

AMERICA'S STUDENT
LOAN PROVIDERS

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GUARANTEED STUDENT LOANS COST TAXPAYERS LESS

Based on New FY 2007 Budget Data

May 2006

AMERICA'S STUDENT
LOAN PROVIDERS

[America's Student Loan Providers](#) represents lenders and guaranty agencies that provide federally guaranteed student loans through the Federal Family Education Loan (FFEL) Program. By leveraging private financial markets and competing for the right to lend to students, the FFEL program brings value to students, schools, and taxpayers. Students benefit through lower cost loans, and simplified loan application and approval processes. More information is available at www.aslp.us or 301 765-0176.

Introduction

In July 2005, **America's Student Loan Providers** (ASLP) released "The Federal Family Education Loan Program: A Better Deal For Students & Taxpayers," a white paper that for the first time quantified the impact of flaws in the federal budget rules on student loan program cost estimates. The aim was not to create a whole new scorekeeping methodology. Rather, the exercise took current budget rules as a given and corrected for obvious flaws as well as others previously identified by government and non-partisan congressional agencies.

After correcting for these flaws, ASLP found that no significant difference exists between the Federal Family Education Loan (FFEL) Program's costs to the government and the Federal Direct Loan Program's. According to this analysis, *the subsidy rate for outstanding FFEL program loans was actually closer to 7.62 percent, not 9.40 percent*, as stated in the President's FY 2006 budget. More important, *the comparable Direct Loan program's subsidy rate was closer to 7.67 percent, well above the 1.76 percent* found in the budget.

On February 6, 2006, the President's Budget for FY 2007 was released and with it, new cost estimates and re-estimates for both programs. ASLP repeated the process used to prepare the 2005 white paper, using this new information. This paper presents new updated findings.

Executive Summary

Federal guaranteed student loans have cost taxpayers less than loans made directly by the U.S. Department of Education, according to analysis by America's Student Loan Providers (ASLP) of new cost estimates found in the President's Budget for FY 2007. After correcting for obvious flaws in current budget methodology, as well as others identified by government and non-partisan congressional agencies, ASLP found that the Federal Family Education Loan (FFEL) Program has cost taxpayers \$2.16 less per \$100 lent than the Federal Direct Loan Program. Specifically, FFEL program loans from 1994 to 2002 are estimated to have cost the government \$7.00 for every \$100 in loans, as compared to \$9.16 for direct loans.

The Office of Management and Budget (OMB), as well as the Congressional Budget Office (CBO), "score" the Direct Loan program as being less expensive than the FFEL program. ASLP found that the official government score is incorrect – that the FFEL program actually costs the government less than the Direct Loan program.

ASLP has long argued that OMB's cost estimates are flawed, not only because they are based on overly optimistic interest rate projections far into the future, *but also because they omit key program costs* (e.g., administrative costs) *and credits* (e.g., tax revenues generated by both programs). This analysis shows that if the cost estimates better reflected the risks associated with *actual program performance* and omitted costs and credits were counted, OMB (and CBO) would draw a far different conclusion.

Drawing on official government data found in the President's FY 2007 budget proposal, as well as reports by the U.S. Government Accountability Office (GAO), CBO, the Department of Education (ED) Office of the Inspector General (IG), and PricewaterhouseCoopers (PWC), among others, the ASLP analysis demonstrates that the FFEL program costs taxpayers less to operate than the Direct Loan program. ASLP came to this conclusion by taking the following steps:

- ❑ **Confining Cost Comparison To Relevant Time Frame.** This is accomplished by comparing program costs for only the years in which loans (a) were made in both the FFEL and Direct Loan programs *and* (b) are mature enough to have actual performance histories;

- ❑ ***Adding In Missing Costs And Credits.*** This analysis adds in the administrative costs of the Direct Loan program and the taxes paid by loan providers and servicers in both student loan programs; and
- ❑ ***Adding a Risk Premium To the Direct Loan Program.*** Even though the costs of the Direct Loan program are highly dependent on future interest and principal payments by borrowers, OMB scoring methodologies do not fully account for the risks of lending money over time, namely, the uncertainty of future cash flows resulting from deviations in projected defaults, consolidations or interest rates. These risks are accounted for by assigning a minimal risk premium of 0.25 percent, or 25 basis points.

After correcting for these factors, *this analysis found that the average lifetime subsidy rate for the FFEL program is 7.00 percent, not 11.01 percent, as stated in the President's FY 2007 budget. More important, the Direct Loan program's subsidy rate is 9.16 percent, not the 3.65 percent found in the budget. In other words, after making these reasonable corrections, the purported cost advantage of the Direct Loan program is more than eliminated.*

This paper reaches this conclusion, it should be pointed out, without correcting for all of the biases found in the government's scorekeeping rules. Nor does it even begin to place a value on the millions of dollars that private and nonprofit loan providers spend each year on college awareness, debt management, anti-default and scholarship programs, not to mention investments in service enhancements, quality improvements and new technologies.

