United States Government Accountability Office

GAO

Report to Congressional Requesters

September 2004

FEDERAL FAMILY EDUCATION LOAN PROGRAM

Statutory and Regulatory Changes Could Avert Billions in Unnecessary Federal Subsidy Payments

G A O

Accountability * Integrity * Reliability

GAO-04-1070

GAO

Accountability·Integrity·Reliability

Highlights

Highlights of GAO-04-1070, a report to congressional requesters

Why GAO Did This Study

To encourage lenders to make student loans under the Federal Family Education Loan Program (FFELP), the federal government guarantees lenders a statutorily specified rate of return—called lender yield. Some lenders may issue tax-exempt bonds to raise capital to make or purchase loans; loans financed with such bonds issued prior to 10/1/93 are guaranteed a minimum lender yield of 9.5% (hereafter called 9.5% loans). When the interest rate paid by borrowers is less than the lender yield, the government pays lenders the difference—a subsidy called special allowance payments. In light of the upcoming reauthorization of the Higher Education Act of 1965, we examined special allowance payments for 9.5% loans.

What GAO Recommends

To address the issues identified in this report, Congress should consider changing the yield for loans made or purchased in the future with the proceeds of pre-10/1/93 tax-exempt bonds, and any associated refunding bonds, to better reflect market interest rates.

GAO recommends that Education change its regulations so that 9.5% loans transferred from a pre-10/1/93 tax-exempt bond no longer receive a minimum 9.5% yield. Education agrees that special allowance payments should be reduced, but believes it has limited options to do so. GAO believes that Education has other options it can explore.

www.gao.gov/cgi-bin/getrpt?GAO-04-1070.

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..

September 2004

FEDERAL FAMILY EDUCATION LOAN PROGRAM

Statutory and Regulatory Changes Could Avert Billions in Unnecessary Federal Subsidy Payments

What GAO Found

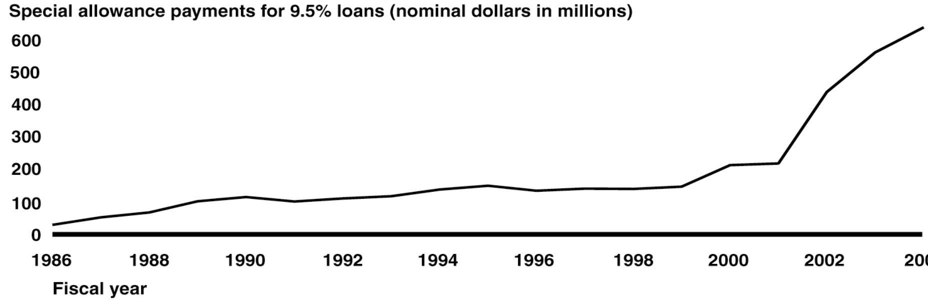
As shown below, special allowance payments for 9.5% loans have risen dramatically in recent years, increasing from $209 million in FY 2001 to well over $600 million as of June 30, 2004. A primary reason for the increase is the sharp decline in the variable interest rates paid by borrowers relative to the minimum 9.5% lender yield.

Another reason for the increase in special allowance payments is the rising dollar volume of 9.5% loans, which increased from about $11 to over $17 billion from FY 1995 to June 30, 2004. Given that current market interest rates are at or near historic lows, lenders have a financial incentive to maintain or increase their 9.5% loan volume and can do so in three ways:

- After paying costs, including payments to bond investors, associated with a pre 10/1/93 tax-exempt bond, lenders can use any remaining money to reinvest in more FFELP loans that, by law, are also guaranteed a minimum 9.5% yield.
- Lenders can issue a new bond, called a refunding bond, to repay an outstanding pre 10/1/93 tax-exempt bond that financed 9.5% loans. Consequently, the refunding bond finances the 9.5% loans and may have a later maturity date than the original bond, allowing lenders to maintain their 9.5% loan volume for a longer time.
- By issuing a taxable bond and using the funds obtained to purchase 9.5% loans financed by a pre-10/1/93 tax-exempt bond, lenders can significantly increase their loan volume. Lenders can use the proceeds from the sale of loans previously financed by the pre-10/1/93 tax-exempt bond to make or buy additional loans, which are also guaranteed a 9.5% yield. Under Education's regulations, loans previously financed by a pre 10/1/93 tax-exempt bond and subsequently financed by (i.e., transferred to) a taxable bond continue to be guaranteed a 9.5% yield.

Some Members of Congress and the Administration have proposed making statutory changes with respect to 9.5% loans, which could save billions of dollars in future special allowance payments. An official representing a leading credit rating agency and some major lenders told us that making changes to the minimum 9.5% yield for loans made or purchased in the future should not affect lenders' ability to make required payments on outstanding tax-exempt bonds.

Special allowance payments for 9.5% loans (nominal dollars in millions)



Source: U.S. Department of Education.

Contents

Abbreviations

FFELP	Federal Family Education Loan Program
HEA	Higher Education Act
IRC	Internal Revenue Code
IRS	Internal Revenue Service
SAP	special allowance payment

United States Government Accountability Office
Washington, DC 20548

September 20, 2004

The Honorable Dale E. Kildee
Ranking Minority Member, Subcommittee on
21st Century Competitiveness
Committee on Education and the Workforce
House of Representatives

The Honorable Chris Van Hollen
House of Representatives

Under the Federal Family Education Loan Program (FFELP), lenders—including banks, state agencies and other nonprofit and for-profit organizations—annually make, or originate, billions of dollars in loans to help students and families finance postsecondary education costs. To encourage lenders to make loans, the federal government guarantees lenders repayment and a statutorily specified rate of return—called lender yield—on the loans they hold. Lender yields as well as the interest rates paid by borrowers are typically tied to, and vary with, money market financial instruments, such as the 91-day Treasury bill. When the interest rate paid by borrowers is less than the guaranteed lender yield, the government pays lenders the difference—a subsidy called special allowance payments. In exercising its oversight of the FFELP, Congress has periodically changed the formula for lender yields to better reflect market interest rates, federal budget constraints, or the costs incurred by lenders to finance loans. To finance loans, some lenders, specifically state agencies and state-designated authorities, may issue tax-exempt bonds to raise capital to make or purchase loans, thereby providing other lenders with more funds to make more loans. Investors who buy these bonds receive interest income that is exempt from federal taxation. Because these investors do not pay taxes on their interest earnings, they are willing to accept a lower pretax rate of return on their investment, which lowers the financing costs for agencies and authorities issuing the bonds. As student loan borrowers repay their loans, loan holders use the money to repay, in turn, bond investors.

Concerned that the lender yield for loans financed with tax-exempt bonds did not adequately reflect the lower costs associated with tax-exempt financing, Congress reduced the yield in passing the Education Amendments of 1980. To do so, Congress reduced the special allowance payments to be paid on loans financed with tax-exempt bonds to one-half of that otherwise payable. At the same time, however, Congress guaranteed that the lender yield for loans financed with tax-exempt bonds would be no less than 9.5 percent. Several years later, in passing the Omnibus Budget Reconciliation Act of 1993[1], Congress eliminated the one-half special allowance payment and minimum 9.5 percent yield provision for loans financed with tax-exempt bonds issued on or after October 1, 1993. In so doing, Congress provided that lenders would receive the same yield on loans, regardless of whether tax-exempt bonds or other sources of funds had been used to finance the loans. Due to these changes, loans that are financed with the proceeds of tax-exempt bonds issued prior to October 1, 1993 are guaranteed a minimum 9.5 percent yield. (These loans are hereafter called 9.5 percent loans).

