



Private in Name Only

LESSONS FROM THE DEFUNCT GUARANTEED
STUDENT LOAN PROGRAM

JASON D. DELISLE

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Executive Summary

Following the 2016 election and with the Higher Education Act’s impending reauthorization, prominent lawmakers and interest groups have proposed expanding private lenders’ roles in the government student loan program. More specifically, they seek to restore the federal program to how it operated before the Obama administration’s reforms in 2010.

Under that system, the government mainly insured the loans that private lenders made to students via a guaranteed loan program, also known as the Federal Family Education Loan (FFEL) program. Today, however, the government makes all the loans itself using its own funds through the Direct Loan program. Nevertheless, the Direct Loan program and the defunct FFEL program are really two different designs of the same government-backed student loan program that entail the same kinds of financial risks for taxpayers.

Despite private lenders’ roles in the FFEL program, policymakers designed it such that it offered

none of the benefits private markets usually provide. Confusion and misinformation about that key point abound. FFEL program supporters erroneously claim that reverting to the FFEL program would produce budgetary savings. They also mistakenly imply that it reduced risk for taxpayers and students by restricting lending to only credentials that provided a positive return on investment or by varying terms based on the risk of each loan. They also assert that the complete switch to the Direct Loan program in 2010 led to record levels of outstanding student debt and defaults—a claim with no causal basis.

In turn, the first part of this report provides a detailed look at the defunct FFEL program and the existing Direct Loan program, including how each one evolved since the federal student loan program’s inception in 1965. The second part addresses the misinformation that undergirds proposals to return to the FFEL program.

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Following the 2016 election and with the Higher Education Act’s impending reauthorization, Republican policymakers will likely consider reforms to the federal student loan program. Currently, the government dominates the student loan market, originating an estimated 90 percent of all student loans each year through its federal Direct Loan program.¹

Some lawmakers and interest groups have proposed expanding the role of private capital and private lenders in the government loan program. Mostly, these proposals have been vague. But a few key lawmakers have been more specific, indicating that they would like to restore the federal loan program to how it operated before the Obama administration’s reforms in 2010.

Under that system, the government mainly insured loans that private lenders made to students through a guaranteed loan program called the Federal Family Education Loan (FFEL) program. Today the government makes all the loans using its own funds through the Direct Loan program.

Prominent politicians have indicated their support for a guaranteed loan program. Last year the media reported that President Donald Trump’s campaign was “planning on moving the government out of lending and restoring that role to private banks, as was the case before President Barack Obama fully shifted loan origination from private lenders to the government.”²

Rep. Virginia Foxx (R-NC), the Republican chairman of the House Committee on Education and the Workforce, said following the 2016 election that she wants to reverse a Democratic Congress’ decision in 2010 to make all federal student loans through the

Direct Loan program.³ Likewise, the 2016 Republican Party platform stated that “the federal government should not be in the business of originating student loans . . . [and] private sector participation in student financing should be restored.”⁴

Private lenders, and the trade associations representing them, also say the government loan program should make more use of private capital. In laying out its postelection agenda, the Consumer Bankers Association said “banks should play a bigger role in the federal student loan program because of the benefits private lenders bring to the table.”⁵ A trade association representing student loan companies wants to restore the FFEL program because “the prior system of a public-private partnership for funding and administering student loans was and would still prove to be a more beneficial approach for students, families, and taxpayers.”⁶

Thus, the most specific proposal so far to expand private lenders’ roles in the student loan market is to reinstate the FFEL program, which would likely replace or compete with the government’s Direct Loan program. That might seem to some an effective way to harness the efficiencies and innovations that private lenders can offer students and taxpayers.

A closer look at the FFEL loan program reveals that it involved private capital in name only. The program was designed to shield lenders from risk using taxpayer dollars, preclude lenders from restricting access to only the most creditworthy borrowers, and prohibit lenders from using prices (i.e., interest rates) to provide signals to borrowers about the quality of different educational choices. In other words, the FFEL program offered none of the benefits one might

associate with private markets. Moreover, efforts to restore it distract from alternative policies that would actually bring the benefits of private lending to bear in the student loan market.

To inform policymakers and others in the policy community about how the FFEL program cannot accomplish the goals its proponents endorse, this report provides a detailed look at that now-defunct program. It explains how FFEL operated and why it was even more heavily subsidized—and costly—than today's Direct Loan program, despite the role private lenders played in it.

The brief is organized into two sections. The first section provides a history of the government's FFEL and Direct Loan programs, an explanation of why policymakers designed each program in different ways, and a discussion of why they ended the FFEL program in 2010. The second section challenges the myths and misinformation about the loan programs that today are fueling proposals to return to the FFEL program.

The Federal Student Loan Program's Evolution

The federal government's present-day role in student lending is rooted in the 1960s, when policymakers aimed to provide low-income and minority students widespread access to higher education. The rationale for a government role in that effort was the same as it is today: many students will unlikely secure affordable private loans, despite the high expected return on the investment, due to inherent obstacles in a private student loan market.

Specifically, there is no natural source of collateral for student loans; traditional undergraduates generally have limited credit histories and earnings; the loans tend to be small and expensive for lenders to service relative to other products; and borrowers may not be able to begin payment for years while they are in school.⁷

The government actually created its first student loan program in 1958, but that program's limitations inspired a different approach in the 1960s.

The original program needed schools to become lenders—a role for which many were ill-equipped and under-resourced—and expanding it would have required a massive infusion of federal capital.⁸ To achieve the scale policymakers desired and minimize costs to the government, the 1965 student loan program tapped private lenders to issue and collect the debt, but not directly.⁹

States were supposed to play the main role in running the program by setting up their own insurance funds, or guaranty agencies, to back private lenders. The approach piggybacked on what some states were already doing. For its part, the federal government provided a small amount of seed capital for these state-based insurance funds.¹⁰ The government set generous terms on the loans for students, but states put their money at risk and ran the programs, while lenders raised the capital and serviced the loans.

Despite the apparent advantages of this third-party approach, it posed challenges for establishing widespread access to student loans. If states and lenders were unwilling to take the government up on its financial incentives, not enough loans would be available, especially for the riskier students for whom the program was intended.

In essence, the third-party arrangement necessitated that lawmakers set a market-clearing price for a government subsidy, one high enough to support the optimal amount of lending, but not so high as to overpay and waste taxpayer resources. That task was made even more difficult because the government was trying to set a price in a market it was creating from scratch. That price, of course, would change over time based on economic trends and the maturing of this new market.

It was a tall order, and policymakers' efforts on that front effectively divided the history of the guaranteed loan program into two eras. In the first, policymakers continuously increased the federal incentives and subsidies to encourage a robust and fully capitalized loan program. In the second, those same subsidies became excessive, and policymakers worked to reduce them, while concurrently developing a direct loan program on the side.

The First Era: Increasing Federal Subsidies

Soon after the guaranteed loan program's inception in 1965—renamed the FFEL program in the 1990s—many states failed to develop guaranty agencies as policymakers had hoped. States that did were swamped with demand for the new student loans, outstripping their comparatively small insurance funds. This was hardly the widespread access to loans for college that Great Society-era policymakers had envisioned.

In 1968, lawmakers expanded the federal commitment by adding a new layer of support. The government began reinsuring states' insurance funds against 80 percent of losses.¹¹ State guaranty agencies would be on the hook for the other 20 percent of claims paid to lenders for students who defaulted, moving guaranty agencies to a risk-sharing role rather than one in which they fully backed loans.

It appeared to be a cheap alternative to appropriating more seed capital for guaranty agencies. Providing even more seed capital to guaranty agencies would be an obvious and immediate cost, but promising to cover 80 percent of losses from loan defaults required no immediate outlay of government funds; federal payments would occur only in the future after borrowers defaulted. In short, the reinsurance *appeared* free for the government. Modern-day budgeting rules would have exposed this gimmick, but no such controls existed in the 1960s.

Just as policymakers introduced federal reinsurance for state guaranty agencies and expanded the government's role in the loan program, a separate threat to the goal of providing widespread access to affordable student loans emerged. This time, it was private lenders and market forces.

Recall that a key benefit of the loan program was that Congress set the interest rate lenders could charge borrowers. Initially, lawmakers set it at a fixed rate of 6 percent, which was in line with a standard bank benchmark (i.e., the prime rate) for consumer loans at that time. But as market forces led to a higher prime rate in the early years of the program, banks were less willing to lend to students, even with the guarantee against default losses. Congress responded by raising the interest rate to 7 percent.¹² But just a

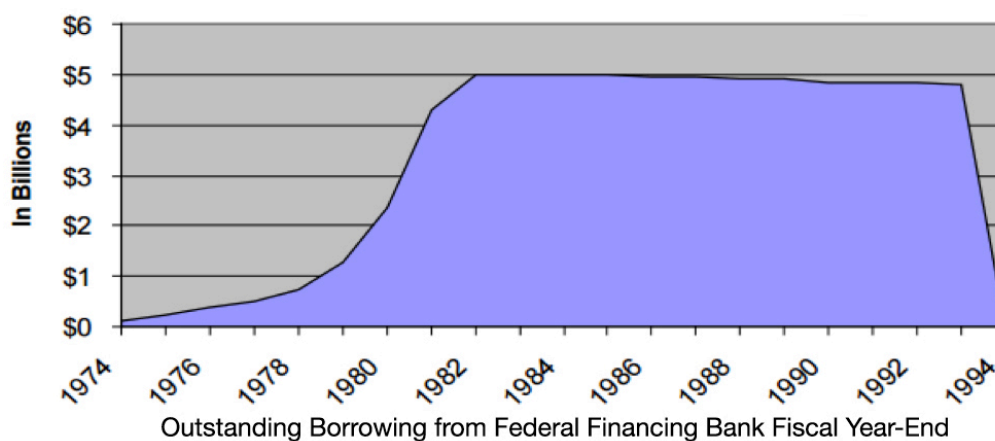
year later, market rates moved higher still, and the new rate was again too low to induce enough lenders to participate. An estimated 40 percent of students seeking a guaranteed loan in 1969 could not find a willing lender.¹³

Congress could have responded again in kind, but raising interest rates on student loans is wildly unpopular with voters. State usury laws capping interest rates on consumer loans at or just above 7 percent were another deterrent.¹⁴ Lawmakers developed a workaround to the problem of keeping students' interest rates low but lenders' rates in line with markets. The government would simply pay lenders an additional amount of interest each financial quarter. But how much more?