Comparing Subsidy Cost Rates

Guaranteed Loans Cost Less than Direct Loans

When proponents of the Direct Loan program claim that direct lending costs taxpayers less than the FFEL program, they base their claim primarily on the government estimates of each program's average lifetime subsidy costs, which this year are found on page 367 of the President's FY 2007 budget.¹ Regrettably, for many the discussion of student loan program costs begins and ends on page 367, despite mountains of analysis and evidence that the information on this page does not reflect the true costs of either program.

This paper starts with the cost comparison on page 367, identifies significant biases in both the comparison and the government's scorekeeping model, and then *quantifies the impact of these biases and other flaws on how program subsidy rates are calculated*. The biases identified in this paper include:

- ❑ Counting years when the Direct Loan program did *not* exist in the subsidy cost of the FFEL program,
- ❑ Counting years in which most student loans have yet to go into repayment,
- ❑ Not accounting for administrative costs of the Direct Loan program or the substantial tax revenues generated by all loan providers and servicers, and
- ❑ Not accounting for the risks associated with lending money over time, which includes the uncertainty of future cash flows resulting from deviations in projected defaults, consolidations (prepayments) or interest rates.

WHAT IS AVERAGE LIFETIME SUBSIDY RATE?

The federal government measures the cost of a loan program by projecting the *average lifetime subsidy rate*.

To arrive at the subsidy rate for loans originated in a fiscal year (or loan cohort), OMB **DIVIDES:**

- Total *projected* costs of the loans to the government over the life of the loans (i.e., the combined *net present values* of all loans or guarantees, including interest subsidies and payments, fees, defaults, etc.) **BY**
- Total amount of loans originated that year.

After correcting for these biases found in the FY 2007 budget, this analysis finds that the per-loan cost of the FFEL program is significantly less than that of the Direct Loan program. *Specifically, the average subsidy rate for the FFEL program is 7.00 percent, not 11.01 percent, as stated in the President's FY 2007 budget.* More

¹ Page 367 of the FY 2007 budget corresponds to page 371 in last year's budget.

important, the Direct Loan program's subsidy rate is more than two and a half times greater than that stated in the budget – closer to 9.16 percent, not the 3.65 percent found in the budget.

In other words, guaranteed loans made through the FFEL program have cost taxpayers \$2.16 less per \$100 lent than loans made directly by the Education Department.

Finally, this paper reaches this conclusion without correcting for all of the biases found in the government's budget scorekeeping rules. It also does not begin to account for the value of loan providers' quality and level of services to students, families and schools, which include significant investments in service enhancements, quality improvements and new technologies. Also not accounted for are the hundreds of college awareness, debt management, borrower benefit, anti-default and scholarship programs sponsored every year by private and nonprofit loan providers.

Funny Numbers: Federal Scorekeeping Model Is Flawed

What explains the huge gap between government estimates of program costs and actual costs? When OMB (and CBO) estimates budget costs of federal credit programs, it follows procedures laid out in the Federal Credit Reform Act of 1990 (CRA).

Under CRA, costs for loan programs are defined in terms of the *net present value* of the government's cash flows over the life of the loans or guarantees. So OMB must account for expected defaults and consolidations, as well as future interest rates – the projected relationship between short- and long-term interest rates (i.e., the shape of the yield curve).

Projecting Interest Rates: Inherently Unpredictable, Usually Wrong

Few things are harder to predict than interest rates. Or as important. Because the borrower's rate on loans made before July 1, 2006, will remain variable (and be in repayment for up to 30 years), determining the net present value of existing direct loans is particularly tricky, imprecise and fraught with error. "Subsidy cost calculations are highly dependent on interest rate forecasts ..., and therefore can vary significantly depending on these forecasts," according to the Congressional Research Service.

The risk is more than theoretical. According to PWC, "[CBO] and the Administration understate the steepness of the yield curve in their interest rate projections," reducing the estimated cost of direct lending. "Significant re-estimates of subsidy costs over the past 10 years illustrate the challenges of estimating the lifetime costs of loans," GAO recently wrote. For every cohort since 1995, but one, government projections for Direct Loans have worsened. As of 2005, OMB is projecting a loss of \$6 billion, a swing of more than \$7 billion.

So savings projections based on future interest rates must be viewed *warily*. "[GAO] cannot predict with any certainty the future prospects for the continued estimated negative subsidy for [Direct Loans] because it is a relatively new program with limited historical data and is very

sensitive to fluctuations in interest rates," a 2001 GAO report states.

As a recent monograph put it, "the final budget is only a plan, often imprecise in student aid as well as other areas, as evidenced by periodically re-estimating the cost of Stafford Loans and other programs."

Other Scorekeeping Biases

Budget rules do not account for the Direct Loan program's administrative costs or the substantial tax revenue produced by FFEL loan providers. In 2005, GAO wrote that "[while] subsidy cost estimates include many of the federal costs associated with FFELP and FDLP loans, they do not capture all federal costs and revenues associated with the loan programs. Consideration of all federal costs and revenues ... would be an important component of a broader assessment of the costs and benefits of the two programs."