Believing that changes to the law should have resulted in a decline in special allowance payments made for 9.5 percent loans since 1993, various news media, policy makers, and others have recently raised questions about the extent to which the government continues to make such payments. In light of the upcoming reauthorization of the Higher Education Act of 1965, which authorizes the FFELP, you asked us to examine special allowance payments for 9.5 percent loans. To conduct our examination, we analyzed the Department of Education's (Education) data on 9.5 percent loan volume and special allowance payments paid to lenders from fiscal year 1986 through the third quarter of fiscal year 2004, the most current data available at the time of our review. On the basis of our review of the documentation for these data and our discussions with Education officials about the steps they take to ensure the reliability and validity of these data, we determined that the data were sufficiently reliable for the purpose of our examination. In addition, we interviewed officials with Education; the Internal Revenue Service; a major credit rating agency that examines and rates the quality of student loan bonds, including those issued by several holders of 9.5 percent loans; a leading bond counsel law firm that provides legal advice to lenders that issue tax-exempt student loan bonds; and 12 lenders that reported holding 9.5 percent loans in fiscal year 2003. We gathered additional data on the amount of 9.5 percent loans in taxable bonds from the top 10 holders of 9.5 percent loans in fiscal year 2003. These 10 lenders held 70 percent of reported 9.5 percent loan volume in fiscal year 2003.

[1]Public Law 103-66, secs. 4105 and 4111, 107 Stat. 312 (1993)

On August 19, 2004, we briefed your staff on the results of our work. This report summarizes the information we shared with your staff and transmits the slides we used to brief your staff that day. In this report, we are also making a recommendation to the Secretary of Education and suggesting a matter for Congress's consideration. We conducted our work between December 2003 and August 2004 in accordance with generally accepted government auditing standards.

Special Allowance Payments For 9.5 Percent Loans Have Increased More Than Threefold Since Fiscal Year 2001

Special allowance payments for 9.5 percent loans have risen dramatically in recent years, increasing from $209 million in fiscal year 2001, to $556 million in fiscal year 2003 and reached about $634 million at the end of the third quarter of fiscal year 2004. Two reasons account for this increase: (1) a decline in the interest rate paid by borrowers and (2) a rise in the dollar volume of 9.5 percent loans. In some cases, restrictions exist on how the nonprofit, for-profit, and state agency lenders that hold 9.5 percent loans may use their earnings, including their special allowance payments, from 9.5 percent loans.

Decline in Interest Rate Paid by Borrowers Is Primary Reason for Increase in Special Allowance Payments

The primary factor influencing the increase in special allowance payments has been the sharp decline in interest rates paid by borrowers relative to the minimum 9.5 percent government guaranteed yield for lenders. As borrower rates have declined, the amount the government has been required to pay to make good on its promise to lenders has increased. To illustrate, in 2001, the borrower interest rate was 8.2 percent.[2] Because this borrower rate is tied to the 91-day Treasury-bill rate and the Treasury-bill rate subsequently declined, the borrower interest rate on the same loan in 2003 was 5.4 percent. While the borrower rate declined, the yield for a lender who used the proceeds, or funds obtained, of a pre-October 1, 1993, tax-exempt bond to originate or purchase the loan remained at 9.5 percent. Over this period, the difference, or spread, between the borrower rate and the 9.5 percent lender yield increased from 1.3 percent to 4.1 percent. As a result, the special allowance payment required to ensure a lender yield of 9.5 percent increased for each dollar of loan volume in this example.

[2]Statutory formulas used to calculate borrower rates are based on several factors, including when the loan was disbursed and loan type. The borrower rates used for this example are for Stafford loans disbursed after July 1, 1998 and are now in repayment.

Increasing 9.5 Percent Loan Volume Is Another Reason for the Increase in Special Allowance Payments

Another factor influencing the increase in special allowance payments has been the rising dollar volume of 9.5 percent loans. Although the overall volume of 9.5 percent loans has increased since fiscal year 1995, volume among lenders has varied. Most lenders experienced a decrease in their 9.5 percent loan volume between fiscal years 1995 and 2003, but by the end of the third quarter of fiscal year 2004, some of these lenders had sharply increased their 9.5 percent loan volume. For example, one lenders' 9.5 percent loan volume had decreased by 46 percent between fiscal years 1995 and 2003 but then increased by 136 percent between 2003 and the end of the third quarter of fiscal year 2004, making its 9.5 percent loan volume greater than it was in 1995.

There are primarily three ways—referred to as recycling, refunding, and transferring—that a lender can slow the decrease in, maintain, or increase its 9.5 percent loan volume.

- First, after paying costs associated with a pre-October 1, 1993 tax-exempt bond (such as payments of interest and principal to bond investors), lenders can reinvest, or recycle, any remaining money earned from 9.5 percent loans to make or purchase additional loans that, under the law, are also guaranteed a minimum 9.5 percent lender yield. Using this method, lenders are able to slow the decrease in, maintain, or slightly increase their 9.5 percent loan volume.

- Second, lenders can issue a new bond, called a refunding bond, to repay the principal, interest, and other costs of an outstanding pre-October 1, 1993 tax-exempt bond. Based on how the HEA has been interpreted, 9.5 percent loans originally financed with a pre-October 1, 1993 tax-exempt bond, but subsequently financed by a refunding bond, continue to carry the government guaranteed minimum yield for lenders of 9.5 percent. Moreover, the refunding bond may have a later maturity, or payoff, date than the original bond. Using this method, lenders can maintain their 9.5 percent loan volume.

- Third, under Education regulations, a lender can significantly increase its 9.5 percent loan volume by issuing a taxable bond and using the proceeds to purchase 9.5 percent loans financed by a pre-October 1, 1993 tax-exempt bond. The lender then uses the cash available from the pre-October 1, 1993 tax-exempt bond to make or buy additional loans, which are guaranteed the minimum 9.5 percent yield. Under regulations issued in 1992, the loans transferred to the taxable bond continue to be guaranteed the minimum 9.5 percent lender yield, so long as the original bond is not retired or defeased. (At the time the regulation was promulgated, Education anticipated that interest rates would rise, resulting in a higher lender yield for loans financed with taxable bonds than for loans financed with tax-exempt bonds. Education believed that if the 1992 regulation was not promulgated, lenders would have had an incentive to transfer loans from tax-exempt bonds to taxable bonds in order to obtain a higher yield, thus resulting in higher special allowance payments for the government.) Among the top 10 lenders holding 9.5 percent loans, more than half of the dollar volume of their 9.5 percent loans had been transferred to taxable bonds as of March 31, 2004. The extent to which lenders have transferred 9.5 percent loans to taxable bonds varies considerably. For example, one lender had none of its 9.5 percent loans in a taxable bond, while another held 90 percent of its 9.5 percent loans in a taxable bond as of March 31, 2004. Some lenders interviewed have been transferring 9.5 percent loans for several years, while another lender just started to transfer 9.5 percent loans in 2004. Additionally, some lenders have also transferred 9.5 percent loans to tax-exempt bonds issued after October 1, 1993, thereby continuing the 9.5 percent minimum guaranteed yield.

As a result of recycling, refunding, and transferring, the overall dollar volume of 9.5 percent loans has increased from about $11 billion in fiscal year 1995 to over $17 billion at the end of the third quarter of fiscal year 2004. While the dollar volume of 9.5 percent loans presently accounts for only about 8 percent of all outstanding FFELP loan volume, these loans account for 78 percent of all special allowance payments made to FFELP lenders thus far in fiscal year 2004.

Earnings on Tax-Exempt Bonds that Finance 9.5 percent Loans May be Used for Borrower Benefits

Under the Internal Revenue Code (IRC), earnings on loans financed by tax-exempt bonds are limited.[3] Lenders can reduce their earnings on loans financed with tax-exempt bonds, and avoid exceeding IRC limitations, by providing benefits to borrowers. Some lenders reported that they have used, or plan to use, earnings in excess of IRC limits to provide interest rate reductions or loan cancellation for borrowers. In contrast to tax-exempt bonds, earnings on taxable bonds are not limited. As a result, lenders have discretion in how they use their earnings from taxable bonds that have financed 9.5 percent loans.

[3] Special allowance payments may or may not be included in the calculation of excess earnings for Internal Revenue Service purposes depending on when a tax-exempt bond, or any associated refunding bond, was issued.

