

GAO

Report to the Ranking Minority Member,
Committee on Education and the
Workforce, House of Representatives

December 2005

STUDENT CONSOLIDATION LOANS

Potential Effects of Making Fiscal Year 2006 Consolidation Loans Exclusively through the Direct Loan Program





Highlights of [GAO-06-195](#), a report to the Ranking Minority Member, Committee on Education and the Workforce, House of Representatives

Why GAO Did This Study

Under the Federal Family Education Loan Program (FFELP) and the Federal Direct Loan Program (FDLP), the government guarantees and makes consolidation loans to help borrowers manage their student loan debt. By combining loans into one and extending repayment, monthly repayments are reduced. Unlike other student loans, consolidation loans carry a fixed interest rate. Recently, trends in interest rates and consolidation loan volume have increased overall federal costs, leading Congress to consider cost reduction proposals. Under the Federal Credit Reform Act, the government calculates, for budgetary purposes, the net cost, or "subsidy cost," of extending or guaranteeing credit over the life of loans. Agencies generally reestimate, subsidy costs annually to include actual results and adjust future program estimates.

GAO was asked to provide information on the budgetary effects of making consolidation loans exclusively through FDLP. We developed information to answer the following questions: (1) What would be the estimated budgetary effect of providing consolidation loans exclusively through FDLP in fiscal year 2006? (2) To what extent and for what reasons might this estimated budgetary effect change as subsidy costs are reestimated in future years? (3) How might FFELP lenders and borrowers be affected if consolidation loans were made exclusively through FDLP?

www.gao.gov/cgi-bin/getrpt?GAO-06-195.

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

STUDENT CONSOLIDATION LOANS

Potential Effects of Making Fiscal Year 2006 Consolidation Loans Exclusively through the Direct Loan Program

What GAO Found

Providing consolidation loans exclusively through FDLP in fiscal year 2006 could yield estimated budgetary cost savings of about \$3.1 billion, based on subsidy cost estimates in the President's fiscal year 2006 budget, but actual savings would remain unknown until all loans made in fiscal year 2006 are repaid. In addition, federal administrative costs, which are not included in subsidy cost estimates, would likely increase and offset estimated subsidy cost savings by about \$46 million over the life of the loans, based on Department of Education (Education) estimates, because FDLP administrative costs are higher than those of FFELP. Tax revenues, which could affect estimated savings, are also excluded from subsidy cost estimates. The \$3.1 billion estimated savings result from

- avoiding an estimated subsidy cost of \$2.5 billion for providing a projected volume of \$25.5 billion in FFELP consolidation loans, and
- an estimated gain to the federal government of \$620 million if the projected FFELP consolidation loan volume of \$25.5 billion were made through FDLP rather than through FFELP.

The \$2.5 billion estimated subsidy costs for FFELP consolidation loans is based in part on the fact that the government-guaranteed minimum yield provided to FFELP lenders, which varies based on market interest rates, was projected to be higher over the life of the loans than the fixed interest rate borrowers would pay. For FDLP loans, the fixed interest rate borrowers would pay was projected to be higher than the rate Education would pay to finance its lending, a fact that, in combination with other assumptions, resulted in a gain to the government for these loans.

The estimated subsidy cost savings from providing consolidation loans exclusively through FDLP could change significantly because of changes in assumptions underlying subsidy cost estimates. Key assumptions include (1) economic conditions, such as interest rates; (2) loan performance, such as the portion of loans that default; and (3) loan volume.

In estimating consolidation loan subsidy costs, Education must make assumptions about cash flows generated many years in the future. Such assumptions are periodically revised as new data about the assumptions and actual loan volume and costs incurred are known. As a result, subsequent subsidy cost reestimates could change substantially from initial estimates, thereby substantially changing the estimated budgetary effect.

The actual impact on lenders and borrowers of making consolidation loans exclusively through FDLP is difficult to predict, but according to lenders, consolidating all loans through FDLP would reduce lender revenues and borrower benefits, such as on-time repayment incentives. These potential impacts could be somewhat offset, however, by other factors. For example, some lenders told us that they would consider providing nonconsolidation loan borrowers alternative repayment options and other incentives to encourage them not to consolidate their loans. If successful, lenders would continue to earn income from loans not consolidated.

Contents

Letter		1
	Summary of Findings	4
	Providing Consolidation Loans Exclusively through FDLP Could Yield Estimated Budgetary Savings of \$3.1 Billion in Fiscal Year 2006	4
	Savings Estimates Could Change Substantially as a Result of Reestimates of Subsidy Costs because of Changes in Key Assumptions and Actual Results	5
	Effect on FFELP Lenders and Borrowers Difficult to Predict	6
	Concluding Observations	6
	Agency Comments	7
Appendix I	Briefing Slides	8

Abbreviations

FCRA	Federal Credit Reform Act
FDLP	William D. Ford Federal Direct Loan Program
FFELP	Federal Family Education Loan Program
PLUS	Parent Loans for Undergraduate Students

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United States Government Accountability Office
Washington, DC 20548

December 5, 2005

The Honorable George Miller
Ranking Minority Member
Committee on Education and the Workforce
House of Representatives

Dear Mr. Miller:

The federal government makes consolidation loans available to help borrowers manage their student loan debt. By combining multiple federal student loans into one and extending the repayment period, consolidation loans can reduce borrowers' monthly payments. Current provisions also allow consolidation loan borrowers to lock in a fixed interest rate, unlike other federal student loans, such as Stafford loans and Parent Loans for Undergraduate Students (PLUS), which carry interest rates that vary from year to year based on statutory formulas.¹ As we previously reported, the annual volume of consolidation loans has increased significantly in recent years, rising from \$12 billion in fiscal year 2000 to over \$68 billion in fiscal year 2005.² Consolidation loans are 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 Federal Direct Loan Program (FDLP).

