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FISCAL RESPONSIBILITY AND FEDERAL CONSOLIDATION LOANS: EXAMINING COST IMPLICATIONS FOR TAXPAYERS, STUDENTS, AND BORROWERS

HEARING

BEFORE THE

COMMITTEE ON EDUCATION
AND THE WORKFORCE
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

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FISCAL RESPONSIBILITY AND FEDERAL CONSOLIDATION LOANS: EXAMINING COST IMPLICATIONS FOR TAXPAYERS, STUDENTS, AND BORROWERS

Wednesday, March 17, 2004
U.S. House of Representatives
Committee on Education and the Workforce
Washington, DC

The Committee met, pursuant to notice, at 10:35 a.m., in room 2175, Rayburn House Office Building, Hon. John Boehner (Chairman of the Committee) presiding.

Present: Representatives Boehner, Miller, Petri, Hoekstra, McKeon, Castle, Johnson, Greenwood, Biggert, Tiberi, Keller, Wilson, Porter, Kline, Carter, Burns, Kildee, Andrews, Woolsey, Tierney, Wu, Holt, Davis, Grijalva, Van Hollen, and Bishop.

Staff present: Kevin Frank, Professional Staff Member; Sally Lovejoy, Director of Education and Human Resources Policy; Catharine Meyer, Legislative Assistant; Krisann Pearce, Deputy Director of Education and Human Resources Policy; Alanna Porter, Legislative Assistant; Alison Ream, Professional Staff Member; Deborah Samantar, Committee Clerk/Intern Coordinator; Kathleen Smith, Professional Staff Member; Jo-Marie St. Martin, General Counsel; Ellynne Bannon, Minority Legislative Associate; Tom Kiley, Minority Press Secretary; John Lawrence, Minority Staff Director; Ricardo Martinez, Minority Legislative Associate; Alex Nock, Minority Legislative Associate; Joe Novotny, Minority Legislative Staff; Lynda Theil, Minority Legislative Associate; and Mark Zuckerman, Minority General Counsel.

Chairman BOEHNER. The Committee on Education and the Workforce will come to order. A quorum being present, the Committee meets today to hear testimony on "Fiscal Responsibility and Federal Consolidation Loans: Examining Cost Implications for Taxpayers, Students, and Borrowers."

Under the Committee rules, opening statements are limited to the Chairman and Ranking Member. If other Members have statements, we will keep the record open for 14 days to include those statements and other extraneous material referred to during today's hearing.

With that, I ask unanimous consent for the record to remain open.

Without objection, so ordered.

STATEMENT OF HON. JOHN A. BOEHNER, CHAIRMAN, COMMITTEE ON EDUCATION AND THE WORKFORCE

Good morning to our witnesses and to all of our guests that are here today. Today's hearing is the latest in our ongoing series of hearings on the reauthorization of the Higher Education Act.

We are here today to examine the Federal Consolidation Loan Program, and how student lending issues fit within our broader goal of expanding access to higher education for low and middle income students.

In particular, we have witnesses before us who will help us understand the cost of consolidation loans—the cost to taxpayers, the cost to graduates repaying their loans, and most importantly, the cost to low and middle income students in college today, or striving to attend college tomorrow.

For the past 2 years, our Committee has been holding these hearings, meeting with members of the higher education community, and moving ahead with legislation to meet one central goal: expanding access to higher education for low-to-middle-income students who strive to attend a university or college of their choice.

Our proposals for reauthorization of the Higher Education Act will reflect that goal, and today's hearing will help shed light on the role of student loans, and particularly consolidation loans, in our efforts to ensure that low and middle income students have access to a higher education.

The Federal Consolidation Loan Program is different than other student aid programs, because it doesn't provide subsidies to people who are currently students. Rather, it provides billions in subsidies to people who are former students, most of whom I would imagine are graduates who have realized their dream of a college education and who have entered the workforce.

The program was created to help college graduates repay their student debt. Consolidation loans allow borrowers with multiple loans, held by multiple lenders, to combine their debt into a single, often lower, monthly payment.

While the program has been largely successful in helping college graduates repay their debt, changes in how the program has been used in recent years raise a number of questions about how the program should operate into the future.

A recent report by the General Accounting Office warned that, as the program becomes more expensive, Congress needs to consider alternatives. I believe the implication of this report is that if we leave the Consolidation Loan Program on autopilot, the cost could balloon, taking billions of dollars away from the very low and middle income students that we are seeking to help.

Chief among the topics we will examine today is the issue of interest rates.

Unlike other Federal student loan programs, the Consolidation Loan Program locks borrowers into a fixed interest rate for the life of the loan. Because interest rates today are the lowest in the history of the Federal student loan programs—and I might add, the lowest interest rates we have seen in this country for 50 years—many graduates are choosing to consolidate their loans simply to lock in these low interest rates. Can't say that I blame them.

However, the fundamental premise of the program was consolidation, not refinancing. This means consolidation loans were never intended to be a tool to secure low interest rates—low interest rates where the Federal Government, I might add, over the next 30 years, will take all of the risk and absorb all of the additional cost.

When the consolidation program began, interest rates were considerably higher than they are today.

For example, consolidation loans made before July 1, 1994 had a fixed interest rate that was determined by the weighted average of the loans being consolidated, rounded to the nearest whole percent, or 9 percent, whichever was greater. That means consolidation loans had an interest rate of at least 9 percent. Compare that to today's 3.42 percent interest rate.

Clearly, when the program began it was never intended to be a tool to secure low interest rates, yet today's historically low rates have resulted in unprecedented growth in the number of consolidation loans, and as a direct result, unprecedented growth in the Federal subsidy that is not targeted to helping today's students, as opposed to graduates.

Now, while we are all aware of the budget realities facing the Congress, with the limited resources, we must establish priorities, and I believe students should be our first priority. For that reason, I question whether dramatically expanding subsidies to non-students and/or graduates is justified.

The Consolidation Loan Program fulfills an important purpose as it exists today, and there are reasonable steps Congress can and should consider to strengthen the program, but any effort to expand it will likely mean reduced resources for the low and middle income students whom we all hope to assist.

If we are targeting our limited resources toward a particular group, I think that group should be students and those who are attempting to enter a college or university of their choice.

I am eager to hear from our witnesses and their different perspectives on the cost of consolidation loans.

In particular, this hearing will help us better understand how Federal subsidies are being used in the program, and how the fixed interest rate structure is different from the variable rate structure used for other Federal student loans, and the overall impact these issues have on our ability to assist current and future students.

I would also encourage the witnesses to help shed light on proposals to change the Consolidation Loan Program. I think everyone would agree the program has been successful in its mission to help college graduates repay their loans.

I oppose weakening the Consolidation Loan Program, but I also oppose isolating it from positive changes at the expense of low and middle income students.

We should ask whether it would be best to maintain the program as it exists today, or make changes to the program in order to address questions about how the program itself has changed in recent years.

We should ask whether it would be prudent to expand subsidies to non-students, as some have proposed, bearing in mind that a massive increase in this program could take resources away from

the very low and middle income students that the Higher Education Act was created to serve.

I look forward to a detailed discussion on this issue, and I am hopeful that this hearing will help us find the right balance as we look to reform the Federal student aid programs and strengthen the Higher Education Act on behalf of current and future students.

I now yield to the gentleman from Michigan, our good friend, Mr. Kildee.

[The prepared statement of Chairman Boehner follows:]

Statement of Hon. John A. Boehner, Chairman, Committee on Education and the Workforce Committee

Good morning. Today's hearing is the latest in our ongoing series of hearings on reauthorization of the Higher Education Act. We're here today to examine the federal Consolidation Loan Program, and how student lending issues fit within our broader goal of expanding access to low and middle income students striving for college. In particular, we have witnesses before us who will help us understand the cost of consolidation loans–the cost to taxpayers, the cost to graduates repaying their loans, and most importantly, the cost to low and middle income students in college today or striving to attend college tomorrow.

For the past two years, our committee has been holding hearings, meeting with members of the higher education community, and moving ahead with legislation to meet one central goal: expanding access to higher education for low and middle income students who strive for it. Our proposals for reauthorization of the Higher Education Act will reflect that goal, and today's hearing will help shed light on the role of student loans–and particularly consolidation loans–in our efforts to ensure low and middle income students have access to a higher education.

The federal Consolidation Loan Program is different than other student aid programs, because it doesn't provide subsidies to people who are currently students. Rather, it provides billions in subsidies to people who are former students—graduates who have realized their dream of a college education and have entered the workforce.

The program was created to help college graduates repay their student debt. Consolidation loans allow borrowers with multiple loans–held by multiple lenders–to combine their debt into a single, often lower monthly payment. While the program has been largely successful in helping college graduates repay their debt, changes in how the program has been used in recent years raise a number of questions about how the program should operate into the future. A recent report by the General Accounting Office warned that as the program becomes more expensive, Congress needs to consider alternatives. I believe the implication of this report is that if we leave the Consolidation Loan Program on autopilot, the cost could balloon, taking billions of dollars away from the very low and middle income students we are seeking to help.

Chief among the topics we will examine today is the issue of interest rates. Unlike other federal student loan programs, the Consolidation Loan Program locks borrowers into a fixed interest rate for the life of the loan. Because interest rates today are the lowest in the history of the federal student loan programs, many graduates are choosing to consolidate their loans simply to lock in these low interest rates. However, the fundamental premise of the program was consolidation, not refinancing. This means consolidation loans were never intended to be a tool to secure low interest rates.

When the Consolidation Loan Program began, interest rates were considerably higher than they are today. For example, consolidation loans made before July 1, 1994 had a fixed interest rate that was determined by the weighted average of the loans being consolidated, rounded to the nearest whole percent, or 9 percent, which ever was greater. That means consolidation loans had an interest rate of at least 9 percent. Compare that to today's 3.42 percent interest rate. Clearly when the program began it was not intended to be a tool to secure low interest rates. Yet today's historically low interest rates have resulted in unprecedented growth in the number of consolidation loans, and as a direct result, unprecedented growth in the federal subsidy that is not targeted to helping today's students.

We are all aware of the budget realities facing this Congress. With limited resources, we must establish priorities and I believe students should be priority number one. Not just one priority of many, but our first priority. For that reason, I question whether dramatically expanding subsidies to non-students is justified. The Con-

solidation Loan Program fulfills an important purpose as it exists today, and there are reasonable steps Congress can and should consider to strengthen the program. But any effort to expand it will likely mean reduced resources for the low and middle income students we all hope to assist. If we are targeting our limited resources toward a particular group, I think that group should be students first and foremost.

I am eager to hear from our witnesses and their different perspectives on the cost of consolidation loans. In particular, this hearing will help us better understand how federal subsidies are being used in the Consolidation Loan Program, how the fixed interest rate structure is different than the variable rate structure used for other federal student loans, and the overall impact these issues have on our ability to assist current and future students.

I would also encourage the witnesses to help shed light on proposals to change the Consolidation Loan Program. I think everyone would agree this program has been successful in its mission to help college graduates repay their loans. I oppose weakening the Consolidation Loan Program, but I also oppose isolating it from positive change at the expense of low and middle income students. We should ask whether it would be best to maintain the program as it exists today, or make changes to the program in order to address questions about how the program itself has changed in recent years. We should ask whether it would be prudent to expand subsidies to non-students as some have proposed, bearing in mind that a massive expansion of this program could take resources away from the low and middle income students the Higher Education Act was created to serve.