An estimated 40 percent of students seeking a guaranteed loan in 1969 could not find a willing lender.

For that task, lawmakers established a committee of officials from three federal agencies. They would meet each quarter to set this extra payment, called a special allowance payment (SAP).¹⁵ For example, when market interest rates rose to 9 percent, the committee had the government issue lenders a 2 percentage point SAP to bring the interest they earned on the student loans up from 7 percent to 9 percent.

Like the decision to provide reinsurance to guaranty agencies, the SAP was a significant break from the limited federal role policymakers originally intended for the student loan program. Barely five years into the program's existence, not only was the federal government backing 80 percent of default losses, but also it was making payments to private lenders to guarantee them an interest rate set via committee. Despite this larger federal commitment, the guaranteed loan

Figure 1. Sallie Mae's Outstanding Borrowing from the Treasury from 1974 to 1994

Source: Department of the Treasury, *Lessons Learned from the Privatization of Sallie Mae*, March 2006, <https://www.treasury.gov/about/organizational-structure/offices/Documents/SallieMaePrivatizationReport.pdf>.

program was *still* plagued by an insufficient supply of lenders and loans in the early 1970s. Lawmakers were going to have to strengthen their efforts, and the 1970s would see a flurry of actions to further subsidize the program.

Early in the decade, Congress established the Student Loan Marketing Authority (Sallie Mae) to support a secondary market for government guaranteed student loans.¹⁶ Sallie Mae was structured to borrow directly from the US Treasury and then buy guaranteed student loans from lenders so that they had more capital to make new loans. Sallie Mae could also advance funds from the Treasury to lenders for the same purpose (see Figure 1).¹⁷ This was a far cry from a loan program that relied on capital drawn from private markets.

Separately, Congress also changed tax law to incentivize state governments and nonprofits to become lenders themselves. These entities now could issue federally subsidized, tax-exempt bonds to finance guaranteed student loans, earning double subsidies from the federal government.¹⁸ The subsidies produced a spread between the interest rate on the loan and the bond issued to finance it as high as 16 percentage points.¹⁹

Congress also threw in the towel on the risk-sharing role it created for guaranty agencies. It upped the federal reinsurance from 80 percent of default claims to 100 percent. The federal government also began paying guaranty agencies' administrative costs.²⁰ Guaranty agencies became merely pass-through entities for federal loan insurance financed with federal administrative funds. Legally, however, they maintained their independence from the federal government.

Congress also abandoned the committee approach to setting the SAP in the 1970s, replacing it with a formula setting the extra payments to short-term interest rates—three-month Treasury rates—plus a 3.5 percentage point markup.²¹ Having a market interest rate dictate changes in the SAP would make lenders more confident and willing to make guaranteed loans. But the SAP was hardly market based. Lawmakers determined the 3.5 percent markup, not markets. In other words, Congress still dictated the price paid to private lenders so they could make student loans.²²

Yet another feature of the SAP lacked a connection to market prices, which again would work in lenders' favor. Under normal market conditions, lenders face a trade-off when issuing loans. They can make

a variable interest rate loan that protects them from the risk of losing out when interest rates rise but could hurt their returns if interest rates fall, or they can make a fixed-rate loan that assures them a decent return if rates remain steady or fall but could leave them exposed to losses if interest rates jump.

Congress decided that the SAP—financed with taxpayer money—should give lenders the best of both worlds. To do that, the SAP ensured lenders received a higher return than what students paid on their fixed-interest loans if short-term interest rates in the market moved upward. If the market rates fell below the student's fixed interest rate, lenders received *the higher of the two interest rates that quarter*. It was double protection from interest rate risk and another big incentive to make student loans.

As the 1970s drew to a close, so did the first era of the guaranteed student loan program. The policymakers were now miles away from their initial role of merely providing seed funds to state insurance agencies to jump-start a market. By this point it had become clear that if policymakers wanted widespread access to loans with affordable terms for students, then the federal government had to take on all the risk and even provide the capital. While policymakers may have failed to keep the federal role small, their efforts would succeed in establishing a robust and well-capitalized program.

The Second Era: Reining in a Big Government Program

The 1970s efforts to infuse the student loan program with federal support were so successful that by the mid-1980s, the program reached a political and financial inflection point. Every state had established a guaranty agency, and more than 11,000 lenders were making guaranteed student loans across the country.²³ Against the mid-1980s backdrop of rising budget deficits and broad spending cuts to domestic programs, lawmakers started asking questions about what had become a big government program. They concluded that the guaranteed loan program was more than adequately meeting demand from students. In fact, it was

oversubsidized and ripe for reform. The second era of the guaranteed loan program had begun.

Guaranty agencies were policymakers' first target for budget cuts in the 1980s. Thanks to the generous payments guaranty agencies earned administering federal loan guarantees and collecting defaulted loans, their revenues were growing at nearly 20 percent annually and far exceeded operating expenses. The Department of Education complained publicly that guaranty agencies were getting rich off taxpayers.²⁴ Some guaranty agencies even used their revenues to finance grant programs and other endeavors not related to student lending, all on the dime of the federal government.²⁵

This excess was a bridge too far for the Reagan administration. The administration called on Congress to reduce the federal reinsurance guaranty from 100 percent to the original 80 percent, restoring their risk-sharing role and cutting government costs. The administration also wanted to stop covering guaranty agencies' administrative costs.²⁶ Members of Congress, reluctant to cut funds flowing to their home states, ignored these requests but did authorize a one-time clawback of some of the guaranty agencies' accumulated revenues in 1986.²⁷

Policymakers targeted the lenders that year, too. For the first time, they shaved the guaranteed interest rate, reducing the 3.5 percent markup in the SAP formula to 3.3 percent.²⁸ Policymakers also limited the rules allowing states and nonprofits to issue tax-exempt bonds to finance guaranteed student loans.²⁹

This trend of paring back subsidies for lenders and guaranty agencies would continue for two more decades. Policymakers cut the SAP three more times, bringing it to 1.8 percentage points above short-term interest rates in 2007.³⁰ Starting in 2006, Congress also required lenders to remit to the government any interest they earned in excess of the minimum guaranteed by the SAP formula.³¹ Those cuts were usually motivated by studies showing that a lower SAP would achieve budget savings without affecting loan availability, the result of financial markets becoming more consolidated, efficient, and national in scope.³² According to the GAO study that precipitated the early 1990s cut to the SAP:

Since bank deregulation, however, the financial services industry has operated on a more sophisticated level. . . . The rate of return most commercial lenders receive on [guaranteed] loans is probably higher than the return necessary to retain them in the program. As such, moderate reductions to the special allowance could generate substantial savings without jeopardizing the program's reliance on private loan capital . . . [furthermore,] the 1986 reductions in the special allowance factor had no observable effect on lender participation in the [guaranteed loan] program.³³

Around this time, the 100 percent guarantee against default losses that the government provided lenders, via guaranty agencies, also started to look unnecessarily high. The loan program had experienced record levels of defaults in the 1980s and early 1990s.³⁴ Requiring lenders to bear at least some of the risk from a default would give them an incentive to do a better job keeping borrowers in good standing.

Risk sharing for lenders would also produce budgetary savings. Plus, at this juncture, the student loan market had matured. Thousands of lenders were lining up to make the loans, and limiting the guarantee would unlikely jeopardize students' access to financing. Thus, in 1993, policymakers reduced the guarantee for default losses lenders could receive (through guaranty agencies) from 100 percent to 98 percent.³⁵ In 2006, they reduced it further to 97 percent.³⁶

Private lenders did not take these changes lightly, and they had a strong hand to play in urging Congress to hold back. As the *Chronicle of Higher Education* reported as Congress considered a reduction to the SAP in the early 1990s:

Among the other student-loan-related changes proposed in the House deficit-reduction bill was a decrease in the interest subsidy the government pays to banks. John E. Dean, special counsel for the Consumers Bankers Association, said he feared that the reduction would cause banks to drop out of the student-loan business. That, he said, would leave fewer loans available for low-income borrowers, who are considered poor credit risks.³⁷

Each time Congress debated cutting subsidies to lenders or guaranty agencies in the 1990s and 2000s, lenders descended on Capitol Hill to issue this warning. Maybe the lenders were bluffing, but how was Congress to know, and could lawmakers really risk testing them? This was yet another inefficiency of the third-party approach: information asymmetry. Lenders knew how much Congress could cut the subsidy before loans were uneconomical for lenders, but Congress could only estimate, with big consequences for underbidding. Thus the guaranteed loan program had its subsidies set by a mix of informed guesswork and political shakedown.