Changes to the Minimum 9.5 Percent Yield For Loans Made or Purchased in the Future Could Save Billions and Is Unlikely to Cause Lenders to Default on Outstanding Tax-Exempt Bonds

Changing law and regulations with respect to 9.5 percent loans made or purchased in the future could reduce the amount of special allowance payments required to be paid by the government without compromising lenders' ability to meet their obligations under their outstanding tax-exempt bonds. The Administration and some members of Congress have, in fact, already put forth proposals to make such changes. The Administration has proposed limiting the extent to which lenders can receive the substantially higher special allowance payments on 9.5 percent loans in the future and estimates savings of $4.9 billion over fiscal years 2005 through 2014 by doing so. Proposed legislation introduced in the 108th Congress also seeks to revise the law pertaining to 9.5 percent loans in order to reduce special allowance payments and change lender yields to reflect current market interest rates.[4]

Changing current regulations that allow lenders to transfer 9.5 percent loans to taxable bonds and retain the minimum 9.5 percent yield could also significantly reduce potential special allowance payments in the future. While Education officials told us that they had considered revising the department's regulations, they believed that Congress could effect such a change by law more quickly and easily. Education officials told us that promulgating new FFELP regulations would likely be difficult and time-consuming, in light of the HEA's requirement that the department engage in negotiated rule making in promulgating FFELP regulations. Negotiated rule making requires the department to convene a committee that would include FFELP industry representatives, such as lenders, and attempt to reach consensus among committee members on proposed regulations. Given the interest of lenders who hold 9.5 percent loans, reaching consensus on new regulations would likely prove to be very difficult, according to Education officials. However, the inability to reach consensus does not invalidate the negotiation of rules.[5] Moreover, regulations are not subject to the negotiated rulemaking requirement if the Secretary determines that applying this requirement would be 'impracticable, unnecessary, or contrary to the public interest.' Representatives from a major credit rating agency as well as some lenders who hold 9.5 percent loans told us that eliminating the minimum 9.5 percent yield for loans made or purchased in the future should not affect lenders' ability to meet their obligations under, and make required

[4]See, for example, the *College Quality, Affordability, and Diversity Improvement Act of 2003* (S. 1793) and *the College Access and Opportunity Act* (H.R. 4283).

[5]See, *U. S. Group Loan Servicing Inc. v. Riley*, 82 F. 3d 708 (7th Cir 1996).

payments on, their outstanding tax-exempt bonds, nor should it have long-term negative effects in the student loan bond market.

Conclusions

Unlike other loans for which the lender yield varies with current market interest rates, the lender yield for loans financed with pre-October 1, 1993 tax-exempt bonds are guaranteed a minimum yield of 9.5 percent. Given that current market interest rates are at or near historic lows, lenders have a significant financial incentive to slow the decrease in, maintain, or increase the volume of loans that yield such a relatively high rate of return unavailable on other FFELP loans. This incentive will remain even if market interest rates gradually rise in the future. Ironically, moreover, an Education regulation over 10 years old and originally intended to limit the government's exposure to increased special allowance payments has today presented lenders with an extraordinary opportunity to generate additional loans that earn a 9.5 percent yield. As we have shown, lenders are taking advantage of these opportunities. Industry experts acknowledge that the government could take action to eliminate the 9.5 percent yield for loans made or purchased in the future without compromising the ability of lenders to meet their obligations with respect to their pre-October 1, 1993 tax-exempt bonds. Without government action, the taxpayers remained exposed to additional special allowance payments that can easily and rapidly escalate into the billions of dollars.

Matter for Congressional Consideration

In light of the rapid increase in special allowance payments for loans guaranteed a minimum 9.5 percent yield and the continuing financial incentive for lenders to originate or purchase additional loans that qualify for a guaranteed yield of 9.5 percent, Congress should consider amending the HEA to address the issues identified by this report, but particularly to change the yield for loans made or purchased in the future with the proceeds of pre-October 1, 1993 tax-exempt bonds, and any associated refunding bonds, to more closely reflect these loans' financing costs and current market interest rates.

Recommendation for Executive Action

Given that lenders are increasing the volume of 9.5 percent loans based on Education regulations that allow lenders to transfer 9.5 percent loans to taxable bonds and tax-exempt bonds issued after October 1, 1993 while retaining the special allowance payment provisions applicable to loans financed with pre-October 1, 1993 tax-exempt bonds, and the resulting increased costs for taxpayers, we recommend that the Secretary of Education promulgate regulations to discontinue the payment of the special allowance applicable to loans financed with pre-October 1, 1993 tax-exempt bonds that are subsequently transferred to taxable bonds or tax-exempt bonds issued on or after October 1, 1993.

Agency Comments

We provided a draft of this report to Education for review and comment. In commenting on our report, Education agreed that special allowance payments for 9.5 percent loans should be scaled back considerably and that, as noted in our report, such a proposal was included in the President's fiscal year 2005 budget.[6] Education also stated that it had considered changing its regulation or its interpretation of the regulation last year, but believed at that time that the HEA would be reauthorized and amended to address the issues discussed in our report before any proposed regulation or regulatory interpretation it might undertake could become effective. Education stated this was the case because of certain requirements contained in the HEA and other laws, including a requirement that it engage in negotiated rule making.

Education also commented on the statutory exception to the general requirement that it engage in negotiated rule making, which we highlighted in our report. As mentioned in our report, the Secretary need not subject a rule making to the negotiated rule making process if the Secretary determines that the process would be "impracticable, unnecessary, or contrary to the public interest." In its comments, Education stated that the courts have construed this exception only to cover routine determinations that are insignificant in nature and impact, inconsequential to industry and to the public, or which raise issues of public safety. While we believe that it is Education's responsibility to interpret the law as it relates to its own programs, on the basis of our review of the case law, we disagree with Education's characterization of the case law concerning the scope of the exception in the Administrative Procedure Act. Specifically, it does not fully address the courts' treatment of the "public interest" prong of the three-pronged exception noted above.

The federal courts have interpreted the three-pronged exception in many cases involving a wide variety of factual situations. Education's characterization of the case law describes the courts' discussion of the first two prongs, "impracticable" or "unnecessary," but does not fully address the potential applicability of the third prong, which, if met, would independently justify use of the exception. In fact, in the case cited by

[6] A similar proposal was made in the prior Administration's fiscal year 2001 budget.

Education in its comments, *Utility Solid Waste Activities Group v. E.P.A.*, 236 F.3d 749 (D.C. Cir. 2001), the court briefly explains the "public interest exception" by pointing to a situation where announcement of the rule in advance would "enable the sort of financial manipulation the rule sought to prevent." *Id. at 755*; see also, *Attorney General's Manual on the Administrative Procedure Act*, pp. 30-31. Thus, it is clear that the applicability of the "public interest" exception turns neither on the insignificance of the rule nor on whether it raises issues of public safety. See also *Nader v. Sawhill*, 514 F.2d 1064 (D.C. Cir. 1975). Moreover, in reviewing challenges to an agency's use of an exception, the Court of Appeals for the District of Columbia has stated that it will review the "totality of the circumstances," including the complexity of the statute and congressionally imposed time frames. See *Methodist Hosp. of Sacramento v. Shalala*, 38 F.3d 1225 (D.C. Cir. 1994); *Petry v. Block*, 737 F.2d 1193 (D.C. Cir. 1984).

Determining whether the unique circumstances present here support the agency's use of an exception is beyond the scope of our report and is a matter, in the first instance, for Education. Nevertheless, we continue to believe that Education should consider all of its options in effecting the desired policy change as we recommend in the report. This could include, for example, determining whether Education could use less formal guidance, as it has in the past, to clarify or alter its position; whether a full consideration of all the facts and circumstances as well as all the applicable case law would support use of an exception to the negotiated rule making requirement; whether an interim final rule could be issued to take effect immediately; or whether negotiated rule making could be accomplished on an expedited basis. Given Education's position that it is essentially unable to implement regulations until July 1, 2006, more than 21 months away, we think it is important that Education fully explore all of its options, consistent with applicable law. Education's written comments appear in appendix II.