While both FFELP and FDLP offer consolidation loans, the federal government's role in FFELP differs significantly from its role in FDLP. Under FFELP, students or their parents borrow from private lenders, such as banks, and the federal government guarantees the lenders a statutorily specified minimum yield that is tied to, and varies with, money market

¹Stafford loans may be either "subsidized" or "unsubsidized." Subsidized loans are awarded based on a student's financial need, and the federal government pays the interest on behalf of students while they are attending school and during a brief grace period when the student first leaves school. Unsubsidized and PLUS loans are available to borrowers regardless of financial need, and borrowers are responsible for interest payments during the life of the loan.

²GAO, *Student Loan Programs: As Federal Costs of Loan Consolidation Rise, Other Options Should Be Examined*, [GAO-04-101](#) (Washington, D.C.: Oct. 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.: Mar. 17, 2004).

financial instruments. When the fixed interest rate paid by consolidation loan borrowers is lower than the minimum yield guaranteed to lenders, the government pays lenders the difference—a subsidy called special allowance payments. Additionally, the federal government guarantees repayment of loans if borrowers default. Under FDLP, students or their parents borrow money directly from, and repay loans to, the federal government. Education uses contractors to carry out the direct loan program.

Although the method for calculating estimated federal budgetary costs of consolidation loans is the same for FFELP and FDLP, the differences between the federal government’s role in one loan program and its role in the other affect these cost estimates. Under the Federal Credit Reform Act (FCRA) of 1990, agencies are required to estimate, for purposes of the budget, the net cost, called the subsidy cost, of extending or guaranteeing credit over the life of a loan. Agencies are required to calculate the subsidy cost to the government based on the net present value of all estimated cash flows, excluding administrative costs, over the life of the loan.³ When the present value of the cash outflows is greater than the present value of the cash inflows, the difference is shown as a subsidy cost in the federal budget. When the present value of the cash inflows is greater than the present value of the cash outflows, the difference is shown as a “negative subsidy,” or gain to the government. Agencies generally update or revise subsidy cost estimates, called reestimates, annually to take into account changes in estimated loan performance (e.g., rates of borrower loan default), actual program costs incurred, and new forecasts of future economic conditions, such as interest rates.

Recent trends in interest rates and consolidation loan volumes have affected consolidations loan costs in the FFELP and FDLP programs in different ways, but overall estimated federal budgetary costs of consolidation loans have increased. This has led Congress to consider changes in the two programs that could reduce federal costs. One alternative, about which you asked us to provide information, is to make consolidation loans available to borrowers only through FDLP. To shed

³Present value is the worth of future streams of returns or costs for a program in terms of money paid immediately. In calculating present value, future amounts are converted into their “money now” equivalents using a discount rate. The discount rate is determined by the Office of Management and Budget and is generally the average annual interest rate for marketable zero-coupon U.S. Treasury securities with the same maturity from the date of disbursement as the cash flow being discounted.

light on this potential alternative, we developed information to address the following questions:

1. What would be the estimated budgetary effect of providing consolidation loans exclusively through FDLP in fiscal year 2006?
2. To what extent and for what reasons might this estimated budgetary effect change as subsidy costs are reestimated in future years?
3. How might FFELP lenders and borrowers be affected if consolidation loans were made exclusively through FDLP?

On October 31, 2005, we briefed your staff on the results of our work based on the briefing slides we include in appendix I. The purpose of this letter is to officially transmit the slides we used to brief your staff.

To determine the estimated budgetary effects of providing consolidation loans exclusively through FDLP in fiscal year 2006, we reviewed cost estimates contained in the budget of the United States government for fiscal year 2006 as well as more detailed cost information prepared by Education on subsidy and administrative cost estimates and projected consolidation loan volume. On the basis of our review of the documentation for these data, we determined that the data were sufficiently reliable for the purpose of our review. We also interviewed officials from Education and the Congressional Budget Office to discuss and obtain information about the development of subsidy and administrative cost estimates for consolidation loans. To determine how these estimated budgetary effects could change and the reasons for such changes as subsidy costs are reestimated in future years, we analyzed original subsidy cost estimates and reestimates for several prior loan cohorts, reviewed analyses developed for a recent GAO report,⁴ reviewed budget documents, and interviewed Education officials to gather information on the reasons why subsidy cost estimates have changed in the past. To determine how lenders and borrowers might be affected if all loans were consolidated through FDLP, we interviewed or obtained written comments from several large FFELP lenders; the Consumer Bankers Association, a national trade association for financial institutions; the Education Finance Council, a nonprofit trade association for state-based student loan secondary market organizations; Education; and

⁴GAO, *Federal Student Loans: Challenges in Estimating Federal Subsidy Costs*, [GAO-05-874](#) (Washington, D.C.: Sept. 29, 2005).

college student aid officials. We conducted our work from January 2005 to October 2005 in accordance with generally accepted government auditing standards.