Direct Lending Emerges as an Alternative

About the time lawmakers started trimming subsidies to lenders and guaranty agencies in the guaranteed student loan program, they also started exploring an alternative to this costly third-party approach. If the government used its own funds to make the loans, it would no longer need to coax private lenders to make loans, tinker with SAP formulas, or support bloated guaranty agencies. There would be no more political shakedowns because the government could ensure all eligible students received loans on its own terms.

Moreover, some policymakers realized that the guaranteed loan program had strayed so far from its original design that it had in effect *become a Direct Loan program*. Instead of kick-starting state insurance funds with seed capital, the government was taking on 100 percent of the default risk and all the interest rate risk through the SAP. It was even paying guaranty agencies' administrative costs. Testimony from the Congressional Budget Office (CBO) in 1979 summed up this state of affairs and helped make the case for a simpler, more efficient Direct Loan program:

Viewed originally as an ingenious and inexpensive way to attract private sector capital to the student loan business, the [guaranteed student loan] program has gone through piecemeal alterations that have transformed it into a system much more costly than a Direct federal loan program, with the higher

costs not redounding to the benefit of student borrowers, but rather to the benefit of the financial institutions that make the loans.³⁸

The idea that a Direct Loan program could achieve budget savings and still provide the same loans for students helped fuel policymakers' interest in the 1980s. Many colleges and universities also wanted a Direct Loan program, but for a different reason. The guaranteed loan program was cumbersome for colleges (loans were disbursed to students through colleges) because they had to engage with the Department of Education, private lenders, and guarantee agencies to secure loans for their students.³⁹ Direct loans would involve only the Department of Education, streamlining the loan application and disbursement processes for colleges.

While the Direct Loan program's advantages became clear in the 1980s, an accounting rule posed a major challenge to realizing them. It obscured the budget savings a Direct Loan program would achieve because it treated direct loans as grants until they were repaid. Loan guarantees, on the other hand, appeared as the opposite: the costs did not show up in the budget until the government paid a default claim to a lender. Thus, direct loans appeared costly and guaranteed loans appeared relatively cheap, even if they were equally risky for taxpayers.⁴⁰

However, by 1990 lawmakers had realized that the accounting rules were creating perverse incentives, artificially favoring guaranteed lending over direct lending, and concealing costs that taxpayers were in fact bearing. That year they changed the accounting rule to put the two types of loan programs on more equal footing.⁴¹ That made the potential direct loan savings official in the eyes of Congress, and the first estimates showed that a proposed Direct Loan program could cut costs by as much as \$2 billion a year.⁴²

Persuaded by the greater administrative simplicity and budget savings, President Bill Clinton and Democratic majorities in Congress enacted a new Direct Loan program in 1993 that would make the same loans as the guaranteed loan program.⁴³ Under the law, the Department of Education would develop a plan to transition schools out of the guaranteed program

such that at least 60 percent of schools would be using the new Direct Loan program by 1998.

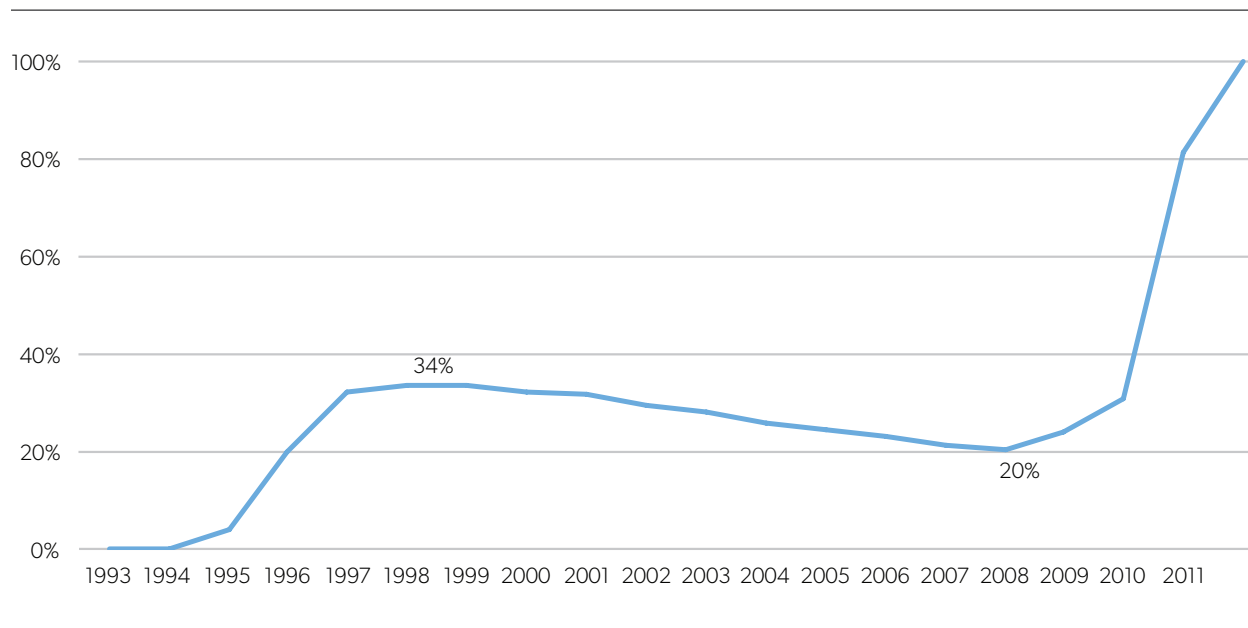
Before the department could reach that goal, the newly elected Republican majorities in Congress halted the policy in 1996.⁴⁴ They opposed the Direct Loan program, but the best they could do was halt its growth.⁴⁵ They were never going to convince President Clinton and Democratic lawmakers to dismantle it.⁴⁶

Dueling Government Loan Programs

The partisan stalemate over the Direct Loan program left the government supporting *two* student loan programs—the Direct Loan program and the FFEL program. Because loans in each program were disbursed through colleges to students, the colleges ultimately chose which program their students would use. The choice mattered little from the student's perspective—each system effectively provided the same loans with the same repayment terms—and colleges chose between FFEL loans and direct loans based largely on which program offered their financial aid offices the most administrative ease. While that created a new element of consumer choice in the programs, students were not the consumers for whom the choice mattered.

Participation in the Direct Loan program grew rapidly in its first few years, peaking at 34 percent of loan issuance in 1997, which was shortly after Congress ended any efforts to transition schools to it.⁴⁷ Then, in the early 2000s, the tide turned. Colleges began reverting to the guaranteed loan program, and they had strong incentives to do so. Lenders had addressed the administrative burdens that plagued the program in the past and began offering additional services and benefits for colleges to persuade them to switch back to the FFEL program.⁴⁸ But that was less a result of private-sector ingenuity than a consequence of excessive government subsidies.

The extra services lenders offered were financed with money they earned from the federal loan program. In other words, lenders were willing to give up some of their subsidies to win business from schools. That meant the program was oversubsidized, and the excess was used to buy loyalty from college financial

Figure 2. Share of Annual New Loan Volume in Federal Direct Loan Program by Fiscal Year

Source: Author's calculations, adapted from data from the Department of Education.

aid offices. The extra benefits of participating in the FFEL program also decreased new volume in the Direct Loan program to its lowest share since the program began—approximately 20 percent in 2007—as schools responded to incentives and switched to the FFEL program (see Figure 2).⁴⁹

Then, in 2008, the financial crisis struck. Like many financial institutions, FFEL lenders were frozen out of the capital markets and could not make new loans. FFEL lenders relied heavily on the asset-backed securities markets to finance their loans, a market that also financed home mortgages and was the epicenter of the financial crisis. The government's guarantee on the loans was no match for panic-stricken markets. Ironically, the FFEL program was about to end up right where it had started in the 1960s, unable to provide loans to every eligible student who wanted one.

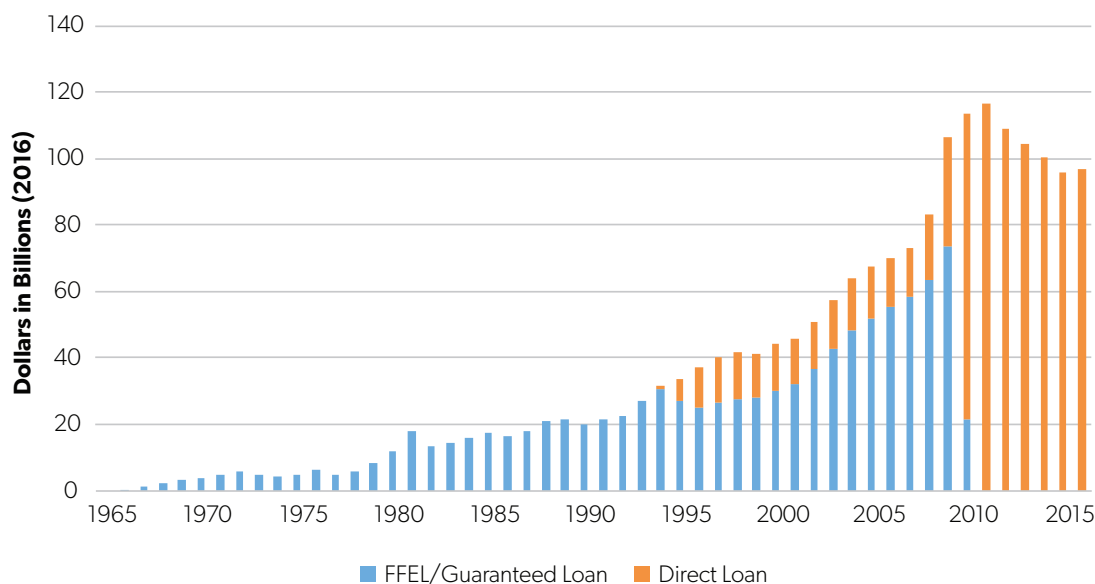
Policymakers found themselves in the same role as their predecessors, inventing new policies to funnel more federal money to private lenders to help them make government-backed student loans. Because schools chose which loan program they would use, students could not simply use direct loans if a FFEL loan was unavailable. Their schools would need to

switch programs, but the financial crisis left them unable to convert to direct loans in time for the 2008–09 academic year.