We are sending copies of this report to the Secretary of Education, appropriate congressional committees, and other interested parties. 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) 512-8403 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. Other contacts and staff acknowledgments are listed in appendix III.

Cornelia M. Ashby

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

Appendix I: Briefing Slides

GAO

Accountability * Integrity * Reliability

Lender subsidy payments for loans financed with tax-exempt bonds issued prior to October 1, 1993, have increased significantly

Briefing to Congressional Requesters
August 19, 2004

1

GAO

Accountability * Integrity * Reliability

Overview

- Introduction
- Research Objectives
- Scope and Methodology
- Summary of Findings
- Background
- Key Findings
- Concluding Observations

2

Introduction

- Private and public lenders made about $42 billion in new loans to students in school year 2002-03 through the Federal Family Education Loan Program (FFELP).
- To encourage lenders to make FFELP loans, the federal government guarantees repayment and provides lenders a guaranteed rate of return.
- Guaranteed rate of return equals the greater of the statutorily specified lender yield or the borrower interest rate.
- When the borrower rate is less than the lender yield, the government makes subsidy payments, called special allowance payments (SAP), to lenders.

3

Introduction

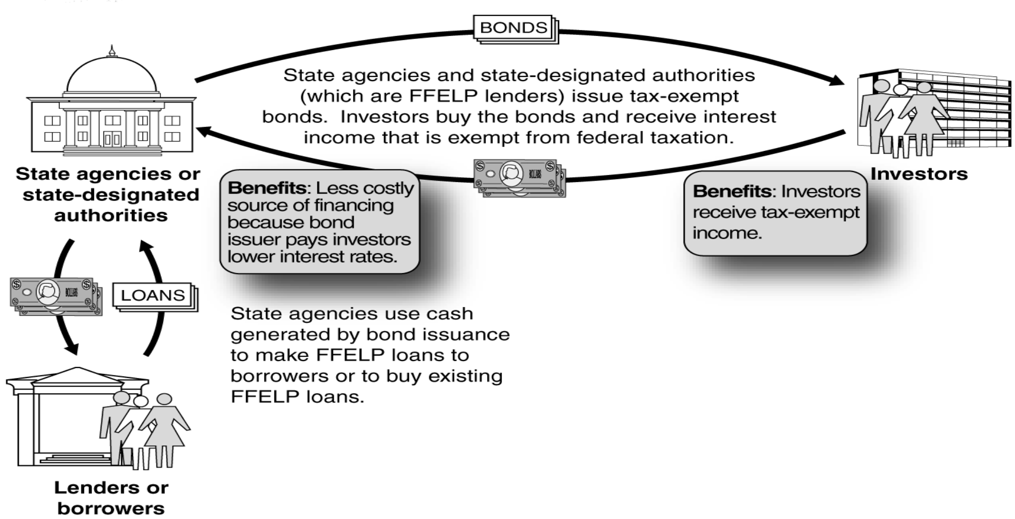
Through the years Congress has made changes to the lender yield to reflect lenders' financing costs and to limit SAP.

- **The Education Amendments of 1980** changed the SAP for loans financed with tax-exempt bonds to reduce profits for loans financed with tax-exempt bonds. Loans disbursed on or after 10/1/80 receive half the SAP of loans financed with taxable bonds but are guaranteed a minimum yield of 9.5 percent.
- **The Omnibus Reconciliation Act of 1993** eliminated the minimum 9.5 percent yield for loans financed with tax-exempt bonds issued on or after 10/1/93 and these loans are guaranteed the same rate of return as that for loans financed with taxable bonds or other sources.
- Because of these changes, loans that are financed with tax-exempt bonds issued prior to 10/1/93 are guaranteed a minimum 9.5 percent yield, hereafter called 9.5 percent loans.

4

Introduction

Bonds are used to finance student loans.



Source: GAO.

5

GAO
Accountability * Integrity * Reliability

Research Objectives

- To what extent have lenders received SAP for 9.5 percent loans?
- What factors influence SAP?
- What would be the effects of making statutory and regulatory changes to the guaranteed minimum 9.5 percent yield?

6

GAO
Accountability * Integrity * Reliability

Scope and Methodology

- Analyzed student loan data submitted by lenders to the Department of Education (Education). These data include information on 9.5 percent loan volume and SAP paid to lenders. On the basis of our analysis, we have determined that data from 1986 onward are sufficiently reliable for purposes of our review.
- Interviewed 12 lenders that reported holding 9.5 percent loans in fiscal year 2003.
  - Gathered data from top 10 lenders that held 9.5 percent loans in FY 2003. These lenders held 70 percent of reported 9.5 percent loan volume in FY 2003.
- Interviewed officials at Education about laws, regulations and policies related to the minimum 9.5 percent yield and Internal Revenue Service (IRS) about legal aspects of tax-exempt bonds.

7

GAO
Accountability * Integrity * Reliability

Scope and Methodology

- Interviewed a major ratings agency that examines and rates the quality of bonds and a law firm that provides legal advice to lenders that issue tax-exempt bonds for student loans.
- To estimate what the SAP for 9.5 percent loans would have been from FY 1995 to 2003 had these loans not been guaranteed a minimum 9.5 percent yield, we used Education's data on SAP made by fiscal year, loan type, and special allowance code (which contains information on when the loan was issued), along with several assumptions.
    - Had the loans not been guaranteed a minimum 9.5 percent yield, we assumed that they would have received the yield for the same loan type financed with taxable bonds with the same disbursement date and repayment status.

8

GAO
Accountability * Integrity * Reliability

Summary of Findings

In FY 2003, 37 lenders received SAP for 9.5 percent loans and these payments have increased by $347 million, from $209 million in FY 2001 to $556 million in FY 2003. SAP have exceeded $600 million through the third quarter of FY 2004.

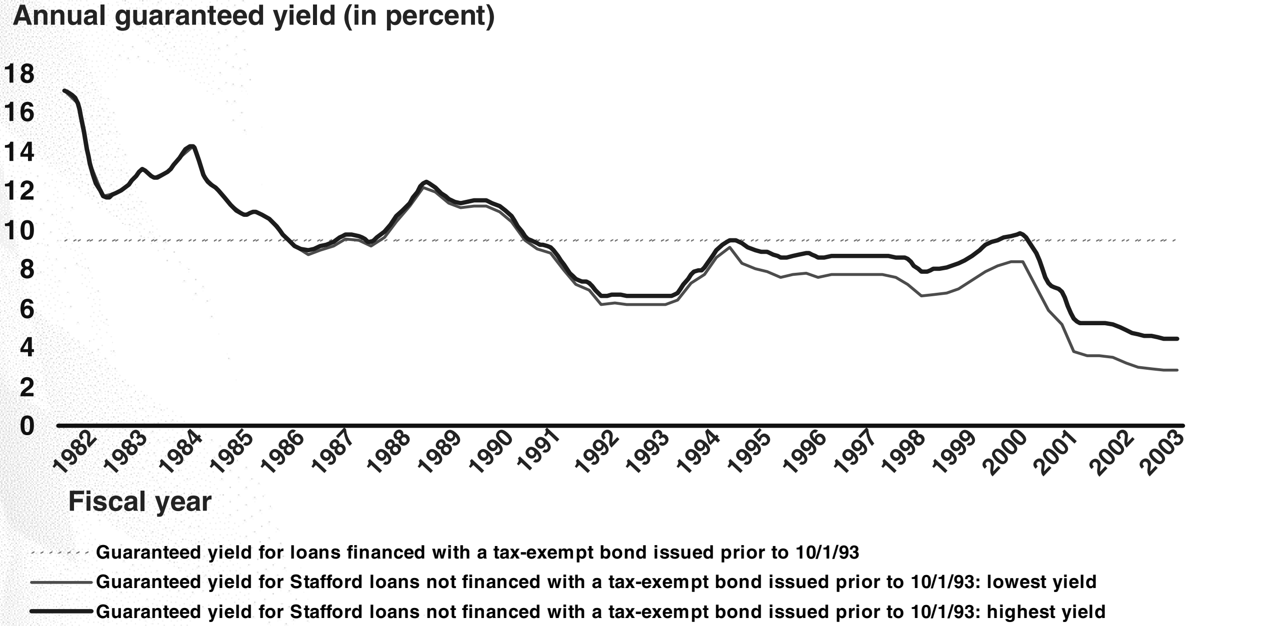
A decline in the interest rates paid by borrowers and a rise in the dollar amount of 9.5 percent loans have influenced the increased SAP.

