years 1995 through 2001, plus any underlying loans these borrowers originated from January 1, 1980, through September 2001.

While figures 2 and 3 present the variations in the percentage of consolidation loan borrowers with an underlying default by school type, we also analyzed volume changes by school type. On this basis, we also observed similar variations in proportions by school type. Because default rate assumptions are based in part on loans consolidated years ago that had a different distribution of underlying loans by school type than current consolidation loans, they may be less reliable than they could be. This could result in less precise cost estimates for consolidation loans.

Education's Fiscal Year 2003 Financial Statements Auditor Reported That Improvements Were Needed in Education's Cost Estimation Process

While Education received an unqualified audit opinion on its fiscal year 2003 financial statements, the auditor's report on internal control⁵ identified certain matters that it considers to be reportable conditions,⁶ including matters related to Education's cost estimates. Among other things, the report noted that Education had made progress in refining various assumptions used in estimating costs related to consolidation loans based on its recently acquired ability to link consolidation loans to the paid-off underlying loans. In light of the significant increase in consolidation loans in recent years, however, the auditor recommended, among other things, that Education continue to identify and gather data to better monitor and report on consolidations, and accelerate studies to validate the basis of assumptions used to determine the effect of loan consolidations, to ensure timely updates of its cost estimates for the best available information. To assist in addressing the auditor's recommendations, as well as address recommendations contained in our January 2001 report,⁷ Education officials have established a "credit reform working group" to formalize and document assumptions used in developing its budgetary cost estimates and to make its estimates more transparent.⁸

Recommendation for Executive Action

To better reflect the impact of consolidation loans on Education's budgetary cost estimates, we recommend that the Secretary of Education direct Education's Director, Budget Service, to consider the type of schools consolidation borrowers attended in developing the risk categories for the department's budgetary cost estimates. Education could

⁵For the report of independent auditors, see *Fiscal Year 2003 Performance and Accountability Report*, U.S. Department of Education, November 14, 2003.

⁶Reportable conditions are matters that come to the auditor's attention that in the auditor's judgment should be communicated because they represent significant deficiencies in the design or operation of internal control, which could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

⁷GAO, *Department of Education: Key Aspects of the Federal Direct Loan Program's Cost Estimates*, GAO-01-197 (Washington, D.C.: January 12, 2001).

⁸As we reported in March 2004, the credit reform working group will also consider more formalized procedures related to performing and documenting sensitivity analysis of its budgetary cost estimates, according to Education officials. For additional information, see GAO, *Department of Education's Federal Direct Loan Program: Status of Recommendations to Improve Cost Estimates and Presentation of Updated Cash Flow Information*, GAO-04-567R, (Washington, D.C.: March 29, 2004).

use the credit reform working group as a vehicle to help the Director, Budget Service, monitor this effort and assess the impact of including the type of schools borrowers attended in the assumptions Education uses to develop its budgetary cost estimates.

Agency Comments

We provided a draft of this report to Education for review and comment. In commenting on the draft, Education, in general, agreed with our findings and recommendation. Education noted that it will conduct an analysis to determine whether expanding risk categories is the best approach and that if it does not expand risk categories it will track and report on consolidating borrowers by school type. Education's written comments appear in appendix I.

Scope and Methodology

To answer the three research questions, we analyzed a randomly drawn, representative sample of borrowers from NSLDS, which is a comprehensive national database of Title IV loan and grant recipients. Our analysis of the characteristics of borrowers and loans focused on FFELP and FDLP borrowers in the sample who originated consolidation loans from 1995, the first full year that FDLP loans were made, through June 2003. Including only those years when both programs were in operation allowed for more meaningful comparisons between programs. For the borrowers in our analysis, we included underlying loans originated from January 1, 1980, through June 2003. To determine the extent to which borrowers with student loans under one program obtain consolidation loans under the other, we linked sample borrowers' consolidation loans to their underlying loans and analyzed these data to determine the extent of loan movement between programs. This linking analysis included borrowers who originated consolidation loans from fiscal years 1995 through 2002, the most recent linking methodology data file available at the time of our review. In order to develop the additional information requested by your staff on consolidation loan default rates by year and of borrowers by type of school attended, we focused on FFELP and FDLP borrowers in the NSLDS sample who originated consolidation loans from fiscal years 1995 through 2001. For these borrowers we reviewed default information through June 2003 in order to determine if these borrowers had subsequently defaulted on their consolidation loans. This approach allowed sufficient time for more recent loans that subsequently defaulted to appear as defaulted loans in NSLDS. We interviewed officials at Education to determine how Education incorporates FDLP and FFELP consolidation loan and borrower characteristics and the movement of loans from one program to the other in its cost estimates. We assessed the

reliability of the NSLDS data by reviewing financial statement audit reports and Education's annual reports on NSLDS data reliability. We also interviewed external auditors and Education officials on the reliability of NSLDS data. In addition, we performed electronic testing of key variables in our sample for obvious problems in accuracy and completeness. We determined that NSLDS data were sufficiently reliable for this review. We conducted our work from December 2003 through July 2004 in accordance with generally accepted government auditing standards.