A Democratic Congress and President George W. Bush responded by enacting an emergency program called the Ensuring Continued Access to Student Loans Act (ECASLA), whereby the government purchased FFEL loans using government funds, which provided lenders with capital to make new loans.⁵⁰ The government also made loans to FFEL lenders themselves, so they could then turn around and lend those funds to students.

The upshot was that policymakers were forced to make the FFEL program even more like the Direct Loan program, with the government advancing its own capital to private lenders so that they could make loans to students, which the government guaranteed against default and interest rate risk. Many surely wondered why the government ended up in such a place when the Direct Loan program was immune to the difficulties FFEL faced during the financial crisis.

In 2009, newly elected President Obama proposed eliminating the FFEL program, arguing that subsidies paid to private lenders under the program were

Figure 3. New Annual Federal Student Loan Volume over Time

Source: Author's calculations, adapted from data from the Department of Education.

unnecessary and costly given the alternative of direct lending.⁵¹ Democratic majorities in Congress and the president enacted this proposal as part of the 2010 Affordable Care Act, and all new federal student loans as of July 1, 2010, have been made through the Direct Loan program.⁵²

The complete changeover to direct loans was projected to save at least \$4 billion a year.⁵³ Importantly, these savings were achieved while providing student loans with more or less the same terms. In other words, direct loans reduced the government's costs while holding students harmless. Figure 3 traces the growth in loan originations under each program since 1965.

Rebutting Myths About the FFEL and Direct Loan Programs

Based on the design, evolution, and added cost of the FFEL program, it is surprising that so many conservatives and senior Republican policymakers want to restore it today. FFEL was as much a government

program as the Direct Loan program and can hardly pass for private capital or private market. That reality is lost on some observers. The debate about which loan program is better reveals much confusion and misinformation about how the FFEL program worked, how it evolved, and what it had in common with the Direct Loan program.

First off, FFEL program supporters often imply that it set loan prices based on the risk and value of the educational programs it funded, like a private market would. It did nothing of the sort, nor did it restrict lending to only credentials that provided a positive return on investment. Supporters also assume that because the FFEL program involved private lenders, it must have realized efficiencies and cost savings for taxpayers. The program did just the opposite.

Then there is the spurious viewpoint that FFEL reduced the risk of financial loss for taxpayers because lenders, not the government, held the loans. Perhaps most outrageous of all are the claims that the Direct Loan program is to blame for record levels of outstanding student debt and a spike in loan defaults. Each of those myths warrants further discussion.

Comparing Taxpayer Costs for the FFEL and Direct Loan Programs

As the history of the two loan programs shows, the rationale for replacing the FFEL program with the Direct Loan program was largely to achieve budgetary savings. The government did indeed realize substantial savings under direct lending, meaning that restoring the FFEL program would impose substantial costs on taxpayers. However, that fact has been obscured for three reasons amid the calls to return to FFEL.

The Role of Private Lenders. The first is the assumption that the presence of private lenders in FFEL—and their absence in the Direct Loan program—must have resulted in efficiencies that flowed to the government’s bottom line. After all, the private market is more efficient, innovative, and responsive to incentives than the federal government. Private lenders also add value by managing risk, restricting lending to investments that stand a good chance of paying off, and varying loan terms accordingly. Generally there is no issue with those views, except that the FFEL program’s design *prevented* the government from realizing any benefits that the private sector could offer.

The government shielded lenders for up to 100 percent of the default risk, and Congress, not markets, set the markup on the SAP, determining the payments lenders would ultimately receive to make a loan. Nor were markets involved in setting how much the government paid guaranty agencies to pass federal money to FFEL lenders. Congress set those payment rates, which should be a red flag for right-leaning policymakers inclined to believe the FFEL program saved taxpayers money.

Perhaps most importantly, the program was designed to ensure access to student loans regardless of students’ backgrounds and the type of college or program they attended. Lenders, therefore, did not manage risk by restricting lending to investments likely to pay off, nor did they vary terms for borrowers and schools with different risk profiles; all students were entitled to the same loans under FFEL.

The inherent problem of Congress setting payment rates for lenders to ensure students would receive loans regardless of their circumstances was amplified by another feature of the FFEL program. Congress did not know what the most efficient payment rate was to encourage just the right amount of lender participation, but the political consequences for setting the rate too low would be severe—students could be left without a loan at the start of a semester. Therefore, lawmakers had to err on the side of setting the payments higher than what was needed to reach an optimal amount of lending.

Accounting Rules. The second source of doubt about the FFEL program’s lower cost is a separate debate over accounting rules the government uses to measure the cost of its loan programs. These rules make it appear as if the government can earn a profit by subsidizing borrowers through direct loans or loan guarantees in which the lender or borrower pays a fee to the government. According to the nonpartisan CBO and many economists, including those at the Federal Reserve, these rules significantly understate the cost of direct or guaranteed government loan programs because they use the government’s relatively low cost of borrowing when assessing risk.⁵⁴ See the sidebar for an explanation of the accounting issue.

Just last year, problems associated with the official accounting rules led *Wall Street Journal* editorial writers to claim that the savings from switching to the Direct Loan program in 2010 were fictitious.⁵⁹ Lost on the *Wall Street Journal* was the fact that the flawed accounting rules understate the cost of *all* government loan programs, not just direct loans. That means the difference in costs between direct loans and FFEL remains even after the accounting flaw is addressed using fair-value accounting (see sidebar).

A 2010 analysis by the CBO makes this clear (see Table 1).⁶⁰ Under the official (albeit flawed) accounting rules, a FFEL loan costs taxpayers 11 percent of each dollar lent. That is, for every \$100 lent, taxpayers pay \$11 to cover default losses, interest rate benefits, and administrative costs. Fair-value accounting shows the cost is higher—\$20.20 for each \$100 in loans.

Flawed Accounting Rules Understate Loan Program Costs

In the early 1990s, lawmakers changed how the budget reflects the cost of loan programs through the Federal Credit Reform Act (FCRA).⁵⁵ The law requires that loan programs appear in the budget on an accrual basis, which reflects the lifetime cost of the loans as a lump sum in the year that they are made. Thus the lifetime cost of a 10-year loan appears entirely in the year that the loan is issued.

Before the FCRA, the budget reflected the cost of loans on a cash-in, cash-out basis, which made it difficult to discern what federal loan programs cost taxpayers.⁵⁶ The budget showed only a snapshot of the cash flows to and from the government associated with a loan program for a given year, even when the repayment terms extended over decades. Furthermore, the cash approach made direct federal loans appear as grants in the year they were issued, even if there was a high likelihood that the loan would be repaid. Meanwhile, the same loan made by a private lender and guaranteed against default by the government appeared to cost nothing, even if there was some risk that the borrower would default.

Many budget experts and economists agreed that the accrual accounting approach enacted under the FCRA was an improvement. Still, the FCRA systematically understates the cost of both direct and guaranteed government loan programs. It requires that budget analysts estimate the cost of loan programs using a discount rate—the rate at which future cash flows from the loan are converted to a present value—that reflects the interest rates on Treasury securities of comparable maturities.

However, that practice results in an incomplete accounting of the risk the government bears in making a direct loan or a loan guarantee. The government would not be able to finance its obligations under a loan program at Treasury interest rates based on the quality of loans themselves. While the government can borrow at lower rates than the private sector, it can do so only because it can repay the bonds with revenue from taxpayers no matter how the loans perform. Of course, pledging taxpayer resources to secure lower borrowing rates is not a free advantage

for the government; it is costly to taxpayers, whose money has been pledged in the transaction.

Another way to understand the problem with the FCRA's mandate to use Treasury rates to discount loan payments is that it essentially requires risky cash flows (the loan payments) to be discounted at a rate appropriate for risk-free cash flows (Treasury bond payments). This treats the average expected cash flows for a federal loan portfolio as indistinguishable from the cash flows of a Treasury security with the same expected performance.

Hypothetically, if the *average* expected payment from a student loan was \$100, and the *average* expected payment from a Treasury bond was also \$100, the FCRA implies that an investor should be indifferent about taking on either investment because they are of equivalent expected value. In actuality, the Treasury bond is a safer bet.

If the economy performs worse than expected, the loan payment will likely be less than \$100, but the Treasury payment will still be \$100. To be sure, if the economy performs better than expected, the loan would indeed end up worth more than \$100 and the Treasury bond still only \$100. Crucially, however, individuals, bondholders, and governments do not assign symmetrical values to gains and losses. They are risk averse.

