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The Obama Administration's Student Loan Proposals: An Expansion of the Federal Government that Harms Students and Taxpayers

Executive Summary

- The Federal Family Education Loan (FFEL) program, which has served students since 1965, currently originates approximately 75 percent of student loans in the United States.
- President Obama has proposed eliminating privately financed federal student loans through the FFEL program, in favor of the government-run Direct Loan (DL) program.
- Under the President's proposal to eliminate the FFEL program, every dollar lent by the DL program is borrowed by the U.S. Treasury. His proposal would add approximately one-half trillion dollars in new debt over five years.
- According to PriceWaterhouseCoopers, projected savings from the shift to DL are unlikely to materialize because existing CBO scoring rules and the requirements of the Credit Reform Act of 1990 exhibit a bias toward DL and assume it is a less expensive program even though that is often not the case.
- Cost projections do not include the administrative costs associated with DL, while those costs are included in the FFEL estimates. This is especially important since the administrative costs associated with DL are almost five times higher, relative to outstanding loans, than those under FFEL. The cost estimates also underestimate the gap between short and long term interest rates and fail to include the benefits of FFEL's tax revenues.
- The elimination of the FFEL program in budget reconciliation would allow Democrats to convert Pell Grants to a mandatory entitlement program.
- Eliminating the FFEL program could result in the loss of approximately 35,000 private sector jobs.
- The implementation of DL could result in a vast expansion of the federal government's role, limit consumer choice, and decrease the availability and quality of services to students, families and institutions of higher education.
- There is bipartisan support for maintaining competition in student lending by preserving the FFEL program.

Background

There are currently two distinct federal student loan programs—the Federal Family Education Loan (FFEL) program and the Direct Loan (DL) program. Both of these programs make loans to undergraduate and graduate students to assist them in financing postsecondary education. In fiscal year 2009 it is estimated that these programs will provide $74 billion in new student loans.[1]

Under the FFEL program, which has served students, parents and schools since 1965, private lenders make loans with private capital and the federal government guarantees lenders against loss due to borrower default, death or permanent disability. FFEL program providers share in the financial risk of borrower default. Under the DL program, the federal government borrows from the Treasury and lends directly to students, with the federal government bearing all the financial risk of default.

Approximately 1,500 out of 5,000 institutions of higher education are currently participating in the DL program. This means that FFEL is the preferred program for more than three-fourths (or 3,500) of the nation's post secondary institutions. In fact, FFEL served more than 6.4 million families in fiscal year 2008, lending $56.2 billion.

President Obama's fiscal year 2010 budget proposal would eliminate the FFEL program and originate all new federal student loans through the DL program beginning July 1, 2010. The fiscal year 2010 Budget conference report, which passed the Senate on April 29, included reconciliation instructions to the HELP Committee for $1 billion in deficit reduction between 2009-2014, with a report due no later than October 15, 2009. It also contained a similar reconciliation instruction for the House Education and Labor Committee.

It is widely assumed that the "savings" generated by eliminating the FFEL program and shifting all loans to DL will then be used to implement the President's proposal to convert Pell Grants to a mandatory entitlement program and index them to inflation.

Recent Controversy and Reforms in Student Lending

Over the past several years, ties between college financial aid offices and the lenders they recommend have been investigated. While these were generally isolated incidents, they received a large amount of media attention.

The 2008 reauthorization of the Higher Education Act included a variety of reforms to address these issues, including:

- Providing more transparency on the relationships between lenders and institutions of higher education;

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[1] Congressional Research Service, "Federal Student Loans Made Under the Federal Family Education Loan Program, and the William D. Ford Federal Direct Loan Program: Terms and Conditions for Borrowers," available at: http://apps.crs.gov/products/r/pdf/R40122.pdf.

- Requiring institutions with a preferred lender list to maintain at least three lenders on the list, disclose why each lender is on the list, inform the students that they do not have to borrow from lenders on the list, and inform students if the lenders are affiliated with one another.
- Prohibiting private lenders from offering any gift to an institution or employee of the institution or entering into revenue sharing arrangements.
- Adding more disclosure requirements for private education loan applications, including: the potential range of interest rates; whether the rate is fixed or variable; eligibility criteria for a loan; the terms of the loan; and that the borrower has 30 days after the borrower receives the disclosure to accept the terms of the loan.

