Through

the

Looking Glass

A CAGW Special Report

# The Direct Loan Program Flunks Out

By: Elizabeth Wright
June 28, 2005

CITIZENS AGAINST GOVERNMENT WASTE

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# Citizens Against Government Waste

Citizens Against Government Waste (CAGW) is a private, nonprofit, nonpartisan organization dedicated to educating the American public about waste, mismanagement, and inefficiency in the federal government.

CAGW was founded in 1984 by J. Peter Grace and nationally syndicated columnist Jack Anderson to build public support for implementation of the Grace Commission recommendations and other waste-cutting proposals. Since its inception, CAGW has been at the forefront of the fight for efficiency, economy, and accountability in government.

CAGW has more than one million members and supporters nationwide. Since 1986, CAGW has helped taxpayers save more than $758.7 billion.

CAGW publishes a quarterly newsletter, *Government WasteWatch*, and produces special reports, monographs, and television documentaries examining government waste and what citizens can do to stop it.

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## Introduction

This year, Congress will consider the re-authorization of the Higher Education Act (HEA). One of the more contentious debates concerns the purported "savings" in the Federal Direct Loan Program (FDLP) and the "more expensive" Federal Family Education Loan Program (FFELP).

Since FFELP's inception in 1965 through 2004, more than $547 billion has been provided to post-secondary students and their parents. FDLP has provided $150 billion in new and consolidated loans since 1994. More than $56 billion in new loans is being made available in 2005, and a total of more than $110 billion in federal student aid grants and loans to 10.2 million students and parents will be provided in fiscal 2006.[1]

The federal government has been involved in assisting students obtaining a college education for more than 60 years, starting with the G.I. Bill in the 40s, to the passage of the National Defense Education Act in the 50s, to the establishment of the Guaranteed Student Loan Program in the 60s, to creating the Student Loan Marketing Association (Sallie Mae) in the 70s, to elevating the Department of Education to cabinet level in the 80s, to beginning the Direct Loan Program in the 90s. At the time FDLP was signed into law, its proponents argued that it would save the taxpayers money by eliminating the "middle man," in other words, banks and other private lenders. The theory was, if the government loans money directly to students for a college education, rather than going through private lenders, who receive a subsidy to keep loan rates low for students, taxpayers will save money.

But recent reports and analyses have shown this is not the case. In fact, studies have concluded that FDLP has not provided the promised savings and is actually paying more out in interest payments – approximately $16.4 billion – than it has taken in from borrowers since its inception 10 years ago.

This analysis of FDLP has found other issues with the program that need to be addressed by Congress as it re-authorizes the HEA. Closer scrutiny of FDLP is warranted and a better cost comparison between FDLP and FFELP is in order. If this is done, policy makers will soon realize FDLP is not the panacea its designers had hoped.

## Background

While funding reauthorization for the HEA expired in September 2004, Congress approved a one-year extension for its programs and activities through fiscal 2005. Due to the large amounts made available in student aid – in fiscal 2005 more than $56 billion in new loans is being provided and in fiscal 2006, more than $110 billion in federal student aid grants and loans has been budgeted for 10.2 million students and parents – the debate will be lengthy and controversial.[2] Competing loan programs, surging costs in tuition and the impact of changing interest rates on loan consolidation create a recipe for a

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[1] Budget of the United States Government, Fiscal Year 2006 Appendix, pp. 364-367.
[2] Idem.

political "perfect storm." Taxpayers should be concerned that their dollars are wisely spent.

Citizens Against Government Waste (CAGW) is particularly interested in the management of and cost differences between FFELP and FDLP as well as the extent to which such expenses are borne by taxpayers.

The President's Private Sector Survey on Cost Control, better known as the Grace Commission, and the precursor to Citizens Against Government Waste, first weighed in on the student loan program in 1984. The commission recommended consolidating the National Direct Student Loan Program (now Perkins Loans) and the Federally Insured Student Loan Program (FISL) into the Guaranteed Student Loan Program – now FFELP – because the latter was "more cost-effective."[3]

Since then, CAGW has periodically spoken out against high student loan default rates as well as the Department of Education (DoED) making improper payments and inappropriately forgiving student loan debts.

**The ABCs of Student Loans**

The federal government has been actively assisting Americans in obtaining a college education for more than 60 years. In 1944, the Servicemen's Readjustment Act, better known as the G.I. Bill, was passed to assist war veterans in furthering their education and help grow the economy. In 1958, as a response to the Sputnik satellite and a growing belief that the United States needed to improve science and technical education, the National Defense Education Act (NDEA) was passed. This law created a loan program primarily for students that wanted to pursue a degree in math, science, or modern languages. It established the idea that students, not institutions, must be the principal beneficiary of student aid.[4]

In his 1965 State of the Union address, President Lyndon Johnson called for the nation to "provide scholarships to high school students of the greatest promise and the greatest need" and to "guarantee low-interest loans to students continuing their college studies."[5] Later that year, the Higher Education Act (HEA) was enacted to strengthen the educational resources of colleges and universities and provide financial assistance to students in postsecondary and higher education through federally backed loans and grants.

[3] President's Private Sector Survey on Cost Control, Report on the Department of Education, Washington, D.C., 1984, pp. 23-31.
[4] Minnesota State University, "History and Philosophy of Financial Aid," (Web site viewed June 2, 2005) <http://www.mnsu.edu/faids/other/history.htm>.
[5] President Lyndon B. Johnson, State of the Union address, January 4, 1964, (Web site viewed June 2, 2005) <http://www.infoplease.com/ipa/A0900149.html>.

There are seven parts to the HEA. They are:

Title I: General Provisions
Title II: Teacher Quality Enhancement Programs
Title III: Institutional Aid
Title IV: Student Assistance
Title V: Developing Institutions
Title VI: International Educational Programs
Title VII: Graduate and Postsecondary Improvement Programs

The Guaranteed Student Loan Program (GSLP), found under Title IV, provides funding for federal financial aid programs and helps to increase college enrollment. Federal loans represent approximately 45 percent of all financial aid for undergraduate and graduate students.[6]

Since the HEA was enacted, characteristics of postsecondary students have changed dramatically. Prior to 1965, 94 percent of all students were white and 62 percent were men. In 2000, 78 percent of students were white and more than 55 percent were women.[7]

Some of the changes to financial aid that are relevant to this report are:

**1966 –** National Association of Student Financial Aid Administrators (NASFAA) was created.

**1972** – Student Loan Marketing Association (Sallie Mae) was created; Basic Educational Opportunity Grant (BEOG), now the Pell Grant, was established; Education Amendments of 1972 were enacted (federal matching grants for state incentive grants).

