

**A FUTURE FEDERAL STUDENT LOAN PROGRAM
MODIFICATION FOR DISCUSSION
April, 2009**

INTRODUCTION

The President's 2010 Budget proposed fundamental changes to federal student loan programs, designed to generate substantial savings to be re-directed to Pell Grants. The savings are driven almost entirely by using federal funding for all loans. This document presents a modification to the Administration's proposal that yields similar savings, but has the added benefits of:

- preserving choice, competition, and innovation in loan delivery systems,
- strengthening programs and incentives to reduce defaults, and
- greatly reducing implementation risks.

BACKGROUND

The President's Budget Proposal for Federal Student Loans

- **President Obama's 2010 Budget calls for eliminating the FFEL program**, which serves 75 percent of US schools, and proposes the transition of the entire market to the federal direct loan (DL) program, beginning in the summer of 2010.
- OMB estimates that the proposed change would generate nearly \$50 billion in budget savings over 10 years; the CBO estimates the 10-year savings at \$94 billion.
- Although labeled as "savings," virtually all of the benefit is derived from estimates of what the federal government will *earn* by funding these loans on its balance sheet, at historically low funding costs. In other words, **the savings is almost entirely driven by the use of federal funding, rather than a change in loan delivery systems.**
- The FFEL program has traditionally relied on private capital to fund student loans. In the midst of the current credit crisis, the flow of private capital has been severely disrupted. As a result, most FFEL loans made through the 2009-10 academic year are being made under the Ensuring Continued Access to Student Loans Act (ECASLA), under which loans are made initially by private lenders, but then funded by federal dollars through a subsequent sale.
- Among many federal market interventions, ECASLA has been uniquely successful in ensuring uninterrupted access to consumer credit, ensuring that all federal dollars are used to make loans, and generating billions in taxpayer savings. However, these taxpayer savings were not captured in the President's Budget because ECASLA expires in 2010.

Value of Choice and Competition in the Current System

- The DL program works for many of the schools that have selected it.
- There are, however, many reasons why **75 percent of schools have chosen the FFEL program**. These include loan origination processes that have been shaped to work best for individual schools, strong customer service for schools and borrowers, and a range of default prevention programs that begin while a student is in school and continue with them through repayment.

- In fact, relative to DL, “best in class” FFEL providers have been shown to materially reduce defaults for borrowers across all school types.
- In addition, schools and borrowers value choice and competition, which drives quality and innovation in loan delivery and servicing. This includes not only competition among FFEL participants, but between FFEL and DL, which has strengthened both programs. In fact, improvements in the DL loan delivery process in recent years can be attributed to vibrant competition among FFELP providers and the DL system.

MODIFIED PROPOSAL

Modified Proposal - Objectives

- Leverage the budget scoring benefits of federal funding to **achieve similar savings**.
- **Preserve the best aspects of the FFELP system and infrastructure:** broad-based competition, choice, and innovation in loan originations and servicing; best practices in default reduction, including an array of school-based and borrower-based programs; and powerful financial incentives, including default risk sharing.
- **Ensure competition throughout the loan delivery process** to assure that innovation, default prevention, and customer service remain the hallmarks of the federal student loan programs.
- Avoid “freezing” one system in place today that will not benefit from continuous improvement.
- Advance budget savings goals while enhancing value to borrowers via **enhanced default reduction programs**.
- Provide a **low-risk path to implementation** that maximizes budget savings. Requiring 75 percent of schools to switch origination systems in less than a year creates the likelihood of large scale transition problems for many schools. Since about 13 percent of the savings in the President’s budget are captured in the first academic year, which depends on more than 4,000 schools switching origination systems by July, 2010, it is unlikely that all of the projected savings will be realized. Utilizing the existing FFEL originations infrastructure would eliminate that risk.
- Minimize FFEL job losses and “multiplier” economic impacts.

Modified Proposal – Key Components

Choice of Loan Origination Approaches

- **Give schools the choice** to originate loans via ED’s DL infrastructure or via private lenders.

Federal Funding

- **Use federal funding for all government loans, modifying the current ECASLA structure** for loans originated by private lenders: lenders provide the initial capital, but subsequently sell 100 percent participation interest to the government. Within 120 days of full disbursement (typically, well into the second semester), all loans would be sold permanently to the government.

- FFEL “**special allowance**” **formulas are eliminated**. Originating lenders’ only compensation is a defined “spread” during the holding period prior to selling the loan to the government and a put fee when the loan is sold.
- The originating lender compensation is set initially at the fees now set by the Department of Education under ECASLA to assure broad participation and eliminate transition risk; afterwards, the compensation will be determined by the Department via a **market mechanism** designed to preserve broad-based participation of originating lenders.

Common Loan Terms

- Convert all loans (FFELP and DL) to one **common set of borrower interest rates, terms and conditions**, which align with the current DL program.

Loan Servicing

- **Servicing is performed by multiple Department contractors selected via competitive bidding, for all loans**, regardless of how they are originated.
- Opportunity for originating private lenders to retain servicing if they meet Department criteria (e.g., price, quality, compliance, etc.)
- Schools choosing DL originations process, or choosing private lenders who do not provide servicing, will have the opportunity to choose a loan servicer from among Department contractors.

Enhanced Default Prevention

- A new risk-sharing program is introduced into loan servicing to **give servicers “skin in the game” to minimize defaults** and keep the student loan portfolio as healthy as possible.
- The Department sets expectations for other school-based and borrower-based default prevention initiatives – such as financial literacy programs and borrower counseling – to be performed by Guaranty agencies.

Modified Proposal – Benefits

- The modified proposal is expected to **capture the vast majority of the President’s proposed savings**.
- If the inability of all FFEL schools to convert to DL originations system by July 2010 is included in budget scoring, the Alternative **could yield more savings**.
- Substantially **strengthens programs to minimize defaults** in the face of a weak economy and rising default rates.
- **Expands choice and competition** in origination and servicing.
- **Minimizes job loss** and economic disruption.
- **Avoids risk in achieving savings targets** due to issues associated with school transition of IT systems and business processes.
- Avoids risk of placing entire loan program infrastructure under the constraints of the federal contracting process.