Specific Concerns with President Obama's Proposal to Eliminate the FFEL Program

Cost

In his speech on April 24, 2009, President Obama claimed that the only real difference between the DL and FFEL programs is the use of lender subsidies.[2] This is absolutely untrue. The President failed to point out that the single biggest difference is the fact that under his proposal the federal government (or more accurately the federal taxpayers), rather than private lenders, would be the source of funds provided for student loans. In fact, under the President's proposal every dollar lent by the Direct Loan program is borrowed by the U.S. Treasury and added to the national debt, which could contribute to continued economic instability. Originating all new federal student loans in this manner would require roughly one-half trillion dollars in new borrowing over the next five years.[3]

A bipartisan group of former members of Congress who served on the Budget Committee and other well-regarded budget experts have raised significant concerns about the cost of eliminating the FFEL program. "Total federally guaranteed student loan volume will soon reach $100 billion per year in new originations. Financing all of those loans through DL would itself increase federal borrowing by a not insignificant amount. This new commitment of additional federal borrowing, particularly when there is an alternative available to the federal government, is troubling to us at a time when federal borrowings have increased dramatically to address problems elsewhere in the economy."[4]

According to the Office of Management and Budget, the President's budget proposal claims that eliminating the FFEL program will create a savings of $4 billion a year, but serious concerns have been raised about those projections. According to a 2005 report by

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[2] President Obama's Remarks on Higher Education, April 24, 2009, available at: http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-on-Higher-Education/

[3] Congressional Budget Office, March 20, 2009.

[4] Former members of Congress Bill Frenzel, David Minge, Jim Nussle, and Tim Penny, along with former OMB Director Rudolph Penner and former staff director of the Senate Budget Committee, Bill Hoagland, in a letter to the Chairmen and Ranking Members of the House and Senate Budget Committees, April 24, 2009.

PriceWaterhouseCoopers, the cost comparisons between the two programs exhibit a bias toward DL and often assume it is a less expensive program—even though actual implementation has found that DL is often more expensive than estimated.[5] The report indicated that the cost projections underestimate the gap between short and long term interest rates, fail to include FFEL's tax revenues, and leave out the administrative costs associated with DL, while including them in the FFEL estimates (even though the administrative costs associated with DL are almost five times higher relative to outstanding loans than those under FFEL).[6] This means that there is no way of knowing the true cost of the proposal and whether it will result in actual savings for taxpayers.

Funds Would Be Used to Convert Pell Grants to a Mandatory Entitlement Program

The President's fiscal year 2010 budget proposal calls for increasing the maximum Pell Grant award to $5,550 in the 2010-2011 school year, making Pell Grants a mandatory entitlement, and indexing them to the Consumer Price Index plus one percentage point to address inflation. The "savings" generated by the elimination of the FFEL program would likely be used for this purpose under reconciliation.

Making Pell Grants mandatory would limit Congress' ability to make critical funding decisions about Pell Grants. It could also contribute to increased college costs by setting a floor for tuition below which institutions of higher education will not go because they know all students can afford college with government assistance.[7]

Job Losses

If the President's proposal to eliminate the FFEL program becomes law, tens of thousands of workers will likely lose their jobs. According to estimates from the National Council of Higher Education Loan Programs, the Consumer Bankers Association, and the Education Finance Council, approximately 35,000 private sector employees could lose their jobs, with additional losses in related industries and professions (such as technology support, graphic artists, and printers).

In these challenging economic times, the federal government should be working to preserve private sector jobs, not eliminate them.

Not Likely to Offset New Spending Commitments, Such As Pell Grants

President Obama's budget proposal would use the hypothetical savings generated by consolidating student loan programs to increase spending on Pell Grants. Much of that savings is contingent on interest income that is expected to be generated by students paying their loans. If

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[5] PriceWaterhouseCoopers, "The Limitations of Budget Score-keeping in Comparing the Federal Student Loan Programs," March 3, 2005.
[6] Ibid.
[7] The Cato Institute, "Making College More Expensive: The Unintended Consequences of Federal Tuition Aid," January 25, 2005. Available at: http://www.cato.org/pub_display.php?pub_id=3344.

Congress makes a commitment to additional mandatory money for Pell Grants and student default rates continue to increase[8] or projected savings turn out to be incorrect (which is highly likely), incoming revenues will not be found and the federal government will be forced to issue additional national debt in order to meet mandatory funding obligations.

It is irresponsible for the federal government to spend billions of dollars with no assurance that savings or additional revenues will materialize to offset those costs. If savings or additional revenues are not available, budget deficits will increase and outstanding public debt will rise. It is a further outrage that all of this could be done through reconciliation—a process intended to reduce the deficit.

Eliminates Competition and Therefore Hurts Students and Families

Republicans have long believed that competition and choice among service providers benefits consumers. Under the FFEL program, borrowers and families have the ability to choose the loan that best fits their needs and to take advantage of competitive interest rates and repayment options. Institutions of higher education can also shop around to try to secure the best deals for their students, both in the loan terms and conditions, and in the quality of loan servicing provided to the students and the institution. If the federal government is the only source of student lending, then consumers will lose the ability to shop around for the loan package that best fits their needs. They will have no choice but to accept the terms and conditions that the federal government deems adequate.

This anti-competition approach will hurt students and serve to weaken the student loan industry rather than strengthen it.

Will Likely Decrease the Level of Service Borrowers Receive

In addition to offering state of the art loan servicing technology through dozens of local, regional, and national servicers, the FFEL program provides a variety of additional services to borrowers, including information on financial literacy, debt management, and default prevention. There is specific statutory language requiring these services in the FFEL program, and many of the FFEL participants go above and beyond the statutory requirements by hosting events for students around the country to help them better understand their financial aid options. No such requirement for providing services to borrowers exists in DL. Even if separate funding is provided for such services, it is unlikely that the wide range of options that are created by a competitive student loan system will be available.