We are sending copies of this report to the Secretary of Education, the Director of Education's Budget Service, and other interested parties.

This report is also available at no charge on GAO's Web site at <http://www.gao.gov>. If you have any questions about this report, please contact me at (202) 512-8403 or Jeff Appel, Assistant Director, at (202) 512-9915. You may also reach us by e-mail at ashbyc@gao.gov or appelc@gao.gov. Key contributors to this assignment were Susan Chin, Julianne Hartman Cutts, Cindy Decker, and John Mingus.

Sincerely yours,



Cornelia M. Ashby
Director, Education, Workforce,
and Income Security Issues



Student Loan Consolidation Program

Briefing for staff of Representative Jim Nussle, Chairman, House
Committee on the Budget

May 20, 2004



Introduction – History of Student Consolidation Loans

The consolidation loan program, as it is currently structured, began operating in 1987. The program aims to reduce default costs on federal student loans and help students repay loans by:

- simplifying loan repayment by combining multiple loans into a single loan,
- allowing a single monthly payment, and
- allowing repayment over a longer time period.



Introduction – Federal Student Loan Programs

Consolidation loans are available under both major federal student loan programs.

The Federal Family Education Loan Program (FFELP)

Established in 1965, it guarantees loans provided by banks and other private lenders to students and their parents. If borrowers default, the federal government repays the loan.

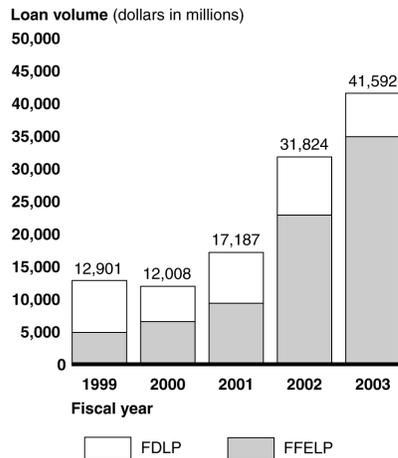
The William D. Ford Direct Loan Program (FDLP)

Established in 1993, it provides direct loans from the federal government, through schools or through Education's contractors, to students and parents.



Introduction – Consolidation Loan Volume

In recent years the volume of consolidation loans originated each year has increased sharply.



Source: U.S. Department of Education, Budget Service, Cost Estimation and Analysis Division.



Key Questions

- What differences exist between FFELP and FDLP consolidation loans and borrowers?
 - To what extent do borrowers with student loans under one program obtain consolidation loans under the other?
 - How are FFELP and FDLP borrower and loan characteristics and the movement of loans between the two programs incorporated into Education's budgetary cost estimates?
-



Scope and Methodology

We analyzed a randomly drawn, representative sample of borrowers from the National Student Loan Data System (NSLDS), which is a comprehensive national database of Title IV loan and grant recipients. This sample contains records as of September 30, 2003, of approximately 6.4 million loans, held by 1.7 million students or their parents.¹

- Our analysis focused on FFELP and FDLP borrowers in the sample who originated consolidation loans from 1995, the first full year that FDLP loans were made, through June 2003. For these borrowers, we included underlying loans originated from January 1, 1980, through June 2003.²
- For the additional information requested by your staff of consolidation loan default rates by year, we focused on FFELP and FDLP borrowers in the sample who originated consolidation loans from fiscal years 1995 through 2001. For these borrowers, we included default information through June 2003, to allow sufficient time for more recent loans that subsequently defaulted to appear as defaulted loans in NSLDS.

¹ In this briefing, at the 95 percent confidence interval, all percentage estimates reported have sampling errors of +/- 4 percent or less and all dollar estimates have sampling errors of +/- 2 percent or less.

² We did not include loans originated prior to 1980 because of concerns about data reliability.



Scope and Methodology

We analyzed data from the sample using Education’s linking methodology for borrowers who originated consolidation loans from fiscal years 1995 through 2002—the most recent linking methodology file available at the time of our review — to:

- link sample borrowers’ consolidation loans to their underlying loans since NSLDS does not directly identify loans underlying borrowers’ consolidation loans, and
- determine the movement, via loan consolidations, of loan volume from one program to the other.

We interviewed officials at Education to determine how the department incorporates FDLP and FFELP consolidation loan and borrower characteristics and the movement of loans from one program to the other in its cost estimates.