Summary of Findings

Providing consolidation loans exclusively through FDLP in fiscal year 2006 could yield estimated budgetary cost savings of about \$3.1 billion, based on subsidy cost estimates in the President's fiscal year 2006 budget. However, actual savings would remain unknown until all loans made in fiscal year 2006 are repaid and actual interest rates over the life of the loans are known. The estimated savings could change substantially as future reestimates of subsidy costs incorporate actual results as well as reflect changes in key assumptions about the future, such as interest rates, loan performance, and loan volume. The actual impact on lenders and borrowers is difficult to predict. However, according to lenders, consolidating all loans through FDLP would reduce lender revenue and certain borrower benefits provided by FFELP lenders.

We provided Education with a copy of our draft report for review and comment. Education reviewed the report and did not have any comments.

Providing Consolidation Loans Exclusively through FDLP Could Yield Estimated Budgetary Savings of \$3.1 Billion in Fiscal Year 2006

Providing consolidation loans exclusively through FDLP in fiscal year 2006, based on figures in the President's budget for fiscal year 2006, could yield estimated budgetary cost savings of about \$3.1 billion, but actual savings would remain unknown until all loans made in fiscal year 2006 are repaid. These estimated budgetary cost savings result from

- avoiding an estimated subsidy cost of \$2.5 billion for providing a projected volume of \$25.5 billion in FFELP consolidation loans, and
- an estimated gain to the federal government of \$620 million if the projected FFELP consolidation loan volume of \$25.5 billion were made through FDLP rather than through FFELP.

The \$2.5 billion subsidy cost estimate in the President's budget for fiscal year 2006 for FFELP consolidation loans is based in part on the fact that the government-guaranteed yield provided to FFELP lenders was projected to be higher than the fixed interest rate consolidation loan borrowers would pay, resulting in special allowance payments to lenders over the entire life of these loans. For FDLP loans, the fixed interest rate consolidation loan borrowers would pay was projected to be higher than the interest rate Education would pay to finance its lending, which, in

combination with other assumptions underlying Education's estimate, resulted in a gain to the government for these loans. Federal administrative costs, which are not included in subsidy cost estimates, would likely increase and offset estimated subsidy cost savings by about \$46 million over the life of the loans, based on Education's most recent estimates, because FDLP administrative costs are higher than those of FFELP per \$100 of loans made. Tax revenues, which could affect estimated savings, are also excluded from subsidy cost estimates.

Savings Estimates Could Change Substantially as a Result of Reestimates of Subsidy Costs because of Changes in Key Assumptions and Actual Results

The estimated savings from providing consolidation loans exclusively through FDLP could change significantly because of changes in key assumptions underlying subsidy cost estimates and actual results. Key assumptions include

- economic conditions, such as interest rates;
- loan performance, such as the portion of loans that default; and
- loan volume.

In estimating subsidy costs for a loan cohort, Education must make assumptions about cash flows that are generated many years in the future. Estimated subsidy costs are periodically revised as new information about the assumptions and actual loan volume and costs incurred are known. As a result, subsequent subsidy cost estimates (i.e., reestimates) for a cohort of loans could change substantially from initial estimates, and actual costs would remain unknown until all loans made in fiscal year 2006 are repaid and actual interest rates over the life of the loans are known. As we recently reported,⁵ for example, the low interest rates that persisted over the last few years were below levels previously forecasted. Subsequent subsidy cost reestimates of prior consolidation loan cohorts varied from original estimates as a result. Estimated savings could further be affected by revised assumptions concerning loan performance, including changes to estimated rates of borrower defaults and loan prepayments. Moreover, estimated cost savings are sensitive to assumptions concerning the volume of consolidation loans that would be made in 2006. As interest rates reached historic lows in recent years, FFELP lenders aggressively marketed consolidation loans. Without such aggressive marketing,

⁵GAO-05-874.

borrower demand for consolidation loans might decrease. If fewer FFELP borrowers consolidated loans through FDLP than estimated, the gain to the federal government would be reduced. For example, if only 75 percent of the projected FFELP consolidation volume of \$25.5 billion in fiscal year 2006 were made through FDLP, estimated subsidy cost savings would decline from about \$3.1 billion to about \$2.9 billion.⁶ On the other hand, if consolidation loan volume was higher than expected, estimated savings could exceed \$3.1 billion.

Effect on FFELP Lenders and Borrowers Difficult to Predict

Although the actual impact on FFELP lenders and borrowers of providing consolidation loans exclusively through FDLP is difficult to predict, major FFELP consolidation loan lenders informed us that it would reduce lender revenues, the total volume of consolidation loans originated, and certain borrower benefits, such as repayment incentives provided by lenders, including lower interest rates, for on-time borrower repayments. These potential impacts could, however, be somewhat offset by such changes as (1) increased earnings for holders of FFELP unconsolidated loans retained as a result of decreased demand for consolidation loans, and (2) lenders providing nonconsolidation loan borrowers alternative repayment options and other incentives to encourage them not to consolidate their loans, as suggested by some FFELP lenders we contacted. Lenders would continue to earn income from loans not consolidated.