Changing the yield for 9.5 percent loans made or purchased in the future should decrease SAP and is unlikely to cause outstanding bonds to default, but lenders may not be able to offer the same borrower benefits, such as loan cancellation and interest rate reductions, in the future because earnings from their tax-exempt bonds may decrease.

9

Background

Since 1991, the guaranteed yield for loans financed with tax-exempt bonds issued prior to 10/1/93 has typically been higher than the yield on other Stafford loans



Source: GAO analysis.

Note: Lender yield varies depending on loan type, when the loan was disbursed, and whether the loan is in repayment status. As a result, there can be multiple lender yields in a given year.

10

Background

SAP calculations are based on formulas established in the Higher Education Act

- SAP equals the difference between the lender yield and the borrower interest rate (calculated as a quarterly rate) times the principal balance.
- If the borrower rate is greater than the lender yield, SAP is zero.
- Lender yield is established by statute and varies depending on whether tax-exempt or taxable funds were used to finance the loan.
- Other factors, such as loan type, whether the loan is in repayment status, and when it was disbursed, also affect the lender yield calculation. As a result there are multiple lender yields.
- Borrower rate adjusts annually, based on a statutorily established market-indexed rate-setting formula.[1]

[1] Borrower rates for some Stafford loans disbursed prior to September 30, 1992, have a fixed interest rate.

11

Background

Rules for tax-exempt bonds are specified in the Internal Revenue Code

- Tax-exempt bonds can be issued for qualified "private activities," and a statutory formula determines how much can be issued by each state in each year, called volume cap allocation.
- Student loans are one of the qualified "private activities" to which states can allocate volume cap for tax-exempt bonds.[1]
- Federal law requires that proceeds of tax-exempt student loan bonds and earnings of loans financed with those bonds be used for residents of the state in which the bond was issued or students that attend schools in that state.
  - Some earnings are used to provide benefits to borrowers, such as interest rate reductions and loan cancellation.

[1]Other private activities include mass commuting facilities and sewage facilities.

12

GAO
Accountability * Integrity * Reliability

Background

About $20 billion of new tax-exempt student loan bonds was issued between 1983 and 1993

- Bonds' proceeds were used to make or purchase FFELP loans.
- It is difficult to ascertain how much of the bonds issued remains outstanding because some portions of a bond issue may mature earlier than others.
  - A tax-exempt bond may be composed of several series of bond issues. Each series could have a different maturity date, typically before the bond's final maturity date.
- Among top 10 holders of 9.5 percent loans in FY 2003, approximately $3.8 billion of $11.7 billion in tax-exempt bonds issued prior to 10/1/93 remains outstanding (this includes refunding bonds).[1]

[1] A refunding bond is a new bond issued to pay the principal, interest, and other costs of an outstanding bond issue.

13

Special Allowance Payments

37 lenders received SAP for 9.5 percent loans in fiscal year 2003

- In FY 2003, a mix of for-profit, nonprofit, and state agency lenders received about $556 million in SAP for 9.5 percent loans.

	Number of lenders	Percentage of SAP for 9.5% loans in FY 2003	Percentage of total 9.5% loans in FY 2003
For-profit	4	37	36
Nonprofit and state agency	33	63	64

- Why do for-profit lenders hold 9.5 percent loans?
  - One for-profit lender acquired two nonprofits.
  - Three nonprofit lenders converted to for-profit companies.

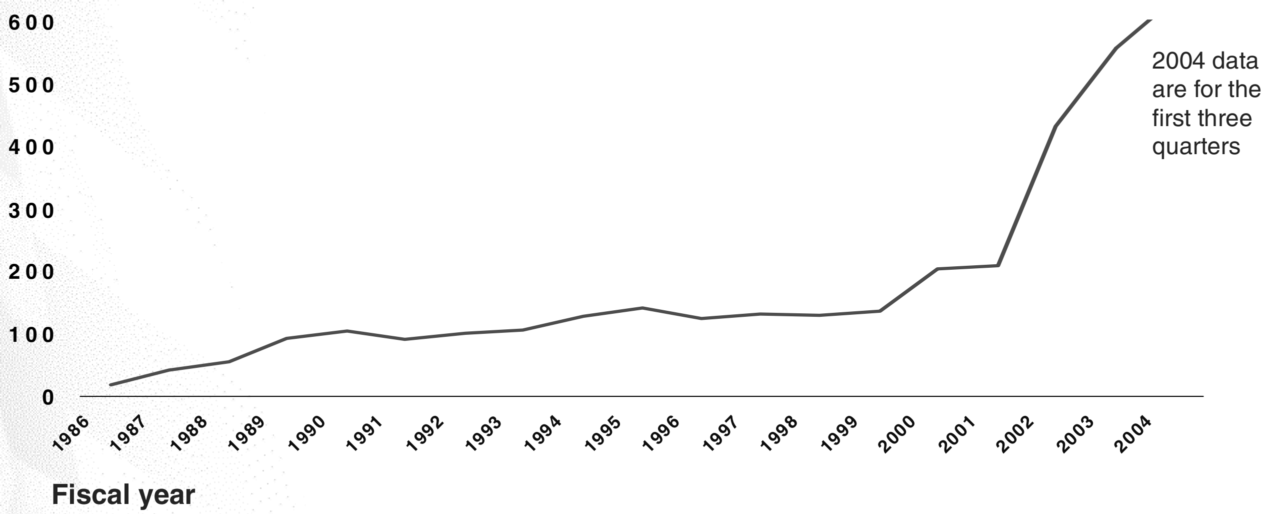
14

GAO
Accountability * Integrity * Reliability

Special Allowance Payments

SAP for 9.5 percent loans have risen dramatically in recent years, increasing by $425 million between FY 2001 & the third quarter of FY 2004

Special allowance payments for 9.5 percent loans (nominal dollars in millions)



Source: U.S. Department of Education.

15

Two factors have influenced increase in SAP for 9.5 percent loans

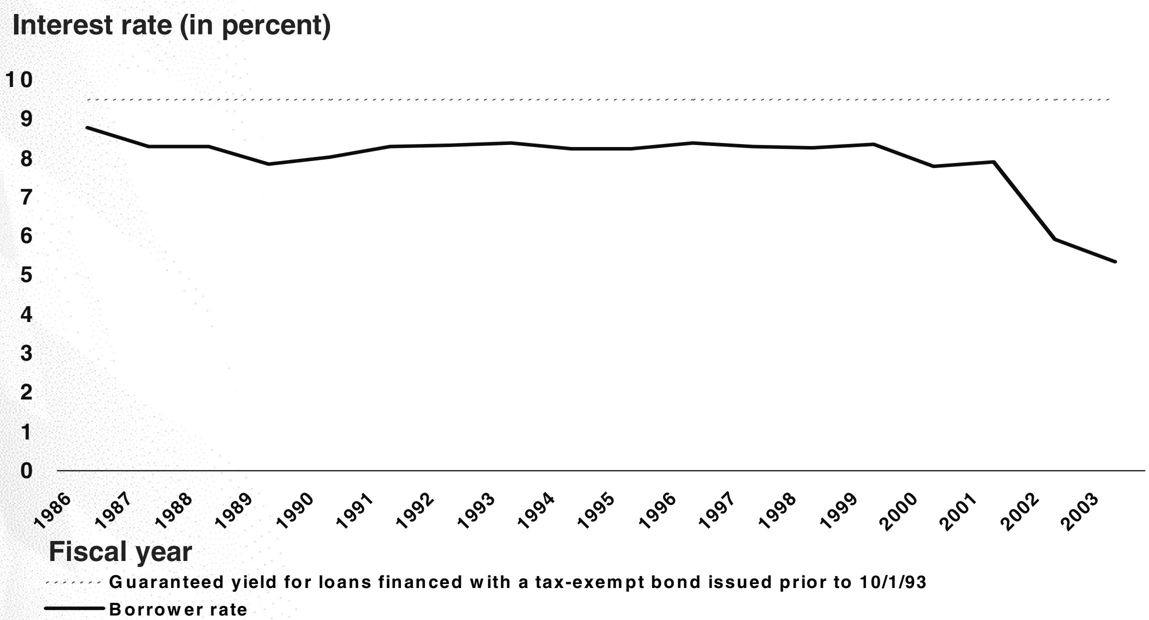
- Major factor that has influenced increase in SAP is the significant drop in borrower rate relative to 9.5 percent yield.
- The volume of 9.5 percent loans has not decreased as expected, which has also influenced the SAP increase.