Scope and Methodology

We determined that NSLDS data were sufficiently reliable for this review by:

- reviewing financial statement audit reports and Education's annual reports on NSLDS data reliability,
 - interviewing external auditors who assessed NSLDS and reviewing their audit documents,
 - discussing the reliability of NSLDS with Education officials, and
 - performing electronic testing of key variables in our sample for obvious problems in accuracy and completeness.
-



Scope and Methodology

To determine whether Education has controls in place to ensure key assumptions are reasonable and considered in the cost estimates, we:

- interviewed external auditors who had reviewed and tested these controls,
- reviewed external auditors' work, including audit programs and summary results, and
- discussed these controls with an Education official.

The external auditors identified no material weaknesses related to internal controls.¹

- However, they did note the lack of a formal process to document the development and approval of key assumptions, and the need to better monitor consolidation loan activity and conduct studies of the assumptions used to estimate budgetary costs of consolidation loans.
- Education officials agreed with these findings and are working to develop such a process and to better monitor and refine these assumptions.

¹A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.



Summary of Results – Borrower and Loan Characteristics

- Compared with FDLP consolidation loan borrowers, FFELP consolidation loan borrowers are more likely to have:
 - higher average consolidation loan debt,
 - attended 4-year versus 2-year or proprietary (for profit) schools prior to consolidation, and
 - borrowed while in graduate school.
- For consolidation loans made in fiscal years 1995 to 2001, FDLP borrowers had higher default rates than FFELP borrowers for 4 of the 7 fiscal years.
- Both FFELP and FDLP borrowers who have defaulted prior to consolidation are more likely to default on their consolidation loan than those who did not default prior to consolidation.
- A higher percentage of consolidation loan volume under the FDLP income contingent repayment plan is in default compared with loan volume in other FDLP repayment plans.¹

¹Under the income contingent repayment plan, borrowers' repayments are based on annual income, loan balance, and family size. Other repayment plans are described later in this report. NSLDS does not contain information about repayment plans for FFELP loans.



Summary of Results – Movement of Loans across Programs

Fiscal Years 1998 – 2002

- The share of FFELP and FDLP loan volume consolidated into FFELP increased while the share of loan volume consolidated into FDLP decreased during the fiscal year 1998-2002 period.
- Defaulted loans, whether from FFELP or FDLP, were much more likely to be consolidated into FDLP.



Summary of Results – Characteristics and Loan Movement in Cost Estimates

FFELP and FDLP consolidation loans:

In general, Education accounts for borrower and loan characteristics, and the movement of loans between the two programs, by:

- grouping loans sharing similar characteristics in risk categories,
- forecasting future loan volume for these categories, and
- applying various assumptions to these categories.



Summary of Results – Characteristics and Loan Movement in Cost Estimates

FFELP and FDLP consolidation loans:

- Characteristics that can significantly affect the estimated cost of consolidation loans, and are incorporated into cost estimates include default history of borrowers, default rate of consolidation loans, and loan movement between programs.
- Some characteristics are not specifically incorporated into cost estimates for consolidation loans but are characteristics considered for nonconsolidation loans (e.g., type of school attended and borrower's level of education).



Background – Borrower Eligibility for FFELP and FDLP Consolidation Loans

- Borrowers must meet certain requirements, including having at least one FFELP or FDLP loan eligible for FFELP or FDLP consolidation.¹
- Borrowers with only FDLP loans may consolidate only with FDLP.
- Borrowers with FFELP loans only, or both FFELP and FDLP loans, may consolidate with
 - any FFELP lender, if the borrower's loans are held by
 - a single FFELP lender that declines to provide a consolidation loan or such a loan with an income sensitive repayment plan, or
 - multiple FFELP lenders.
 - FDLP, if the borrower is unable to obtain a consolidation loan or a consolidation loan with income-sensitive repayment terms acceptable to the borrower and the borrower is eligible for the income contingent repayment plan under FDLP.

¹Loans eligible for both FFELP and FDLP consolidation include FFELP and FDLP Stafford loans (subsidized and unsubsidized), PLUS loans, and consolidation loans. Other Federal student loans, such as Perkins loans, and Health Education Assistance Loans, may be included. Under FFELP, consolidation loans are eligible only when combined with at least one other eligible loan not yet consolidated.



Background – When Borrowers Can Consolidate

- Borrowers may consolidate under either FFELP or FDLP if they have entered into the grace or repayment period of loans to be consolidated.¹
- Borrowers consolidating under FFELP cannot be enrolled in school at the time of consolidation.
- In contrast, borrowers consolidating under FDLP may consolidate while enrolled in school if they have:
 - FDLP loans only,
 - both FDLP and FFELP loans, or,
 - only FFELP loans and are in a school offering FDLP loans.

¹A grace period is a period of time when repayment is not required by the borrower. It begins the day after a student is no longer enrolled in school at least half-time.



Background – Borrowers with Defaulted Loans

- To be eligible for a FFELP or a FDLP consolidation loan, borrowers with defaulted loans must have:
 - made satisfactory repayment arrangements on loans in default, or
 - agreed to repay defaulted loans under the income-sensitive plan for FFELP consolidation loans or under the income-contingent plan for FDLP consolidation loans.