CBO wrote last fall that "the subsidy calculations under the [CRA] are not designed to fully capture the economic costs to the government of the assistance that the student loan programs provide, nor do they capture all of the effects of the programs on federal spending and revenues."

Net Result

"In any given year either FFELP or FDLP total costs ... may be greater, given the impact of prevailing economic conditions on subsidy costs," a point made in 1999 by the ED's IG and since repeated by PWC and the Center on Federal Financial Institutions.

Sources: "The Limitations of Budget Score-keeping in Comparing the Federal Student Loan Programs," PWC, March 2005; "Student Loans and FY2006 Budget Reconciliation," CRS Report for Congress, Oct. 24, 2005; "Study of Cost Issues: FFELP and FDLP," ED Office of the IG, March 1999; "Key Aspects of the Federal Direct Loan Program's Cost Estimates," GAO-01-1977, Jan. 2001; "Student Loans: Modeling Federal Costs," Center on Federal Financial Institutions, Nov. 9, 2005; GAO, "Federal Student Loans Challenges In Estimating Federal Subsidy Costs," GAO-05-874, Sept. 2005; "Subsidy Estimates for Guaranteed and Direct Student Loans," CBO, Nov. 2005; "A Primer on the Federal Budget Process," Monograph Number 18, National Association of School Financial Aid Administrators, April 2006.

Starting Point: Page 367 of FY 07 Budget

The President's FY 2007 budget appendix contains information on the cost of the annual cohorts of FFEL program and Direct Loan program loans made from 1992 through 2005.² Information on this page 367 is often cited as the "proof" by direct lending advocates that direct lending is cheaper than the FFEL program. Yet, after examining what is included in the numbers and what is excluded, it is clear that page 367 provides no such proof.

The historical information on page 367 incorporates the *cumulative* budget cost re-estimates to date for these loan cohorts and shows the average lifetime subsidy cost differential of the two programs to be 7.38 percent. These re-estimates were based on changes in actual and assumed borrower behavior, interest rates, and other factors.³ In the aggregate, the re-estimates to date have reduced the original estimates of the cost of FFEL program loans and increased the original estimates of the cost of Direct Loan program loans. This information from the budget, our starting point, is summarized in Table 1.

OFFICE OF FEDERAL STUDENT AID—Continued			367
Federal Funds—Continued			
Total	1.58	2.17	0.20
Federal administrative costs	1.50	1.50	1.50
Total adjusted cost	3.88	3.67	1.70

¹ Fees primarily reflect borrower origination fees and, in FFEL, lender origination and consolidation loan holder fees. Other primarily reflects loan discharges due to death, disability, or bankruptcy. Totals may not add due to rounding.

The Federal Credit Reform Act of 1990 requires the cost of existing loan cohorts to be reestimated to reflect changes in actual and assumed borrower behavior, interest rates, and other factors. The following table shows the impact of these reestimates in FFEL and Direct Loans.

Loan Disbursement and Subsidy Costs		
Total Subsidy Costs—1992–2006		
	FFEL	Direct Loans
Original Subsidy Costs	+\$55.3bil	-\$1.4bil
Cumulative Reestimates	+\$0.7bil	+\$37.7bil
1992–2005 Subsidy Costs	\$56.0bil	+\$36.3bil
Total Disbursements	\$588.8bil	\$173.7bil

Changes in interest rate projections are a significant factor in FFEL and Direct Loan reestimates; recent declines in interest rates below historical averages have accordingly been a major driver in changes to program costs. Changes in borrower behavior (notably, prepayment of loans through consolidation and reduction in defaults) have also contributed to these reestimates. The average lifetime subsidy rate for all outstanding FFEL loans after the most recent reestimate is 11.01; the comparable Direct Loan rate is 3.65. For the oldest loan cohorts, many of the subsidy costs have been expended (e.g., in-school interest subsidies).

Loan Disbursements and Subsidy Costs			
Total Subsidy Costs -- 1992 to 2005			
	FFEL	Direct Loan	Difference
President's Budget*			
1992 to 2005 Subsidy Costs	56.0	6.3	
Total Disbursements	508.8	173.7	
Average Subsidy Rate	11.01%	3.63%	7.38%

*In billions of dollars

² Budget of the United States Government, Fiscal Year 2007 – Appendix, p. 367.

³ It should be noted that even after being "re-estimated," loan cohort costs remain "estimates" of what the loans disbursed in those years will cost. In a January 2001 report, GAO found that the Department of Education did not track loan performance by cohort. GAO-01-197, p. 23. Thus, the Department had no ability to determine the actual costs of the loans disbursed in those years. It was using a model to "estimate" what was actually spent. GAO's follow-up report last year found that the Department had improved its estimating capability but still did not compare what it had forecast for loans disbursed in each year with what those loans actually cost. GAO, "FDLP Cost Estimates," GAO-04-567R, p. 34.