16

GAO
Accountability * Integrity * Reliability

Factors influencing SAP

Difference between borrower rate and minimum 9.5 percent yield has widened significantly since FY 2001



Source: GAO analysis.

17

Factors influencing SAP

Example of how low borrower rates affect SAP

- $$\text{SAP} = \frac{\text{(9.5\% - borrower rate)}}{\text{4 (quarter)}} * \text{principal balance}$$
- As an illustrative example, the borrower rate dropped from 8.2 percent in 2001 to 4.1 percent in 2003 for recently originated Stafford loans.[1]
  - Estimated SAP for $1,000 of 9.5 percent loans in quarter 1 2001 =

    (9.5%-8.2%)/4 x $1,000 = $3.28
  - Estimated SAP for $1,000 of 9.5 percent loans in quarter 1 2003 =

    (9.5%-4.1%)/4 x $1,000 = $13.60

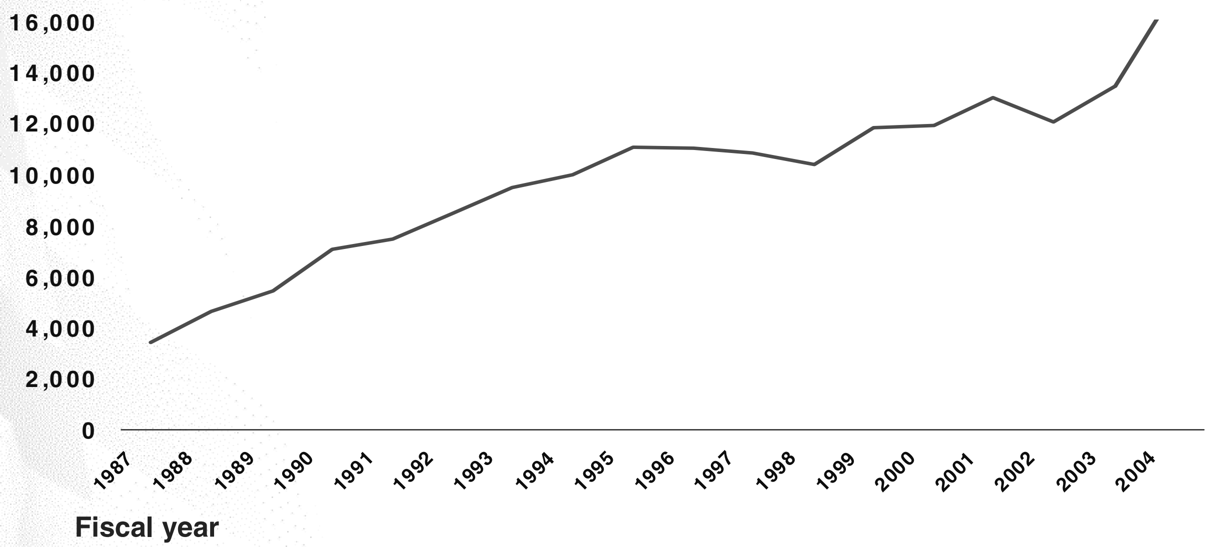
[1]These borrower rates are for Stafford loans from October to June of that fiscal year disbursed after July 1, 1998, that were in repayment.

18

Factors influencing SAP

The volume of 9.5 percent loans has not decreased as expected, which has also contributed to the SAP increase

9.5 percent loan volume (nominal dollars in millions)



Note: 2004 data are as of June 30, 2004

Source: U.S. Department of Education.

19

GAO
Accountability * Integrity * Reliability

Factors influencing SAP

Increase in total amount of 9.5 percent loans masks differences in 9.5 percent loan volume by lender

- For 21 lenders, the amount of 9.5 percent loans they held between FY 1995 and FY 2003 decreased.
  - Some of these lenders, however, have increased the amount of 9.5 percent loans they held in the first three quarters of 2004.
- For the remaining 16 lenders, the amount of 9.5 percent loans held between FY 1995 and FY 2003 has increased.
- There are three primary ways that a lender could slow the decrease in, maintain, or increase its 9.5 percent loan volume:
  - recycling earnings to make or purchase loans
  - transferring loans from pre-10/1/93 tax-exempt bond financing to taxable bond financing
  - refunding a pre-10/1/93 tax-exempt bond

20

GAO
Accountability * Integrity * Reliability

Factors influencing SAP

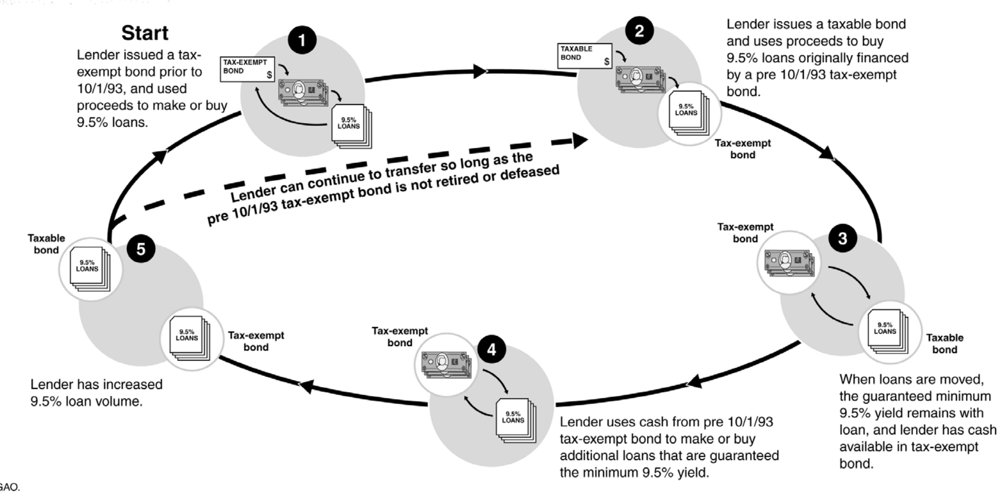
Recycling allows lenders to maintain or slightly increase 9.5 percent loan volume

- After lenders pay costs (such as interest payments and servicing fees) associated with a tax-exempt bond, they may use any remaining money earned from loans to reinvest in FFELP loans, called recycling. These loans are guaranteed the minimum 9.5 percent yield.
- All 12 lenders interviewed utilize recycling to reinvest in 9.5 percent loans.
- Length of time that a lender can recycle depends on the terms of the bond—some lenders have recycling periods of 1 to 3 years while others have recycling periods that last until the bond matures
  - Lenders may ask ratings agency to extend their recycling period up to the bond's maturity date.
  - For a bond with a maturity date in 2025 and a recycling period that lasts until maturity, the lender can likely recycle and slow the decrease in, maintain, or slightly increase its 9.5 percent loan volume until that time.