To address this issue and improve the FCRA, the CBO and many academic economists recommend that the discount rate incorporate the cost of bearing market risk, an approach that the CBO calls fair-value accounting. In that effort, the CBO has historically added a risk premium to the Treasury interest rate applied under the FCRA estimates for student loans that ranges from 2.4 to 3.5 percentage points, depending on the type of student loan.⁵⁷

According to the latest estimates under the FCRA, federal student loans issued over the coming 11 years, all of which will be direct loans, will earn \$10.2 billion per year for the government. Under fair-value accounting, the estimate changes to a projected cost of \$12.2 billion per year.⁵⁸

Table 1. Comparing the Cost of the FFEL and Direct Loan Programs

	Fair-Value Accounting		Official FCRA Accounting	
	FFEL	Direct Loan	FFEL	Direct Loan
Loan Subsidy to Borrowers	\$10.50	\$11.20	-\$3.50	-\$2.70
Lenders' Default Risk Sharing	-\$1.30	\$0.00	-\$0.30	\$0.00
Government's Administrative Costs	\$0.70	\$2.20	\$0.80	\$2.50
Special Allowance Payment	\$9.40	\$0.00	\$13.00	\$0.00
Government's Payments to Guaranty Agencies	\$0.90	\$0.00	\$1.00	\$0.00
Total	\$20.20	\$13.40	\$11.00	-\$0.20

Note: The amounts reflect the present value of the lifetime cost per \$100 loan issued. Positive numbers denote cost to the government, and negative numbers denote earnings for the government. "FCRA" refers to the standards set by the Federal Credit Reform Act. Source: Author's calculations, adapted from Congressional Budget Office, "Costs and Policy Options for Federal Student Loan Programs," Table 4.

The same loan made through the Direct Loan program earns a \$0.20 profit for the government under flawed accounting rules, and it incurs a \$13.40 loss under fair-value accounting. While it is true that the Direct Loan program costs about \$11 less than the FFEL program (per \$100 in loans) under the flawed accounting rules, better accounting procedures do not erase this gap—the Direct Loan program still costs \$7 less per \$100 in loans.

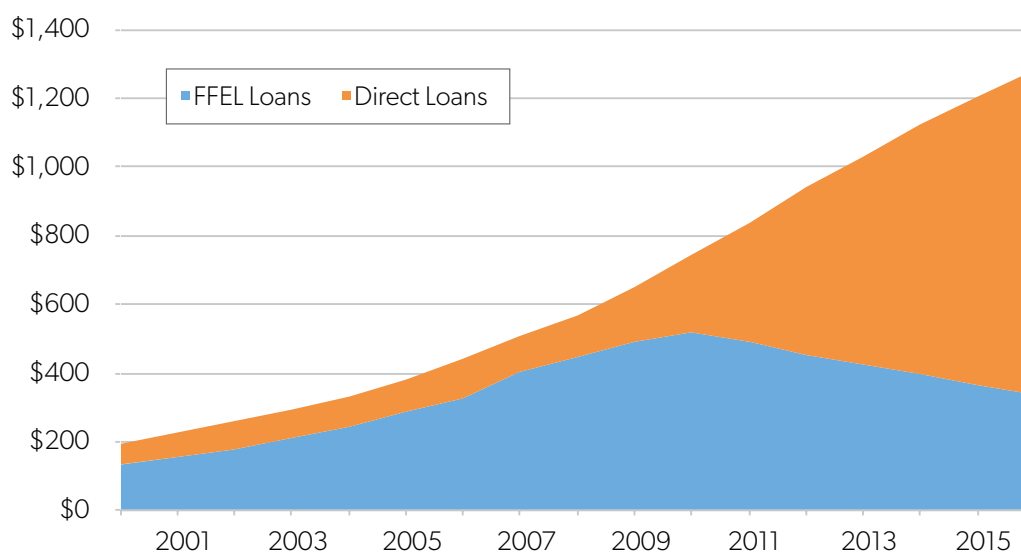
It makes sense that the FFEL program would cost substantially more than the Direct Loan program under fair-value accounting. Fair-value accounting more comprehensively measures the financial risks taxpayers bear in loan programs. The FFEL program did nothing to reduce those risks relative to the Direct Loan program. Moreover, it compensated lenders with an arbitrarily high payment rate. More comprehensive accounting cannot change those facts.

Finally, the FFEL program costs more than the Direct Loan program under both accounting approaches, which means that eliminating the FFEL program did produce real budget savings. Under the official but flawed accounting rules, eliminating FFEL saved \$62 billion over an 11-year budget window, according to the CBO. Under fair-value accounting,

the CBO projected savings of only \$40 billion.⁶¹ The savings are lower under fair-value accounting, but certainly not fictitious.⁶²

Why are the savings not exactly the same? Mainly because fair-value accounting cancels out the financing advantage the government appears to have in issuing Treasury securities at interest rates lower than private entities can. That artificial advantage is more pronounced in the official estimates for the Direct Loan program than those for the FFEL program because the Direct Loan program requires the government to borrow rather than rely on the private sector to finance student loans upfront. Thus, when the artificial advantage is removed (i.e., using fair-value accounting), the cost of the Direct Loan program increases by more than the costs increase for the FFEL program.⁶³ Crucially, however, that effect is not enough to close the cost gap between the two programs.

Administrative Costs. The third source of doubt regarding the Direct Loan program's lower cost is a misleading argument that says the government spends more in administrative overhead to operate the Direct Loan program. At first glance, this might appear true.

Figure 4. Outstanding Federal Student Loans (Dollars in Billions)

Source: Author's calculations, adapted from data from the Department of Education and the Office of Management and Budget.

As Table 1 shows, administrative costs for the federal government were lower under the FFEL program. A \$100 loan made through the FFEL program cost just \$0.70 to administer at the Department of Education. In the Direct Loan program, the department spent \$2.20.⁶⁴ Yet this is hardly a case of private market efficiency versus government bloat. Private lenders and guaranty agencies carried out the bulk of the administrative tasks in the FFEL program, such as loan origination and servicing, which made administrative costs for the government appear lower.

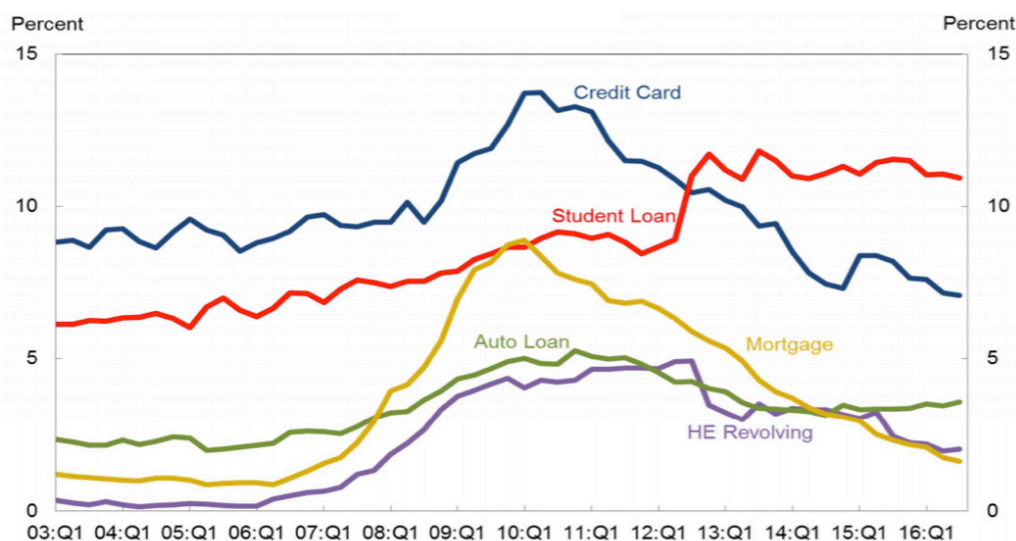
But recall that the government compensated lenders and guaranty agencies for their costs. More specifically, the interest rate the government guaranteed FFEL lenders included a markup over lenders' financing costs to compensate lenders for all servicing costs. Guaranty agencies earned fees to administer the default guarantees, perform loan rehabilitations, and collect on defaulted loans.

Table 1 shows that the interest rate markup to lenders totaled \$9.40 for every \$100 lent under the FFEL program, and payments to guaranty agencies totaled \$0.90 for every \$100 lent, which is high enough to more than cancel out the lower administrative costs

the Department of Education incurred in supporting the FFEL program.⁶⁵ Private lenders might have had lower administrative costs than the government, but by design the FFEL program rendered these savings irrelevant for taxpayers by compensating lenders at arbitrarily high rates set in law.

Blaming Direct Loans for Delinquencies, Defaults, and Record Levels of Student Debt

When student debt doubled in less than a decade and surpassed \$1 trillion around 2012, some attributed the milestone to the 2010 switch to direct lending (see Figure 4).⁶⁶ In 2013, a *Wall Street Journal* editorial said that the "federal student-loan explosion" was "predicted by those who opposed the federal takeover of student loans."⁶⁷ Two years later, *Investor's Business Daily* claimed that President Obama "manufactured" this crisis when he "eliminated the federal guaranteed loan program."⁶⁸ While one event did follow the other, a few points reveal why there was no causal relationship.

Figure 5. Percentage of Balance 90+ Days Delinquent by Loan Type

Note: "HE Revolving" is an abbreviation for home equity loans.

Source: Federal Reserve Bank of New York, *Quarterly Report on Household Debt and Credit*, November 2016, www.newyorkfed.org/medialibrary/interactives/householdcredit/data/pdf/HHDC_2016Q3.pdf.