Confine Cost Comparison To Relevant Time Frame

It's only logical that, in order for a cost comparison to be meaningful, it must compare apples to apples. It also should exclude data on loans with little or no performance history. Therefore, this analysis begins by narrowing the calculation of program costs to years in which both programs were actually operating, and to those loan cohorts for which actual performance data exists.

The first problem with the budget data information set forth in Table 1 is that it includes FFEL program information for 1992 and 1993, fiscal years which *predate the launch of the Direct Loan program*. (FFEL loans made then also had different terms than what both programs offered in subsequent years.) Since no comparable direct loans are included in the comparison, it is deceptive to include FFEL program costs from those years in the comparison. To correct this flaw, the following table deletes information for these years in which no direct loans were made:

	FFEL	Direct Loan	Difference
1994 to 2005 Subsidy Costs*	52	6	
Total Disbursements*	480	174	
Revised Average Subsidy Rate	10.85%	3.63%	7.22%

**In billions of dollars*

A second problem with the budget data found in Tables 1 and 2 is that they include information on loans made in FY 2003 through FY 2005 – loans that are still early in their life-cycle aging process and most likely have not yet entered repayment. Based on experience, as loans in the Direct Loan program mature, subsidy estimates are revised upward. For FY 1994 to FY 2002, the estimated cost difference between the FFEL program and the Direct Loan program has been cut to one-fifth the original estimate, from 13.17 percent to 2.68 percent. *See further discussion on page 9.*

It's also worth noting that the subsidy cost estimates for the Direct Loan program for FY 2003-2005, collectively, are 1/7th of the current subsidy cost estimates for direct lending for FY 1994-2002.⁴

⁴ Budget of the United States Government, Fiscal Year 2007 - Federal Credit Supplement, p. 35.

While OMB's presentation on page 367 intends to account for the effect of re-estimates of outstanding loan cohorts, the re-estimates of these new cohorts have barely begun to occur. If re-estimates are important (and history shows they are), then lumping cohorts lacking a re-estimate history in with those that have such a history results in an apples and oranges comparison. Therefore, to make an accurate comparison between the cost of the FFEL program and the Direct Loan program, loans made in 2003-2005 must be excluded from any comparison made between the two programs. Taking this action leaves only those years where there is at least some performance data.⁵ This simple adjustment reduces the difference in subsidy costs to 2.68 percent, as shown in the following table:

	FFEL	Direct Loan	Difference
1994 to 2002 Subsidy Costs*	20	6	14
Disbursements*	254	111	143
Revised Average Subsidy Rate	8.06%	5.37%	2.68%

** In billions of dollars*

By simply correcting a pair of methodological flaws, the difference in subsidy costs between the two programs is reduced by 60 percent.

⁵ It should be noted that the remaining loan cohorts all have a remaining life expectancy. All therefore are subject to continuing re-estimation. Based on our experience to date, we can expect that the cost of these existing cohorts will, on average, continue to be re-estimated upward.

Annual Re-Estimates Narrow Subsidy Costs Gap

There's another reason to exclude the most recent years from the comparison of FFEL and Direct Loan subsidy costs: *They're unreliable*. Take loan cohorts for FY 1994 to 2002 (years for which repayment experience exists). As loans in each cohort have matured, their *original* subsidy cost estimates have been revised dramatically, as a result of annual OMB re-estimates.

More to the point, the differences between the programs' subsidy estimates narrowed considerably. For the loan cohorts for FY 1994-2002, the estimated cost difference between FFEL and Direct Loans has been cut to one-fifth of the *original* estimates.⁶

- The weighted average difference between the *original* subsidy estimates for FFEL and for Direct loans was 13.17 percent. However, the President's budget *now* estimates that difference to be 2.68 percent.
- 70 percent of this reduction has occurred because of the increase in the cost estimates for Direct Loans, from an average *original* subsidy estimate of -1.88 percent to a current estimate of 5.37 percent, an increase of 7.35 percentage points in the subsidy estimate.
- The remainder of the difference is the *decrease* in the cost estimate for FFEL. The original subsidy estimates averaged 11.30 percent; the current subsidy estimates have fallen to 8.06 percent.

Re-estimates Narrow Gap Between FFEL and Direct Loans (FY 1994-2002) ⁷			
	FFEL	Direct Loan	Difference
Original Subsidy Estimates	11.30%	-1.88%	13.17%
Cumulative Change in Estimates	-3.24%	7.25%	-10.49%
Current Subsidy Estimate	8.06%	5.37%	2.68%

See Appendix 3 for underlying government data.

⁶ Credit Supplement to the President's Budget for Fiscal 2007

⁷ Credit Supplement to the President's Fiscal 2007 Budget, Tables 7 and 8.