**1979** – The Department of Education (DoED) was created, P.L. 96-88.

**1980** – Parent Loans for Undergraduates (PLUS) approved, which allowed parents of dependent undergraduate students to obtain low-interest loans to pay for their children's college education.

**1983** – Student Loan Consolidation and Technical Amendments Act approved, which allowed borrowers to consolidate multiple loans into a single loan with a longer repayment term and smaller monthly payments.

**1986 –** Reauthorization of the Higher Education Act gave financial aid administrators broader discretion and ability to use "professional judgment" on loans; required financial need for the GSLP interest subsidy; NDSL was renamed Perkins Loan; Supplemental

[6] The College Board, "Trends in Student Aid—2004," Washington, D.C., p. 4, (Web site viewed June 2, 2005) <http://www.collegeboard.com/prod_downloads/press/cost04/TrendsinStudentAid2004.pdf>.
[7] James B. Stedman, "The Higher Education Act: Reauthorization Status and Issues," Congressional Research Service (CRS) Issue Brief for Congress, The Library of Congress, October 12, 2004, p. 2.

Loan to Students (SLS) for graduate, professional and independent students was created; PLUS loans to parent borrowers were restricted.

**1987** – GSLP was renamed Stafford Loans in honor of Senator Robert Stafford (R-Vt.).

**1992 –** GSLP program was renamed the Federal Family Education Loan Program (FFELP) in the 1992 HEA reauthorization. FFELP is a public-private partnership that provides affordable private sector financing for students and their families seeking postsecondary education. The Direct Lending pilot project was created.

**1993 –** FDLP becomes a full-scale program under the Student Loan Reform Act. Loans would be financed and managed directly by the federal government and an income contingent repayment process was added.[8]

**2004** – Taxpayer-Teacher Protection Act of 2004 suspended for one year the ability of certain FFELP lenders to expand the number of federally-backed loans that are guaranteed a 9.5 percent return. This is expected to be made permanent when HEA is re-authorized in 2005.

**Dollars for Degrees**

Financial aid has become a necessity for a majority of students that wish to continue their education. In 2000, 71 percent of all full-time dependent undergraduate students received financial aid, a 31 percent increase from the 54 percent of undergrads who received financial aid just 10 years earlier. The average amount received per student increased (adjusted for inflation) from $6,200 per year in 1990 to $8,700 in 2000.[9]

Undergraduate and graduate students have several choices when applying for financial aid. The largest Title IV student aid programs are Pell Grants, FFELP and FDLP. Pell Grants are directed only to undergraduates and are strictly based on need. In fiscal 2003, Pell Grants assisted 5.1 million students with $12.7 billion in funds. In fiscal 2004, approximately 5.3 million students received $13.1 billion in funds.[10] Pell Grants do not have to be paid back to the taxpayers.

For a student to be eligible for FFELP or FDLP, he or she must be enrolled as a regular student at a participating qualified institution and at a minimum, attend school on a half-time basis. The student must maintain satisfactory academic progress that is defined by the school; not be in default on a current student loan; agree that the loan will only be used for educational purposes; meet any required Selective Service requirements; and be a citizen or permanent resident of the United States.[11]

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[8] FinAid, "History of Student Financial Aid," (Web site viewed June 2, 2005) <http://www.finaid.org/educators/history.phtml>.

[9] U.S. Department of Education, National Center for Education Statistics, "Paying for College: Changes Between 1990 and 2000 for Full-Time Dependent Undergraduates: Findings from the Coalition of Education 2004,"(Web site viewed June 2, 2004) <http://nces.ed.gov/programs/coe/2004/analysis/sa04.asp#info>.

[10] Stedman, p. 3.

[11] Adam Stoll, "Federal Student Loans: Terms and Conditions for Borrowers," Congressional Research Service (CRS) Report for Congress, The Library of Congress, June 1, 2004, pp. 3-4.

The type of loan and borrowing limit will vary with regard to the dependent status of a student. A "need" analysis is undertaken to determine how much a student or student's family must contribute based on their financial resources and how much aid the student will be eligible for under the loan program, as well as the extent to which the loan will be subsidized or unsubsidized.

Depending on the type of loan and need, students will be required to pay back the interest while attending school or when they leave school. Interest payments that are paid for by the government while the student is in school, or while in deferment and grace periods, are considered subsidized. Loans whose interest must be paid back while the student is in school are considered unsubsidized. Federally-backed loans can either be made available through private lenders, such as a bank, or directly through the federal government. Of particular interest to CAGW is the direct loan program, which is completely funded and secured by taxpayers.

**Federal Family Education Loan Program (FFELP)**

Private lenders provide federally guaranteed loans to undergraduate students, graduate students, or parents. They can be Stafford Loans, either subsidized or un-subsidized, and loaned to students; PLUS Loans that are loaned to parents of dependent students; or Consolidation Loans. Loan capital is provided and serviced by private lenders and borrowers pay the loans back to a bank or other private lender. Lenders in FFELP may receive a special allowance payment (SAP) that varies by loan type, is determined quarterly, and is based on current borrower interest rates and market-yield formulas.[12]

Many private banks and lenders originate, hold or consolidate college loans. The top ten lenders who originate loans are Sallie Mae, Bank One Education Finance Group, Citibank Student Loan Corp., J.P. Morgan Chase Bank, Bank of America, Wells Fargo Education Financial Services, Wachovia Education Finance, U.S. Bank, Access Group, and Edamerica. In 2004, these 10 companies had an origination loan volume of approximately $24 billion.[13]

Not all lenders originate, hold and consolidate loans but several do. Probably the best known of the companies that do all three is the Student Loan Marketing Association (SLMA), better known as Sallie Mae. It began operating in 1973 as a government-sponsored enterprise (GSE) responsible for a secondary market for guaranteed student loans. In 1984, Sallie Mae listed its non-voting common stock on the New York Stock Exchange.[14]

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[12] Budget of the United States Government, Fiscal Year 2006 Appendix, p. 367.
[13] FinAid. "Largest Education Lenders," (Web site viewed June 2, 2004) <http://www.finaid.org/loans/biglenders.phtml>.
[14] Sallie Mae, "About Us," (Web site viewed June 2, 2005) <http://www.salliemae.com/about/index.html>; Sallie Mae,"History of Sallie Mae," (Web site viewed June 2, 2005) <http://www.salliemae.com/about/slma_name.html>.