Concluding Observations

On the basis of subsidy cost estimates presented in the President's budget for fiscal year 2006, an estimated \$3.1 billion could be saved if all consolidation loans made in fiscal year 2006 were made exclusively through FDLP. The estimated effect, however, remains sensitive to the assumptions used in estimating subsidy costs and will likely change as Education updates assumptions and revises subsidy cost estimates to reflect actual program results. Actual savings would remain unknown until all the loans made in fiscal year 2006 were repaid, actual interest rates over the life of loans were known, and an analysis of what FFELP consolidations would have cost was completed. With respect to potentially making all consolidation loans exclusively through FDLP, Congress would need to consider not only the potential budgetary effects for fiscal year 2006, but the budgetary effects for fiscal years 2007 and beyond. In fiscal

⁶Cost analysis includes impact of reduced consolidation loan volume on the costs of loans not consolidated.

year 2007 and beyond, FFELP and FDLP subsidy cost estimates could vary significantly from those of prior cohorts because of potential legislative as well as economic changes affecting the programs. For example, proposed legislation introduced in the 109th Congress has included changes to borrower interest rates and provisions concerning lender yields for both consolidation and other types of federal student loans, as well as changes in fees paid by FFELP lenders to the government. These potential changes could significantly affect consolidation loan subsidy cost estimates and, thereby, the estimated budgetary effect of providing consolidated loans exclusively through FDLP.

Agency Comments

We provided Education with a copy of our draft report for review and comment. Education reviewed the report and did not have any comments.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its date. At that time we will send copies of this report to the Secretary of Education, appropriate congressional committees, and other interested parties. We will also make copies available to others upon request. In addition, the report will be available at no charge on GAO's Web site at <http://www.gao.gov>.

If you or your staff have any questions about this report, please contact me at (202) 512-7215 or ashbyc@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report were Jeff Appel, Assistant Director; Susan Chin, Analyst in Charge; and Chuck Novak.

Sincerely yours,



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

Appendix I: Briefing Slides



Federal Student Loan Consolidation Program

Briefing for Staff of Representative George Miller
Ranking Minority Member
House Committee on Education and the Workforce

October 31, 2005

1



Introduction: Federal Student Consolidation Loans

Congress established consolidation loans to help borrowers combine and reduce monthly repayments so as to help decrease federal student loan default costs.

- Instead of making concurrent repayments on several loans over a period usually limited to 10 years, consolidation loan borrowers can combine their loans and extend their repayment periods beyond 10 years.
- Consolidation loans also allow borrowers to lock in a fixed interest rate, unlike most other federal student loans, which carry an interest rate that varies from year to year.



Introduction: The Two Major Federal Loan Programs Provide Consolidation Loans

Consolidation loans are available under both of the Department of Education's major student loan programs:

The Federal Family Education Loan Program (FFELP)

First 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. In addition, lenders are guaranteed a minimum yield based on current market rates. When the interest paid by borrowers is lower than the guaranteed minimum yield, the government pays lenders special allowance payments (SAP).

The William D. Ford Federal Direct Loan Program (FDLP)

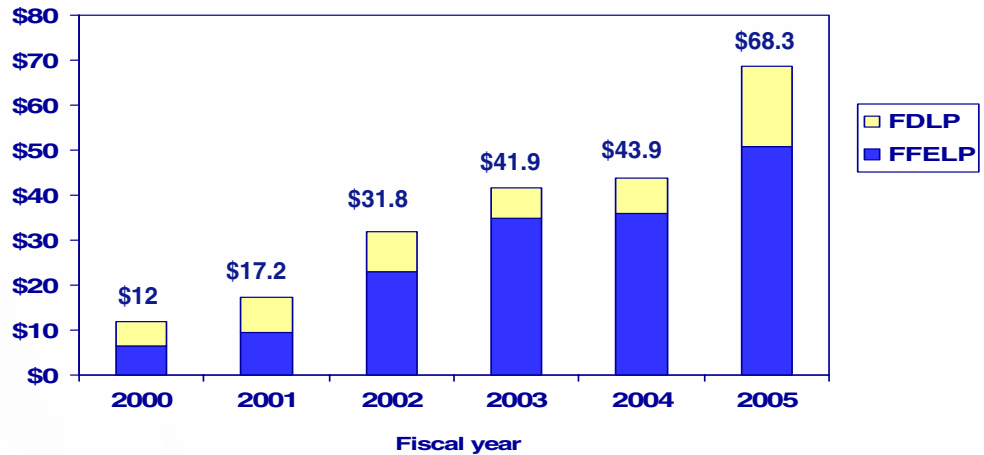
Established in 1993, it provides direct loans from the federal government, to students and parents. The Department of Education (Education) uses contractors to carry out the loan program.



Introduction: Consolidation Loan Volume

In recent years, the annual volume of federal student loans consolidated has increased sharply—from \$12 billion in fiscal year 2000 to \$68.3 billion in fiscal year 2005.

Annual loan volume (dollars in billions)



Source: U.S. Department of Education.



Introduction: Cost to Federal Government

- Under the Federal Credit Reform Act of 1990 (FCRA), agencies are required to estimate the lifetime costs of guaranteed and direct loans. Agencies do so by estimating the “subsidy cost” to the government of loans made or guaranteed in a single fiscal year, called a loan cohort. Subsidy costs are generally reestimated annually to take changing conditions into account.
- In recent years, with relatively low interest rates, estimated costs to the government for consolidation loans have been higher per \$100 disbursed under FFELP than FDLP, mainly because the minimum yield guaranteed to lenders is projected to be higher over most FFELP loans’ lifetimes than the fixed interest rate at which consolidation loan borrowers will pay.
- The growth in consolidation loan volume and associated federal costs has focused congressional attention on the costs of the two student loan programs and whether program changes should be made to reduce federal costs.