Adding Missing Costs and Credits

The next steps in this analysis take into account the scorekeeping biases identified by GAO, CBO, CRS and PricewaterhouseCoopers (PWC), among others – biases OMB has not been able to address because of the dictates of credit reform accounting. Although the OMB cost estimates for the Direct Loan program omit administrative costs, the President’s budget for only the second time includes *an estimate* of the unaccounted-for administrative costs. This estimate, offered for informational and analytical purposes only, is inaccurate and understates the Direct Loan program’s operating costs. How? By including forward-looking estimates, based on the new Common Services for Borrowers contract that will be fully implemented over the FY 2004-2008 period.

To accurately account for the lifetime costs of administration for loans made from 1994 to 2002, the cost of administration under *previous* contractual arrangements needs to be taken into consideration for the time period those contracts were in place. Current costs can then be taken into consideration for the remaining life of each of the loan cohorts. A 1999 Department of Education study found that the administrative cost of the Direct Loan program was 3.62 percent on a net present value basis, while that of the FFEL program was 1.02 percent.⁸ Thus, for each of the loan cohorts, we have calculated administrative costs for the period such cohorts were administered under the old arrangements as well as for their expected life under the new contract. As shown in Table 4, the effect of correcting for this bias in the FY 2007 budget is to reduce the differential between the two programs’ subsidy rates by another 1.51 percent.

	FFEL	Direct Loan	Difference
Revised Subsidy Rate Through Table 3	8.06%	5.37%	2.86%
Administrative costs			
Future, under new arrangement	0.38%	0.90%	
Past, under old arrangement	0.45%	1.44%	
Total Administrative costs	0.84%	2.34%	-1.51%
Revised Average Subsidy Rate	8.90%	7.72%	1.19%

⁸ U.S. Department of Education, “Incorporating Federal Administrative Costs into FFEL and Direct Loan Program Cost Estimates,” November 1999, p. 6.

Another item left out of the President’s budget is the federal tax revenue generated by both programs. A key finding of the PWC report is that participants in the FFEL program paid \$650 million in federal taxes in 2004.⁹ The report uses IRS data and industry sources to project the difference in tax revenues generated from the two programs. PWC estimated that the federal government collects 0.23 percent to 0.30 percent in taxes for every outstanding dollar of FFEL program loans, while collecting less than 0.01 percent for every dollar of outstanding direct loans. The Direct Loan program generates very little tax revenue. Virtually all of the expected “profit” made by the program is already considered in budget scoring projections as revenue to the government.

Applying these percentages to FFEL program and Direct Loan cohorts over their estimated lives demonstrates that, on a net present value basis, the amount of federal taxes generated as a result of FFEL program lending is about \$0.019, or 1.90 percent, of every dollar loaned, while that of direct lending is about \$0.0006, or 0.06 percent, of every dollar loaned.

Table 5: Adjustment for Federal Taxes Paid

	FFEL	Direct Loan	<i>Difference</i>
Revised Subsidy Rate Through Table 4	8.90%	7.72%	1.19%
Tax impact	-1.90%	-0.06%	-1.84%
Revised Subsidy Rate	7.00%	7.66%	- 0.66%

Remarkably, by simply adding the administrative costs and the tax revenues to OMB’s cost estimates for the years 1994 to 2002, not only does the cost differential between the two programs disappear but, in fact, the FFEL program becomes cheaper.

Use a Discount Rate That Reflects Risk

In 2004, the GAO issued a report that states that the Direct Loan program could not accurately estimate future interest income on student loans, as evidenced by the program’s overestimating interest income by 67 percent between 1994 and 2003. Along the same lines, the PWC report shows that inaccurate interest rate projections in the federal budget have had the effect of underestimating the Direct Loan

⁹ The PWC report was co-authored by Linden C. Smith, Managing Director for PWC’s National Economics Consulting group and former economist responsible for revenue estimating and scorekeeping work for the Joint Committee on Taxation and, before that, the U.S. Department of Treasury; and John Stell, Senior Manager for National Economics Consulting group and former analyst for the Congressional Budget Office.

program's costs and overestimating the FFEL program's. In fact, OMB has had to raise the Direct Loan program's subsidy costs every year as actual interest rates have replaced earlier projections. While we can expect this process to continue as each year's loans mature, it is not possible to accurately quantify the magnitude of this future adjustment.

There is another way, however, to account for the risk associated with loans made by the Direct Loan program and its effects on the program's subsidy costs.

In testimony before the Senate Budget Committee in 2005, then-CBO Director Douglas Holz-Eakin stated that there is a shortcoming with the Credit Reform Act, since "it appears to understate the economic cost of federal credit programs, because the discounting of expected cash flows at the government's risk-free borrowing rate ignores certain costs of risk." The director stated that a "market-based rate" should be used to discount cash flows for these programs.¹⁰ This rate would, by definition, be higher than the risk-free rate of government bonds, which is what is currently used to discount these cash flows.

"It may be time to revisit the credit-reform model and its application. ... it appears to understate the economic cost of federal credit programs, because the discounting of expected cash flows at the government's risk-free borrowing rate ignores certain costs of risk."