21

Factors influencing SAP

Transferring loans from pre-10/1/93 tax-exempt bonds to taxable bonds increases lenders’ 9.5 percent loan volume



Source: GAO.

22

GAO
Accountability * Integrity * Reliability

Factors influencing SAP

Almost all lenders interviewed have transferred loans to taxable bonds, which has increased their 9.5 percent loan volume

- Among top 10 lenders the proportion of 9.5 percent loans that have been transferred to a taxable bond increased between FY 2003 and 2004.

Proportion of Top 10 Lenders' 9.5% Loans Financed by Taxable Bonds			
FY 2003		FY 2004 (as of 3/3/1/04)	
Total 9.5% loan volume	***Percentage in taxable bond***	***Total 9.5% Loan Volume***	***Percentage in taxable bond***
9,593,466,896	**46%**	11,569,635,549	**54%**
one lender reported FY 2004 data as of June 14, 2004			

  - Percentage of 9.5 percent loans financed by a taxable bond in the first half of FY 2004 varied among the 10 lenders, from 0 to 90 percent.
  - Some lenders interviewed have been transferring for several years while another just started in 2004.
  - Some lenders have also transferred to tax-exempt bonds issued after 10/1/93.

23

Factors influencing SAP

Policy that allows lender to transfer loans and increase 9.5 percent loan volume was intended to limit SAP

- In 1992, Education issued regulations intending to limit SAP by changing how SAP is calculated for a loan that is transferred from a tax-exempt bond to a taxable bond.
  - Under the 1992 regulation and clarified in a 1996 guidance letter, a loan transferred from a pre-10/1/93 tax-exempt bond to a taxable bond remains subject to the SAP provisions applicable to loans financed with the tax-exempt bonds so long as the lender retains a legal interest in the original tax-exempt bond and the original bond has not been retired or defeased.
- At that time, Education anticipated that interest rates would rise, resulting in a higher lender yield for loans financed with taxable bonds compared with loans financed with tax-exempt bonds.
- Education believed that if the regulation was not issued lenders would have an incentive to transfer loans from tax-exempt bonds to taxable bonds, which would mean that the federal government would have paid greater SAP for those loans.

24

GAO
Accountability * Integrity * Reliability

Factors influencing SAP

Refunding a pre-10/1/93 tax-exempt bond extends the life of a bond, and loans continue to be guaranteed the minimum 9.5 percent yield

- Lenders may refund a pre-10/1/93 tax-exempt bond, and the refunding bond may have a later maturity date than the original bond.
- Based on interpretation of the Higher Education Act, loans now financed with the refunding bond continue to be guaranteed the minimum 9.5 percent yield.
- Almost all nonprofit lenders interviewed refunded a pre-10/1/93 tax-exempt bond.
  - A lender that did not refund made this choice because its bonds had maturity dates 20 to 30 years from their issue date.
  - For-profit lenders are not permitted to refund tax-exempt bonds.
  - Some reported reasons to refund included: to obtain a lower interest rate than paid on the original bond or to extend period of time loans are guaranteed the minimum 9.5 percent yield.

25

Factors influencing SAP

Lenders have refunded tax-exempt bonds using the IRS's 17-year rule or with new volume cap allocation

- Most lenders interviewed refunded using the 17-year rule.
  - Using the 17-year rule, a lender does not need to receive authority to issue a refunding bond from the state. However, the maturity date must not be later than the longer of 17 years from the original bond issue date or the average maturity of the original bond.
- Some lenders interviewed have used a new volume cap allocation from the state to refund a bond, and the loans continue to be guaranteed the minimum 9.5 percent yield.
  - When a lender uses new volume cap allocation from the state to refund a bond, the maturity date for the new bond is not restricted as it is under the 17-year rule.

26

GAO
Accountability * Integrity * Reliability

Changing the yield for 9.5 percent loans made or purchased in the future should decrease SAP while not having a significant effect on lenders or borrowers

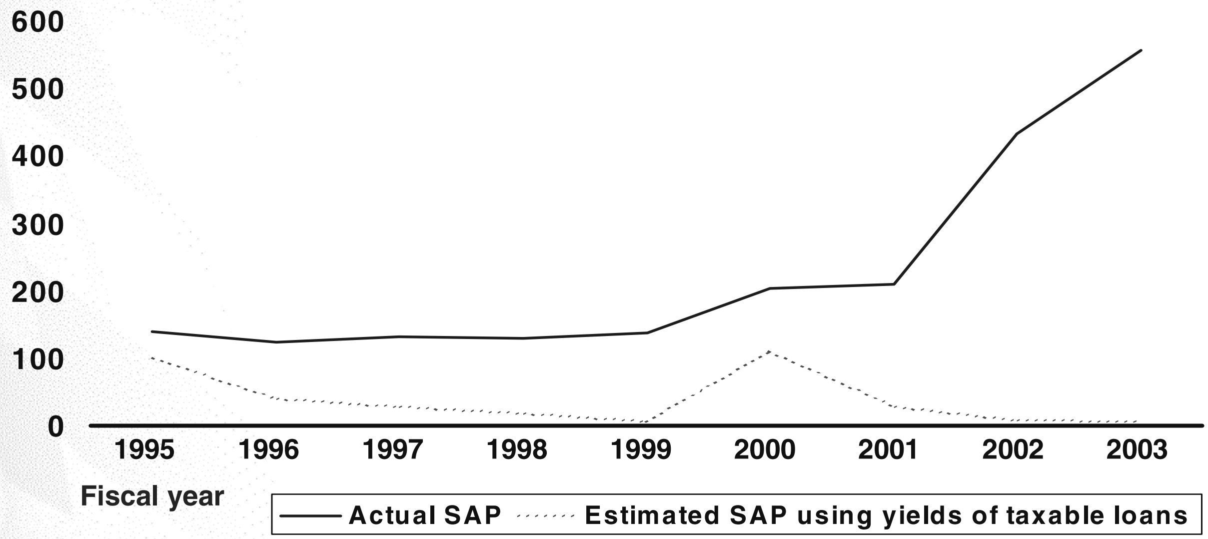
- Changing the yield for 9.5 percent loans to a yield that eliminates the minimum could lower SAP for loans made or purchased in the future.
- Changing the yield for 9.5 percent loans made or purchased in the future is unlikely to cause outstanding bonds to default, but lenders may not be able to offer the same borrower benefits, such as loan cancellation and interest rate reductions, in the future.

27

Effects of Changing 9.5 Percent Yield

Estimated SAP for 9.5 percent loans would have been $1.7 billion less if the yield used was the same as that for taxable loans

Special allowance payments on 9.5 percent loans (dollars in millions)



Source: U.S. Department of Education.and GAO estimate.

28

Effects of Changing 9.5 Percent Yield

Changes to the minimum 9.5 percent yield should lower future federal costs significantly

- Education's HEA reauthorization proposal includes changing the 9.5 percent yield prospectively and estimates savings of $4.9 billion for loans issued between FY 2005 and 2014.
- The Congressional Budget Office estimates that Education's proposed changes would save $1.8 billion for loans issued between FY 2005 and 2014.
- H.R. 4283 College Access and Opportunity Act of 2004 and S.1793 College Quality, Affordability, and Diversity Improvement Act of 2003, also seek to make changes with respect to 9.5 percent loans.

29

Effects of Changing 9.5 Percent Yield

Changes to minimum 9.5 percent yield for loans made or purchased in the future should not cause bonds to default but may curtail some future borrower benefits

- A major ratings agency and some lenders interviewed stated that making changes to the minimum 9.5 percent yield for loans made or purchased in the future should not cause lenders to default on outstanding bonds nor should it have long-term negative effects in the student loan bond market.
- If the 9.5 percent yield were changed for loans made or purchased in the future, lenders reported that earnings from their tax-exempt bonds may decrease, and as a result they may not be able to offer the same borrower benefits, such as loan cancellation, in the future.
  - Some lenders have earned amounts on their student loan investments in excess of what is allowed for tax-exempt bonds by law.
  - By law lenders can use these excess earnings to provide benefits to borrowers whose loan is financed by the tax-exempt bond.[1]
  - Taxable bonds do not have any legal restrictions on earnings.