GSEs are created by Congress to fund loans for particular borrowers, such as farmers, homeowners or in the case of Sallie Mae, students. In general, GSEs are created to allow Congress to help certain sectors of the population borrow money at a lower rate than the marketplace. Sallie Mae was created to provide liquidity for private lenders that participate in the Federal Guaranteed Student Loan Program. Now the company is privately owned by stockholders and trades its shares on the New York Stock Exchange.

In 1997, Congress passed and President Clinton signed into law the Student Loan Marketing Association Reorganization Act. This act gave Sallie Mae shareholders the opportunity to vote on whether to change their government-controlled charter to a shareholder charter. Sallie Mae, seeing growing encroachment due to the advent of direct student loans and declining stock, sought to release itself from its federal charter that restricted its operations to servicing and processing student loans and branch out into new areas.[15] Share holders voted for privatization and Sallie Mae gradually transitioned from a limited-purpose GSE to a private corporation.

As part of the privatization process, Sallie Mae's parent company changed its name to the SLM Corporation. The GSE, which had operated as a subsidiary of the parent company since the beginning of the privatization process, was completely phased out ahead of schedule by the end of 2004. Sallie Mae currently owns or manages approximately 37 percent of outstanding FFELP loans for 8 million borrowers.[16]

CAGW has long supported privatization of GSEs and the Sallie Mae process has been considered by many as a good model to follow. However, this does not completely allay CAGW's concern about government-created entities that are released into the private market. While a GSE, Sallie Mae paid no state or federal taxes and therefore had a huge advantage over its competitors during the transition to a private company. Its sheer size could be enough to scare off any new private lender that might be considering going into the student loan market. Although Sallie Mae originated $4.2 billion in loans in 2004, its nearest competitor, Bank One Education Finance Group, originated $3.9 billion, not that much of a difference. But when it comes to holding FFELP loans, Sallie Mae is the 500-pound gorilla. Its volume as of 2004 was at $85 billion, while its closest competitor was Citibank Student Loan Corporation at $21.5 billion.[17]

Although Sallie Mae certainly lived up to the obligations required for defeasing the remaining liabilities of its GSE, the company's size and its huge advantage in entering the private market bears further monitoring. Congress needs to make sure whatever actions it takes in reauthorization of the HEA or the future, these actions will not lead to less competition in FFELP.

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[15] Daniel Gross, "Sallie Mae Sallies Forth," Slate On-Line Magazine, August 27, 2002, (Web site viewed June 2, 2005) <http://slate.msn.com/id/2070149>.
[16] FinAid, Largest Education Lenders; Sallie Mae, "SLM Corporation Completes Privatization of Student Loan Marketing Association," Press Release, December 29, 2004, (Web site viewed June 2, 2004) <http://www2.salliemae.com/news/newsreleases/122904.htm>.
[17] FinAid, Largest Education Lenders.

**Direct Student Loans (FDLP)**

FDLP was established in 1993 and was authorized under Part D of Title IV of the HEA. The program offers the same type of loans as FFELP, only it uses a different administrative structure and draws on a different source of capital – funds are taken directly from the U.S. Treasury. FDLP allows schools to serve as the direct loan originator or the loans can originate with contractors that work for the Department of Education.[18]

FDLP was created because President Clinton wanted to change the makeup of the student loan program from the very beginning of his administration. While governor of Arkansas, he came to the conclusion that many young people did not attend college because they were concerned they would not be able to pay the loans back when they graduated. Clinton was also incensed by the high default rate among students. He advocated for a system that would be "simpler" and could increase college attendance by providing more flexible repayment terms. He wanted to guarantee students who may not have a large salary when they graduate that there would be a limit to how much they would have to repay as a percentage of their earnings.[19]

Unlike FFELP, which uses private sources such as banks or other lenders to provide federally guaranteed student loans, FDLP loans are taken directly from the U.S. Treasury, and recipients pay the money back to the federal government. When first created, FDLP was supposed to simplify the loan process by avoiding the "middle man," such as a bank, and theoretically, at the same time save taxpayers' money. Congress also intended for FDLP to replace FFELP. However, due to start-up problems in the implementation of FDLP, Congress realized there was a danger in relying on it as the sole source for college loans.[20] The 1998 HEA reauthorization kept FFELP in place, thus creating two separate programs. FDLP is also called the William D. Ford Direct Loan Program.

While there are many similarities between FFELP and FDLP, there are great differences in how they issue loans and how they collect them. Troubling disparities are found in the effect changing interest rates have on the two programs, and administrative and program costs have also raised concerns. No doubt this led Lawrence Lindsey, President Bush's former chief economic advisor, to state, "leave it to the government to lose money on a sure thing."[21]

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[18] Stoll, pp. 1-2.
[19] President William J. Clinton, Remarks by President on Student Loans with Students, November 2, 1994, (Web site viewed June 2, 2005) <http://www.clintonpresidentialcenter.org/legacy/110294-remarks-by-president-on-student-loans-with-students.htm>.
[20] House of Representatives Budget Committee Chairman Jim Nussle, Letter to the Editor, *The New York Times*, June 2, 2004.
[21] Lawrence B. Lindsey, "Losing on a Sure Thing: Government Defaults with Student Loan Program," *The Washington Times*, May 14, 2004, p. A21.