Former CBO Director Douglas Holz-Eakin

In two recent reports, both CBO and GAO reached the same conclusion.¹¹

- "In the calculation of the subsidy rate for the direct loan program," the November 2005 CBO report states, "principal and interest payments are discounted at a different, and generally lower, rate than the borrower pays. The result is a net budgetary gain to the federal government that does not exist in the FFEL program. In general, as long as the borrower's interest rate on a loan is higher than the rate at which the federal government discounts the loan, the federal budget will show that the government earns money on the loan (barring other factors such as default or consolidation)."
- "Other costs and revenues," the GAO report states, "are also not considered in subsidy costs estimates, *including interest rate risk inherent to lending programs*, and federal tax revenues generated by private-sector activity in

¹⁰ Statement of Douglas Holz-Eakin, "The Economic Costs of Long Term Federal Obligations," testimony before the Senate Budget Committee, February 16, 2005, p. 8.

¹¹ CBO, Subsidy Estimates for Guaranteed and Direct Student Loans, November 2005; GAO, "Federal Student Loans: Challenges in Estimating Federal Subsidy Costs," GAO-05-874, September 2005.

both FFELP and FDLP. Calculations of total federal costs would be enhanced were these additional costs and revenues considered...”

In the case of direct loans, not accounting for risk through the discount rates assures that the budget subsidy amounts overvalue the future cash flows and that the government fails to set aside sufficient funds to pay for the loans originated in that year. In the private sector, companies are required to discount future cash flows, such as residual cash flows from securitizations, at higher rates. If they did not, they would be accused of inflating their earnings. There is a risk associated with the Direct Loan program, which can be demonstrated by the large amount of adjustments made retroactively to loan cohorts made in prior years. Prudent budgeting requires a higher discount rate, especially when projecting future interest earnings on loan cohorts.¹²

Determining an appropriate discount rate raises many issues. We estimate that current budget procedure omits, *at a minimum*, a risk premium of about 0.25 percent from the annual borrowing cost of the Direct Loan program. Applying this factor to the remaining lives of the outstanding direct loans translates into an increase of approximately 1.50 percent in the subsidy cost of direct lending (since historically the average life of a loan has been about six years).¹³ It is certainly possible that this adjustment is not sufficient to capture the risk inherent in the cash flows for interest and principal payments in the Direct Loan program. One reason why the estimate is low is that the average life of a loan has been increasing as loan consolidation has become more prevalent. We strongly recommend this as an area for additional study and action.

	FFEL	Direct Loan	Difference
Revised Subsidy Rate Through Table 5	7.00%	7.66%	-0.66%
Tax impact	---	1.50%	
Revised Average Subsidy Rate	7.00%	9.16%	-2.16%

¹² See “A Primer on the Federal Budget Process,” Monograph Number 18, National Association of School Financial Aid Administrators, April 2006: “The cost-scoring process ... ignores costs associated with market risk because it bases the anticipated cash flow on the interest for risk-free bonds issued by the U.S. Treasury.”

¹³ Because most of the FFEL program costs are early in the loans’ lives (in-school interest payments and defaults), FFEL program subsidy estimates are far less sensitive to discount rates and are not affected by the higher rate.

As a result of taking this final step of adjusting subsidy costs to reflect the risks associated with direct lending, the cost differential between both programs widens, with the FFEL program costing 2.16 percent less.

	FFEL	Direct Loan	Difference
Revised Subsidy Costs*	18	10	8
Disbursements*	254	111	143
Revised Subsidy Rate	7.00%	9.15%	-2.16%

**In billions of dollars*

Conclusion

For years, proponents of the Direct Loan program have argued that the program has saved taxpayers “billions.” This argument has always been based on future projections of savings – savings that have not materialized in the 12-year history of the Direct Loan program.

After correcting the flaws in the budget comparisons and scorekeeping, this paper shows that the average lifetime subsidy rate of the FFEL program is less than the Direct Loan program’s – by \$2.16 per \$100 lent. A complete tabulation of these results, contained in Appendix 1, outlines how the rosy projections of cost benefits of the Direct Loan program disappear and then some when the biases are corrected.

And there are other considerations, not factored in, that would tend to further reduce the FFEL program’s cost to taxpayers. First, no attempt was made to quantify the full impact of the government’s use of problematic interest rate projections. Second, no attempt was made to adjust for substantial programmatic changes recently enacted by the Congress in the FY 2006 budget reconciliation law, most of which will reduce the cost of the FFEL program relative to the Direct Loan program. The Department of Education estimates that for loans made in FY 2007 these changes increase the subsidy rate of Direct Loans relative to that of the FFEL program by 1.48 percent.¹⁴

¹⁴ U.S. Department of Education Budget Service, Cost Estimation Briefing on FY 2007 Budget, March 22, 2006.

There is one other factor which we address in Appendix 2. While this paper has looked at the costs of the two programs from a subsidy cost perspective, the performance of the two programs on a cash basis cannot be ignored. On a cash basis, the FFEL program has performed far better than the Direct Loan program.