[1] SAP may or may not be counted in calculations of excess earnings depending on when a bond, and any refunding bonds, was issued. Lenders could also rebate excess earnings to the federal government.

30

Concluding Observations

- Unlike other loans whose rates of return vary because they are tied to market interest rates, those financed with pre-10/1/93 tax-exempt bonds have a guaranteed minimum rate of return.
- In an environment where interest rates are low, current law and policies provide an opportunity for lenders to increase the amount of loans guaranteed a minimum 9.5 percent rate.
- Even if interest rates rise somewhat in the future, the difference between the borrower rate and the minimum 9.5 percent yield will still be large. This will require the government to continue to pay larger SAP than it would otherwise have if the loans did not have a guaranteed minimum of 9.5 percent.

Appendix II: Comments from the Department of Education

UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF POSTSECONDARY EDUCATION

THE ASSISTANT SECRETARY

SEP 14 2004

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 providing the Department of Education (the Department) with a draft copy of the U.S. Government Accountability Office's (GAO's) report entitled, "Federal Family Education Loan Program: Statutory and Regulatory Changes Could Avert Billions in Unnecessary Federal Subsidy Payments" (GAO-04-1070). We have reviewed the draft and have the following comments.

This study reports the recent increases in the Department's special allowance payments to lenders and other loan holders on student loans financed with tax-exempt securities, i.e. "9.5 percent loans," and describes three strategies employed by such lenders and loan holders to maintain and even increase their 9.5 percent loan portfolios. The report recommends the Department change, through rulemaking, its current interpretation of the provision in the Higher Education Act of 1965, as amended (HEA), that governs eligibility for the special subsidy for 9.5 percent loans.

In general, under the Department's regulations, loans that are eligible for the special 9.5 percent subsidy retain that eligibility as long as the tax-exempt bond whose proceeds were used to make or purchase the loans remains open. In other words, absent a change in the law, unless and until the original financing instrument is retired or defeased, the loans it supports qualify for the special subsidy.

The Department believes that these special allowance payments should be scaled back considerably, and, as you noted, the President proposed this in his fiscal year 2005 budget request. Last year the Department considered undertaking the process to issue new regulations or to reverse the Clinton Administration's regulatory interpretation. However, we quickly realized that doing so would have resulted in the new policy becoming effective no sooner than July 2005—long after we expected the HEA to be amended to address the issue. This is so because of certain requirements in the HEA and other applicable laws.

Section 492 of the HEA[1] requires the Secretary to obtain public involvement in the development of proposed regulations for any program authorized under Title IV of the

[1] 20 U.S.C. 1098a.

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

Our mission is to ensure equal access to education and to promote educational excellence throughout the Nation.

Page 2 – Ms. Cornelia M. Ashby

HEA, and to develop such proposed regulations by means of a negotiated rulemaking process. Changes of regulatory interpretation, like new legislative rules, require rulemaking under the Administrative Procedure Act (APA),[2] as interpreted by the United States Court of Appeals for the D.C. Circuit.[3] Therefore, the Department believes negotiated rulemaking is required for changes of regulatory interpretation, like changes to the 1996 interpretation at issue here, just as it is required for new legislative rules.

The Department's experience with the negotiated rulemaking process for the Title IV programs dates to 1994. In the development phase the issues to be regulated, and therefore negotiated, require the advice of and recommendations from individuals and representatives of the groups involved in the federal student aid programs, such as students, legal assistance organizations that represent students, institutions of higher education, guaranty agencies, lenders, secondary markets, loan servicers, guaranty agency servicers, and collection agencies. Participants in the negotiation phase are chosen by the Secretary from individuals nominated by the aforementioned groups and must include both representatives of such groups from Washington, D.C. and industry participants. To the extent possible, the Secretary selects individuals reflecting the diversity in the industry, representing both large and small participants, as well as individuals serving local areas and national markets. At the conclusion of the negotiation phase, the Secretary publishes the Notice of Proposed Rulemaking and accepts public comment. After considering public comment, the Secretary issues the final rule.

As the draft report notes, the Secretary may choose not to subject Title IV rulemaking (or Title IV change of regulatory interpretation) to the negotiated rulemaking process if the Secretary determines that the process, with respect to the particular regulations (or changes of regulatory interpretation) that are preferred, would be impracticable, unnecessary, or contrary to the public interest, within the meaning of the APA.[4] That standard appears in the APA as an exemption applicable to all federal agencies that are otherwise required to conduct rulemaking. However, the draft report neglects to note that the courts have generally construed the standard only to cover routine determinations that are insignificant in nature and impact, inconsequential to industry and to the public, or which raise issues of public safety.[5] The standard is not met here to exempt this issue from rulemaking, including negotiated rulemaking, because the issue would involve a policy decision to change a current interpretation of regulations issued under Title IV of the HEA that would greatly affect the student loan industry. Moreover, it is obviously not a matter of public safety.

Additionally, the Department is bound to follow the "Master Calendar" provisions of section 482(c) of the HEA.[6] These provisions provide that, with certain exceptions not applicable here, any regulatory changes initiated by the Secretary affecting Title IV programs that have not been published in final form by November 1, prior to the start of

---

[2] 5 U.S.C. 551 *et seq.*
[3] *See, e.g., Paralyzed Veterans of America v. D.C. Arena*, 117 F.3d 579 (D.C. Cir. 1997)
[4] 5 U.S.C. 553(b)(3)(B).
[5] *See, e.g., Utility Solid Waste Activities Group v. E.P.A.*, 236 F.3d 749, 754-55 (D.C. Cir. 2001).
[6] 20 U.S.C. 1089(c).

Page 3 – Ms. Cornelia M. Ashby

the award year on the following July 1, cannot become effective until the beginning of the second award year after such November 1 date. Therefore, if final regulations are not published by November 1, 2004, then they cannot take effect before July 1, 2006.

We look forward to working with the Congress to address this important reform that will enable the government to modernize the Federal student aid programs to help millions of students and families realize their dreams through higher education.

I appreciate your examination of this important issue and the opportunity to comment on the draft report.

Sincerely,

Sally L. Stroup

Appendix III: GAO Contacts and Staff Acknowledgments

GAO Contacts

Jeff Appel, Assistant Director (202) 512-9915
Andrea Romich Sykes, Analyst-in-Charge (202) 512-9660

Staff Acknowledgments

In addition to those named above, the following people made significant contributions to this report: Cynthia Decker, Margaret Armen, Richard Burkard, Jason Kelly, Rebecca Christie, and Jeff Weinstein.

GAO's Mission

The Government Accountability Office, the audit, evaluation and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO's Web site (www.gao.gov). Each weekday, GAO posts newly released reports, testimony, and correspondence on its Web site. To have GAO e-mail you a list of newly posted products every afternoon, go to www.gao.gov and select "Subscribe to Updates."

Order by Mail or Phone

The first copy of each printed report is free. Additional copies are $2 each. A check or money order should be made out to the Superintendent of Documents. GAO also accepts VISA and Mastercard. Orders for 100 or more copies mailed to a single address are discounted 25 percent. Orders should be sent to:

U.S. Government Accountability Office
441 G Street NW, Room LM
Washington, D.C. 20548

To order by Phone:	Voice:	(202) 512-6000
	TDD:	(202) 512-2537
	Fax:	(202) 512-6061

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm
E-mail: fraudnet@gao.gov
Automated answering system: (800) 424-5454 or (202) 512-7470

Congressional Relations

Gloria Jarmon, Managing Director, JarmonG@gao.gov(202) 512-4400
U.S. Government Accountability Office, 441 G Street NW, Room 7125
Washington, D.C. 20548

Public Affairs

Jeff Nelligan, Managing Director, NelliganJ@gao.gov (202) 512-4800
U.S. Government Accountability Office, 441 G Street NW, Room 7149
Washington, D.C. 20548