**Direct Loans + Interest Payments = A Minus for Taxpayers**

Congressional concerns about the actual costs of FDLP are nothing new. In January, 2001, Congress asked the General Accounting Office (GAO – now the Government Accountability Office) to report on DoED's reliance on estimates to project the costs of extending credit or guaranteeing credit over the life of student loans. GAO noted that because FDLP was still relatively new and borrowers were allowed to defer payment of their loans until out of school, a negative cash flow would result until more borrowers begin repayment. GAO also said DoED was unable to determine when FDLP will have a positive cash flow because of the uncertainty of its cash flow assumptions. As a result, GAO found that the DoED cost estimates needed improvement.[22]

Yet, 10 years into FDLP, the program is still losing money. It has paid more in interest to the Treasury than the amount of interest it has gotten back from borrowers. In a report March, 2004 report, GAO found DoED had improved somewhat but had not taken the steps necessary to develop and implement a plan to compare cost estimates and actual cash flow in order to determine if predicted performance corresponded to *actual* performance. GAO reevaluated FDLP cash flow and came up with disturbing results. It broke the data down into funds borrowed from the Treasury, appropriations received, both cash inflows and outflows, and how the actual cash flows compared with estimated cash flows.[23]

FDLP borrowed $137 billion from the Treasury during fiscal years 1995-2003, which is expected to be repaid by borrowers in the future. Of this amount, $92 billion was outstanding as of September 30, 2003. In turn, appropriations received, which will be used to cover the interest subsidy, was $2.7 billion for loans approved during this same time period. However, total cash outflows exceeded total inflows during this time period by $10.7 billion. This was primarily due to the fact that the interest the DoED paid to Treasury was significantly higher than the interest rates collected from borrowers. The reason this happened is because DoED paid the required interest back to the Treasury for students who are not obligated to make interest payments when they are in school or in a grace period.[24]

During the same period, GAO found that actual key cash flows were underestimated by $4.2 billion. Key cash flows include principal receipts, interest receipts, origination fees, and collections on defaults. DoED had incorrectly over-estimated interest receipts by $6.1 billion. According to the GAO, the DoED claims that interest receipts are "a difficult cash flow to estimate because of the complexities associated with periods during which students are not required to make interest payments" but they would continue to evaluate their calculations in cash flow models to improve their estimates.[25]

[22] General Accounting Office (GAO), "Key Aspects of the Federal Direct Loan Program's Cost Estimates," (GAO-01-197), January, 2001, pp. 3-7.
[23] GAO, "FDLP Cost Estimates," (GAO-04-567R), March 29, 2004, pp. 1-11.
[24] Ibid., pp. 2-3.
[25] Ibid., p. 3.

CAGW also reviewed the cash inflows and outflows by fiscal year reported in the March GAO report and added a column entitled "net interest only inflows/outflows." As indicated in Table 1 below, CAGW included GAO's numbers plus FY 2004's results, a figure GAO did not have at the time. Loan originations fees and interest receipts represent income or the "profit" to the DoED. The net interest payments represent what the DoED had to borrow to finance the direct loans or the "cost." Ironically, President Clinton claimed FDLP would save "taxpayers $12 billion over five years."[26] In fact, as the numbers show in Table 1, FDLP continues to lose money.

**Table 1: Cash Inflows and Outflows by Fiscal Year (In Millions)**

| | | A | B | C | D | E |
|---|---|---|---|---|---|---|
| | **Fiscal Year** | **Loan Origination Fees** | **Interest Receipts from Borrowers** | **Net Interest Payments on Treasury Borrowing** | **Net Cash Inflows/Outflows (A+B) – C = D** | **Net Interest Only Inflows/Outflows (B+C) = E** |
| 1 | 1995 | $ 85 | $ 14 | $ (86) | $ 13 | $ (72) |
| 2 | 1996 | 318 | 113 | (348) | 83 | (235) |
| 3 | 1997 | 352 | 300 | (1,180) | (528) | (880) |
| 4 | 1998 | 382 | 606 | (1,686) | (698) | (1,080) |
| 5 | 1999 | 387 | 1,067 | (2,395) | (941) | (1,328) |
| 6 | 2000 | 359 | 1,463 | (3,211) | (1,389) | (1,748) |
| 7 | 2001 | 283 | 1,868 | (4,043) | (1,892) | (2,175) |
| 8 | 2002 | 334 | 1,961 | (4,744) | (2,449) | (2,783) |
| 9 | 2003 | 366 | 1,720 | (4,954) | (2,868) | (3,234) |
| 10 | **Subtotal** | **2,866** | **9,112** | **(22,647)** | **(10,669)** | **(13,535)** |
| 11 | 2004 | 392 | 1,876 | (4,763) | (2,495) | (2,887) |
| 12 | **Total** | **3,258** | **10,988** | **(27,410)** | **(13,164)** | **(16,422)** |

Table 1 Sources: GAO-04-567R-FDLP, p. 52, 2004 figures from Budget of the United States Government, Fiscal Year 2006 Appendix, p. 371.

CAGW also reviewed and compared GAO's results for the estimated interest received from borrowers with the actual amount received by DoED from FY 1995-2004. For fiscal years 1995 through 2003, GAO found actual interest receipts were less than estimated by $6.1 billion.[27] The underlying figures from GAO were unavailable, as the agency obtained them from DoED and generally does not release them to the public. CAGW added the estimated interest to be received from Stafford Loans (subsidized and unsubsidized), PLUS Loans and Consolidation Loans that are found in the President's budget appendices for fiscal years 1995 to 2006, figures that are available to the public. (CAGW also added fiscal 2004 figures that were not available when GAO produced its report.) In Table 2, CAGW's figures show that the DoED has consistently missed the mark in predicting what the income would be from collecting interest. The CAGW comparison reveals that DoED overestimated expected interest payments on outstanding loans by $11.2 billion, or 49 percent – almost double what was actually received.

[26] President Bill Clinton, Remarks to the Association of Community Colleges, Minneapolis, Minnesota, April 24, 1995, (Web site viewed June 2, 2005) <http://www.clintonfoundation.org/legacy/042495-remarks-by-president-to-association-of-community-colleges.htm>.

[27] GAO, "FDLP Cost Estimates," pp. 57-58.