Policymakers determine how much students can borrow in the federal loan program by setting annual and lifetime borrowing limits in statute, and those limits were always the same under both the FFEL and Direct Loan programs. Policymakers did not increase those borrowing limits following the complete switch to direct lending in 2010.⁶⁹

Furthermore, the eligibility rules for students were always the same in the FFEL and Direct Loan programs. Every college or university that was eligible to participate in the FFEL program was also eligible to participate in the Direct Loan program. Given those facts, it is nearly impossible to imagine that had the 2010 switch to direct lending not happened, outstanding student debt would be lower today.

FFEL program supporters often make another dubious claim: borrowers with loans made under the FFEL program were less likely to be delinquent or default because FFEL lenders and guaranty agencies had a stronger financial incentive to prevent defaults and were more adept than the federal government at managing risk. So when student loan default rates spiked

in the years following the switch to 100 percent direct lending (see Figure 5), FFEL supporters drew a causal link. As a 2015 *Investor's Business Daily* editorial put it:

In less than five years, President Obama turned a relatively small, privately run, guaranteed student-loan program into a massive government-run disaster. . . . Delinquency rates on the feds' \$1.2 trillion of student loans are sky high—worse than mortgage loans during the housing crisis. . . . Here's why people are no longer paying back their loans, now that Big Government is running things: Experts say that the Education Department is ill-equipped to identify risks when making loans.⁷⁰

This line of reasoning suffers from the same breakdown in logic as the claim that direct lending caused outstanding student debt to increase. Nothing in the design of the FFEL or Direct Loan program suggests that the default and delinquency rates on student loans would be lower if lawmakers had not eliminated the FFEL program in 2010.

Table 2. Estimated Lifetime Default Rates by Loan Program and Loan Type

Loan Type	FFEL	Direct Loan
Subsidized Stafford	11.7%	11.9%
Unsubsidized Stafford	10.1%	10.8%
PLUS	4.5%	5.6%
Consolidation	14.5%	26.3%
Total	11.6%	13.9%

Note: Total is weighted by loan volume for the fiscal year 2008 cohort of loans.

Source: Department of Education, "Budget 2009 Appendix," 2008, www.gpo.gov/fdsys/pkg/BUDGET-2009-APP/pdf/BUDGET-2009-APP-1-8.pdf.

As this paper has discussed in detail, policymakers made the same students entitled to the same loans with the same terms in both the FFEL and Direct Loan programs, thereby ensuring students would receive a government loan from either program at the same terms no matter their risk profile or the school they chose to attend. Every loan, good or bad, made since 2010 under the Direct Loan program would almost certainly have been made under the FFEL program as well, assuming policymakers would have maintained the emergency policies under ECASLA for as long as needed to keep the FFEL program afloat during the financial crisis.

The surge in borrowing and defaults that occurred around 2010 is largely explained by changes in college enrollment patterns following the economic recession that were unrelated to the change to direct lending. In the aftermath of the recession, a large wave of nontraditional students enrolled in institutions of higher education and took out federal student loans. These students, who had historically made up a small share of borrowing, accounted for half of loan disbursements in those years.

This trend, according to one widely cited study, "shifted the composition to borrowers more likely to struggle with their loan burdens—toward older, mid-career borrowers; borrowers from more disadvantaged family backgrounds and poorer neighborhoods; and toward programs many were less likely to complete."⁷¹ Of course, the FFEL program was designed to make loans to this exact population, as was the Direct Loan program.

Default Rates Were the Same Under Both Programs. Official statistics do not support the assertion that default rates were meaningfully lower in the FFEL program. Table 2 shows that the estimated default rates for loans issued in 2008 were comparable under the two programs. Specifically, 11.6 percent of loans issued under the FFEL program were expected to default compared with 13.9 percent of loans made in the Direct Loan program.⁷² The rate is slightly higher for loans in the Direct Loan program, but nearly all that difference can be explained by a provision in the Direct Loan program that channeled likely defaulters out of the FFEL program and into direct loans.

Before the development of today's income-based repayment options for federal student loans, the government maintained a limited income-based repayment program called Income-Contingent Repayment (ICR) only available under the Direct Loan program. If they agreed to use ICR, borrowers could rehabilitate their defaulted loans by consolidating their debt. Because ICR was not available under FFEL, borrowers with FFEL loans taking this option were moved into the Direct Loan program.

As a result, many consolidation loans in the Direct Loan program had previously been FFEL loans that defaulted. Because borrowers who default and then rehabilitate their loans will more likely default a second time than the average borrower will default once, consolidation loans in the Direct Loan program appeared to have an unusually high rate of default.⁷³ To be sure, as Table 2 shows, default rates are slightly

lower in the FFEL program for the other types of loans besides consolidation loans. But those differences are likely too small to indicate a meaningful correlation between default rates and loan program, a conclusion other researchers have also reached.⁷⁴

In addition, even if the FFEL program could achieve a lower default rate, taxpayers paid extra to achieve it because the FFEL program cost more. While borrowers benefit from a lower default rate, paying more to achieve better performance in a loan program is not indicative of one program's competitive advantage or efficiency. That the FFEL program cost taxpayers more but *did not* realize a lower default rate is evidence of its competitive disadvantage and inefficiency.

The Government Risks Financial Loss in Both Programs. Despite the evidence that the FFEL program entailed much larger costs for taxpayers, the program's supporters often imply that the Direct Loan program exposes taxpayers to greater risk of losses from defaults than the FFEL program because of the debt on the government's balance sheet. Therefore, they reason, the government could reduce the risk of financial losses to taxpayers by making loans through the FFEL program instead, keeping direct loans off the government's books and precluding it from borrowing to finance the loans.

Reducing government debt and the risk of financial losses for taxpayers are desirable outcomes, but the FFEL program could not bend the laws of finance. The moment a student borrower takes out a loan, risk is created. It makes no difference whether the government bears that risk directly by lending to students with its own funds or indirectly by guaranteeing the returns of private-sector creditors.

Moreover, the risk of incurring losses that taxpayers bear through a direct loan or a guarantee of the same loan are theoretically identical. Put simply, the government providing a lender a guarantee against 100 percent of default losses on a \$1,000 loan is no different from the taxpayer's perspective than making a \$1,000 direct loan. Of course, in the FFEL program, lawmakers actually made the guarantee approach more costly by setting arbitrarily high interest rate payments to lenders through the SAP.

To be sure, the government may need to borrow to finance a direct loan, which increases the government's debt compared with an equivalent loan guarantee. But the government's net financial position is no different in that case than if a lender issued the loan with a government guarantee. An equivalent loan guarantee would still require that a private lender finance the government-backed loan with debt—debt that would be indirectly backed by the government through the 100 percent guarantee on the student loan it financed. Under both transactions, then, the government or a lender issues debt to finance a student loan fully backed by the government.

Selling or Securitizing Direct Loans. FFEL program supporters often extend the dubious argument about reducing risk with loan guarantees by proposing that the government sell or securitize the direct loan portfolio. They believe that selling the existing stock of direct loans would be a net gain for taxpayers. A recent position paper from a trade association of former FFEL lenders and guaranty agencies explains the argument:

The Federal Direct Loan portfolio now stands at \$911.6 billion and is expected to continue to grow at a substantial rate, leaving taxpayers at significant risk as default rates, severe delinquencies, and the cost of generous loan forgiveness programs continue to rise. . . . One such short-term idea is to securitize a portion of the Direct Loan portfolio initially on a limited basis using state, nonprofit, and for-profit entities, who could be responsible for servicing and collecting the loans. This would remove the debt, and the corresponding risk, from the nation's balance sheet and decrease taxpayer exposure.⁷⁵

It is not exactly clear how this proposal would work, but there are at least two possible interpretations. In one, the government would continue to guarantee the loans after it sells them to private entities. Yet this proposal is nothing more than the FFEL program in disguise. The government is still bearing the financial risks (i.e., default losses) associated with the loan, but lenders hold the loans on their books,

just like in the FFEL program. The only difference is the government originates the loans and later moves them to private lenders through a sale.

Alternatively, the government could sell the loans without a guarantee, but this proposal cannot be a net gain for the government because the “nation’s balance sheet” has two sides. Once the government issues a student loan and enters into a contract with the student, it has put the risk of financial loss on its balance sheet. It cannot remove that risk from its balance sheet unless it pays other entities to put it on theirs, either by paying them a fee or selling them the loans at a discounted price that reflects that risk. At best, the transaction is zero sum—the government pays a lender \$1 million to remove every \$1 million of risk from its balance sheet. At worst, the transaction results in a net cost to taxpayers—the private market outsmarts the government and buys the loans for less than their fair value.

The only way a loan sale would result in a net gain for taxpayers is if the government convinces private lenders to buy the loans for *more than they are worth*. That seems unlikely if one believes that the private market is better at pricing risk and making loans than the government.

Conclusion

Much of the debate about the FFEL and Direct Loan programs has been driven by the view that the FFEL program was a public-private partnership that relied on the private market to issue loans and was therefore a better approach than an entirely direct program. Meanwhile, the Direct Loan program is seen by some as a large government program, with all the attendant disappointments and inefficiencies one would expect. Today, those views undergird the calls to restore the FFEL program, bring private capital back into the student program, or sell the direct loan portfolio to private lenders and investors.

But as this paper has argued, the private market and big government distinctions are artificial. FFEL and direct loans are really two different designs of the same government-backed student loan program that

entail the same kinds of financial risks for taxpayers. In both loan programs, the government makes students legally entitled to loans at the same terms set by the government regardless of student risk profiles or the colleges and universities they choose to attend. To make good on those entitlements, the government is on the hook for the full cost of making those loans under the FFEL and Direct Loan programs.