I look forward to a detailed discussion on this issue, and I am hopeful that this hearing will help us find the right balance as we look to reform the federal student aid programs and strengthen the Higher Education Act on behalf of current and future students. With that, I would yield to Mr. Miller for any opening statement he may have.

Mr. KILDEE. Thank you, Mr. Chairman, and happy St. Patrick's Day to you.

Chairman BOEHNER. Thank you.

Mr. KILDEE. I love your tie.

Chairman BOEHNER. Everyone, a happy St. Patrick's Day.

Mr. KILDEE. Mr. Chairman, our colleague, Mr. Miller, has been temporarily delayed, so I would ask that his opening statement be submitted for the record.

Chairman BOEHNER. Without objection.

[The prepared statement of Mr. Miller follows:]

Statement of Hon. George Miller, Ranking Member, Committee on Education and Workforce

Thank you Mr. Chairman. I am pleased to join you at today's hearing on student loan consolidation.

I particularly want to welcome Titus Hamlett to the committee today. I look forward to your testimony and the testimony of the other witnesses, too.

Higher education has a long tradition of providing opportunities towards a better life for millions of Americans. Today, the Higher Education Act is more important than ever to succeeding in the global marketplace, lifting millions of Americans out of poverty, and keeping Americans safe in the post–9/11 society.

Despite the need to expand access to an affordable education, college is fast becoming a pipe dream for too many students. States are cutting support for higher education and pushing higher tuition prices onto students and their families.

In addition to budget cuts and rising prices, millions of students are taking on high debt levels that discourage college attendance and encourage default—which costs taxpayers billions of dollars.

This year, almost 7 million students will borrow more than $50 billion in federal student loans—accounting for almost 70 percent of all federal financial aid.

Over the past ten years, student loan debt has nearly doubled to $17,000 and about one-fifth of full-time working students spend 35 or more hours per week on the job to cover college costs. At the same time, student aid is falling further and further behind the cost of a college education. In fact, last year the maximum Pell Grant was worth $500 less than the maximum grant in 1975–76.

It is imperative that we return to the original premise of the Higher Education Act of 1965—that no college qualified student should be denied a college education because he or she is lacks the financial resources.

A key tool to ensuring that millions of students can access a college education is the low-fixed rate benefit of consolidation loans, which allows students to lock in a low rate and save thousands of dollars. In addition, borrowers can eliminate the need for dealing with multiple lenders, extend their repayment period, or enroll in payment plans based on a percentage of their income when they consolidate their loans.

As more and more students take on high debt levels it is important to focus on the financial need of students both as they enter college and when they leave. For student borrowers, the cost of college does not impact them until they graduate and begin repayment. This is the critical time when consolidation can, and does, make repayment manageable for student borrowers.

The benefits of consolidation are particularly important today, as graduates face a weakened economy and rising unemployment rates. A recent study by the Economic Policy Institute (EPI) found that the long-term unemployment among college-educated workers increased by nearly 300 percent between 2000 and 2003—almost double the increase of non-college graduates in the same time period.

In addition, the General Accounting Office (GAO) found that the average annual income for consolidation borrowers is $47,000 and that their debt to ratio income is 9.4 percent—just above the 8 percent industry suggested standard for borrowers in repayment to maintain financial stability.

A recent analysis by the State PIRGs' Higher Education Project found that the average borrower with $20,000 in debt would be forced to pay more than $7,000 in additional interest if the low-fixed consolidation rate benefit is eliminated.

At a time of rising college costs, high unemployment and little job growth, we should not be forcing students and their families to pay more for a college education.

As we reauthorize the Higher Education Act, I look forward to working with my colleagues on the committee to strengthen loan consolidation program and to expand college access to low and middle-income students.

Thank you Mr. Chairman.

STATEMENT OF HON. DALE E. KILDEE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. KILDEE. You mentioned that the students are attracted to consolidating their loans at a fixed rate. Well, they aren't the only ones in this market right now.

I, for the, I think, third time in 3 years, just refinanced my home mortgage—at the solicitation of the lender, by the way. They were afraid I might go someplace else. So I did reduce it, at a fixed rate also. The economy right now does attract people toward consolidation or refinancing.

Thank you, Mr. Chairman. I want to join you in welcoming today's witnesses before this Committee. This is indeed an important topic which deserves the attention of the Committee today, and I appreciate the fact that you are having this hearing.

Everyone in this room would agree that a higher education is critical to future earning potential and the ability to provide for your family and your children.

The reality facing most students, however, is high tuition, and grant aid from the Federal Government and state government that has lost much of its buying power. Also, student debt now is at an all-time high.

Our economic policies have lost rather than created jobs, and worse, outsourced many of our jobs overseas. Students graduating from college and looking for employment simply can't catch a break right now.

There are so many people out there who graduated from my University of Michigan still looking for a job, even with all the talents they have accrued there at the University of Michigan.

On top of all this comes today's discussion about changing the interest rate structure on consolidation loans from a fixed rate to a variable rate.

Let us be clear. Once we cut through all of the arguments, one fact is undeniable. This proposal will heap thousands of dollars in increased interest costs on the backs of students and recent college graduates.

You will hear a lot today about helping current students, and that we should be investing in programs which provide benefits to students who are entering college, and I couldn't agree with that more. However, financing those up-front benefits on the backs of those who have consolidated their loans I do not think is the proper approach.

Cutting benefits from one part of the program to finance another doesn't increase access. Rather, I believe it short-changes those who are struggling to find employment in an economy which isn't even producing enough jobs to keep pace.

If members want to reduce origination fees, and consider whether we should increase loan limits, we should not be robbing Peter to pay Paul. Instead, let us get the resources we need to enact these changes.

The Senate budget resolution includes $5 billion in funding to address these types of higher education priorities. Our goal should be to expand our higher education programs, not move resources around an already paltry pie.

In closing, I want to again stress what this proposal will mean for students.

A variable rate structure for consolidation loans means that the average student will face thousands of dollars in increased interest rate cost. When the Bush administration proposed this very change just 2 years ago, Mr. Chairman, it was met with bipartisan opposition because of its impact on students. I hope today's discussion keeps these points in mind.

Thank you, Mr. Chairman. I yield back the balance of my time.

Chairman BOEHNER. Thank you, Mr. Kildee.

It is my pleasure to introduce our witnesses today.

Our first witness will be Ms. Cornelia Ashby. Ms. Ashby has served in numerous capacities since she joined the U.S. General Accounting Office in 1973. That is a few years ago, Ms. Ashby.

Currently, Ms. Ashby serves as the Director of Education, Workforce, and Income Security, directing studies in numerous areas, including higher education. Prior to this position, Ms. Ashby was GAO's Associate Director for Tax Policy and Administrative Issues.

In addition to her job as Director, Ms. Ashby is presently pursuing her Ph.D. in sociology at American University.

Then we will hear from Mr. Titus Hamlett. Mr. Hamlett is currently a student at the University of Maryland, majoring in government and politics. In addition to his studies, Mr. Hamlett is also engaged in numerous extra-curricular activities. He is an active member of the Student Government Association and the Maryland Student Legislature, a non-profit organization that organizes dele-

gates from colleges and universities across Maryland to research and debate issues of local and national importance.

Then we will hear from Dr. Tom Neubig. Dr. Neubig is a partner and also the National Director of Quantitative Economics and Statistics in the national tax department of Ernst & Young, LLP. He was a consultant to numerous public and private clients from Federal and state tax policy issues before joining Ernst & Young.

Dr. Neubig served as director and chief economist at the U.S. Treasury Department's office of tax analysis and is the top executive branch career economist in tax policy.

Lastly, we will hear from Dr. Robert Shapiro. Dr. Shapiro is a founding partner and current Chairman of Sonecon, LLP, a private economic advisory firm. In addition, Dr. Shapiro is a non-resident senior fellow of the Brookings Institution and also the Progressive Policy Institute. From 1997, Dr. Shapiro served as the Under Secretary of Commerce for Economic Affairs, providing economic policy oversight for the Commerce Department.

Dr. Shapiro was the principal economic advisor to President Bill Clinton in his 1991-1992 Presidential campaign, and also served as legislative director and economic counsel to Senator—former Senator and late Senator—Daniel Moynihan.

Let me explain the lights. You will have 5 minutes to give your testimony. We are not real rough on people who want to talk a little longer than that, unless you get too carried away, and then I will gently remind you.

And with that, Ms. Ashby, you may begin.

STATEMENT OF CORNELIA M. ASHBY, DIRECTOR, EDUCATION, WORKFORCE, AND INCOME SECURITY ISSUES, U.S. GENERAL ACCOUNTING OFFICE, WASHINGTON, D.C.

Ms. ASHBY. Mr. Chairman and members of the Committee, thank you for inviting me here today to discuss issues related to consolidation loans and cost implications for taxpayers and borrowers. My testimony will focus on recent changes in interest rates and consolidation loan volume, and how these changes have affected Federal costs for FFELP and FDLP consolidation loans.

My comments are based on our October 2003 loan consolidation report done for this Committee. For this testimony, we updated our numbers to reflect recent estimates made by the Department of Education.

In recent years, there has been a drop in interest rates for student loan borrowers, along with dramatic overall growth in consolidation loan volume. From July of 2000 to June 2003, the interest rate for consolidation loans dropped by more than half, with consolidation loan borrowers obtaining rates as low as 3.5 percent as of July 1, 2003.

From fiscal year 1998 through fiscal year 2003, the volume of newly originated consolidation loans rose from $5.8 billion to over $41 billion.

The dramatic growth in consolidation loan volume in recent years is due in part to declining interest rates that have made it attractive for many borrowers to consolidate their variable rate loans at low fixed rates. The chart on the screen shows this rela-

tionship. Note that the interest rates set on July 1 of each year corresponds to the loan volume for the following fiscal year.

In addition, increased marketing effort has likely contributed to the record level of consolidation loan volume. Many lenders, including newer companies that are specializing in consolidation loans, have aggressively marketed consolidation loans to compete for consolidation loan business, as well as to retain the loans of their current customers.

Recent transit interest rates in consolidation loan volume have affected the cost of the FFELP and FDLP Consolidation Loan Programs in different ways, but in the aggregate. Estimated subsidy and administration costs have increased.

For FFELP consolidation loans, subsidy costs grew from about $650 million for loans made in fiscal year 2002 to over $2 billion for loans made in fiscal year 2003. Both higher loan volumes and lower interest rates in fiscal year 2003 increased these costs.

Education's estimate of over $2 billion in subsidy costs is based on the assumption that the guaranteed lender yield will rise over the next several years.

The effect of this rise is shown on the chart on the screen, where the bottom line shows the fixed borrower rate for an FFELP consolidation loan made in the first 9 months of fiscal year 2003, and the top line shows Education's estimate values for the guaranteed lender yield over time.

In fiscal year 2003, market interest rates were such that the guaranteed lender yield was actually below the borrower rate. Lenders, therefore, received only the rate paid by borrowers. No special allowance payment, or SAP, was paid.

However, in future years, when the guaranteed lender yield is expected to increase and be above the borrower rate, Education would have to make up the difference with a SAP. As the chart shows, Education's assumptions would call for lenders to receive a SAP over most of the life of the consolidation loans made in fiscal year 2003.

Changing interest rates and loan volumes affected costs in the FDLP loan consolidation program, as well. In both fiscal years 2002 and 2003, there was no subsidy cost to the government because the interest rate paid by borrowers who consolidated their loans was greater than the interest rate education paid to the treasury to finance the lending.