Looking at fiscal 2004, after DoED implemented its new plan to estimate costs and cash flow, there is little evidence there has been an improvement since DoED is again short of expected interest payments by 44 percent. Interest payments are the "profit" the government makes and the key assumption underlying current budget estimates that FDLP is cheaper than FFELP. Yet, DoED still falls far short of accurately forecasting interest payments on its outstanding loans. Direct loan advocates argue that the problem is just a matter of timing – borrowers will eventually pay back the interest to cover the cost of the loan. But FDLP is still in the red after 10 years and taxpayers deserve to know how much time it will take to turn a "profit."

**Table 2: Interest Receipts in Direct Loan Program to DoED Estimated, Actual and Percent Off ($ in Millions)**

| | Fiscal Year | CAGW Budget Estimate | Actual | Overestimated Interest Payments | Percent Off |
|---|---|---|---|---|---|
| 1 | 1995 | $ 95 | $ 14 | $ 81 | 85% |
| 2 | 1996 | 225 | 113 | 112 | 50% |
| 3 | 1997 | 532 | 299 | 233 | 44% |
| 4 | 1998 | 1,242 | 611 | 631 | 51% |
| 5 | 1999 | 1,725 | 1,082 | 643 | 37% |
| 6 | 2000 | 2,943 | 1,509 | 1,434 | 49% |
| 7 | 2001 | 3,905 | 2,028 | 1,877 | 48% |
| 8 | 2002 | 4,427 | 2,079 | 2,348 | 53% |
| 9 | 2003 | 4,190 | 1,892 | 2,298 | 55% |
| 10 | 2004 | 3,371 | 1,876 | 1,495 | 44% |
| | **Total** | 22,655 | 11,503 | 11,152 | 49% |

Source: Budget of the United States Government Appendix; Fiscal Years 1995-2004

A report released by PriceWaterhouseCoopers (PWC) in March, 2005 entitled, "The Limitations of Budget Score-keeping in Comparing the Federal Student Loan Programs"[28] also demonstrated that FDLP is not more cost effective than FFELP. In fact, PWC concluded that under certain economic conditions, either program can be the more expensive of the two, and recent economic conditions have put the savings on the side of FFELP. While critics of FFELP claim PWC's paper was just another "accountant-for-hire report" (the study was prepared for the Consumer Bankers Association, Education Finance Council and the National Council of Higher Education Loan Programs), they haven't been able to dispute the crux of the report: additional factors must be considered when comparing the costs of the two loan programs and FDLP is not providing its promised savings.

The report pointed out that current budget scoring methods do not consider important factors when comparing the costs of FFELP to FDLP. This scoring bias includes the prediction of FDLP "savings" with respect to the projected relationship between short-term and long-term interest rates or the "shape of the yield curve." PWC

[28] PriceWaterhouseCoopers (PWC), "The Limitations of Budget Score-keeping in Comparing the Federal Student Loan Programs," March 3, 2005, pp. i-iii, (Web site viewed June 2, 2005) <http://www.studentloanfacts.org/NR/rdonlyres/65DDECF9-3020-4C6A-8C8F-B568556FEA64/2456/PWCReport.pdf>.

noted that budgetary predictions of the cost of FDLP as opposed to that of FFELP do not take into account the impact of interest rate variability and that FDLP costs are more sensitive to changes in the shape of the yield curve.

In other words, DoED pays interest to the Treasury on net borrowed amounts and the interest is based on intermediate to long-term rates. Because most of the student loan principal will be paid off later, the interest rate DoED pays Treasury is consistent with long-term rates. However, borrowers pay back DoED based on short-term Treasury debt, which is reset every July 1. So if short-term interest rates fall during the life of the loan, a borrower's payments will fall. However, DoED's cost of the loan, based on long-term rates, will not change. This results in a loss to DoED and of course, taxpayers. Only when short-term rates (what the borrower pays) are close or higher than long-term rates (what DoED pays Treasury) will FDLP "make money" and save tax dollars.[29]

The report concluded that these losses could be offset if there are future periods of high interest rates, but the 8.25 percent cap on borrower rates prevents DoED from recouping past losses. Furthermore, if borrowers sensed interest rates were to climb, they would be more likely, and aptly so, to pay off the loan sooner, which would reduce the amount of time DoED could make up the loss.[30]

However, in FFELP, an opposite effect has occurred. The rates of borrowers and payments to the lenders in FFELP are connected by statute and market rates. For every year since 1994 (except for 1998) subsidy costs have been lower then projected.[31] In other words, interest subsidies in FFELP follow the market and adjust yearly so there is not as much variability of the yield curve as there is in FDLP. This relationship during the recent fluctuating and lower interest rate market has better protected the taxpayer's investment.

**STAR – A Desperate Gambit**

A sure sign that FDLP is in financial trouble is the introduction of the Student Aid Reward Act (S. 754/H.R. 1425) by Sen. Ted Kennedy (D-Mass.) and Rep. Tom Petri (R-Wisc.). Also known as STAR, the legislation essentially bribes colleges and universities to use the direct loan program. In exchange for switching to FDLP, the school would receive from the government an increase in Pell Grants for low-income students, possibly as much as an additional $1,000 per eligible student.

No doubt concerned that FDLP has continued to lose participants since its inception, some policymakers hope that STAR will prop up the program. In 2003, the GAO reported that FDLP's share of new loans steadily decreased from a peak of 34 percent in 1998-99 to 28 percent in 2001-2002. The decline apparently continues as the president's fiscal 2006 budget reported that FDLP is expected to account for only 24

[29] Ibid., pp. 1-8.
[30] Ibid., p. 9.
[31] Ibid., pp. 4, 11.

percent of all new loans in the academic year 2005-2006.[32] That is a 29 percent drop in seven years.

Ignoring the financial problems of the direct loan program, advocates for STAR believe the promised increase of Pell Grants will be funded by transferring some $17 billion in "savings" over the next 10 years[33] that the government will receive because of the subsidies they won't have to pay FFELP lenders. Considering FDLP is already shelling out more money in interest payments than it receives, this is akin to telling someone who has maxed out on one credit card to just use another card.