Background – Interest Rates for Consolidation Loans

Consolidation loans offer interest rates to borrowers that currently are:

- fixed over the life of the loan and
- calculated based on the weighted average of the interest rate of loans consolidated, rounded up to the nearest one-eighth of 1 percent, not to exceed 8.25 percent.

By comparison, borrowers' interest rates on most non-consolidation loans vary annually over the life of the loan based on the 91-day Treasury bill rate.¹

¹ FFELP and FDLP nonconsolidation loans, such as subsidized and unsubsidized Stafford loans and PLUS loans, account for the majority of federal student loans and carry variable borrower interest rates. Other types of non-consolidation federal student loans made outside FFELP and FDLP, such as Perkins Loans and Health Professions Student Loans and Nursing Student Loans, may carry a variable or fixed borrower interest rate.



Background – Consolidation Loan Repayment Options¹

- **Standard:** Equal monthly payments up to 30 years based on loan balance for FFELP loans and up to 10 years for FDLP loans.
- **Graduated:** Monthly payments increase over course of repayment, up to 30 years based on loan balance, for both FFELP and FDLP.
- **Extended:** Fixed or graduated monthly payments up to 25 years for FFELP and fixed payments up to 30 years for FDLP based on loan balance.
- **Income-sensitive (FFELP)/ income-contingent (FDLP):** Monthly payments up to 10 years for FFELP, with payments based on annual income, and 25 years for FDLP, with payments based on annual income, loan balance, and family size.

¹ Names of payment options may vary by program. Similar options are available for other student loans. However, they sometimes differ by the amount of time allowed to repay loans. Under FDLP, alternative repayment plans may also be provided by the Secretary on a case-by-case basis to accommodate a borrower's unique circumstances.



Background – Consolidation Loan Repayment Periods by Loan Amount

Amount	Maximum term (years)
Less than \$7,500 (FFELP)	10
Less than \$10,000 (FDLP)	12
\$7,500 to \$9,999 (FFELP)	12
\$10,000 to \$19,999	15
\$20,000 to \$39,999	20
\$40,000 to \$59,999	25
\$60,000 or more	30

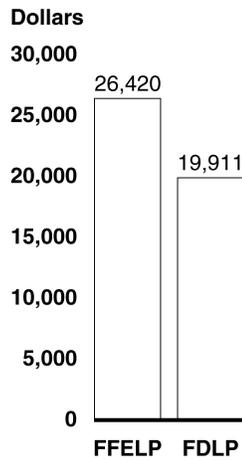
Source: Higher Education Act, Congressional Research Service, and Education.



Objective One

Borrower and Loan Characteristics: Average Consolidation Loan Amount

Average consolidation loan amount borrowed was higher among FFELP borrowers than among FDLP borrowers.



Source: GAO analysis of NSLDS data.

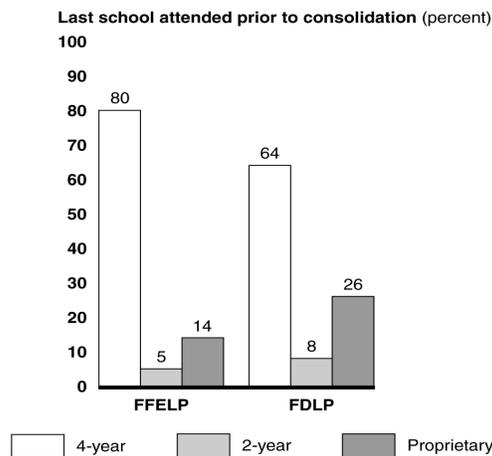
Notes:
Analysis based on borrowers in the NSLDS sample who originated a consolidation loan from January 1995 through June 2003.
Based on borrowers' most recent consolidation loan.



Objective One

Borrower and Loan Characteristics: Type of School Attended

FFELP consolidation borrowers were more likely than FDLP borrowers to have attended a 4-year school and less likely to have attended a 2-year or proprietary (for profit) school.



Source: GAO analysis of NSLDS data.

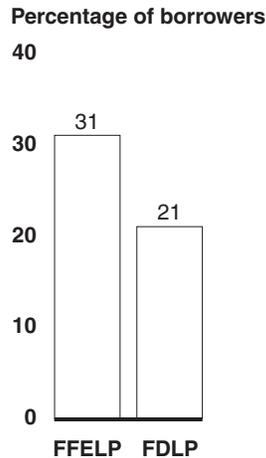
Note: Analysis based on borrowers in the NSLDS sample who originated a consolidation loan from January 1995 through June 2003, plus any underlying loans these borrowers originated from January 1, 1980, through June 2003.



Objective One

Borrower and Loan Characteristics: Borrowed while in Graduate School

Thirty-one percent of FFELP consolidation loan borrowers borrowed while in graduate school, compared with 21 percent of FDLP consolidation borrowers.