However, the drop in loan volume and interest rates that occurred in fiscal year 2003 contributed to cutting the government's estimated gain from $570 million in fiscal year 2002 to $543 million for loans made in fiscal year 2003.

Administration cost is not specifically tracked for either Consolidation Loan Program, but available evidence indicates that these costs have risen, primarily reflecting increased overall loan volume.

In our October 2003 report, we recommended that the Secretary of Education assess the advantages of consolidation loans for borrowers and the government in light of program costs, and identify options for reducing Federal costs.

We suggested options that include targeting the program to borrowers at risk of default: extending existing consolidation alter-

natives to more borrowers and changing from a fixed to a variable rate the interest charged to borrowers on consolidation loans.

We noted that, in conducting such an assessment, Education should also consider how best to distribute program costs among borrowers, lenders, and taxpayers. Education agreed with our recommendation.

Mr. Chairman, this concludes my statement. I would be pleased to answer any questions.

[The prepared statement of Ms. Ashby follows:]

Statement of Cornelia M. Ashby, Director, Education, Workforce, and Security Issues, U.S. General Accounting Office

Mr. Chairman and Members of the Committee:

Thank you for inviting me here today to discuss issues related to consolidation loans and their cost implications for taxpayers and borrowers. Consolidation loans, available under the Department of Education's (Education) two major student loan programs—the Federal Family Education Loan Program (FFELP) and the William D. Ford Direct Loan Program (FDLP)—help borrowers manage their student loan debt. By combining multiple loans into one loan and extending the repayment period, a consolidation loan reduces monthly repayments, which may lower default risk and, thereby, reduce federal costs of loan defaults. Consolidation loans also allow borrowers to lock in a fixed interest rate, an option not available for other student loans. Consolidation loans under FFELP and FDLP accounted for about 48 percent of the $87.4 billion in total new student loan dollars that originated during fiscal year 2003. FFELP consolidation loans comprised about 84 percent of the fiscal year 2003 consolidation loan volume, while FDLP consolidation loans accounted for the remaining 16 percent.

Two main types of federal cost pertain to consolidation loans. One is "subsidy"—the net present value of cash flows to and from the government that result from providing these loans to borrowers. For FFELP consolidation loans, cash flows include, for example, fees paid by lenders to the government and a special allowance payment by the government to lenders to provide them a guaranteed rate of return on the student loans they make. For FDLP consolidation loans, cash flows include borrowers' repayment of loan principal and payments of interest to Education, and loan disbursements by the government to borrowers. The subsidy costs of FDLP consolidation loans are also affected by the interest Education must pay to the Department of Treasury (Treasury) to finance its lending activities. The second type of cost is administration, which includes such items as expenses related to originating and servicing direct loans.

My testimony today will focus on two key issues: (1) recent changes in interest rates and consolidation loan volume and (2) how these changes have affected federal costs for FFELP and FDLP consolidation loans. My comments are based on the findings from our October 2003 report for this Committee, Student Loan Programs: As Federal Costs of Loan Consolidation Rise, Other Options Should Be Examined (GAO–04–101, October 31, 2003). Those findings were based on review and analysis of data from a variety of sources, including officials from Education's Office of Federal Student Aid and Budget Service, and representatives of FFELP lenders; a sample of student loan data extracted from Education's National Student Loan Data System (NSLDS)—a comprehensive national database of student loans, borrowers, and other information; relevant cost analyses prepared by Education; and statutory, regulatory and other published information. For this testimony, we updated our numbers to reflect recent estimates made by the Department of Education. Our work was conducted in accordance with generally accepted government auditing standards.

In summary:

- Recent years have seen a drop in interest rates for student loan borrowers along with dramatic overall growth in consolidation loan volume. From July 2000 to June 2003, the interest rate for consolidation loans dropped by more than half, with consolidation loan borrowers obtaining rates as low as 3.50 percent as of July 1, 2003. From fiscal year 1998 through fiscal year 2003, the volume of consolidation loans made (or "originated") rose from $5.8 billion to over $41 billion. The dramatic growth in consolidation loan volume in recent years is due in part to declining interest rates that have made it attractive for many borrowers to consolidate their variable rate student loans at a low, fixed rate.

- Recent trends in interest rates and consolidation loan volume have affected the cost of the FFELP and FDLP Consolidation Loan Programs in different ways, but in the aggregate, estimated subsidy and administration costs have increased. For FFELP consolidation loans, subsidy costs grew from $0.651 billion for loans made in fiscal year 2002 to $2.135 billion for loans made in fiscal year 2003. Both higher loan volumes and lower interest rates available to borrowers in fiscal year 2003 increased these costs. Lower interest rates increase these costs because FFELP consolidation loans carry a government-guaranteed rate of return to lenders that is projected to be higher than the fixed interest rate paid by consolidation loan borrowers. When the interest rate paid by borrowers does not provide the full guaranteed rate to lenders, the federal government must pay lenders the difference. FDLP consolidation loans are made by the government and thus carry no interest rate guarantee to lenders, but changing interest rates and loan volumes affected costs in this program as well. In both fiscal years 2002 and 2003, there was no net subsidy cost to the government because the interest rate paid by borrowers who consolidated their loans was greater than the interest rate Education must pay to the Treasury to finance its lending. However, the drop in loan volume and interest rates that occurred in fiscal year 2003, contributed to cutting the government's estimated net gain from $570 million in fiscal year 2002 to $543 million for loans made in fiscal year 2003. Administration costs are not specifically tracked for either Consolidation Loan Program, but available evidence indicates that these costs have risen, primarily reflecting increased overall loan volumes.

In our prior report, we recommended that the Secretary of Education assess the advantages of consolidation loans for borrowers and the government in light of program costs and identify options for reducing federal costs. Education agreed with our recommendation.

Background

Consolidation loans differ from other loans in the FFELP and FDLP programs in that they enable borrowers who have multiple loans—possibly from different lenders, different guarantors,[1] and even from different loan programs—to combine their loans into a single loan and make one monthly payment. By obtaining a consolidation loan, borrowers can lower their monthly payments by extending the repayment period longer than the maximum 10 years generally available on the underlying loans. Maximum repayment periods allowed vary by the amount of the consolidation loan (see table 1). Consolidation loans also provide borrowers with the opportunity to lock in a fixed interest rate on their student loans, based on the weighted average of the interest rates in effect on the loans being consolidated rounded up to the nearest one-eighth of 1 percent, capped at 8.25 percent. Borrowers can qualify for consolidation loans regardless of financial need. Loans eligible for inclusion in a consolidation loan must be comprised of at least one eligible FFELP or FDLP loan, including subsidized and unsubsidized Stafford loans, PLUS loans,[2] and, in some instances, consolidation loans. Both subsidized and unsubsidized Stafford loans, and PLUS loans are variable rate loans. Other types of federal student loans made outside of FFELP and FDLP, which may carry a variable or fixed borrower interest rate, are also eligible for inclusion in a consolidation loan, including Perkins loans, Health Professions Student loans, Nursing Student Loans, and Health Education Assistance loans (HEAL).[3]

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[1] State and nonprofit guaranty agencies receive federal funds to play the lead role in administering many aspects of the FFELP program, including reimbursing lenders when loans are placed in default and initiating collection work.

[2] Both subsidized and unsubsidized Stafford loans are available to undergraduate and graduate students. The interest rates borrowers pay on these loans adjust annually, based on a statutorily established market-indexed rate setting formula, and may not exceed 8.25 percent. To qualify for a subsidized Stafford loan, a student must establish financial need. The federal government pays the interest on behalf of subsidized loan borrowers while the student is in school. Students can qualify for unsubsidized Stafford loans regardless of financial need. Unsubsidized loan borrowers are responsible for all interest costs. PLUS loans are variable rate loans that are available to parents of dependent undergraduate students. The interest rates on these loans adjust annually, based on a statutorily established market-indexed rate setting formula, and may not exceed 9 percent. Parents can qualify for PLUS loans regardless of financial need.

[3] Perkins Loans are fixed rate loans for both undergraduate and graduate students with exceptional financial need. Perkins loans are made directly by schools using funds contributed by the federal government and schools; borrowers must repay these loans to their school. The Health Professions Student Loans and Nursing Student Loans are fixed rate loans for borrowers who pursue a course of study in specified health professions. The HEAL program provided loans

Continued

Table 1: Consolidation Loan Repayment Periods, by Loan Amount

Amount	Maximum term (years)
Less than $7,500 (FFELP)	10
Less than $10,000 (FDLP)	12
$7,500 to $9,999 (FFELP)	12
$10,000 to $19,999	15
$20,000 to $39,999	20
$40,000 to $59,999	25
$60,000 or more	30

Source: Higher Education Act, Congressional Research Service, and Education.

The Federal Credit Reform Act (FCRA) of 1990 helps define federal costs associated with consolidation loans and was enacted to require agencies, including Education, to more accurately measure federal loan program costs. Under FCRA, Education is required to estimate the long-term cost to the government of a direct loan or a loan guarantee—generally referred to as the subsidy cost. Subsidy cost estimates are calculated based on the present value of estimated net cash flows to and from the government that result from providing loans to borrowers.[4] For FFELP consolidation loans, cash flows include, for example, fees paid by lenders to the government[5] and a special allowance payment by the government to lenders to provide them a guaranteed rate of return on the student loans they make. For FDLP consolidation loans, cash flows include borrowers' repayment of loan principal and payments of interest to Education, and loan disbursements by the government to borrowers. Unlike FFELP, FDLP involves no guaranteed yields or special allowance payments to lenders because the program is a direct loan program. The subsidy costs of FDLP consolidation loans are also affected by the interest Education must pay to Treasury to finance its lending activities. Another type of cost pertaining to consolidation loans is administration, which includes such items as expenses related to originating and servicing direct loans.[6]

In estimating loan subsidy costs, Education first estimates the future economic performance (net cash flows to and from the government) of direct and guaranteed loans when preparing its annual budgets. These first estimates establish the subsidy estimates for the current-year originated loans. The data used for the first estimates are reestimated in later years to reflect any changes in actual loan performance and expected changes in future performance. Reestimates are necessary because projections about interest and default rates and other variables that affect loan program costs change over time. Any increase or decrease in the estimated subsidy cost results in a corresponding increase or decrease in the estimated cost of the loan program for both budgetary and financial statement purposes.

Borrowers' Rates Have Dropped, and Loan Volume Has Risen

Recent years have seen a drop in interest rates for student loan borrowers along with dramatic overall growth in consolidation loan volume. From July 2000 to June 2003, the interest rate for consolidation loans dropped by more than half, with consolidation loan borrowers obtaining rates as low as 3.50 percent as of July 1, 2003. From fiscal year 1998 through fiscal year 2003, the volume of consolidation loans made (or originated) rose from $5.8 billion to over $41 billion. Over four-fifths of the fiscal year 2003 loan volume is in FFELP. While overall volume rose in 2003, the trends differed by program. FDLP consolidation loan volume for fiscal year 2003 decreased, but loan volume in the larger FFELP increased, resulting in total consolidation loan volume of well over $41 billion.

The dramatic growth in consolidation loan volume in recent years is due in part to declining interest rates that have made it attractive for many borrowers to consolidate their variable rate student loans at a low, fixed rate. Figure 1 shows the relationship between these two factors. When interest rates are low, some borrowers

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to eligible graduate students in specified health professions. HEAL was discontinued on September 30, 1998.