It is doubtful this enticement will work. Many financial aid directors prefer FFELP and the declining FDLP numbers mentioned above prove it. One financial aid director summed up the prevailing view of FDLP: "Direct lending has been around for 10 years. If it is so wonderful, we all would have joined."[34]

**Mandatory Spending for Administrative Costs**

The Office of Federal Student Aid (FSA) was officially established in the 1998 re-authorization of the HEA as a "performance-based" organization to administer student aid programs, such as FDLP, at DoED.

The Bush administration pointed out in previous budget requests and again in its fiscal 2006 budget that two funding mechanisms exist for student aid management: the discretionary appropriation that partially supports student aid administrative activities and the mandatory funds that are provided under section 458 of the HEA. The budget recommends consolidating funding for FSA activities into a single discretionary account to "improve accountability and simplify program oversight and operations."[35]

Few government programs have administrative costs (salaries and expenses) covered under mandatory funding. It is far easier to get automatic increases under mandatory funding and likewise, much harder to cut funding for programs that receive such funds. It is a wonder why any part of administrative costs for FSA have been covered under a mandatory program. But this is Washington and usually politics is the answer.

According to current and former government sources, in 1992 when the HEA re-authorization was in a conference committee, Sen. Robert Byrd (D-W.Va.), at that time chairman of Senate Appropriations Committee, did not want to give up any of his outlay monies to fund the administration of the FDLP demonstration program. He demanded

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[32] GAO, "Direct Student Loan Program: Management Actions Could Enhance Customer Service," (GAO-04-107), November, 2003, p. 3; Budget of the United States Government, Fiscal Year 2006 Appendix, p. 367.

[33] Office of U.S. Rep. Tom Petri, "Rep. Petri Unveils Legislation to Cut Waste In Student Loan Programs and Increase Pell Grants," Press Release, March 15, 2004 (Web site viewed June 2, 2005) <http://www.house.gov/petri/press/loan_intro.htm>.

[34] Amy Weaver, "Direct Loan Program Not for Every College, University," *Manitowoc Herald Times Reporter*, January 18, 2005, p. 2, (Web site viewed June 2, 2005) <http://www.wisinfo.com/heraldtimes/news/archive/local_19437345.shtml>.

[35] Budget of the United States Government, Fiscal Year 2006 Appendix, p. 364.

that it be placed in mandatory spending and the conferees agreed. The HEA conference report (102-630) seems to support this result. While the legislation says, "There are authorized to be appropriated such sums as may be necessary for fiscal year 1993 and for each succeeding fiscal year thereafter for administrative expenses necessary for carrying out this title, including expenses for staff personnel, program reviews, and compliance activities,"[36] the conference report says, *"The provision providing administration and servicing funds is clarified to ensure that these funds are a mandatory expenditure and capping the amount of such funds."*[37]

When the direct loan program was first implemented in 1993, the budget authority for salaries and expenses under section 458 in the HEA was $10 million. After 12 years, the level is at a $600 million, a 600 percent increase.[38]

The number of FTE's, or full time equivalents, which is the number of government employees expressed in terms of annual productive work hours rather than annual available hours, has also increased. In 1993, the number of FTEs was 47. By 2004, the number was at 534, an increase of 1,136 percent.[39]

**A Billion Here, a Billion There**

In the private sector, when a company makes a bad decision, the people who suffer the consequences and pay for the mistake are the company and stockholders. When the government makes a mistake, it is the taxpayers who pay. Fortunately, due to outside forces, taxpayers were spared paying for a bad decision worth $1 billion in one recent episode at FSA.

In late 2001, the FSA extended a contract it had with Affiliated Computer Services (ACS) through September 2006, with an option for an additional year, without seeking rival bids. ACS, based in Dallas, Texas, handled borrower correspondence and other duties for the direct loan program on behalf of FSA. At that time, the student loan contract provided approximately 4 percent of the company's total revenue.[40]

But a FFELP provider challenged FSA's effort to provide the extension without going out to bid, stating that federal departments and agencies are required to have a competing bid process before any extension is given. Under pressure from senior DoED officials, FSA relented, conducted a market research study, and stated that at the end of January 2003 it would undertake a competitive bid process to obtain direct loan servicing.[41]

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[36] 102 Congress, S. 1150, Title IV, Part D, Sec. 452, Administrative Expenses, July, 1992.
[37] U.S. Congress, Higher Education Amendments of 1992 Conference Report to Accompany S. 1150, Report 102-630, Congressional Record, June 29, 1992, p. H5505 (emphasis added).
[38] Figures from DoED, Office of Budget Service.
[39] Ibid.
[40] Peter Loftus, "SLM to Bid on Student Loan Contract Held by ACS," *Dow Jones News Service*, February 3, 2003.
[41] Idem.

In November 2003, FSA announced that it had awarded a $1 billion contract, once again, to ACS to handle services related to its direct student loan program. FSA also proposed in bidding the new contract to actually extend the services ACS had originally provided. FSA combined several functions such as borrower's correspondence, loan consolidation, and collection activities that were split among five different contractors into one contract.[42]

FSA Chief Operating Officer Terri Shaw proclaimed that, "Taxpayers stand to save more than $1 billion, and more than nine million student loan borrowers will benefit from more modern, streamlined services under a new contract awarded to ACS Education Solutions, LLC." She went on to say, "Our top priority at Federal Student Aid is our customers – the students and their families who are working hard to achieve their dreams through a higher education. This contract helps us to do just that – improve service, reduce costs, increase accountability and strengthen program integrity. I want to thank the FSA team for their dedication, commitment and hard work throughout the process."[43]

Lost in FSA's self-congratulatory press release is that the improved service and billion dollar savings would never have come about unless FSA had been challenged by the private sector on its contracting process. This case clearly demonstrates that too often, either out of risk aversion or simply because it is easier to do so, bureaucrats will often defend the status quo. With $600 million in mandatory funds for administration, a virtual slush fund with little oversight, what other monies are being squandered?

## A Costly Crisis with Consolidation Loans

The problems with FDLP don't end with interest rates for the original loans or a loss of customers. Loan consolidations are also creating a financial problem in both student loan programs and taxpayers are being left with the bill.