Objectives

Provide information addressing the following questions:

- What would be the estimated budgetary effect of providing consolidation loans exclusively through FDLP in fiscal year 2006?
 - To what extent and for what reasons might this estimated budgetary effect change as subsidy costs are reestimated in future years?
 - How might FFELP lenders and borrowers be affected if consolidation loans were made exclusively through FDLP?
-



Scope and Methodology

- To determine the budgetary effects of providing consolidation loans exclusively through FDLP in fiscal year 2006, we reviewed detailed cost information prepared by Education on subsidy cost estimates and consolidation loan volume contained in the President's fiscal year 2006 budget. We also reviewed Education's estimate of administrative costs for consolidation loans.
- To determine how subsidy cost estimates could vary over time, we analyzed original subsidy cost estimates and reestimates for several loan cohorts and interviewed Education officials to gather information on the extent of change and the reasons why subsidy cost estimates change. We also reviewed budget documents and results found in our past reports.
- To determine how lenders and borrowers might be affected if all loans were consolidated through FDLP, we interviewed or obtained written comments from lenders; the Consumer Bankers Association, a national trade association for financial institutions; the Education Finance Council, a nonprofit trade association for state-based student loan secondary market organizations; Education; and college student aid officials.
- We conducted our work from January 2005 to October 2005 in accordance with generally accepted government auditing standards.
- We met with the Department of Education to obtain its comments on the information presented in this briefing. The department provided technical comments, which we incorporated as appropriate.



Summary of Findings

- Providing consolidation loans exclusively through FDLP in fiscal year 2006 could yield estimated budgetary cost savings of about \$3.1 billion, based on subsidy cost estimates in the President's fiscal year 2006 budget, but actual savings would be unknown until all loans made in 2006 are paid off.
 - The savings estimate could change substantially, however, as future reestimates of subsidy costs are affected by changes in key assumptions, such as interest rates, loan performance, and loan volume. Actual subsidy costs remain unknown until all loans are fully repaid; as a result, actual budgetary effects will also remain unknown until all loans are repaid and could differ from estimates.
 - The actual impact on lenders and borrowers is difficult to predict. However, according to FFELP lenders, consolidating all loans through FDLP would reduce lender revenue and borrower benefits.
-



Background: Federal Student Loans

- The federal government makes loans to students through private and public sector lenders in FFELP or directly to students through FDLP. These two programs provide four types of loans to students and parents:
 - **Stafford Loans** (subsidized and unsubsidized)—variable rate loans available to students. The federal government pays the interest on behalf of subsidized loan borrowers while the student is in school and during a brief grace period when the student first leaves school. The borrower interest rate for loans originated 7/1/1998 through 6/30/2006 is based on the bond equivalent rate of the 91-day Treasury bill, adjusted annually and capped at 8.25 percent.
 - **Parent Loans for Undergraduate Student (PLUS)**—variable rate loans made to parents. The borrower pays all interest costs. The borrower interest rate for loans made 7/1/1998 through 6/30/2006 is based on the bond equivalent rate of the 91-day Treasury bill, adjusted annually and capped at 9 percent.
 - **Consolidation Loans**—borrowers may combine multiple federal student loans into a single loan. The borrower interest rate for loans made on or after 2/1/1999 is fixed based on the weighted average of the interest rates in effect on the loans being consolidated, capped at 8.25 percent.
- Consolidation loan borrowers have several repayment options in both programs that may allow them to pay back loans over a period of 10 to 30 years, depending on loan amount.



Background: Developing Estimates of Subsidy Costs

- Under FCRA, the total long-term subsidy cost to the government of a direct loan or a loan guarantee is based on the net present value of all estimated cash flows, excluding administrative costs.
 - In calculating present value, future amounts are converted into their “money now” equivalents using a discount rate.
 - The discount rate is determined by the Office of Management and Budget (OMB) and is generally the average annual interest rate for marketable zero-coupon U.S. Treasury securities with the same maturity from the date of disbursement as the cash flow being discounted.
 - The discount rate is also generally the same rate at which interest is paid by Education on the amounts borrowed from the U.S. Treasury to finance FDLP loans.
- Although the method for calculating the subsidy cost is the same for both FFELP and FDLP, the federal government’s role in each loan program differs significantly, in turn affecting the type and timing of cash flows in each program.



Background: Administrative Costs

- Under FCRA, federal administrative costs are excluded from subsidy cost estimates. Such expenses are accounted for separately in Education's budget.
- Under FDLP, the federal government is primarily responsible for administering the program, and for the most part, Education has contracted with private sector companies to perform administrative tasks, such as originating and servicing loans. These costs are not included in the FDLP subsidy cost figures.
- Under FFELP, lenders and guaranty agencies perform administrative functions. A portion of the subsidy paid to lenders to guarantee a minimum yield covers the administrative expenses incurred. In addition, Education pays guaranty agencies account maintenance fees for their administrative costs.
- In the fiscal year 2006 budget, Education included, as supplementary information, a preliminary analysis of administrative cost per \$100 of loans disbursed for both FFELP and FDLP student loans.



Background: Other Costs and Revenues Not Included in Subsidy Cost Estimates

In addition to reporting on administrative costs, we recently reported that other federal costs and revenues associated with the student loan programs are not included in subsidy cost estimates.¹ These costs include

- Some costs of risk associated with lending money over time, such as interest rate risk—unanticipated fluctuations in the interest rate due to changes in the economy that cause changes in the present value of the loans' cash flows. Interest rate fluctuations could affect estimates of SAP and borrower interest payments as well as borrower behavior with respect to loan prepayment and consolidation.
- Federal tax revenues generated by both student loan programs from private sector activity. These revenues are reflected in the revenue portion of the federal budget but are not included in subsidy cost calculations. Estimating the amount of federal tax revenues generated by the loan programs would be challenging. To make such an estimate would require knowledge of each lender's profits from its student loan business and applicable tax rates.