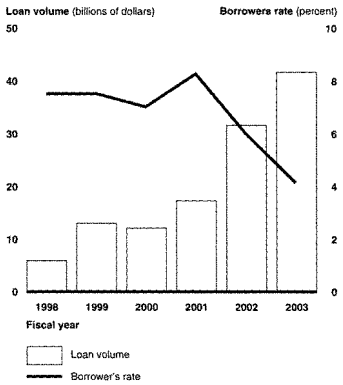
[4] Present value is the value today of the future stream of benefits and costs, discounted using an appropriate interest rate (generally the average annual interest rate for marketable zero-coupon U.S. Treasury securities with the same maturity from the date of disbursement as the cash flow being discounted).

[5] For consolidation loans, FFELP loan holders must pay, on a monthly basis, a fee calculated on an annual basis equal to 1.05 percent of the unpaid principal and accrued interest on the loans in their portfolio.

[6] Under FFELP, a large portion of the administration cost is borne by the private lender. The federal government pays many of these costs in its subsidy payment to lenders—specifically, in the 2.64 percent add on paid over and above the 3-month rate on commercial paper.

may find it in their economic self-interest to consolidate their loans so that they can lock in a low fixed interest rate for the life of the loan, as opposed to paying variable rates on their existing loans, regardless of whether they need a consolidation loan to avoid difficulty in making loan repayments and avert default.

Figure 1: Consolidation Loan Volume Increased Dramatically as Borrower Interest Rates Fell from Fiscal Year 2001 to Fiscal Year 2003



Source: GAO analysis based on data provided by Education's Budget Service.

Underscoring the potential attractiveness of these loans to potential borrowers, many lenders, including newer loan companies that are specializing in consolidation loans, have aggressively marketed consolidation loans to compete for consolidation loan business as well as to retain the loans of their current customers. Their marketing techniques have included mass mailings, telemarketing, and Internet pop-ups to encourage borrowers to consolidate their loans. This increased marketing effort has likely contributed to the record level of consolidation loan volume.

Changes in Interest Rates and Loan Volume Affect FFELP and FDLP Costs in Different Ways but in the Aggregate, Estimated Costs Increased

While the estimated future costs for consolidation loans can vary greatly from year to year, low interest rates and recent loan volume changes have resulted in substantial increases in overall costs to the federal government. However, in light of the differences between how FFELP and FDLP operate, the subsidy costs within these two programs were affected in very different ways. For FFELP, the result was a substantial increase. For FDLP, the result was a narrowing of the net difference between the estimated interest payments paid by consolidated loan borrowers to Education and the costs paid by Education to Treasury to finance direct loans.

FFELP Subsidy Costs Affected by Increased Special Allowance Payments to Lenders and Increased Loan Volume

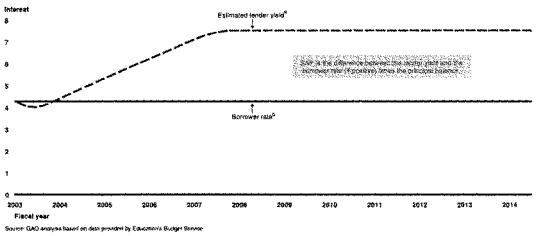
Estimated subsidy costs for FFELP consolidation loans rose from $0.651 billion for loans made in fiscal year 2002 to $2.135 billion for loans made in fiscal year 2003. The increase is largely due to the higher interest subsidies the government is expected to pay to lenders to ensure they receive a guaranteed rate of return on student loans and the result of greater loan volume. The interest subsidy, which is called a special allowance payment (SAP), is based on a formula specified in law and paid by Education to lenders on a quarterly basis when the "guaranteed lender yield" exceeds the borrower rate. This guaranteed lender yield is currently based on the average 3-month commercial paper[7] interest rate plus an additional 2.64 percent. When this guaranteed yield is higher than the amount of interest being paid by borrowers, Education makes up the difference. If the borrower's interest rate exceeds the guaranteed lender yield, Education does not pay a SAP, and the lender receives the borrower rate.

Education's estimate of $2.135 billion in subsidy costs for FFELP consolidation loans made in fiscal year 2003 is based on the assumption that the guaranteed lend-

[7] Commercial paper is short-term, unsecured debt with maturities up to 270 days. It is issued in the form of promissory notes, primarily by corporations. Many companies use commercial paper to raise cash for current transactions and many find it to be a lower-cost alternative to bank loans.

er yield will rise over the next several years, reflecting Education's assumption that market interest rates are likely to rise from the historically low levels experienced in fiscal year 2003. The effect of this rise is shown in figure 2, where the bottom line shows the fixed borrower rate for a FFELP consolidation loan made in the first 9 months of fiscal year 2003, and the top line shows Education's estimated values for the guaranteed lender yield over time. In fiscal year 2003, market interest rates were such that the guaranteed lender yield established under the SAP formula was actually below the borrower rate. Lenders, therefore, received only the rate paid by borrowers; no SAP was paid. However, in future years, when the guaranteed lender yield is expected to increase and be above the borrower rate, Education would have to make up the difference in the form of a SAP. As figure 2 shows, Education's assumptions would call for lenders to receive a SAP over most of the life of the consolidation loans made in fiscal year 2003.

Figure 2: Illustration of Estimated SAP Paid to Holders of FFELP Consolidation Loans Originated in Fiscal Year 2003



Source: GAO analysis based on data provided by Education's Budget Service

[a]The estimated lender yield, which is based on the average 3-month commercial paper rates, as provided by the Office and Management and Budget, does not vary much after fiscal year 2007 since the projected commercial paper rates do not vary much after fiscal year 2007. The actual lender yield could vary from these projections depending on future interest rates.

[b]This borrower rate is for a consolidation loan originated from October to June of fiscal year 2003 and whose underlying loans are Stafford loans disbursed after July 1, 1998, and in repayment at time of consolidation.

An increase in loan volume also played a role in the subsidy cost increase from fiscal years 2002 to 2003. However, the effect of the increased loan volume was not as large as that of the higher interest subsidies the government is expected to pay to lenders in the future.

FDLP Loans also Affected by Changing Interest Rates

Subsidy costs can occur within FDLP as well, but in a different way. FDLP's consolidation program is a direct loan program and, therefore, involves no guaranteed yields to private lenders. Still, the program has potential subsidy costs if the government's cost of borrowing is higher than the interest rate borrowers are paying. The government's cost of borrowing is determined by the interest rate Education pays Treasury to finance direct student loans, which is equivalent to the discount rate.[8] The difference between borrowers' rates and the discount rate—called the interest rate spread—is a key driver of subsidy estimates for FDLP loans. When the borrower rate is greater than the discount rate, Education will receive more interest from borrowers than it will pay in interest to Treasury to finance its loans, resulting in a positive interest rate spread—or a gain (excluding administrative costs) to the government. Conversely, when the borrower rate is less than the discount rate, Education will pay more in interest to Treasury than it will receive from borrowers, which will result in a negative interest rate spread—or a cost to the government.

For FDLP consolidation loans made in fiscal years 2002 and 2003, no such negative interest rate spreads were incurred in either year, based on the methodology Education uses to determine these costs. In both years, borrower interest rates for FDLP consolidation loans were somewhat higher than the discount rate, resulting in a net gain to the government. However, while Education continued to benefit from lending at interest rates higher than its cost of borrowing for FDLP consolidation loans made in fiscal year 2003, the size of this benefit declines from $571 million in fiscal year 2002 to $543 million in fiscal year 2003.

The smaller net gain that occurred in fiscal year 2003 reflects both a decrease in the loan volume and a narrowed difference between the discount rate and the borrower rate. Loan volume in fiscal year 2003 was $6.7 billion, a decrease from $8.8

[8] While the discount rate is the interest rate used to calculate the present value of the estimated future cash flows to determine subsidy cost estimates, it is also generally the same rate at which interest is paid by Education on the amounts borrowed from Treasury to finance the direct loan program.

billion in fiscal year 2002. In fiscal year 2003, this difference narrowed in part because borrower rates dropped more than the discount rate. The borrower rates for FDLP consolidation loans dropped 1.2 percentage points, from 6.3 percent in fiscal year 2002 to 5.1 percent in fiscal year 2003. The discount rate, on the other hand, dropped by only 0.88 percentage points, from 4.72 percent in fiscal year 2002 to 3.84 percent in fiscal year 2003. The resulting interest rate spread decreased from 1.59 percent to 1.22 percent (see table 2). In other words, each $100 of consolidated FDLP loans made in fiscal year 2002, will result in $1.59 more in interest received by Education than it will pay out in interest to the Treasury. A similar loan originated in fiscal year 2003, however, will generate only $1.22 more in interest for the government.

Table 2: Interest Rate Spread for FDLP Consolidation Loans Originated in Fiscal Years 2002 and 2003

Fiscal year	Borrower rate	Discount rate	Interest rate spread	Estimated interest payments for each $100 of loans
2002	6.31%	4.72%	1.59%	1.59% x $100 = $1.59
2003	5.06%	3.84%	1.22%	1.22% x $100 = $1.22

Source: GAO analysis of data provided by Education's Budget Service.

Administration Costs also Increase, Mainly because of Loan Volume

Loan volume affects administrative costs, in that cost is in part a function of the number of loans originated and serviced during the year. As a result, when loan volume increases, administration costs also increase. Education's current cost accounting system does not specifically track administration costs incurred by each of the student loan programs. Consequently, we were unable to determine the total administration costs incurred by Consolidation Loan Programs or any off-setting administrative cost reductions associated with the prepayment of loans underlying consolidation loans. However, based on available Education data, we were able to determine some of the direct costs associated with the origination, servicing, and collection of FDLP consolidation loans. For fiscal year 2002, these costs totaled roughly $52.3 million. This does not include overhead costs, which include costs incurred for personnel, rent, travel, training, and other activities related to maintaining program operations. For fiscal year 2003, the estimated costs for the origination, servicing, and collection of FDLP consolidation loans is projected to increase to $59.5 million. While we similarly were unable to determine Education's administration costs directly related to FFELP consolidation loans, they are likely to be smaller than for FDLP consolidation loans. This is because a large portion of FFELP administration cost is borne directly by lenders, who make and service the loans. The special allowance payments to lenders, which rise and fall as interest rates change, are designed to ensure that lenders are compensated for administration and other costs and provided with a reasonable return on their investment so that they will continue to participate in the program.

Concluding Observations

As the discussion of both FFELP and FDLP loans shows, interest rates have a strong effect on whether subsidy costs occur and how large they are. The movement of subsidy costs for consolidation loans made in future years will depend heavily on what happens to interest rates. As we have shown, subsidy cost estimates for FFELP consolidation loans can increase substantially, depending on how much the guaranteed lender yield rises above the fixed rate paid by borrowers, which, in turn, requires the federal government to pay subsidies to lenders. Conversely, if borrowers obtained consolidation loans with a fixed interest rate at a time when rates were expected to decrease in the future, federal subsidy costs could be lower, than is currently the case, because the borrower rate could exceed the rate guaranteed to lenders, and the federal government might not be required to pay lender subsidies. For FDLP consolidation loans, allowing borrowers to lock in a low fixed rate might result in decreased federal revenues if the variable interest rates on those loans borrowers converted to a consolidation loan would have otherwise increased in the future. The exact effects of FDLP consolidation loans, however, depend on a number of factors, including the length of loan repayment periods, borrower interest rates, and discount rates.