Lack of Capacity to Implement

Considering the fact that, historically, the majority of student loans are made with private capital through the FFEL program, it is unclear how the federal government would be able to implement

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[8] *The Wall Street Journal*, "Student Loans: Default Rates Are Soaring," April 21, 2009. Available at: http://online.wsj.com/article/SB124027600001437467.html

this change. The Department of Education's capacity to more than quadruple its annual direct loan volume from approximately $20 billion to $80 billion is questionable.

Even if the federal government can develop the capacity to administer all federal student loans, it will result in either a dramatic increase in the number of federal employees or an increase in the number of contractors. This will simply serve to further expand the size of the federal government.

Some institutions of higher education may also face significant capacity issues when it comes to transferring from the FFEL program to DL, and the potential exists for a major disruption in the delivery of loan funds.

There is Bipartisan Support for Maintaining the FFEL Program

While there have been efforts to portray this issue as Republicans fighting for the rights of the banking industry, there is actually bipartisan support for maintaining competition within the student loan industry. Several Democratic Senators, including Senators Bingaman, Udall (NM), Begich, Lincoln and Nelson have voiced their support for the FFEL program.[9]

A bipartisan group of state treasurers from Alabama, Alaska, Indiana, Maine, Maryland, Massachusetts, Mississippi, Nebraska, New Mexico, Pennsylvania, Rhode Island, South Carolina, Tennessee, Utah, Vermont, Washington, Wisconsin and Wyoming have also made it clear that "the FFELP has helped millions of students attend college since its inception in 1965. It is a good example of how the federal government can work with states, non-profit organizations, and the private sector to extend the reach of higher education."[10] They go on to say, "We believe that ending the FFELP as it now exists and administering all federal student loans through the Federal Direct Loan Program would imperil the success of the government's efforts."[11]

Further Reforms to Student Lending Should Not Be Implemented Through the Reconciliation Process

As noted above, the fiscal year 2010 budget conference report includes reconciliation instructions that will impact higher education and likely will be the mechanism that Democrats use to federalize student lending and eliminate the FFEL program. While there are certainly reforms that can be made to our nation's student loan system, reconciliation is not the appropriate process by which to achieve those improvements.

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[9] Letter from Senator Jeff Bingaman and Senator Tom Udall to the Chairman and Ranking Member of the Budget Committee, March 24, 2009. Letter from Senator Mark Begich to OMB Director Orzag, March 27, 2009. Letter from Senator Blanche Lincoln to the Chairman and Ranking Member of the Budget Committee, March 18, 2009. Letter from Senator Nelson to President Obama, March 12, 2009.

[10] Letter from state treasurers to President Obama, March 31, 2009.

[11] Ibid.

A number of organizations have made it clear that the use of the reconciliation process for higher education reforms is not desirable under these circumstances. According to the Western Association of Student Financial Aid Administrators, “The decision being proposed to change the major student loan program affecting millions of students should be subject to open debate to prevent unintentional negative consequences.”[12] The Virginia Association of Student Financial Aid Administrators “fervently oppose such an approach. This topic is far too complex and the consequences too important to be considered under a process that limits debate.”[13]

A bipartisan group of former Members of Congress who served on the Budget Committee, as well as a former OMB Director and a former staff director on the Senate Budget Committee, stated, “Using the reconciliation process to spend tens of billions in the next few years under the assumption that future offsetting savings will materialize seems fiscally irresponsible due to the limitations of budget-scoring in this area, and the inherent unpredictability of the projections.”[14]

It should be noted that changes to student loan programs have been made through the reconciliation process under Republican-controlled Congresses, but the circumstances were very different. Those changes were made as part of a widespread deficit reduction effort that affected nearly every Senate committee. The Obama Administration is using the process to eliminate the nation’s largest student loan program and make Pell Grants mandatory, two proposals that otherwise might not have the votes to pass the Senate.

Conclusion

The President’s budget proposal would eliminate a program that has been the overwhelming choice of consumers for more than 40 years. It would eradicate private sector competition in the student loan industry and shift all student loans to the Direct Loan program. This would result in a vast expansion of the federal government’s role, limit consumer choice, and decrease the availability and quality of services to students, families and institutions of higher education. The proposal would also be unlikely to produce the savings that have been suggested, and would therefore likely contribute to further expansion of budget deficits and the national debt.

[12] Western Association of Student Financial Aid Administrators in a letter to the House Education and Labor Committee, March 24, 2009.

[13] The Virginia Association of Student Financial Aid Administrators in a letter to Senator Jim Webb, March 19, 2009.

[14] Former members of Congress Bill Frenzel, David Minge, Jim Nussle, and Tim Penny, along with former OMB Director Rudolph Penner and former staff director of the Senate Budget Committee, Bill Hoagland, in a letter to the Chairmen and Ranking Members of the House and Senate Budget Committees, April 24, 2009.