It seems perfectly logical for students to consolidate their prior loans from many different sources – lenders, guarantors and even different loan programs, into one loan with one monthly payment that they will slowly pay off. With a consolidation loan, students can extend their repayment period from the current maximum of 10 years for the underlying loan up to 30 years in a consolidation loan, depending on the amount of the loan. With highly attractive, low interest rates currently available, many students have moved several of their annually-adjusted variable interest rate loans into one low fixed-rate loan. But this approach has created long-term costs for taxpayers and in some cases inequities for students, depending on when they consolidated their loans. It is a problem for both FDLP and FFELP programs, but in different ways. In FDLP, the problem occurs

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[42] Diane Frank, "ACS Wins $1 Billion Education Deal," *Federal Computer Week*, November 20, 2003 (Web site viewed June 2, 2005) <http://www.fcw.com/article81477-11-19-03-Web>.
[43] Department of Education, "Taxpayers Stand to Save $1 Billion Under New Contract," Press Release, November 20, 2003, (Web site viewed June 2, 2005) <http://www.ed.gov/news/pressreleases/2003/11/11202003.html>.

when DoED's cost of borrowing is higher than the interest rate borrowers are paying. This difference, called the interest rate spread, becomes a cost to taxpayers.[44]

During a March, 2004 hearing before the House Committee on Education and the Workforce, the GAO was asked if taxpayers were better off consolidating loans in the direct loan program. GAO responded that while it may appear it would be less expensive for the taxpayer, there was no definite answer to the question as it depended on several factors, including the two interest rates – the rate of DoED's borrowing and the rate charged to students – and loan volume.[45]

GAO pointed out that DoED is receiving less in interest payments on loans made in 2003 than those made in 2002 and therefore the government's income is lower. Also, GAO stated that DoED's cost accounting does not specifically track administrative costs for consolidation. GAO does believe based on available information that FDLP consolidation costs roughly totaled $52.3 million in fiscal 2002 and are projected to increase to $59.5 million in 2003. (GAO noted that FFELP consolidation costs are less to the taxpayer because they are borne directly by the private lenders.)[46]

But a problem also exists in FFELP. In testimony before Congress on the Student Loan Consolidation Program, economist Robert Shapiro pointed out that interest rates charged for initial student loans are adjusted annually to ensure that the cost of funds loaned to students correlates closely to the cost of funds to the lender. But this stable relationship is completely eliminated in the consolidation program with the fixed interest rate at the heart of the problem. Not only does the Consolidation Loan Program create a large cost for taxpayers, it doesn't help anyone go to college.[47]

Shapiro said that when market interest rates fall sharply, and then rise again, as they have recently, there is a cost for taxpayers in the FFELP consolidated loan program. Therefore, in the next few years, unless the country enters a period of stagnation, interest rates will increase. When this occurs, former students who consolidated their loans in 2002, 2003, and in 2004 will pay interest based on the 1 percent Treasury bill, while the lenders who lent the money will receive payments from the government based on market rates that are much higher. The difference between the locked-in fixed rate and the potential price of future commercial paper is what determines the higher costs in the program. Considering the likely path of interest rates, taxpayers will pay almost $14 billion over the next 20 years to subsidize the interest on existing stock of consolidated loans. If interest rates go higher, taxpayers could even pay more, possibly as much as $48 billion.[48]

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[44] Cornelia Ashby, GAO, "Student Loan Programs: Lower Interest Rates and Higher Loan Volume Have Increased Federal Consolidation Loan Costs," (GAO-04-568T), Testimony before the House Committee on Education and the Workforce, March 17, 2004, pp. 8-9.
[45] Cornelia Ashby, GAO, U.S. House Committee on Education and the Workforce Hearing, "Fiscal Responsibility and Federal Consolidation Loans: Examining Cost Implications for Taxpayers, Students, and Borrowers," Washington, D.C., March 17, 2004, p. 72.
[46] Ashby, "Student Loan Programs," p. 10.
[47] Robert J. Shapiro, Chairman, Sonecon, LLP, "Fiscal Responsibility and Federal Consolidation Loans: Examining Cost Implications for Taxpayers, Students, and Borrowers," Testimony before the House Committee on Education and Workforce, Washington, D.C., March 17, 2004, p. 48.
[48] Ibid., pp. 48-49.

Fixed interest rates to consolidate loans are a problem in both FFELP and FDLP for taxpayers. Considering that DoED already has problems figuring out FDLP cash inflows and outflows, the total cost for the administration of FDLP consolidation loans are unknown, and GAO cannot state with any certainty whether FDLP consolidated loans are a better deal for taxpayers, there are sufficient concerns for taxpayers to demand action from Congress.

**What to Do**

All aspects of the student loan program need to be reviewed and re-evaluated to make sure taxpayers are getting value for their tax dollars. Congress made a good start last year by passing H.R. 5186, the Taxpayer-Teacher Protection Act of 2004. This law will eliminate for one year the federal loan subsidy to lenders that sell tax-exempt bonds to finance student loans. The government guaranteed return of 9.5 percent to lenders is a cash cow giveaway of 6 percentage points placed on the back of taxpayers, considering the current market rate for loans is hovering around 3.5 percent.[49] Congress needs to make this provision permanent when it re-authorizes HEA.

Another serious issue is consolidation of student loans. Unfortunately, it appears taxpayers are on the hook for billions of dollars as thousands of former students have moved their variable loans into low-interest rate consolidated fixed loans. Considering those who consolidate their loans tend to have higher incomes,[50] the Loan Consolidation Program should be changed from a fixed-rate interest formula to a variable rate formula.