We noted in our prior report[9] that borrowers' choices between obtaining a fixed rate consolidation loan or retaining their variable rate loans can significantly affect federal costs. While consolidation loans may be an important tool to help borrowers manage their educational debt and thus reduce the cost of student loan defaults,

[9] GAO–04–101.

the surge in the number of borrowers consolidating their loans suggests that many borrowers who face little risk of default are choosing consolidation as a way of obtaining low fixed interest rates—an economically rational choice on the part of borrowers. If borrowers continue to consolidate their loans in the current low interest rate environment, and interest rates rise, the government assumes the cost of larger interest subsidies. Providing for these larger interest subsidies on behalf of a broad spectrum of borrowers may outweigh any government savings associated with the reduced costs of loan defaults for the smaller number of borrowers who might default in the absence of the repayment flexibility offered by consolidation loans.

In our October 2003 report, we also discussed the extent to which repayment options other than consolidation loans allow borrowers to simplify loan repayment and reduce repayment amounts. We found that other repayment options that allow borrowers to make a single payment to cover multiple loans and smaller monthly payments are now available for some borrowers under both FFELP and FDLP, but these alternatives are not available to all borrowers. In that report, we concluded that restructuring the Consolidation Loan Program to specifically target borrowers who are experiencing difficulty in managing their student loan debt and at risk of default, and/or who are unable to simplify and reduce repayment amounts by using existing alternatives, might reduce overall federal costs by reducing the volume of consolidation loans made. In addition, making the other nonconsolidation options more readily available to borrowers might be a more cost-effective way for the federal government to provide borrowers with repayment flexibility while reducing federal costs. An assessment of the advantages of consolidation loans for borrowers and the government, taking into account program costs and the availability of, and potential change to, existing alternatives to consolidation, and how consolidation loan costs could be distributed among borrowers, lenders, and the taxpayers, would be useful in making decisions about how best to manage the Consolidation Loan Program and whether any changes are warranted.

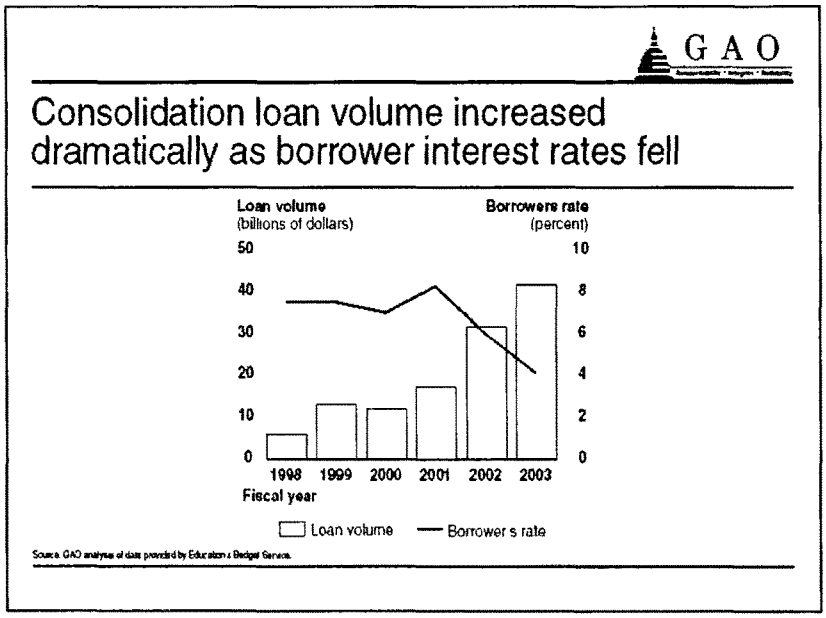
In our October 2003 report, we recommended that the Secretary of Education assess the advantages of consolidation loans for borrowers and the government in light of program costs and identify options for reducing federal costs. We suggested options that could include targeting the program to borrowers at risk of default, extending existing consolidation alternatives to more borrowers, and changing from a fixed to a variable rate the interest charged to borrowers on consolidation loans. We also noted that, in conducting such an assessment, Education should also consider how best to distribute program costs among borrowers, lenders, and the taxpayers and any tradeoffs involved in the distribution of these costs. Furthermore, if Education determines that statutory changes are needed to implement more cost-effective repayment options, we believe it should seek such changes from Congress. Education agreed with our recommendation.

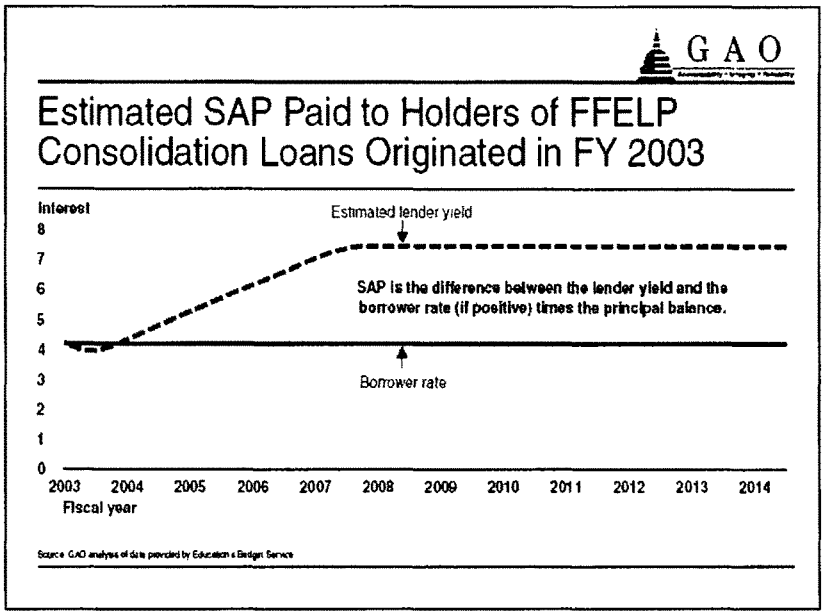
Mr. Chairman, this concludes my prepared statement. I would be pleased to respond to any questions that you or other members of the Committee may have.

GAO Contact and Acknowledgments

For further contacts regarding this testimony, please call Cornelia M. Ashby at (202) 512–8403. Individuals making key contributions to this testimony include Jeff Appel, Susan Chin, Cindy Decker, and Julianne Hartman–Cutts.

[Attachments to Ms. Ashby's statement follow:]


GAO
Consolidation loan volume increased dramatically as borrower interest rates fell
Loan volume
(billions of dollars)
Borrowers rate
(percent)
50
40
30
20
10
0
10
8
6
4
2
0
1998
1999
2000
2001
2002
2003
Fiscal year
Loan volume
Borrower s rate
Source GAO analysis of data provided by Education s Budget Service


GAO
Estimated SAP Paid to Holders of FFELP Consolidation Loans Originated in FY 2003
Interest
8
7
6
5
4
3
2
1
0
Estimated lender yield
SAP is the difference between the lender yield and the borrower rate (if positive) times the principal balance.
Borrower rate
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
Fiscal year
Source GAO analysis of data provided by Education s Budget Service

Chairman BOEHNER. Thank you, Ms. Ashby.

Mr. Hamlett, you may begin.

STATEMENT OF TITUS M. HAMLETT, STUDENT, UNIVERSITY OF MARYLAND

Mr. HAMLETT. Thank you, Chairman Boehner and distinguished Committee members, for inviting me here today to speak on consolidation loans and financing a college education.

I just wanted to mention that this is my first time testifying. I am a little nervous and I am also feeling a little under the weather today, so please bear with me.

My name is Titus Hamlett. I am a senior at the University of Maryland, College Park. I will graduate this May with a degree in government and politics, and I plan to pursue a career in public service. I will be the first person in my family to graduate from college, which is a major accomplishment, and I am very proud of that.

I currently work at the U.S. Department of Justice as a student paralegal. I am actually in the Civil Division and I do work with the U.S. attorneys. I do a lot of research and different things for them.

Basically what I want to talk about is the effects of student loans on students, and the effects of tuition increases on students.

As you all know, many students like myself struggle to pay for higher education today. In the University of Maryland system, tuition prices have risen by 20 percent in the last year alone. Despite rising prices, growing student loan debt, and more students working to pay for college, the Governor in Maryland has continued to cut funding for higher education, unfortunately.

The real impact has been that, along with thousands of other University of Maryland students, I have had to take out more loans and work longer hours for these unexpected, and they are unexpected, tuition increases. I am currently working 20-plus hours a week while balancing an 18-credit course load, which is tough, but it's what I have to do, because I have to graduate, and I have to pay for my college education.

My mother, who is a single parent, works two full-time jobs, but even with her two jobs, she cannot afford to pay a significant amount toward my college education, so I rely on some help from my mother—financial help, that is.

I work during the summer; as I mentioned, I work throughout the school year; and I have also received Pell Grants, which have helped a lot. However, I primarily rely on student loans to pay for my college education.

When I graduate this May, unfortunately, I will have about $41,000 in Federal education loan debt. I have taken out $22,000 in subsidized Stafford loans, and $19,540 in unsubsidized Stafford loans.

When I graduate, I plan to consolidate my loans in a locked low interest rate, hopefully, to save thousands of dollars, and to make repaying my college loans manageable.

In addition to my loans, working through school and receiving scholarships and grants have made it possible for me to attend college. However, as I near graduation, I worry that I am not going

to be able to manage the $41,000-plus that I am going to have in undergraduate loan debt.

I would like to pursue a career in public service, because I feel that it's important for me to give back to my community and my country, but if my monthly student payments are too high once I graduate, I may have to reconsider whether or not I want to go into the public sphere or into the private sector.

I really, really like—my heart is into public service. It's what I want to do. But I may have, you know, more debt than I would make in my first year as a graduate, and I have to take that into consideration when I apply for a job once I graduate.

I believe the grants and the loans that I received while I have been in college have been key to making my education possible.

As I mentioned before, given that both tuition prices and student debt has been constantly rising, I was shocked to learn that Congress may consider eliminating the low fixed rate benefit for student borrowers.

Eliminating this benefit will push higher prices on thousands of students like myself, and increase the numbers of student borrowers who simply won't be able to manage repaying their student loans.

When I graduate this spring, I plan to continue working at the Department of Justice because, like I mentioned before, I really want to work in public service and give back to my country. I know that this is possible for me, because consolidation will allow me to save thousands of dollars on my loans overall and make my monthly payments a lot lower.

I strongly support making college more affordable by allowing student borrowers to consolidate their loans to a low, fixed interest rate.

Chairman Boehner and Ranking Members of the Committee, I urge you to retain the low fixed interest rate for student borrowers, and I oppose any efforts to raise costs on student loans.

Thank you for allowing me to testify today.

[The prepared statement of Mr. Hamlett follows:]

Statement of Titus M. Hamlett, Student, University of Maryland

Thank you Chairman Boehner, Ranking Member Miller and distinguished committee members for inviting me here to speak today on the issue of student loan consolidation and financing a college education.

My name is Titus Hamlett and I am a senior at University of Maryland College Park. I will graduate this May with a degree in Government and Politics and I plan to pursue a career in public service. I will be the first person in my family to graduate from college. I currently work at the U.S. Department of Justice in the Civil Division as a part-time paralegal.

As you know, many students like myself struggle to pay for higher education today. In the University of Maryland system tuition prices have risen by 20 percent, or over $1000 (for in-state students), in the last year alone. Despite rising prices, growing student loan debt and more students working to pay for college, The Governor of Maryland has continued to cut funding for higher education. The real impact has been that along with thousands of other University of Maryland students, I have had to take out more loans and work longer hours to pay for these unexpected tuition increases. I am currently working 20 plus hours a week while balancing an 18-credit course load.