Source: GAO analysis of NSLDS data.

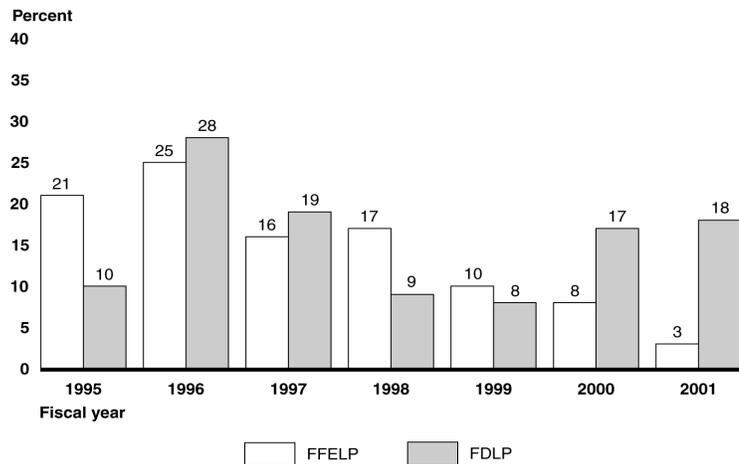
Note: Analysis based on borrowers in the NSLDS sample who originated a consolidation loan from January 1995 through June 2003, plus any underlying loans these borrowers originated from January 1, 1980, through June 2003.

Objective One



Borrower and Loan Characteristics: Consolidation Loan Defaults

Borrower default rates for consolidation loans made from fiscal years 1995 to 2001



Source: GAO analysis of NSLDS data.

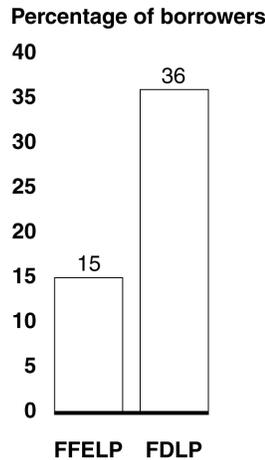
Note: Analysis based on borrowers in the NSLDS sample who originated a consolidation loan from fiscal years 1995 through 2001, including default information through June 2003.



Objective One

Borrower and Loan Characteristics: Prior Loan Defaults

Fifteen percent of FFELP consolidation loan borrowers defaulted on a student loan prior to consolidation, compared with 36 percent of FDLP consolidation borrowers.



Source: GAO analysis of NSLDS data.

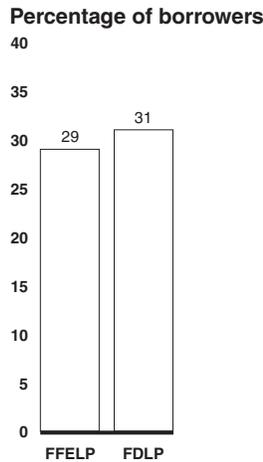
Note: Analysis based on borrowers in the sample who originated a consolidation loan from January 1995 through September 2002, plus any underlying loans these borrowers originated from January 1, 1980, through September 2002.



Objective One

Borrower and Loan Characteristics: Prior Loan and Consolidation Loan Defaults

Of those borrowers who defaulted on a loan prior to consolidation, about equal percentages of FFELP and FDLP consolidation loan borrowers also defaulted on their consolidation loans.



Source: GAO analysis of NSLDS data.

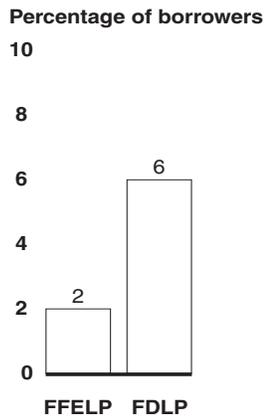
Note: Analysis based on borrowers in the NSLDS sample who originated a consolidation loan from January 1995 through September 2002, plus any underlying loans these borrowers originated from January 1, 1980, through September 2002.



Objective One

Borrower and Loan Characteristics: Prior Loan and Consolidation Loan Defaults

Of those borrowers who had not defaulted on a loan prior to consolidation, 2 percent of FFELP consolidation loan borrowers defaulted on their consolidation loans, compared with 6 percent of FDLP consolidation borrowers.



Source: GAO analysis of NSLDS data.

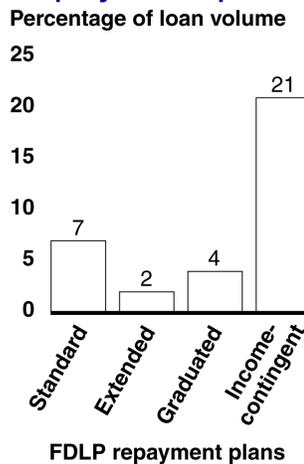
Note: Analysis based on borrowers in the NSLDS sample who originated a consolidation loan from January 1995 through September 2002, plus any underlying loans these borrowers originated from January 1, 1980, through September 2002.