FDLP, in particular, is not living up to expectations and is actually costing taxpayers far more than originally promised. Furthermore, FDLP's total new loan volume has decreased steadily since its peak in 1998-1999 of 34 percent to 28 percent in 2001-2002, and is projected to be at 24 percent for the upcoming year. More than 500 schools have left FDLP since its beginning in 1994. Some schools cite difficulties in meeting the demand that they match their records with DoED's loan origination and contractor records and resolve any differences. Others found that FFELP lenders provided better loan terms.[51]

At a May 26, 2005 hearing before the House Committee on Government Reform, financial aid directors from several universities stated they preferred FFELP over FDLP because "only FFELP offers choice," competing private lending institutions provide "savings and other benefits to parents and students that Direct Lending cannot match," FFELP offers " 'value-added services' at no cost to institutions," and "reconciliation in the FFELP program is much easier than reconciliation in the FDLP."[52] Simply put, it

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[49] Mela Louise Norman, "Congress Eliminates Student Loan Loophole," *Washington Square News*, October 14, 2004, (Web site viewed June 2, 2005) <http://www.pbs.org/weta/washingtonweek/voices/200410/1014nat.html>.
[50] Ashby, p. 62.
[51] GAO, "Direct Student Loan Program: Management Actions Could Enhance Customer Service," p. 3; Weaver.
[52] Sarah Bauder, Director of Financial Aid, University of Maryland, College Park, Maryland; Alan G. Merten, President, George Mason University, Virginia; Cynthia Thornton, Director of Financial Aid,

would appear FFELP lenders provided better customer service and competitive pricing, something government bureaucrats cannot duplicate.

Direct loan advocates and federal budget officials believe FDLP is a good deal for taxpayers because it skips the "middleman" and borrowers pay interest to DoED for several years, either while in school or after graduating. Yet, since the direct loan program was implemented more than 10 years ago, it is still in the red with no recouping of losses in sight.

In addition, direct loan advocates point to page 371 of President Bush's FY 2006 Budget Appendix that "proves" FDLP costs less than one cent on the dollar as opposed to the 12 cents per dollar in FFELP. However, the PWC report exposed many aspects of the costs of FDLP and FFELP that are not considered under current government accounting methods. This is not a new problem when it comes to budget scoring and calculating costs.

For example, CAGW has long supported Energy Savings Performance Contracts (ESPCs.) ESPCs are a contracting method which allows a private contractor to cover the costs of implementing energy savings measures at government facilities. The contractor pays for the installation and is paid back a share of the energy-related savings resulting from the improvements during the term of the contract. It is a great deal for taxpayers because the contractor's payback is limited to the lesser of either the savings generated or the amortized cost of the upgrade.

However, after more than 10 years of scoring ESPCs at zero, the Congressional Budget Office (CBO) reversed course in April, 2003. CBO has now decided that these revenue-neutral contracts need to be scored as if the government payments under the contracts are not offset by any savings. This is completely illogical since no government obligation to pay can ever arise unless the savings occur first. CBO says this change was necessary to be consistent with government wide accounting principles.[53]

In addition to pointing out the loss FDLP has suffered due to not collecting promised interest payments from borrowers, PWC also argued that any comparisons in costs should consider other factors in comparing the two programs. For example, lenders in FFELP pay taxes to the government that should offset government costs. According to the report, FFELP lenders generated $651 million in tax revenue in FY 2004 compared to the $7 million paid by private parties that perform services in FDLP.[54]

Considering the DoED had budget authority in FY 2005 of $600 million (salaries and expenses) and a discretionary appropriation of $119 million for student aid administration, these costs in FDLP should be looked at in a new light. Currently, when costs are compared between FDLP and FFELP, CBO and other government accounting

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Dillard University, New Orleans, Louisiana; Testimony before the House Committee on Government Reform, May 26, 2005.

[53] Alliance to Save Energy, "Energy Savings Performance Contracts-Congressional Action Needed for Permanent Authority," *Fact Sheet*, May , 2005, (Web site viewed June 2, 2005) <http://www.ase.org/uploaded_files/policy/ESPC-NDESA%20Fact%20Sheet.pdf >.

[54] PWC, pages i-iii.

agencies must exclude administrative costs from subsidy calculations which are mandated under the Credit Reform Act. This exclusion in administrative costs makes the direct loan program appear less expensive as opposed to FFELP, where most administrative costs are included in any accounting procedure.[55]

The administration's proposal to consolidate funding for student aid administration into a single discretionary account rather than maintain the current two funding sources will not solve the problem with respect to comparing administrative costs in FDLP and FFELP, but it certainly will improve accountability and simplify program oversight and operations.

Direct loan advocates point out the supposed risk to taxpayers if a student defaults on an FFELP loan and that lenders are only on the hook for 2 percent of the loan principal if a student fails to pay back the loan. They gloss over that fact that in FDLP, taxpayers are on the hook for 100 percent of the loan if the student defaults. Some simply respond that in FDLP this default expense is covered by "the interest paid by borrowers" and that this is the "biggest reason direct loans are cheaper,"[56] conveniently missing the fact that the direct loan program continues to pay more in interest to the Treasury than it has received back from borrowers. Currently, students default at about the same rate in both programs. In fact, DoED announced last year that the national average default rate was at a record low 5.2 percent.[57]

**Conclusion**

Just like parents who cannot face the reality that their child is flunking out of school, the original creators and supporters of the direct loan program cannot face the fact that their cherished concept is not performing as hoped. As FDLP continues to bleed, both financially and by losing participants, FDLP policy makers are desperately designing strategies such as STAR to buttress the program, putting more tax dollars at risk.

Congress must take a long, close look at FDLP. It certainly is not the panacea President Clinton had promised. It continues to pay more out in interest than it receives and the cost to administer the program has increased almost by 600 percent. More and more schools show their preference with their feet by walking away from FDLP and the services it doesn't provide, opting instead for the privately-run loan program where competition provides value-added services such as computers to assist in the financial aid process, scholarships, reduced fees, and flexible repayment terms.

After spending 10 years in college with little to show in return except a $13 billion deficit, it is apparent FDLP is flunking out. Our tax dollars would be better spent elsewhere.

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[55] Ibid.; Budget authority and FTE allocation figures are from DoED's Office of Budget Service.
[56] Robert Shireman, "Straight Talk on Student Loans," Progressive Policy Institute, September, 2004, pp. 3-4.
[57] DoED, "Low Interest Rates, Better Management Factor in All-Time Low Student Loan Default Rate, Paige Says," press release, September 14, 2004, (Web site viewed June 2, 2005) <http://www.ed.gov/news/pressreleases/2004/09/09142004.html>.