My mother, who is a single parent, works two full-time jobs, but even with her two jobs she cannot afford to pay for my college education. I rely on some financial help from my mother; I work during the summer and throughout the school year,

and I also received a $4050.00 Pell Grant this year. However, I have primarily relied on student loans to pay for my college education.

When I graduate this May I will have $41,540.00 in federal education loan debt. I have taken out $22,000.00 in subsidized Stafford loans and $19,540.00 in unsubsidized Stafford loans. When I graduate I plan to consolidate my loans and lock in a low interest rate to save thousands of dollars and to make repaying my college loans manageable.

In addition to my loans, working through school and receiving scholarships/grants have made it possible for me to attend college. However, as I near graduation I am worried that I will not be able to manage the $41,000.00 that I have in undergraduate loan debt. I would like to pursue a career serving my community and country. I am counting on the benefit of a low-fixed rate consolidation loan, which would save me thousands of dollars, to help make my career in public service possible. Otherwise, I may have no other choice but to go into the private sector.

I believe that the grants and loans that I received while I was in college were key to making my college education possible. However, the impact of my loans won't really hit me until I graduate and have to make monthly payments. It's important to have financial assistance at both points for students with need.

If I were not able to consolidate my loans under a fixed rate, I would have to pay thousands more for my education. Higher total and monthly payments would dictate where I work, when or if I am able to purchase a home, and various other important life choices.

Given that both tuition prices and student loan debt have been rising rapidly, I was shocked to learn that Congress may consider eliminating the low-fixed rate benefit for student borrowers. Eliminating this benefit would push higher prices on thousands of students and increase the number of student borrowers who cannot afford to repay their loans.

When I graduate this spring, I plan to continuing working at the Department of Justice, because I believe that it is important to give back to the community and my country. I know that this is possible for me because consolidation will allow me to save thousands of dollars on my loans overall and lower my monthly payments.

I strongly support making college more affordable by allowing student borrowers to consolidate their loans and lock in a low-fixed interest rate. Chairman Boehner, Ranking Member Miller and all of the distinguished members here today I urge you to retain the low-fixed rate benefit for student borrowers and oppose any efforts to raise the cost of student loans. Thank you for allowing me to testify here today.

Chairman BOEHNER. Thank you, Mr. Hamlett.

Dr. Neubig.

STATEMENT OF THOMAS S. NEUBIG, NATIONAL DIRECTOR, QUANTITATIVE ECONOMICS AND STATISTICS, ERNST & YOUNG, LLP, WASHINGTON, D.C.

Dr. NEUBIG. Mr. Chairman and members of the Committee, thank you for inviting me to testify on the results of two recent studies I prepared on the costs and benefits of the consolidation student loan program. The results of both reports rely heavily on Congressional Budget Office interest rate projections, and I have included some updated estimates based on CBO's most recent projections.

In today's hearing, you are going to see large differences in the cost estimates of the Consolidation Loan Program, and if I can leave you with two takeaways, I would like you to understand why the cost of the program has changed over time, and also why different cost methodologies show vastly different results.

When I trained to be an economist, I did not want to be a crystal ball gazer, forecasting GDP, employment, interest rates. At the U.S. Treasury Department, we estimated tax revenue and tax policy changes, taking the macroeconomic forecasts of CBO and OMB as a given.

Economists rarely agree on future projections, especially interest rates. Even OMB and CBO disagree on the magnitude and timing of the interest rate changes. One advantage of using CBO interest rate projections is that they underlie all congressional budget estimates.

Since accurate forecasting of the future is impossible, budget numbers should at least be consistent across programs. The principal reason for the varying costs of the Consolidation Loan Program is that the cost is tied to the direction of interest rate movements. As interest rates change over time, the cost of each year's loans also changes.

I like to think of the consolidation loans as falling into three buckets.

The first bucket includes loans consolidated before 2003. That's when interest rates were high, but then fell sharply.

Due to that pattern of interest rate changes, lender-paid fees on these loans will exceed the cost of the interest subsidy to the tune of almost $4 billion over the entire life of those loans.

The second bucket includes loans consolidated between 2003 and 2006, and those loans have low interest rates for the students, and interest rates are projected to increase.

Based on the CBO projections of increasing interest rates, I estimate that those loans consolidated in those 4 years will cost Federal taxpayers $6 billion over the life of the loans. That is a 180-degree cost change, but it is due to the shift from stable, or falling interest rates, to a rapidly rising interest rate environment.

The third bucket includes loans consolidated after 2006, when future interest rates stabilize. In this stable interest rate period—you know, again, based upon the CBO interest rate forecast—consolidation loan fees will again exceed the interest subsidy for a positive $2 billion benefit to the U.S. Treasury between 2007 and 2010.

When you look at the cost of the Consolidation Loan Program over the 16-year period between 1995 and 2010, and you combine all three buckets of loans, the program is positive in the initial years. It's quite costly for today's loans, and then it is positive again once interest rates stabilize. If you look at the program over 16 years, it is essentially cost-neutral. Lender-paid fees roughly match the interest subsidy.

Now, if you are uncomfortable with people forecasting future interest rates, you can look at the actual budget cash-flow experience of the program to date.

From 1995 to 2003, the government collected $2.6 billion in fees and only spent $400 million in special allowance payments. That's a net positive of $2.2 billion. You can see those actual budget numbers on Page 3 of my testimony.

The cost estimates I have provided the Committee follow the Federal Credit Reform Act requirement to discount future cash-flows from Federal loan guarantee programs to current dollars. This recognizes that a dollar in 2024 is worth much less than a dollar today. If future cash-flows are not discounted, the estimates will be inflated and also inconsistent with other loan guarantee program cost estimates.

Up to this point, I've focused on the cost side, but let me briefly describe one of the benefits of the current program. That is the one-time ability to lock in a fixed interest rate.

Similar to mortgage refinancing, consolidation loans have become very popular at the current low interest rate. Changing the consolidation loan interest rate formula from a fixed rate to a variable rate would roughly double the interest cost paid by students taking out a consolidation loan today, based on the CBO interest rate forecast.

Whether student borrowers or the Federal taxpayer should bear the risk of future interest rate increases is a key public policy question.

I hope my testimony is helpful in the Committee's deliberations.

Thank you.

[The prepared statement of Dr. Neubig follows:]

Statement of Dr. Thomas S. Neubig, National Director, Quantitative Economics and Statistics, Ernst & Young LLP

I am the National Director of Ernst & Young LLP's Quantitative Economics and Statistics practice. I was previously the Director and Chief Economist of the U.S. Treasury Department's Office of Tax Analysis.

I appreciate the invitation to testify before the Committee to discuss the results of two studies on the costs and benefits of the Federal Family Education Loan (FFEL) consolidation student loan program. The two reports, "The Net Incremental Cash Flow and Budget Effects of the FFEL Consolidation Loan Program, fiscal year 2005–FY2010" and "The Effect on Student Borrowing Costs if Consolidation Loans Were Variable Rate Loans Rather Than Fixed Rate Loans," are also submitted for the record. Both reports were prepared at the request of Collegiate Funding Services LLC. My testimony summarizes the key findings from the reports, with estimates updated for the most recent loan volume and interest rate projections.

Two Key Considerations

Two key considerations for policymakers considering the cost implications of consolidation loans during the coming Higher Education Act reauthorization are:

1. Consolidation student loans are not all alike from a cost perspective. The cost of future consolidation loans will be much less than the estimated cost of the current 3.5% loans.

Depending on the interest rate environment, a year's issuance of consolidation loans could bring in significant fee revenue to the U.S. government or could require significant expenditures. Three groups of consolidation loans should be distinguished:

- Loans made before fiscal year 03 have already generated $1.7 billion of consolidation loan fees from lenders to date with only $0.3 billion of government payments to lenders. The estimated net cost of the Consolidation Loan Program for loans originated in fiscal year 1995–2002 is a positive $3.7 billion over the life of the loans.
- Loans made between fiscal year 03 and fiscal year 06 are expected to have significant future subsidy costs if the predicted sharp increase in interest rates occurs. Consolidation loans made at historically low interest rates during this four-year period are estimated to cost $6.1 billion over the life of the loans in net present value.
- Loans made after fiscal year 06, when the interest rate forecast is relatively stable, are estimated to have fees that will exceed expenditures. The estimated net cost of loans made in fiscal year 2007–2010 is a positive $2.3 billion.

The large estimated cost of current consolidation loans is due to current historically low interest rates combined with projected higher future interest rates. These loans will provide significant interest savings to student borrowers if the projected interest rate increases occur. The costs and benefits of these loans have already been committed. This is why the August 2003 report focused primarily on future loans.

2. The real cost of the Consolidation Loan Program is its additional cost over and above the cost of the underlying Stafford/Plus loans (i.e., its "incremental" net cost) less lender-paid consolidation fees.

Measuring the real cost of the Consolidation Loan Program is not easy, and its further complicated by the many different types of estimates that are possible. I believe the appropriate cost for policymakers to consider will include:

Fee offset. The cost of the Consolidation Loan Program from defaults and special allowance payments is partially offset by the 0.5% origination fee and the annual 1.05% consolidation loan holder fee. These lender-paid fees are generated from consolidation loans and reduce the net cost of those loans.

Incremental cost. If fewer consolidation loans were made, there would be more interest subsidy paid on the Stafford/Plus loan program. The cost of consolidation loans is the cost over and above the interest subsidy on the underlying Stafford/Plus loans, less the lender-paid consolidation fees.

Discounted present value of future cash flows. The Federal Credit Reform Act (FCRA) of 1990 requires the budget effect to be calculated as the net present value of the future cash flows over the life of the loans issued in each year. Simply adding future dollars without discounting is inconsistent with the FCRA and overstates the costs of the consolidation program.

Future interest rate projections. Interest rate forecasts, like interest rates, change over time as the economy changes. For budgeting purposes, the Congressional Budget Office and Office of Management and Budget forecast interest rates over the next 5–10 years. These forecasts underlie not only student loan costs, but also the government's interest expense, the macroeconomic forecast of GDP, employment and tax revenues. Extreme scenarios of interest rate increases are inconsistent with every other budget forecast.

Estimates that do not take these issues into account will overstate the cost of the FFEL Consolidation Loan Program.

The Budget Cost of Consolidation Loans

The August 2003 report on "The Net Incremental Cash Flow and Budget Effects of the FFEL Consolidation Loan Program, fiscal year 2005–FY2010" showed that on a cash flow basis the program has been a net plus to the federal government since 1995. I have updated the numbers for the most recent Department of Education budget numbers and loan volume forecasts, plus the CBO's most recent interest rate projections.

Consolidation loan fees have totaled $2.6 billion through fiscal year 03 while gross special allowance payments have been only $0.4 billion. Based on the most recent Department of Education fiscal year 05 Budget numbers, the FFEL Consolidation Loan Program will bring in an additional $2.2 billion of lender-paid fees, with only $0.5 billion of expenses in fiscal year 04 and fiscal year 05. These cash flow numbers represent the actual fiscal experience to date of the program, but they are not the full cost, which requires projecting future interest rates and the future cash flow for the entire life of the loans.