¹GAO, *Federal Student Loans: Challenges in Estimating Federal Subsidy Costs*, GAO-05-874 (Washington, D.C.: Sept. 29, 2005).



Background: Loan Program Differences Affecting Cash Flows

- In FFELP
 - Private lenders provide loan capital.
 - The federal government guarantees lenders a statutorily specified minimum yield that is tied to, and varies with, the average 3-month commercial paper interest rate. When the borrower rate is below that yield, the government pays lenders a subsidy.
 - State-designated guaranty agencies provide insurance to lenders for 98 percent of the unpaid principal of defaulted loans, and the federal government, in turn, reinsures the guaranty agencies for the default claims paid.

- In FDLP
 - Federal funds are used to fund the loans.
 - Education administers the program through private sector contractors.



Background: Cash Flows Included in FFELP Subsidy Calculation

The net present value of the following estimated cash flows to and from the government are included in the calculation of the subsidy cost of FFELP consolidation loans:



Source: GAO analysis.

Note: Loans may be discharged or forgiven because of total and permanent disability, death, closed school, or, in some cases, bankruptcy.

^aFFELP consolidation loan holders pay, on a monthly basis, a fee equal to 1.05 percent annually of the unpaid principal and accrued interest of the loans in their portfolio. FFELP consolidation loan originators pay a fee of 0.5 percent of the amount of the loan.

^bThe government pays interest to holders of FFELP loans on the subsidized portion of consolidation loans while borrowers are in periods of deferment.

Background: Cash Flows Included in FDLP Subsidy Calculation

The net present value of the following estimated cash flows to and from the government are included in the calculation of the subsidy cost of FDLP consolidation loans:



Source: GAO analysis.

^a Principal repayment may be less than disbursements, reflecting defaults, loan discharges, and loan forgiveness.



Background: Cash Flows Included in FDLP Subsidy Calculation

- When all future cash flows are converted into their equivalents in today's dollars or present value, the aggregate present value of all the cash inflows is compared with the present value of the cash outflows.
- When the present value of the cash outflows is greater than the present value of the cash inflows, the difference is shown as a subsidy cost in the federal budget.
- When the present value of the cash inflows is greater than the present value of the cash outflows, the difference is shown as a "negative subsidy," or a gain to the government.



Budgetary Effects of Consolidating All Loans through FDLP in Fiscal Year 2006

- Based on cost estimates prepared for the President's fiscal year 2006 budget, providing consolidation loans exclusively through the FDLP in fiscal year 2006 could yield estimated budgetary cost savings of about \$3.1 billion. These estimated savings result from:
 - avoiding estimated fiscal year 2006 subsidy costs of \$2.509 billion for the FFELP program
 - a gain to the federal government of \$620 million from borrower interest payments through FDLP.
- These estimated savings would be somewhat offset by the difference in FDLP versus FFELP administrative costs, which are estimated by Education to be about \$46 million.



Budgetary Effects of Consolidating All Loans through FDLP in Fiscal Year 2006

Costs under current situation:

Based on figures in the President’s budget for fiscal year 2006, operating consolidation loan programs as is would create a gain to the government of \$224 million for FDLP and a subsidy cost of \$2.509 billion for FFELP.

Consolidation loan program	Estimated subsidy cost per \$100 disbursed	Estimated FY 2006 loan volume (dollars in millions)	Total estimated cost (dollars in millions)
FDLP	-\$2.99 ^a	\$7,611	-\$224 ^a
FFELP	\$9.90	\$25,527	\$2,509
Total		\$33,138	\$2,285

Source: President’s budget for fiscal year 2006.
^aNegative subsidy rate/amount denotes a gain to the government.



Budgetary Effects of Consolidating All Loans through FDLP in Fiscal Year 2006

- Subsidy costs are currently estimated to result in a gain to the government for FDLP consolidation loans, mainly because of the assumption that the interest rate the government charges borrowers will be higher than the interest rate Education would pay to finance its lending. As a result, the present value of cash inflows exceeds the present value of cash outflows, resulting in a gain to the government.
- For FFELP consolidation loans, the present value of cash outflows is estimated to exceed the present value of cash inflows, mainly because of the assumption that the government-guaranteed yield provided to FFELP lenders will remain higher than the fixed interest rate consolidation loan borrowers would pay, resulting in a cost to the government.



Budgetary Effects of Consolidating All Loans through FDLP in Fiscal Year 2006

Providing all consolidation loans exclusively through FDLP:

Estimated FFELP subsidy costs of \$2.509 billion would be avoided, and estimated federal income of \$620 million could be earned by making all FFELP consolidation loans through FDLP. Rather than producing a subsidy cost of \$9.90 per \$100 of loans disbursed, such loans would produce federal income of \$2.43 per \$100 of loans disbursed.

Consolidation loan program	Estimated subsidy cost per \$100 disbursed	Estimated FY2006 loan volume (dollars in millions)	Total estimated cost (dollars in millions)
FDLP	-\$2.99 ^a	\$7,611	-\$224 ^a
FFELP volume made through FDLP	-\$2.43 ^a	\$25,510 ^b	-\$620 ^a

Source: President's budget for fiscal year 2006 and GAO analysis of Department of Education data.