Objective One



Borrower and Loan Characteristics: Defaults by Repayment Plan

A higher percentage of consolidation loan volume under the income-contingent repayment plan for FDLP has defaulted compared with loan volume in other FDLP repayment plans.



Source: GAO analysis of NSLDS data.

Notes:
Analysis based on borrowers in the NSLDS sample who originated a consolidation loan from January 1995 through September 2002.
NSLDS does not contain information about repayment plans for FFELP loans.



Objective Two

FFELP Loan Movement across Programs

Cumulative FFELP loan volume consolidated from 1998 through 2002:

- 25 percent was consolidated into FDLP
- 35 percent of FFELP loan volume that was consolidated into FDLP was in default compared with 5 percent of the volume consolidated into FFELP

Underlying program	Consolidation program	Underlying loan volume	Percentage of underlying loan volume	Underlying loan volume in default	Percentage of underlying loan volume in default
FFELP	FFELP	\$44,450,586,275	75	\$2,049,094,100	4.6
	FDLP	15,207,911,700	25	5,333,504,400	35.1
Total		\$59,658,497,975	100	\$7,382,598,500	12.4

Source: GAO analysis of NSLDS data.

Note: Data are weighted projections based on a randomly drawn, representative sample of borrowers in the NSLDS. The analysis is based on borrowers in the sample who originated a consolidation loan from October 1997 through September 2002, plus any underlying loans these borrowers originated from January 1, 1980, through September 2002. 28



Objective Two

FDLP Loan Movement across Programs

Cumulative FDLP underlying loan volume consolidated from 1998 through 2002:

- 40 percent was consolidated into FFELP
- less than 0.5 percent of FDLP underlying loan volume consolidated into FFELP was in default compared with 2.5 percent of the volume consolidated into FDLP

Underlying program	Consolidation program	Underlying loan volume	Percentage of underlying loan volume	Underlying loan volume in default	Percentage of underlying loan volume in default
FDLP	FFELP	\$ 7,462,558,625	40	\$ 27,624,475	0.4
	FDLP	11,178,297,300	60	274,051,375	2.5
	Total	\$18,640,855,925	100	\$301,675,850	1.6

Source: GAO analysis of NSLDS data.

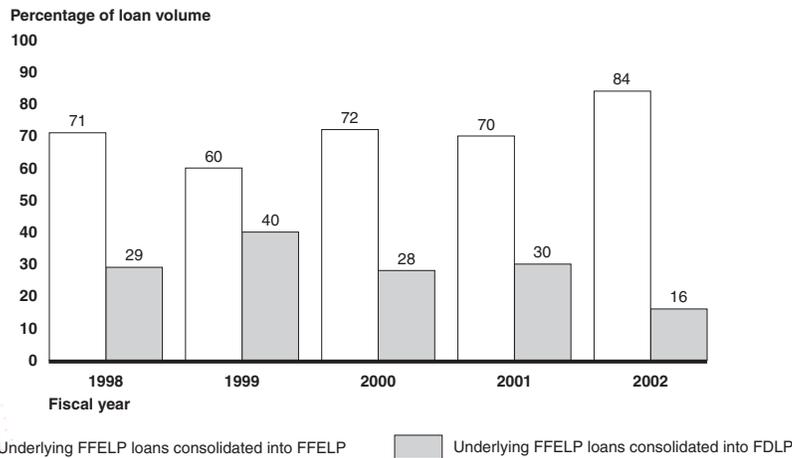
Note: Data are weighted projections based on a randomly drawn, representative sample of borrowers in the NSLDS. The analysis is based on borrowers in the sample who originated a consolidation loan from October 1997 through September 2002, plus any underlying loans these borrowers originated from January 1, 1980, through September 2002. 29



Objective Two

FFELP Loan Movement across Programs by Fiscal Year

Share of underlying FFELP loan volume consolidated into FFELP and FDLP, fiscal years 1998-2002



Source: GAO analysis of NSLDS data.

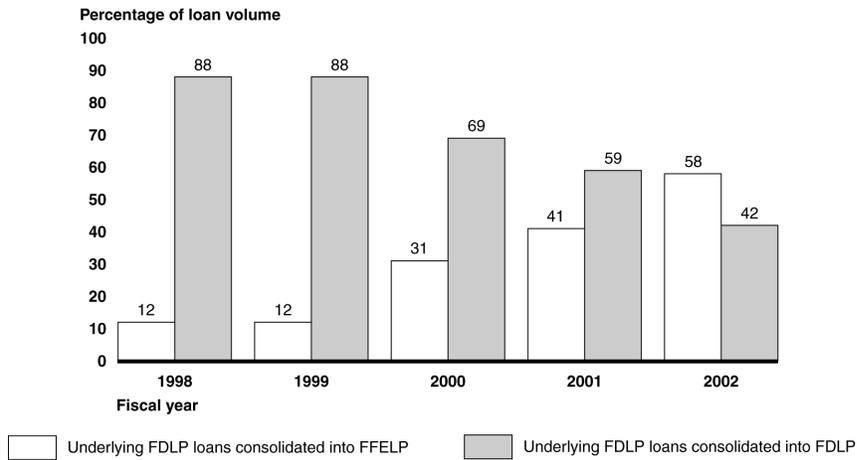
Note: Analysis based on borrowers in the NSLDS sample who originated a consolidation loan from October 1997 through September 2002, plus any underlying loans these borrowers originated from January 1, 1980, through September 2002.