Historical Cash Flow of the FFEL Loan Consolidation Program

($ millions)

	Income			Cost	
Fiscal Year	**Lender Origination Fee**	**Lender Holder Fee**	**Total Fees**	**Gross Special Allowance Payment**	**Net Cash Flow**
1995	23	22	45	0	45
1996	22	66	88	0	88
1997	12	130	142	0	142
1998	16	131	147	53	94
1999	25	196	221	92	129
2000	27	210	237	6	231
2001	28	287	315	129	186
2002	91	383	474	34	440
2003	176	743	919	61	858
Total FY 95-03	**420**	**2,168**	**2,588**	**375**	**2,213**
Estimated					
2004	128	925	1,053	68	985
2005	110	1,031	1,141	476	665
Total FY 95-05	**658**	**4,124**	**4,782**	**919**	**3,863**

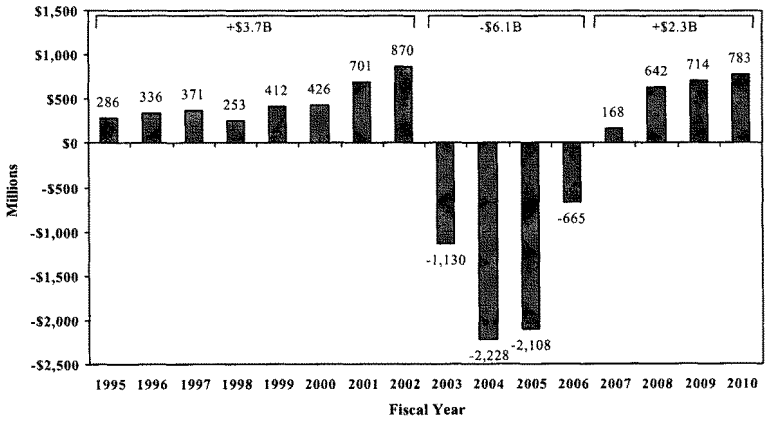
Source: Department of Education Federal Budget Appendices, FY1996-2005

The figure below shows the estimated cost of the three groups of FFEL consolidation loans based on the latest loan volume estimates and CBO interest rate projections. These estimates take into account both special allowance payments and fees, the incremental cost of consolidation loans in excess of Stafford/Plus loans, and the discounted present value of the future cash flows.

The cost of the Consolidation Loan Program varies over time with different interest rate environments. When loan rates at the time of consolidation are high and then interest rates fall (fiscal year 1995–2002), the program is estimated to have a net effect of positive $3.7 billion. When loan rates at the time of consolidation are low and interest rates are expected to rise (fiscal year 2003–06), the cost is estimated to be $6.1 billion over the four years. When interest rates are relatively stable (fiscal year 2007–10), consolidation loans will again return to a positive net effect of $2.3 billion. Over the 16-year period, the FFEL Consolidation Loan Program is estimated to be essentially cost neutral (less than negative $0.2 billion).

When the HEA reauthorization occurs, only changes to the Consolidation Loan Program will be scored for budget purposes. The expected cost of the current loans has already been included in prior budgets, and will not affect the HEA reauthorization budget.

Budget Effects[1] of FFEL Consolidation Loans FY1995-2010



[1] Budget effect is the net present value of the incremental impact of consolidation loan program. Methodology is described in Ernst & Young LLP, "The Net Incremental Cash Flow and Budget Effects of the FFEL Consolidation Loan Program, FY2005-FY2010" (August 2003), updated with loan volumes from U.S. Department of Education, *Student Loan Volume Tables- FY 2005 President's Budget* and interest rate projections from the Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2005 to 2014" (January 2004).

The Benefit Side

The FFEL Consolidation Loan Program was enacted to provide student loan borrowers with a simpler loan repayment plan, plus a one-time opportunity to lock in a longer payment term and a fixed interest rate to reduce the likelihood of default. A lower, fixed monthly payment was thought to result in lower default rates for student borrowers. How much of the lower default effect is due to the extended repayment period, the fixed interest rate, or the type of student refinancing the loans, has not been studied, but that information would be helpful for policymakers to know.

One benefit, particularly during the current low interest rate environment, is the ability of student borrowers to lock in a fixed interest rate. This is similar to what has happened in the residential mortgage market, where there has been an explosion of refinancing to lower families' mortgage interest expense and monthly payments. Recent developments in the mortgage market to allow borrowers to choose fixed rate or variable rate loans with different maturities have been a major benefit to both borrowers and the residential housing market. Private market lenders are willing to lend money at 4–6% interest rates for 15–30 years. If interest rates go up as the CBO projects, many mortgage lenders will experience lower returns on those fixed mortgages, while the borrowers will view them as very beneficial.

Similarly, the potential cost of the FFEL Consolidation Loan Program for loans originated between July 1, 2002 and June 30, 2004 could be large if interest rates rise as the CBO projects. The total net incremental cost of those two years of loans is an estimated $3.4 billion in net present value terms. On the borrower side, the student loan borrowers will benefit significantly from the low 3.5% fixed interest rate. The March 2004 study, "The Effect on Student Borrowing Costs If Consolidation Loans Were Variable Rate Loans Rather Than Fixed Rate Loans," shows the effect on borrower costs if those consolidation loans had not been available at a fixed rate.

Using a $30,000 20-year consolidation loan originated in July 2003 at 3.5%, and the CBO interest rate projections, the monthly payment would increase 34% from $174 under a fixed rate loan to $233 in 2008 if it had been a variable rate loan. The total interest expense would increase from $11,800 to $22,900 over the life of the loan, a 95% increase. The variable rate loan would have the same total interest cost as a comparable 6.32% fixed rate loan, 2.72% above the current fixed consolidation loan rate.

The benefits of the fixed interest rate include potentially lower default rates and the ability to lock in a lower rate. Congress has limited the ability of student borrowers to refinance their student loans more than once. The budget cost, which provides the interest rate subsidy for the borrower's benefit, is one reason for the limitation on student loan refinancing.

Conclusion

The FFEL Consolidation Loan Program is an important part of the Higher Education Act reauthorization. The Consolidation Loan Program's benefits and costs are not easily measured, and continually revised interest rate projections and different methodologies result in a myriad of numbers. I hope these two reports and these updated estimates provide the Committee with useful information for your deliberations, particularly the important considerations that:

- Consolidation student loans are not all alike from a cost perspective. The net cost of future consolidation loans will be much less, even positive, compared to the estimated cost of the current 3.5% loans.
- The reported cost of the Consolidation Loan Program will be overstated unless lender-paid loan fees, the net cost above the cost of the otherwise underlying Stafford/Plus loans, the discounted present value of future cash flows, and government interest rate projections are included in the analysis.

That concludes my testimony. I would be happy to answer any questions about my testimony and the two consolidation loan studies.

[Attachments to Dr. Neubig's statement follow:]

QUANTITATIVE ECONOMICS
& STATISTICS

The Effect on Student Borrowing Costs If Consolidation Loans Were Variable Rate Loans Rather Than Fixed Rate Loans

Prepared for Collegiate Funding Services LLC

March 1, 2004

ERNST & YOUNG

Quality In Everything We Do

The Effect on Student Borrowing Costs If Consolidation Loans Were Variable Rate Loans Rather Than Fixed Rate Loans

Executive Summary

Ernst & Young LLP was asked by the Collegiate Funding Services Corporation to analyze the effect on student loan borrowing costs if the Federal Family Education Loan (FFEL) consolidation loan program was changed to a variable interest rate from the current fixed interest rate.

The analysis uses an example of a FFEL consolidation loan originated in July 2003 and the Congressional Budget Office interest rate projections for the FY2005 budget. In addition, the effects on student borrowing costs for loans originated in July 2004 and July 2005 are also presented.

The major findings of the study are:

- Due to the projected increase in future interest rates a variable interest rate would result in significantly higher borrowing costs to students with FFEL consolidation loans than the current fixed interest rate.

- A student borrower with a $30,000 twenty-year consolidation loan originated in July 2003 would pay an additional $11,187 in interest cost over the life of the loan if the loan had been variable rather than fixed at the current interest rate of 3.5 percent.
    - This represents a 95 percent increase in the interest borrowing cost.
    - A variable interest rate loan would have the same total interest cost as a comparable 6.32 percent fixed rate loan, 2.72 percentage points above the current fixed consolidation loan interest rate.

- A student consolidating a similar loan during its grace period would pay an additional $10,879 in interest cost over the life of the loan if the loan had been variable rather than fixed at the interest rate of 2.875 percent.
    - This represents a 115 percent increase in the interest borrowing cost.

- A similar loan originated in July 2004, with a projected fixed interest rate of 3.5 percent (3.0 percent for a grace period loan) would pay an additional $12,208 in interest cost ($11,444 for a grace period loan) over the life of the loan if the loan were variable rather than a fixed rate.
    - This represents a 104 percent (115 percent for a grace period loan) increase in the interest borrowing cost.

- A similar loan originated in July 2005, with a projected fixed interest rate of 5.125 percent (4.625 percent for a grace period loan) would pay an additional $6,989 in interest cost ($6,334 for a grace period loan) over the life of the loan if the loan were variable rather than a fixed rate.
    - This represents a 39 percent increase in the interest borrowing cost for both a loan in repayment and for a grace period loan.

One attractive feature of the current consolidation loan program is the fixed interest rate. The fixed interest rate on consolidation loans, similar to the fixed interest rate on home mortgages, provides the borrower with a fixed monthly payment plus the benefit of locking in the current low interest rate. Moving to a variable interest rate would eliminate these current benefits to consolidation loan borrowers.

I. Description of the FFEL Consolidation Student Loan Program

The FFEL consolidation loan program was started in the mid 1980s to assist students consolidated multiple loans into a single fixed rate, up to 30-year, loan. The consolidation loan program grew modestly during the late 1990s, but the volume of consolidation student loans increased dramatically in the past few years when interest rates fell sharply.

The FFEL consolidation loan program consists primarily of consolidated Stafford student loans, but other types of student loans, including Perkins, PLUS, Health Professions and Loans to Disadvantaged Students are also consolidated.

The loans can only be consolidated once, and have up to a 30-year term as determined by statute and depending on the amount of indebtedness. The interest rate is fixed for the life of the loan, set at the time of consolidation to the weighted average of the loans consolidated, rounded up to the nearest 1/8 percentage point.

The current interest rate on a new consolidation loan, consolidating Stafford loans originated since July 1, 1998, is 3.5 percent, or 2.875 percent if consolidated within six months of the student's separation from the school. For Stafford loans originated after July 1, 1998, the student loan rate is the 91-day T-bill rate plus 2.3 percent for loans originated in repayment period, and the T-bill rate plus 1.7 percent for loans originated in the six-month grace period.

II. The Effect on Student Borrowing Costs If FFEL Consolidation Loan Rates Were Variable Rates

The historically low interest rates available on student loans currently and during the past two years have resulted in a significant increase in consolidation loans, with commensurate benefit to the student loan borrowers. These borrowers will benefit from fixed interest rates to the extent that interest rates increase in the future, as forecast by the U.S. Congressional Budget Office.

As part of the pending reauthorization of the Higher Education Act, a number of possible program changes have been discussed. One possible change that has been mentioned would change the current fixed interest rate on FFEL consolidation loans to a variable interest rate, which would fluctuate each year.

Since one of the benefits of the consolidation loan program is the fixed interest rate, it is important for policymakers to understand the potential effect on student borrowing costs if such a change were made. Since the effect on borrower costs depends on future interest rates, the effect can only be estimated. Different scenarios of future interest rates can be used. The Congressional Budget Office (CBO) forecasts federal government expenditures and revenues for the Congress, and as part of those forecasts makes public their interest rate forecast for 91-day T-bill rates. For longer periods, the CBO generally holds the interest rates constant after the 10-year period.