Both programs also involve the private sector and public-private partnerships. Many of the same companies that made loans under the FFEL program, such as Navient (formerly Sallie Mae), Nelnet, and Great Lakes Educational Loan Servicing, now operate the Direct Loan program for the government. The Department of Education has contracted with these companies to administer and service direct loans.⁷⁶

The government also hires private collection agencies to recover bad debts.⁷⁷ In addition, the government determines which companies will service the loans and how much it will pay them through a competitive bidding process. While that process is not without its shortcomings, it does harness market forces and competition to set prices for private companies operating the loan program.

Compare that to the FFEL program’s design. Lawmakers entitled any lender willing to make loans at terms set by the government (i.e., Stafford and PLUS loans) to a guaranteed return. Lawmakers set that rate, which was largely imprecise and excessive. It was not set based on market competition, auctions, or some similar process. FFEL lenders did indeed compete for business from schools, but not in a way that harnessed efficiency or cost reductions for the government.

Moreover, FFEL lenders were prohibited from offering different terms to students with different risk profiles. Even if they could engage in such practices, they would have had no incentive to do so because the government took on virtually all the risks of making bad loans. The FFEL program was a government program through and through.

However, none of these arguments should be construed as making a case for or against a government student loan program per se. The focus here is only on the best design for such a program. Whether the

government should support one is a separate topic, as is the question of how much the government should subsidize borrowers through either type of loan program.

Accordingly, this paper has not addressed those questions. One could make a strong case, though, that policymakers have set subsidies for today's students and borrowers at overly generous levels. As a result, they have taken the loan program far beyond the original goal of creating a student loan market where one never existed; the program now *displaces* what would otherwise be a competitive private market for large categories of students.

While this paper makes a case for a particular approach to government-backed loans, it does not argue that private capital has nothing to offer over a government program. On the contrary, this paper has maintained throughout that private capital and market-based incentives have many advantages.

However, rather than subsidize private lenders, the most straightforward way for policymakers to bring those advantages to bear on the student loan market is to restrict the amount that the current loan program lends, such as by eliminating government loans to graduate students (Stafford and Grad PLUS loans) and to parents of undergraduates (Parent PLUS loans). Unlike undergraduate students, graduate students and parent borrowers have had the chance to establish earnings and credit histories and, in the case of graduate students, earn college degrees, making them good candidates for purely private loans.

Above all else, policymakers must understand that the goal of bringing private capital into the loan program in a way that adds value for the government and

The most straightforward way for policymakers to bring those advantages to bear on the student loan market is to restrict the amount that the current loan program lends.

students is in conflict with other goals for the program. That is because the way private capital adds value in a loan program is by varying terms and loan amounts for borrowers based on risk, denying access to credit for bad investments, and sharing in the financial risks.

Put another way, private capital adds value by precluding universal access to student loans at universal terms. If policymakers believe the most important goal is to provide widespread access to loans at terms the government sets, then there is nothing private capital can offer over the Direct Loan program.

About the Author

Jason D. Delisle is a resident fellow at AEI's Center on Higher Education Reform.

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29. The Education Amendments of 1980 cut in half the special allowance paid on loans originating from or purchased with the proceeds of tax-exempt bonds. The Student Loan and Technical Amendments Act of 1983 required that authorities issue no more bonds than were necessary to meet the need for student loan credit in their areas. The Deficit Reduction Act of 1984 set limits on the volume of student loan bonds. See Congressional Budget Office, “The Tax-Exempt Financing of Student Loans,” August 1986, www.cbo.gov/sites/default/files/cbofiles/ftpdocs/61xx/doc6189/doc20b-entire.pdf.
30. In 1992, Congress cut SAP to 3.1. See Higher Education Amendments of 1992, S. 1150, 102nd Cong., www.govtrack.us/congress/bills/102/s1150/text. In 1993, it cut SAP to 2.5 for in-school period but left it at 3.1 for repayment. See Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, www.congress.gov/bill/103rd-congress/house-bill/2264/text. Finally, in 2007 Congress cut SAP to 1.8 in the College Cost Reduction and Access Act. See College Cost Reduction and Access Act, Pub. L. No. 110-84, www.congress.gov/bill/110th-congress/house-bill/2669/text.
31. The issue is discussed and analyzed most thoroughly in a 1992 report from the Government Accountability Office, but the issue had changed since then as borrowers paid fixed interest rates on their loans under the 2006 policy, not variable rates as was the case under the 1992 Government Accountability Office report. See Government Accountability Office, “Guaranteed Student Loans: Eliminating Interest Rate Floors Could Generate Substantial Savings,” July 1992, www.gao.gov/assets/220/216387.pdf. In addition, the

legislation that changed the SAP to capture excess interest was the Deficit Reduction Act of 2005. See Deficit Reduction Act of 2005, Pub. L. No. 109-171, www.congress.gov/109/plaws/publ171/PLAW-109publ171.pdf.

32. Government Accountability Office, “Stafford Student Loans”; and Sarah Jenkins, “Lender Profitability in the Student Loan Program,” Department of Education, April 1991, <http://files.eric.ed.gov/fulltext/ED338155.pdf>.

33. Government Accountability Office, “Stafford Student Loans.”

34. Franklin Frazier, “The Stafford Student Loan Program,” testimony before the Subcommittee on Permanent Investigations Committee on Governmental Affairs, US Senate, February 20, 1990, <http://www.gao.gov/assets/110/102992.pdf>.

35. Omnibus Budget Reconciliation Act of 1993.

36. Deficit Reduction Act of 2005. Subsequent legislation would have reduced it to 95 percent starting in 2012, but the guaranteed loan program ended before that change could take effect. See College Cost Reduction and Access Act.

37. Thomas J. DeLoughry, “Budget-Cutting Plan Could Bar 60 Colleges from Guaranteed-Student-Loan Program,” *The Chronicle of Higher Education*, October 24, 1990, www.chronicle.com/article/Budget-Cutting-Plan-Could-Bar/88294.

38. Alfred B. Fitt, testimony before the House Committee on Education and Labor, Subcommittee on Postsecondary Education, May 30, 1979, www.cbo.gov/sites/default/files/96th-congress-1979-1980/reports/doc203.pdf.

39. Government Accountability Office, “Student Loans: Direct Loans Could Save Money and Simplify Program Administration,” September 1991, www.gao.gov/assets/80/78232.pdf.

40. Congressional Budget Office, “Credit Reform: Comparable Budget Costs for Cash and Credit,” December 1989, www.cbo.gov/sites/default/files/101st-congress-1989-1990/reports/89-cbo-031.pdf. For additional history, see Jason D. Delisle, “Learning from History: Correcting the Credit Reform Act,” *Economics21*, December 13, 2010, <https://economics21.org/html/learning-history-correcting-credit-reform-act-303.html>.

41. Federal Credit Reform Act of 1990, Pub. L. No. 93-344, www.fiscal.treasury.gov/fsreports/ref/ussgl/creditreform/fcratoc.htm.

42. See US Committee on Labor and Human Resources, “Student Loan Reform,” May 26, 1993, <http://files.eric.ed.gov/fulltext/ED363187.pdf>.

43. US Committee on Labor and Human Resources, “Student Loan Reform”; and Omnibus Budget Reconciliation Act of 1993.

44. Omnibus Consolidated Rescissions and Appropriations Act of 1996, Pub. L. No. 104-134, www.gpo.gov/fdsys/pkg/PLAW-104publ134/pdf/PLAW-104publ134.pdf.

45. Republicans originally attempted to cap participation in the Direct Loan program but reached a compromise deal with congressional Democrats that let schools choose which program to use. Later Republicans would restrict using administrative funds at the Department of Education for the Direct Loan program, prohibit promoting the program, and discontinue small payments the department made to schools using direct loans to help cover their administrative costs. See Stephen Burd, “Long-Awaited Budget Deal Drops Cap on Direct-Lending Program,” *Chronicle of Higher Education*, May 3, 1996, www.chronicle.com/article/Long-Awaited-Budget-Deal-Drops/94538; and Stephen Burd, Andrew Mytelka, and Paulette V. Walker, “House Votes to Increase Spending on Student Aid and the NIH,” *Chronicle of Higher Education*, July 26, 1996, www.chronicle.com/article/House-Votes-to-Increase/96391.

46. Stephen Burd, “The Fight over Direct Lending Enters a New Phase,” *Chronicle of Higher Education*, December 6, 1996, www.chronicle.com/article/The-Fight-Over-Direct-Lending/76278.

47. Author’s calculations based on Department of Education, “Federal Student Loan Data Book FY94-FY96,” <https://www2.ed.gov/finaid/prof/resources/data/fslpdata94-96/index.html>; Department of Education, “Federal Student Loans Program FY1997-FY2000 Data Book,” <https://www2.ed.gov/finaid/prof/resources/data/fslpdata97-01/edlite-index.html>; and Department of Education, “Student Loan Volume Tables—FY 2009 President’s Budget,” <https://www2.ed.gov/about/overview/budget/studentloantables/index.html>.

48. See Megan Barnett, Julian E. Barnes, and Danielle Knight, “Big Money on Campus: How Taxpayers are Getting Scammed by Student Loans,” *US News & World Report*, October 27, 2003, <http://ire.org/resource-center/stories/20900/>; and Anne Marie Chaker, “School-As-Lender Programs Draw Participants, Critics,” *Sun-Sentinel*, October 31, 2005, http://articles.sun-sentinel.com/2005-10-31/business/0510280236_1_federal-student-loans-student-financial-support-new-schools.