Objective Two

FDLP Loan Movement across Programs by Fiscal Year

Share of underlying FDLP loan volume consolidated into FFELP and FDLP, fiscal years 1998-2002



Source: GAO analysis of NSLDS data.

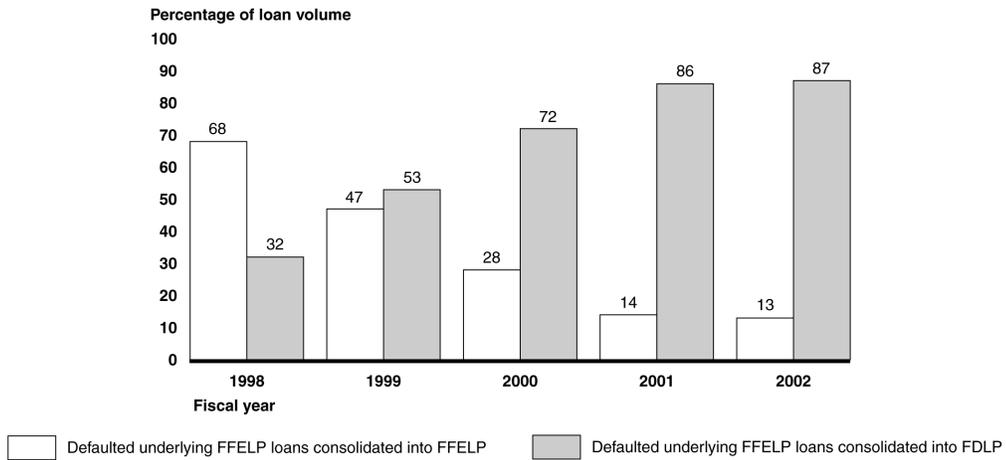
Note: Analysis based on borrowers in the NSLDS sample who originated a consolidation loan from October 1997 through September 2002, plus any underlying loans these borrowers originated from January 1, 1980, through September 2002.



Objective Two

FFELP Loan Movement of Defaulted Loans across Programs by Fiscal Year

Share of defaulted underlying FFELP loan volume consolidated into FFELP and FDLP, fiscal years 1998-2002



Source: GAO analysis of NSLDS data.

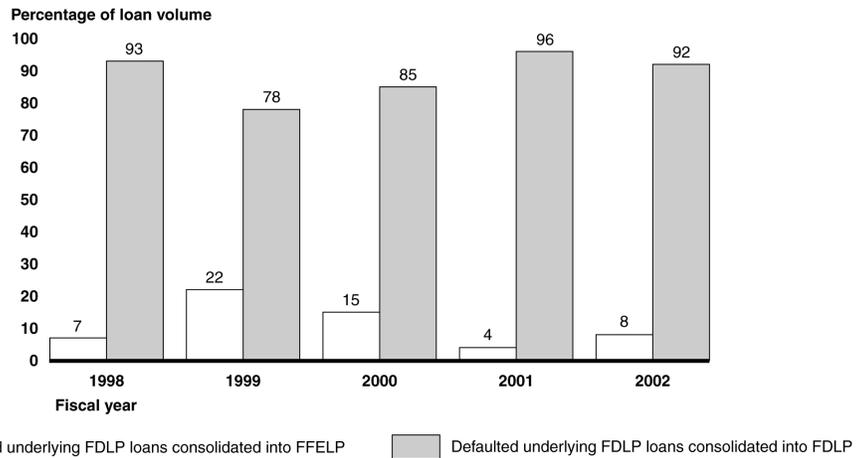
Note: Analysis based on borrowers in the NSLDS sample who originated a consolidation loan from October 1997 through September 2002, plus any underlying loans these borrowers originated from January 1, 1980, through September 2002.



Objective Two

FDLP Loan Movement of Defaulted Loans across Programs by Fiscal Year

Share of defaulted underlying FDLP loan volume consolidated into FFELP and FDLP, fiscal years 1998-2002



Source: GAO analysis of NSLDS data.

Note: Analysis based on borrowers in the NSLDS sample who originated a consolidation loan from October 1997 through September 2002, plus any underlying loans these borrowers originated from January 1, 1980, through September 2002.