As Congress continues to weigh the relative merits and costs of the two major loan programs, this new analysis presents policymakers with a far more accurate estimate of the true costs of both student loan programs. It is imperative that OMB and CBO address the flaws in the scoring models that continue to create the erroneous impression that the Direct Loan program somehow generates profits for the federal government and is significantly cheaper than the private sector-based student loan program.

Furthermore, as GAO wrote last November, when Congress weighs the relative merits of the two programs, more than dollars and cents ought to be considered: “Assessing and comparing the total costs and benefits of the two loan programs would require consideration of, among other things, costs incurred by schools in operating the loan programs [and] quality of services provided to schools and borrowers...” In other words, Congress must somehow account for the value to students, families and schools of the hundreds of college awareness, debt management, borrower benefit, anti-default and scholarship programs sponsored every year by private and nonprofit loan providers, not to mention investments in service enhancements, quality improvements and new technologies.

Appendix 1

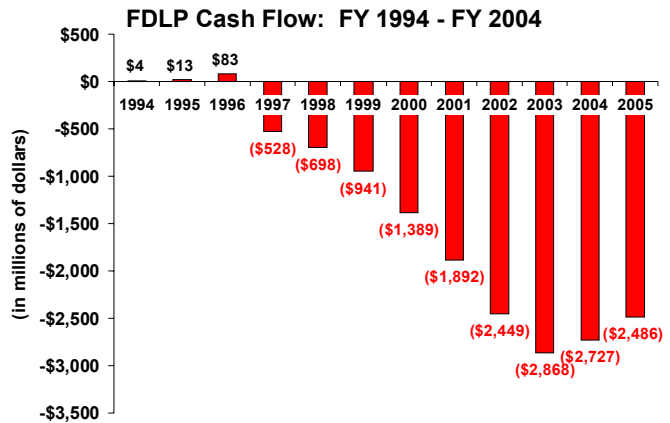
LOAN DISBURSEMENT AND SUBSIDY COSTS			
TOTAL SUBSIDY COSTS – 1992 TO 2005			
	<u>FFEL</u>	<u>FDLP</u>	<u>Difference</u>
President's Budget for FY 2007			
1992-2005 Subsidy Costs	56	6	50
Total Disbursements	509	174	335
Subsidy Rate	11.01%	3.63%	7.38%
Adjusted for Years before Direct Lending			
1994 to 2005 Subsidy Costs	52	6	46
Disbursements	480	174	306
Subsidy Rate	10.8%	3.63%	7.22%
Adjusted for Years with Little/No Performance Data			
1994 to 2002 Subsidy Costs	20	6	14
Disbursements	254	111	143
Subsidy Rate	8.06%	5.37%	2.68%
Adjusted to Reflect PWC Findings			
Administrative costs			
Future, under new contract	0.38%	0.90%	-0.52%
Past, under old contract	<u>0.45%</u>	<u>1.44%</u>	<u>-0.99%</u>
Total Administrative Costs	0.84%	2.34%	<u>-1.51%</u>
Tax impact	-1.90%	-0.06%	-1.84%
Interest rate adjustments	<u>---</u>	<u>1.50%</u>	<u>-1.50%</u>
Total missing costs	<u>-1.06%</u>	<u>3.78%</u>	<u>-4.85%</u>
Subsidy Costs (after adjustments)	18	10	8
Disbursements	254	111	143
Subsidy Rate (after adjustments)	7.00%	9.16%	-2.16%
*Subsidy costs and loan disbursements are in billions of dollars			

Appendix 2

As Measured by Cash Flow, FFEL Costs Less

Although the primary purpose of this paper is to demonstrate that the subsidy cost of the FFEL program is less than that of the Direct Loan program, it is important to recognize that the FFEL program has been significantly less expensive using another important measurement – cash flow.

According to the GAO, the Department of Education has since 1994 received almost \$16 billion less in fees and interest payments from Direct Loan borrowers than it has paid the Treasury Department in interest. This number has been a negative number every year since 1997.¹⁵



Source: GAO-04-567R FDLP cost estimates measured on a cash basis

An even more powerful conclusion emerges when one looks at all the cash costs of the two programs. Using official sources, the table on page 18 compiles these costs and offsets for direct lending for each year since 1995. As a percentage of loans outstanding, the table shows that there has been only one year in which the net cash cost of the Direct Loan program was less than that for the FFEL program. And, since 2000, the total cash cost of the FFEL program has been less in each year than that of the Direct Loan program, despite the fact that total FFEL program loans outstanding are roughly three times that for direct lending.

This cash flow analysis supports the conclusion of this paper that the optimistic subsidy cost predictions for the Direct Loan program are inaccurate. Ultimately, the cash and subsidy cost numbers will need to reconcile. Given the actual cash flow history, current subsidy cost projections will not be able to stand up over time.

¹⁵ GAO report, GAO-04-567R FDLP Cost Estimates, updated by the President's FY 2006 Budget Appendix.