^aNegative subsidy rate/amount denotes a gain to the government.

^bDoes not include \$17 million of FFELP consolidated loans containing at least one defaulted PLUS loan because an estimated subsidy cost for making these loans through the FDLP is not available.



Budgetary Effects of Consolidating All Loans through FDLP in Fiscal Year 2006

The estimated subsidy cost of $-\$2.43$ per $\$100$ of loans disbursed for projected FFELP loans made as FDLP consolidation loans (actually a gain to the government) differs from the current projected subsidy cost (also a gain) of $-\$2.99$ per $\$100$ of FDLP loans disbursed because the characteristics of the underlying loans (e.g., loan type, loan maturity, and portion of loans in default) in the two programs differ.



Budgetary Effects of Consolidating All Loans through FDLP in Fiscal Year 2006: Estimated Lifetime Administration Costs

Federal administrative costs, which are not included in subsidy cost estimates but are reflected elsewhere in the budget, would likely increase and offset estimated subsidy cost savings by about \$46 million over the life of the loans, based on Education's most recent estimates of administrative cost per \$100 of loans disbursed, reducing the estimated subsidy cost savings from \$3.13 billion to \$3.08 billion.

Loan program	Estimated administrative cost per \$100 disbursed for FY 2005 ^a	Estimated FY 2006 loan volume for FFELP	Estimated administrative cost
FDLP	\$0.27	\$25.527 billion	\$68.9 million
FFELP	\$0.09	\$25.527 billion	\$23.0 million
Difference	\$0.18		\$45.9 million

Source: Administrative cost per \$100 disbursed based on preliminary analysis of Department of Education, Budget Service, February 2004.

Note: Education's analysis does not include certain FFELP administrative costs paid through the transfer of funds to guaranty agencies' Agency Operating Fund from their Federal Student Loan Reserve Fund because such transfers are not included in the U.S. budget.

^aFiscal year 2005 administrative cost subsidy rates are the most recent information available.



Potential for Change in Estimates

- Future estimates of savings from providing consolidation loans exclusively through FDLP could vary significantly from initial estimates because of changes in key assumptions underlying subsidy cost estimates and actual program results.
- In estimating subsidy costs for a loan cohort, Education must make assumptions about interest rates, loan performance (such as how likely borrowers will pay early, pay late, or default on their loans), and loan volume.
- Such assumptions are made about cash flows that are generated many years in the future; as a result, cost estimates for a cohort of loans could change substantially as new information about the assumptions and actual loan volume are known. This makes it challenging to determine the actual budgetary impact of making all fiscal year 2006 consolidation loans through FDLP until all the loans made in fiscal year 2006 are paid off and actual program costs are known.



Potential for Change in Estimates: Recent GAO Analysis

- In a recent report, we highlighted the challenges involved in estimating FFELP and FDLP subsidy costs,¹ in part by determining how subsidy cost reestimates differed from original estimates of subsidy costs for both FFELP and FDLP, across loan cohorts and loan types.
- We compared originally estimated subsidy costs with the most recent reestimated subsidy costs and found that all of the reestimated subsidy costs for both FFELP and FDLP loans made in fiscal years 1996 through 2004 were different from what was originally estimated. Reestimated costs for some loan cohorts were higher than original estimates and some were lower.

¹GAO-05-874.



Potential for Change in Estimates: Past Years' Changes

Reestimated subsidy costs presented in the President's fiscal year 2006 budget for consolidation loans disbursed between fiscal years 1996 and 2004 differ from original estimates for both FFELP and FDLP.

Original and Reestimated FFELP and FDLP Consolidation Loan Subsidy Costs (in dollars per \$100 disbursed)

Program	Estimate	1996	1997	1998	1999	2000	2001	2002	2003	2004
FDLP	Original	-\$0.59 ^a	-\$6.59	-\$0.14	-\$0.61	-\$7.72	-\$3.92	-\$6.96	-\$3.75	\$1.13
	Reestimated	\$0.77	\$1.58	-\$0.51	-\$2.97	\$1.62	-\$3.42	-\$4.29	-\$6.00	-\$1.75
FFEL	Original	\$7.86	\$0.06	\$0.75	-\$3.55	\$2.35	\$2.91	\$3.51	\$10.19	\$15.76
	Reestimated	\$0.57	-\$0.17	\$2.12	\$1.15	\$0.80	-\$0.46	\$3.11	\$11.21	\$15.98

Note: Original estimates of subsidy costs per \$100 in loans for a given cohort are based on the President's budget for that fiscal year. Reestimates are based on the fiscal year 2006 budget. Subsidy costs were not calculated for consolidation loans until the fiscal year 1996 budget.

^aNegative subsidy rate denotes a gain to the government.



Potential for Change in Estimates: Change to Recent Cohort Costs

- A review of recent loan cohorts showed that in the fiscal year 2000 to 2002 period, FDLP consolidation loan cohorts all had higher reestimated subsidy costs per \$100 disbursed than originally estimated, while all FFELP consolidation loan cohorts had lower reestimated costs.
 - The higher costs for FDLP resulted because actual interest rates differed from original estimates, which increased reestimated subsidy costs.
 - The lower reestimated subsidy costs for FFELP resulted because the guaranteed minimum yield paid to lenders was lower than the fixed interest rate consolidation loan borrowers pay, which resulted in lower levels of subsidy payments to holders of FFELP consolidation loans.
- In fiscal years 2003 and 2004 the situation was just the reverse: FDLP consolidation loan cohorts had lower reestimated subsidy costs per \$100 disbursed than originally estimated, while FFELP consolidation loan cohorts had higher reestimated costs.