49. Department of Education, “Federal Student Loan Data Book FY94-FY96”; Department of Education, “Federal Student Loans Program FY1997-FY2000 Data Book”; and Department of Education, “Student Loan Volume Tables—FY 2009 President’s Budget.”

50. Ensuring Continued Access to Student Loans Act of 2008, Pub. L. No. 110–227, <http://uscode.house.gov/statutes/pl/110/227.pdf>. For a description of the programs, see Jason D. Delisle, “Student Loan Purchase Programs Under the Ensuring Continued Access to Student Loans Act of 2008,” *New America*, December 15, 2009, www.newamerica.net/publications/policy/student_loan_purchase_programs_under_ensuring_continued_access_student_loans_act_2008_o.

51. Department of Education, “Fiscal Year 2010 Budget Summary—May 7, 2009,” <https://www2.ed.gov/about/overview/budget/budget10/summary/edlite-section1.html>.

52. Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111–152, www.gpo.gov/fdsys/pkg/PLAW-111publ152/pdf/PLAW-111publ152.pdf.

53. Congressional Budget Office, “Letter from Douglas W. Elmendorf to Senator Judd Gregg,” March 15, 2010, www.cbo.gov/sites/default/files/cbofiles/ftpdocs/113xx/doc11343/03-15-student_loan_letter.pdf.

54. See Kelly D. Edmiston, Lara Brooks, and Steven Shepelwich, “Student Loans: Overview and Issues (Update)” (working paper, Federal Reserve Bank of Kansas City, Kansas City, MO, April 2013), www.kansascityfed.org/publicat/reswkpap/pdf/rwp%2012-05.pdf; Financial Economists Roundtable, “Accounting for the Cost of Government Credit Assistance,” October 16, 2012, <http://fic.wharton.upenn.edu/fic/policy%20page/FER%20Statement%202012%2010-16-12%20final.pdf>; and Congressional Budget Office, “Fair-Value Accounting for Federal Credit Programs” (issue brief, Washington, DC, March 2012), www.cbo.gov/sites/default/files/112th-congress-2011-2012/reports/03-05-FairValue_Brief.pdf.

55. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101–508, www.congress.gov/bill/101st-congress/house-bill/5835/text.

56. Congressional Budget Office, “Credit Reform.”

57. Congressional Budget Office, “Fair-Value Supplemental Data,” June 2012, www.cbo.gov/sites/default/files/112th-congress-2011-2012/reports/Fair-Value%20Supplemental%20Data.xls.

58. Congressional Budget Office, “CBO’s January 2017 Baseline Projections for the Student Loan Program,” March 2016, www.cbo.gov/sites/default/files/recurringdata/51310-2016-03-studentloan.pdf.

59. Editorial Board, “Obama’s Giant Student-Loan Con,” *Wall Street Journal*, December 1, 2016, www.wsj.com/articles/obamas-giant-student-loan-con-1480640259.

60. Congressional Budget Office, “Costs and Policy Options for Federal Student Loan Programs,” March 2010, www.cbo.gov/sites/default/files/111th-congress-2009-2010/reports/03-25-studentloans.pdf.

61. Congressional Budget Office, “Letter from Douglas W. Elmendorf to Senator Judd Gregg.”

62. The Democratic majorities in Congress eliminated the FFEL program on legislation that partly enacted the 2010 Affordable Care Act. Lawmakers opted to use the savings from eliminating FFEL in that law to offset the cost of increasing the Pell Grant program for low-income undergraduate students on the same piece of legislation. While they had the option to assume the lower estimate under fair-value accounting, they instead opted for the higher figure. However, they did not allocate 100 percent of the savings to increasing student aid programs; the legislation spent all but \$19 billion of the savings on student aid. That fact has led some to argue that the savings from eliminating the FFEL program were used to “pay for” the Affordable Care Act of 2010. See Dick Morris, “Loans Subsidize ObamaCare,” *The Hill*, May 28, 2013, <http://thehill.com/opinion/columnists/dick-morris/302247-loans-subsidize-obamacare>; and Congressional Budget Office, “Letter from Douglas W. Elmendorf to Speaker Nancy Pelosi,” March 20, 2010, www.cbo.gov/sites/default/files/cbofiles/ftpdocs/113xx/doc11379/amendreconprop.pdf.

63. Some have come to understand that this effect is caused by the differences in cash flow timing between the two loan programs. That is, payments that the government makes occur at different times over the life of a loan in each program, with payments in the FFEL program occurring later. Thus, changing the discount rates (i.e., fair-value accounting) produces different effects for each program. However, this view is not completely accurate. It is true for some parts of the FFEL program, such as payments to guaranty agencies and risk sharing for lenders. But the main source of the smaller effect fair-value accounting has on FFEL costs stems from the SAP payments. The CBO models a FFEL as if it is a direct loan because the cash flow from the loan is what is driving SAP payments and default claims. Then, CBO models the SAP payments on a FFEL as the government’s financing cost for making a FFEL in the way that borrowing from the Treasury is its cost of funds for a direct loan. Under that approach, the differences in costs between the two programs is the government’s cost of funds to make a direct loan and its cost of funds to make a FFEL loan. The FFEL program already

incorporates a risk-adjusted, or fair-value, cost of funds because the SAP is linked to commercial paper interest rates; direct loans are not linked to a similar risk-adjusted rate. That is why the cost for a FFEL does not increase as much as the cost for direct loans using fair-value accounting. For an explanation of this modeling approach, see Deborah Lucas and Damien Moore, “Guaranteed Versus Direct Lending: The Case of Student Loans” (working paper 2007–09, Congressional Budget Office, Washington, DC, June 2007), www.cbo.gov/sites/default/files/110th-congress-2007-2008/workingpaper/2007_09_studentloans_o.pdf.

64. Ibid.

65. Ibid.

66. Department of Education, “Federal Student Loan Portfolio,” <https://studentaid.ed.gov/sa/about/data-center/student/portfolio>.

67. Editorial Board, “Bursting Debt Bubble,” *Wall Street Journal*, March 4, 2013, www.wsj.com/articles/SB10001424127887324662404578332633167660430.

68. Editorial Board, “The Real Student Loan Crisis Is the One Obama Created,” *Investor’s Business Daily*, April 16, 2015, www.investors.com/politics/editorials/obama-created-student-loan-crisis-with-1-trillion-in-loans/.

69. Republicans and Democratic majorities in Congress increased loan limits in 2006 and 2008 under both loan programs before the switch to direct lending, which contributed to the increases in outstanding debt in the years following the change to direct lending. The change in 2006 allowed graduate students to borrow up to the full cost of attendance without limit, which had previously been \$20,500 per year. In short, policy changes contributed to the run-up in student debt around 2010, but it was not the change to direct lending. Surging student enrollment and weak household finances also contributed.

70. Editorial Board, “Obama’s \$1.2 Trillion Student Loan Program Is Falling Apart,” *Investor’s Business Daily*, August 24, 2015, www.investors.com/politics/editorials/obama-student-loan-program-is-falling-apart/.

71. Adam Looney and Constantine Yannelis, *A Crisis in Student Loans? How Changes in the Characteristics of Borrowers and in the Institutions They Attended Contributed to Rising Loan Default*, Brookings Institution, 2015, www.brookings.edu/wp-content/uploads/2015/09/LooneyTextFall15BPEA.pdf.

72. Department of Education, “The Budget for Fiscal Year 2009,” 2008, www.gpo.gov/fdsys/pkg/BUDGET-2009-APP/pdf/BUDGET-2009-APP-1-8.pdf.

73. See Deborah Lucas and Damien Moore, “Guaranteed Versus Direct Lending: The Case of Student Loans,” in *Measuring and Managing Federal Financial Risk*, ed. Deborah Lucas (Chicago, IL: University of Chicago Press, February 2010): 163–205, www.nber.org/chapters/c3038.pdf. The authors explain: “Default rates are for the most part similar in the two programs, reflecting similarities in the borrower populations. The exception is for consolidation loans, which experience much higher default rates in the Direct program. As noted earlier, the higher default rate may be explained by the reluctance of guaranteed lenders to consolidate loans on the brink of default, and the fact that the Direct program must consolidate the loans of qualified borrowers that wish to consolidate but have been turned down by guaranteed lenders.”

74. Lucas and Moore find that “default rates are for the most part similar in the two programs, reflecting similarities in the borrower populations.” To elaborate on their point, even if the differences were statistically significant, recall that FFEL lenders could opt not to make loans at particular schools—such as a small cosmetology school with low loan issuance and relatively high rates of default. The federal government would be willing to back a FFEL loan at that school if lenders made them because students are entitled to the loans, and the school is eligible for the federal loan program, but because the school cannot rely on private lenders to make FFEL loans, it elects to participate in the Direct Loan program instead. That the Direct Loan program issued loans at such a school and the FFEL program did not is not a case of federal employees who administered the Direct Loan program poorly judging risk. Rather, policymakers had already decided through law and regulation that students at such schools were entitled to government student loans under either FFEL or direct loans. By making direct loans a de facto lender of last resort, policymakers steered bad loans to the Direct Loan program like they had through the consolidation program. Together those features explain any differences in default rates between the two programs. See Lucas and Moore, “Guaranteed Versus Direct Lending: The Case of Student Loans.”

75. Bergeron, Letter from National Council of Higher Education Resources to President-Elect Donald J. Trump.

76. Department of Education, “Loan Servicers,” <https://studentaid.ed.gov/sa/repay-loans/understand/servicers>.

77. Department of Education, “Collections,” <https://studentaid.ed.gov/sa/repay-loans/default/collections>.