Objective Three

How Education Incorporates Characteristics and Loan Movement into Cost Estimates

In general, Education incorporates characteristics and loan movement into cost estimates by:

- identifying groups of loans, or risk categories, with similar characteristics that are expected to have about the same default rates and other costs (e.g., consolidation loans with underlying defaulted loans).
- forecasting loan volume for each risk category within each loan program and loan type (e.g., subsidized, unsubsidized, PLUS, and consolidated).
- applying various assumptions based on historical data from each loan program (e.g., interest, prepayment and default rates), and other economic data, such as unemployment rates, to each risk category.



Objective Three

How Education Incorporates Characteristics and Loan Movement into Cost Estimates

Characteristics that can significantly affect the estimated cost of FFELP and FDLP consolidation loans, and are incorporated in cost estimates for consolidation loans, include:

- default history of borrowers,
- default rates of consolidation loans, and
- loan movement across programs.



Objective Three

How Education Incorporates Default History of Borrowers into Cost Estimates

- Education accounts for the default history of borrowers by defining risk categories for consolidation loans based on whether FFELP and FDLP consolidation loans have underlying defaulted loans and then applying various default rate assumptions to each risk category.
- Assumptions applied to risk categories are based on historical data showing that borrowers who previously defaulted are more likely to default again, resulting in higher estimated costs for consolidation loans with underlying defaulted loans than for consolidation loans without underlying defaulted loans.



Objective Three

How Education Incorporates Default Rate of Consolidation Loans into Cost Estimates

Education accounts for the higher default rate of FDLP consolidation loans—primarily due to high levels of defaulted consolidation loans under the income contingent repayment plan—by:

- defining separate risk categories for each repayment plan, and
- applying higher default rate assumptions to defaulted consolidation loans under the income-contingent plan category.¹
(Loans under this repayment plan account for about 36 percent of FDLP consolidation loan volume and over one-third of all defaulted underlying consolidation loan volume.)

Lower default rate assumptions are applied to consolidation loans under FFELP and other FDLP repayment plans because historically they have had somewhat lower default rates than income-contingent repayment plan consolidation loans.

¹ FFELP repayment plan information is not available in NSLDS so Education does not analyze FFELP loans by repayment plan.



Objective Three

How Education Incorporates Loan Movement Across Programs into Cost Estimates

Education accounts for an increasingly higher percentage of FFELP and FDLP loans consolidated into FFELP by applying various loan volume forecasts and prepayment assumptions (estimates of the volume of loans paid off before maturity) to each program.

Education accounts for the higher percentage of defaulted FFELP loan volume consolidated into FDLP by:

- assuming a higher default rate for the risk category that contains the defaulted underlying loans, and
- assuming a higher default rate for defaulted consolidation loans under FDLP's income contingent repayment plan, which takes into account that a majority of defaulted loans under this repayment plan were defaulted FFELP loans prior to consolidation into FDLP.



Objective Three

How Education Incorporates Characteristics and Loan Movement into Cost Estimates

- Characteristics related to type of school attended and borrower's level of education are not accounted for in cost estimates for consolidation loans.
- These characteristics are, however, used to define risk categories for nonconsolidation loans.
- Education does not use these characteristics to define risk categories for consolidation loans because:
 - consolidation loans could reflect multiple underlying loans with different risk categories, and
 - other differences, such as default rates of underlying loans, are more likely to significantly affect the estimated costs of consolidation loans, according to Education officials.

Appendix I: Comments from the Department of Education



UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF POSTSECONDARY EDUCATION

AUG -4 2004

THE ASSISTANT SECRETARY

Ms. Cornelia M. Ashby
Director, Education, Workforce,
and Income Security Issues
United States Government Accountability Office
Washington, DC 20548

Dear Ms. Ashby:

Thank you for the opportunity to respond to the U.S. Government Accountability Office's (GAO's) report entitled "STUDENT CONSOLIDATION LOANS: Further Analysis Could Lead to Enhanced Default Assumptions for Budgetary Cost Estimates" (GAO-04-843), which highlights the recent growth in the volume of Federal Family Education Loan and Federal Direct Student Loan consolidation loans. While we generally agree with your findings, we believe there may be a better way to obtain the data you discuss in your recommendation.

Your findings indicate a need to track the type of school associated with underlying loans consolidated. To accomplish this, you recommend that the Department expand risk categories used in cost estimation models. There may be more efficient ways to monitor this information. The Department will conduct an analysis to determine whether expanding risk categories is the best approach.

The Department's current assumptions reflect default and re-default experience of borrowers from various school types at an aggregate level. If the Department does not expand risk categories, it will track and report on consolidating borrowers by school type.

I appreciate your examination of this important issue. The Department is committed to the continued development of our cost estimation model for the Federal student loan programs.

Sincerely,

A handwritten signature in cursive script that reads "Sally L. Stroup".

Sally L. Stroup

1990 K STREET, N.W. WASHINGTON, D.C. 20006

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