Potential for Change in Estimates: Change to 2006 and Later Years

- Projected savings estimates will likely change as Education periodically updates assumptions and revises subsidy cost estimates to reflect any changes in loan performance, borrower behavior, and interest rates.
- For example, subsequent to the estimates prepared for the President's 2006 budget, Education revised certain loan performance and borrower behavior assumptions that resulted in revised subsidy cost estimates for FFELP and FDLP consolidation loans made in fiscal year 2006. These revised estimates were, in part, due to a new approach Education is using to explicitly include assumptions about borrowers' use of deferment and forbearance options that allow them to delay making payments on a loan when they return to school or are experiencing economic hardship. Such revisions could increase subsidy cost under both programs as borrowers' interest and principal payments are delayed.
- The subsidy cost estimated for fiscal year 2006 will also be revised due to changes in interest rates. Education is required to revise the interest portion of subsidy cost estimates when the fiscal year 2006 cohort of loans is substantially (at least 90 percent) disbursed. This reestimate will likely change the projected savings estimates because the subsidy cost estimate for the 2006 cohort will be adjusted for the difference between the originally estimated discount rate and the actual rate.



Potential for Change in Estimates: Loan Volume

Estimates are also sensitive to assumptions about the volume of loan consolidation.

- For example, if only 75 percent (\$19.145 billion) of the projected fiscal year 2006 volume of \$25.527 billion of FFELP consolidation loans were made as FDLP consolidation loans, our analysis of Education's data found that the government would reduce subsidy costs by an estimated \$2.9 billion instead of about \$3.1 billion.
- On the other hand, if loan volume was higher than expected, estimated savings could exceed \$3.1 billion.

Note: Cost analysis includes impact of reduced consolidation loan volume on the costs of loans not consolidated.

28



Potential Impact on Lenders and Borrowers: View of FFELP Lenders

It is difficult to predict how lenders and borrowers would respond to consolidating all loans through FDLP. However, according to major FFELP consolidation loan lenders, such a change could

1. reduce lender revenue, profits, and the number of people lenders employ;
2. reduce the total volume of consolidation loans originated;
3. reduce the likelihood of lenders continuing to provide FFELP unconsolidated loans; or
4. reduce consolidation loan borrower benefits—such as a reduced interest rate for on-time repayments.



Potential Impact on Lenders and Borrowers: Revenues, Profits, and Employees

- Generally, major consolidation loan lenders we contacted stated that their revenues, profits, and employment levels would be significantly affected.
- A college financial aid director suggested that raising Stafford loan limits, as is now proposed in Senate and House bills for first- and second-year students, could provide FFELP lenders with increased Stafford loan origination volume and thereby potentially offset losses of consolidation loan earnings.



Impact on Lenders and Borrowers: Volume of Consolidation Loans

- Most lenders we contacted stated that without their marketing efforts and the borrower benefits they offer, total consolidation loan volume would decline.
- A decline in the volume of consolidation loans could increase the earnings of holders of unconsolidated FFELP Stafford and PLUS loans, thus offsetting some of the earnings these lenders would lose as a result of diminished holdings of consolidation loans.



Potential Impact on Lenders and Borrowers: Continued Lender Participation in FFELP

- Consolidation loan lenders' views obtained by the Consumer Bankers Association indicated that lenders would reconsider their participation in FFELP if making FFELP consolidation loans was no longer an option because the holding period for many unconsolidated loans would be too short to cover origination costs and provide an appropriate return on equity before the loans were consolidated in FDLP.
- Two lenders informed us that they would consider working with nonconsolidation loan borrowers and offering them alternative repayment options or other incentives to encourage them not to consolidate their loans in FDLP.



Potential Impact on Lenders and Borrowers: Borrower Benefits

- Lenders stated that only FFELP lenders provide certain borrower benefits, such as a reduced interest rate or partial loan principal cancellations for borrowers who make consecutive on-time loan repayments for a period of time, such as 48 months.
- FDLP does not offer similar borrower benefits, and according to some lenders and college financial aid officers, few borrowers (between 5 and 15 percent) make a sufficient number of on-time payments to receive such benefits from FFELP lenders.



Observations

- Providing consolidation loans exclusively through FDLP in fiscal year 2006 could yield estimated budgetary cost savings of about \$3.1 billion, but actual savings would be unknown until all the loans made in fiscal year 2006 are paid off.
- For loans made in fiscal year 2007 and beyond, FFELP and FDLP estimated subsidy costs could vary significantly from those of prior cohorts because of potential legislative and economic changes affecting the programs.



Observations

- Recently, legislative proposals have been introduced in Congress that, if enacted, could significantly change the existing consolidation loan program and affect savings estimates.
- The changes being considered include
 - changing the borrower interest rate on consolidation loans from a fixed rate to a borrower choice of a fixed or a variable rate,
 - increasing the amount of fees paid to the government by consolidation loan lenders, and
 - increasing the maximum amount of subsidized loans that can be borrowed by first- and second-year students, and the amount of unsubsidized loans that can be borrowed for each year of graduate school.

35

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