

GAO Highlights

Highlights of [GAO-14-234](#), a report to congressional committees.

Why GAO Did This Study

Federal student loans issued under the Direct Loan program play a key role in ensuring access to higher education for millions of students. The costs of the program to the government include administrative costs like loan servicing. They also include subsidy costs, which are the estimated long-term costs to the government of providing loans, such as the government's cost of borrowing and defaults on loans. Some have questioned whether borrower interest rates can be more precisely set to cover these costs without generating excess federal income. The Bipartisan Student Loan Certainty Act of 2013 required GAO to provide information on issues related to the cost of federal student loans.

This report addresses (1) how the costs of administering the Direct Loan program have varied in recent years, (2) how estimated subsidy costs have varied in recent years, and (3) how changes in different variables influence the overall cost of the program and the borrower interest rate needed to cover those costs.

GAO reviewed Direct Loan administrative cost data and analyzed subsidy cost data from Education for fiscal years 2007 through 2012, which are presented in nominal dollars throughout the report. In addition, GAO worked with Education to illustrate how changes in variables such as government borrowing costs could affect Direct Loan subsidy costs. GAO also examined whether borrower rates could be set so the government could cover Direct Loan costs without generating excess revenue (known as a breakeven analysis). GAO reviewed relevant federal laws, guidance, and reports; and interviewed Education and other agency officials.

GAO does not make recommendations in this report. The Department of Education agreed with our findings.

View [GAO-14-234](#). For more information, contact Melissa Emrey-Arras at (617) 788-0534 or emreyarras@gao.gov.

January 2014

FEDERAL STUDENT LOANS

Borrower Interest Rates Cannot Be Set in Advance to Precisely and Consistently Balance Federal Revenues and Costs

What GAO Found

Total Direct Loan administrative costs grew from \$314 million to \$864 million from fiscal years 2007 to 2012, but federal costs per borrower have generally remained steady or fallen. The increase in total administrative costs largely results from an increase of over 300 percent in the number of Direct Loans during that same time period. One key factor contributing to this loan volume increase was a law that ended student loan originations under a federally guaranteed loan program, resulting in new originations being made under the Direct Loan program. Loan servicing—which includes activities like counseling on borrowers on selecting repayment plans, processing payments, and collecting on loans in delinquent status—is the largest category of administrative costs, comprising 63 percent of total Direct Loan administrative costs in fiscal year 2012. While total administrative costs have increased, costs per borrower and other unit costs have remained steady or declined. For example, the servicing cost per borrower remained roughly \$25 over the six-year period we examined. However, a number of factors, including a new payment structure for loan servicing contracts to reward servicers for keeping more borrowers in repayment status, have created some uncertainty about the servicing cost per borrower in coming years.

Separate from administrative costs, estimated subsidy costs vary by loan cohort—a group of loans made in a single fiscal year—and change over time. Based on the Department of Education's (Education) recent estimates, the government would generate subsidy income for the 2007 to 2012 Direct Loan cohorts as a group. However, estimates will change, because current subsidy cost estimates for these cohorts are based predominantly on assumptions about future revenue and costs. Actual subsidy costs will not be known until all cash flows have been recorded, generally after loans have been repaid. This may be as many as 40 years from when the loans were originally disbursed, because many borrowers do not begin repayment until after leaving school, and some face economic hardships that extend their payment periods. Subsidy cost estimates fluctuate over time due to the incorporation of updated data on actual loan performance and the government's cost of borrowing, as well as revised assumptions about future revenue and costs, through the annual reestimate process. As a result, there can be wide variations in the estimated subsidy costs for a given cohort over time. For example, the 2008 loan cohort was estimated to generate \$9.09 of subsidy income per \$100 of loan disbursements in one year, but in the next year that same cohort had an estimated subsidy cost of 24 cents per \$100 of loan disbursements, a swing of \$9.33. Volatility in subsidy cost estimates for a given cohort is generally expected to decrease over time as more actual loan performance data become available.

Because Direct Loan costs fluctuate with changes in certain variables, borrower interest rates cannot be set in advance to balance government revenue with costs consistently over the life of the loans. In a simulation of how loan costs respond to changes in selected variables, the costs were highly sensitive to changes in the government's cost of borrowing. This, coupled with cost estimates regularly updated to reflect loan performance data, means the total costs associated with Direct Loans are in flux until updates are recorded through the end of the loans' life cycle, which takes several decades. Therefore, the

borrower interest rates that would generate revenue to exactly cover total loan costs—known as breaking even—would change over time. To determine whether or not a set of conditions that would break even for one cohort would also break even for another cohort under different circumstances, GAO used data forecasted for future years to experiment with certain aspects of the borrower interest rate for two separate cohort years.

- GAO selected cohort years 2014 and 2019 because economic conditions may be different several years apart.
- For these cohorts, the following three aspects of the borrower interest rate were altered: the index (the base market rate to which student loan interest rates are pegged), the mark-up rate (the percentage-point increase over the base rate that students are charged), and the differences in the mark-up rates among loan types, including undergraduate, graduate student, and parent loans.
- GAO looked at how these changes to the borrower rates would affect total government costs, taking into account both administrative and subsidy costs.
- Changing the index and mark-up rates helped achieve a breakeven point based on current cost estimates for the 2014 cohort; however, cost estimates for this cohort will change as updated data become available over the life of the loans.

- When GAO applied the same index and mark-up rates that temporarily resulted in a breakeven point for the 2014 cohort to the 2019 cohort, it resulted in a net cost to the government.
- The difference in outcome for these two cohorts is because Direct Loan costs are sensitive to variables, such as government borrowing costs, that are projected to look very different for 2019 than they did for 2014.
- As illustrated in the simulation, the borrower interest rates that are needed to cover costs at one point in time may not be effective at another point in time and cannot be precisely determined in advance to enable the government to break even consistently.

Available information on Direct Loan costs illustrates the difficulties of accurately predicting what these program costs will be, and how much borrowers should ultimately be charged to achieve a particular outcome. Specifically, fluctuations in the actual and expected costs of the student loan program over time make it challenging to target a particular borrower interest rate that would consistently break even. Making frequent changes to the borrower interest rate could help program costs more closely match revenues in the short term, but it could confuse potential borrowers and complicate efforts to make the program transparent to students.