Selected Program Costs and Offsets (in millions of dollars)

	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>
FFEL:											
Interest benefits	2,171	2,522	2,237	3,198	3,658	1,943	1,946	2,171	1,224	1,495	1,782
Special allowance payments	159	380	272	642	858	976	945	221	452	1,205	4,229
Default claims/ discharges/forgiveness	1,330	2,574	3,320	2,056	3,639	1,647	3,069	2,874	2,874	2,943	3,862
GA payments	228	210	172	261	437	330	424	509	600	613	549
Borrower origination fees	-710	-583	-277	-924	-637	-750	-832	-776	-933	-1,060	-1,202
Lender fees	-182	-105	-46	-154	-106	-125	-28	-211	-327	-362	-423
Net default collections	-210	-2,265	-1,751	-1,892	-4,421	-4,158	-4,332	-4,292	-3,973	-4,001	-3,956
Contract collection costs	7	145	97	104	93	81	43	102	172	126	119
Federal administrative costs	101	116	145	150	170	211	228	230	225	232	225
Net Cash Flow, FFEL	2,894	2,994	4,169	3,441	3,691	155	1,463	828	314	1,190	5,184
COST AS % / OUTSTANDING LOANS	3.4%	3.1%	4.0%	3.0%	2.9%	0.1%	1.0%	0.5%	0.2%	0.5%	1.9%
Direct Loans											
Borrower interest payments	-14	-113	-300	-606	-1,067	-1,463	-1,868	-1,961	-1,720	-1,643	-1,818
Borrower origination fees	-85	-318	-352	-382	-387	-359	-283	-334	-366	-392	-390
Contract collection costs/payments for origination	14	15	---	1	---	29	87	56	89	81	147
Federal administrative costs	169	195	243	252	286	354	383	386	377	389	372
Net interest payments to Treasury	86	348	1,180	1,686	2,395	3,211	4,043	4,744	4,954	4,763	4,694
Net Cash Flow, FDLP	170	127	771	951	1,227	1,772	2,362	2,891	3,334	3,198	3,004
COST AS % of OUTSTANDING LOANS	12.0%	1.8%	4.7%	3.6%	3.2%	3.5%	3.7%	3.8%	4.0%	3.7%	3.3%

Source: FFELP Costs from Student Loan Accounts from the President's Budget Appendix, "Summary of Program Costs and Offsets" from the budgets for fiscal 1997 to 2005; "Selected Program Costs and Offsets" from fiscal 2006 budget; FDLP Costs: GAO-04-567R FDLP Cost Estimates; fiscal 2004 amounts from p. 371, Fiscal 2006 President's Budget Appendix and p. 367 of Fiscal 2007 President's Budget Appendix; administrative expenses only reported in FY 2006 Appendix, other years' administrative expenses estimated based on 2004 share of total administrative expenses.

Appendix 3

COMPARISON OF SUBSIDY ESTIMATES (Weighted Average)

Fiscal Year	FFEL				Direct Loan				Direct Loans Minus FFEL	
	Disbursements (billions)	Subsidy			Disbursements (billions)	Subsidy			Subsidy	
		Original	Current	Difference		Original	Current	Difference	Original	Current
1994	\$22.627	11.92%	11.45%	-0.47%	\$0.821	10.00%	8.97%	-1.03%	-1.92%	-2.48%
1995	\$21.967	15.03%	11.04%	-3.99%	\$4.948	8.82%	8.57%	-0.25%	-6.21%	-2.47%
1996	\$21.856	12.83%	9.42%	-3.41%	\$9.454	2.56%	6.85%	4.29%	-10.27%	-2.57%
1997	\$23.224	12.71%	9.03%	-3.68%	\$11.131	3.09%	6.75%	3.66%	-9.62%	-2.28%
1998	\$23.311	8.82%	9.46%	0.64%	\$12.520	1.70%	5.13%	3.43%	-7.12%	-4.33%
1999	\$25.488	12.34%	8.78%	-3.56%	\$17.786	-2.11%	5.08%	7.19%	-14.45%	-3.70%
2000	\$29.267	14.20%	7.02%	-7.18%	\$16.004	-8.96%	8.77%	17.73%	-23.16%	1.75%
2001	\$34.234	8.68%	5.22%	-3.46%	\$18.115	-4.46%	4.29%	8.75%	-13.14%	-0.93%
2002	\$51.549	8.84%	5.77%	-3.07%	\$20.094	-3.88%	1.67%	5.55%	-12.72%	-4.10%
2003	\$69.109	9.58%	10.60%	1.02%	\$18.527	-1.46%	-1.26%	0.20%	-11.04%	-11.86%
2004	\$75.398	11.61%	13.44%	1.83%	\$20.222	-0.62%	0.58%	1.20%	-12.23%	-12.86%
2005	\$81.712	11.71%	17.31%	5.60%	\$24.142	3.94%	2.37%	-1.57%	-7.77%	-14.94%
Totals/ average										
1994 - 2002	\$253.524	11.30%	8.06%	-3.24%	\$110.873	-1.88%	5.37%	7.25%	-13.17%	-2.68%

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