The CBO interest rate forecast is shown in Table 1 below. The expected FFEL consolidation loan rates can be calculated. Based on the CBO interest forecast, the consolidation loan rate will stay at 3.5 percent for loans originated between July 1, 2004 and June 30, 2005 (increase slightly to 3.0 percent for grace period loans), and increase to 5.125 percent for loans originated between July 1, 2005 and June 30, 2006 (4.625 percent for grace period loans).[1]

Table 1: CBO Interest Rate Forecast of 91-day T-Bill and Consolidation Loan Rate

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
CBO 91-Day T-Bill Estimate Fiscal Year	1.10%	1.10%	2.60%	3.80%	4.50%	4.60%	4.60%	4.60%	4.60%	4.60%	4.60%	4.60%
CBO 91-Day T-Bill Estimate Calendar Year	1.00%	1.30%	3.03%	4.01%	4.59%	4.60%	4.60%	4.60%	4.60%	4.60%	4.60%	4.60%
Consolidation Loan Rate (Grace) 1/	2.88%	3.00%	4.63%	5.63%	6.25%	6.38%	6.38%	6.38%	6.38%	6.38%	6.38%	6.38%
Consolidation Loan Rate (Repayment) 1/	3.50%	3.50%	5.13%	6.25%	6.88%	7.00%	7.00%	7.00%	7.00%	7.00%	7.00%	7.00%

Source: U.S. Congressional Budget Office, The Budget and Economic Outlook: Fiscal Years 2005-2014, January 2004, and E&Y calculation of consolidation loan rates.
1/ Consolidation loan rate set equal to current and projected rates for Stafford loans in repayment made after 1/1/98 and rounded up to the nearest 1/8th of a percent.

Methodology

To estimate the effect on student borrowers using consolidation loans, the analysis estimates the monthly payments and total interest expense for a $30,000 twenty-year consolidation loan originated on July 1, 2003 under the current law fixed interest rate, compared with a variable interest rate. The analysis examines the total interest expense of consolidation loans made in repayment and during the grace period.[2] The analysis also presents the total interest expense for loans originated during the next two years, originated on July 1, 2004 and July 1, 2005.

The analysis assumes that the student borrowers use the "standard" level payment (rather than graduated or interest sensitive payments) and keep the loans in good standing for the entire term of the loan. The analysis assumes that the variable interest rate loan changes the monthly

[1] The CBO forecast presents 91-day T-bill rates for the calendar year and the federal government fiscal year. The FFEL consolidation loan rate is set based on the 91-day T-bill rate in May of each year. An average of the fiscal year and calendar year rates was used to approximate the rate estimated to be in effect in May of each year.
[2] The analysis assumes that the loans consolidated are Stafford student loans, which were originated on or after July 1, 1998. Loans originated before July 1, 1998 had higher interest rates, so the weighted average interest rate would depend on the fraction of loans originated before and after July 1, 1998.

payment each year, keeping the repayment period constant.[3] The variable loan rate is set to the projected Stafford loan rate, rounded up to the nearest 1/8 of a percentage point.

The analysis also uses the CBO interest rate forecast during the 2004-2014 period, and assumes that interest rates will remain steady after their forecast period.

Comparison of Variable and Fixed Interest Rates on Monthly Payments of Consolidation Loans

Table 2 shows the monthly payments over the life of the loan for the six different types of loans:

- Consolidation loan originated July 1, 2003
  - Loans in repayment
  - Loans in grace period
- Consolidation loan originated July 1, 2004
  - Loans in repayment
  - Loans in grace period
- Consolidation loan originated July 1, 2005
  - Loans in repayment
  - Loans in grace period

In all six cases, based on the CBO interest rate forecast, student borrowers will face higher monthly payments in the future with a variable rate consolidation loan compared to a fixed rate loan. In some cases, the monthly payment will increase by 34 percent.

[3] Alternatively, the regulations provide for an automatic extension of the repayment period of up to three years on variable rate loans. Extending the repayment period would increase the total interest cost by even more than the variable monthly payments, since the amount of the principal balance would be larger longer.

Table 2: Monthly Payments on Consolidation Loans with Fixed and Variable Interest Rates, Loans Originated in 2003-2005

	Loans Originated July 1, 2003					
	Loans in Repayment			Loans in Grace		
Year 1/	Variable	Fixed	Difference	Variable	Fixed	Difference
1	$174	$174	$0	$165	$165	$0
2	$174	$174	$0	$166	$165	$2
3	$200	$174	$26	$192	$165	$27
4	$219	$174	$45	$208	$165	$44
5	$230	$174	$56	$219	$165	$55
6	$233	$174	$59	$221	$165	$57
7	$233	$174	$59	$221	$165	$57
8	$233	$174	$59	$221	$165	$57
9	$233	$174	$59	$221	$165	$57
10	$233	$174	$59	$221	$165	$57
11	$233	$174	$59	$221	$165	$57
12	$233	$174	$59	$221	$165	$57
13	$233	$174	$59	$221	$165	$57
14	$233	$174	$59	$221	$165	$57
15	$233	$174	$59	$221	$165	$57
16	$233	$174	$59	$221	$165	$57
17	$233	$174	$59	$221	$165	$57
18	$233	$174	$59	$221	$165	$57
19	$233	$174	$59	$221	$165	$57
20	$233	$174	$59	$221	$165	$57
Average	**$224**	**$174**	**$50**	**$214**	**$165**	**$49**

	Loans Originated July 1, 2004					
	Loans in Repayment			Loans in Grace		
Year 1/	Variable	Fixed	Difference	Variable	Fixed	Difference
1	$174	$174	$0	$166	$166	$0
2	$200	$174	$26	$192	$166	$25
3	$219	$174	$45	$208	$166	$42
4	$230	$174	$56	$219	$166	$53
5	$233	$174	$59	$221	$166	$55
6	$233	$174	$59	$221	$166	$55
7	$233	$174	$59	$221	$166	$55
8	$233	$174	$59	$221	$166	$55
9	$233	$174	$59	$221	$166	$55
10	$233	$174	$59	$221	$166	$55
11	$233	$174	$59	$221	$166	$55
12	$233	$174	$59	$221	$166	$55
13	$233	$174	$59	$221	$166	$55
14	$233	$174	$59	$221	$166	$55
15	$233	$174	$59	$221	$166	$55
16	$233	$174	$59	$221	$166	$55
17	$233	$174	$59	$221	$166	$55
18	$233	$174	$59	$221	$166	$55
19	$233	$174	$59	$221	$166	$55
20	$233	$174	$59	$221	$166	$55
Average	**$227**	**$174**	**$53**	**$216**	**$166**	**$50**

	Loans Originated July 1, 2005					
	Loans in Repayment			Loans in Grace		
Year 1/	Variable	Fixed	Difference	Variable	Fixed	Difference
1	$200	$200	$0	$192	$192	$0
2	$219	$200	$19	$208	$192	$17
3	$230	$200	$30	$219	$192	$27
4	$233	$200	$33	$221	$192	$30
5	$233	$200	$33	$221	$192	$30
6	$233	$200	$33	$221	$192	$30
7	$233	$200	$33	$221	$192	$30
8	$233	$200	$33	$221	$192	$30
9	$233	$200	$33	$221	$192	$30
10	$233	$200	$33	$221	$192	$30
11	$233	$200	$33	$221	$192	$30
12	$233	$200	$33	$221	$192	$30
13	$233	$200	$33	$221	$192	$30
14	$233	$200	$33	$221	$192	$30
15	$233	$200	$33	$221	$192	$30
16	$233	$200	$33	$221	$192	$30
17	$233	$200	$33	$221	$192	$30
18	$233	$200	$33	$221	$192	$30
19	$233	$200	$33	$221	$192	$30
20	$233	$200	$33	$221	$192	$30
Average	**$230**	**$200**	**$30**	**$219**	**$192**	**$27**

Source: E&Y calculations. See text for methodology and assumptions.
1/ Years from the date of loan consolidation.

Comparison of Variable and Fixed Interest Rates on Total Interest Expense of Consolidation Loans

Table 3 shows the total interest expense over the life of the loan for the six different types of loans. The total interest expense for consolidation loans originated during repayment in July 2003 at the current 3.5 percent fixed interest rate is an estimated $11,757 over the life of the loan. If that same loan had been a variable interest rate, the estimated total interest cost would increase to $22,944. The extra $11,187 of interest expense would be a 95 percent increase for student borrowers. The total interest cost of a variable interest rate loan is equivalent to the total interest cost of a fixed interest rate loan of 6.32 percent, rather than the current 3.5 percent.

The total interest cost of the variable interest rate on consolidation loans originated during the grace period assumes that the lower grace rate applies throughout the life of the loan. If the grace rate only applied for the six-month grace period, similar to Stafford loans, the interest cost on the variable loan would be very similar to the interest cost of variable rate loans in repayment shown in column 1, and the difference would be a lot larger.

Table 3: Total Interest Expense on Consolidation Loans with Fixed and Variable Interest Rates, Loans Originated in 2003-2005

Loans Originated July 1, 2003

	Loans in Repayment			Loans in Grace		
Year 1/	Variable	Fixed	Difference	Variable	Fixed	Difference
1	$1,033	$1,033	$0	$848	$848	$0
2	$996	$996	$0	$851	$815	$36
3	$1,422	$957	$465	$1,278	$781	$496
4	$1,693	$917	$776	$1,513	$746	$767
5	$1,811	$875	$937	$1,633	$711	$922
6	$1,779	$832	$948	$1,603	$674	$929
7	$1,706	$787	$919	$1,534	$636	$898
8	$1,628	$741	$887	$1,460	$597	$863
9	$1,544	$693	$851	$1,382	$557	$825
10	$1,454	$643	$810	$1,298	$516	$782
11	$1,357	$592	$765	$1,209	$473	$735
12	$1,253	$539	$714	$1,113	$429	$684
13	$1,142	$484	$658	$1,012	$384	$628
14	$1,023	$427	$596	$904	$338	$566
15	$895	$368	$527	$789	$290	$499
16	$758	$306	$451	$666	$241	$425
17	$611	$243	$368	$536	$191	$345
18	$453	$177	$276	$396	$139	$257
19	$284	$109	$175	$248	$85	$162
20	$103	$39	$64	$90	$30	$59
Total	**$22,944**	**$11,757**	**$11,187**	**$20,361**	**$9,482**	**$10,879**

Loans Originated July 1, 2004

	Loans in Repayment			Loans in Grace		
Year 1/	Variable	Fixed	Difference	Variable	Fixed	Difference
1	$1,033	$1,033	$0	$885	$885	$0
2	$1,471	$996	$475	$1,324	$851	$473
3	$1,750	$957	$793	$1,567	$816	$751
4	$1,875	$917	$958	$1,693	$780	$913
5	$1,848	$875	$973	$1,668	$743	$925
6	$1,779	$832	$948	$1,603	$705	$898
7	$1,706	$787	$919	$1,534	$666	$868
8	$1,628	$741	$887	$1,460	$625	$835
9	$1,544	$693	$851	$1,382	$584	$798
10	$1,454	$643	$810	$1,298	$541	$757
11	$1,357	$592	$765	$1,209	$496	$712
12	$1,253	$539	$714	$1,113	$451	$663
13	$1,142	$484	$658	$1,012	$404	$608
14	$1,023	$427	$596	$904	$355	$549
15	$895	$368	$527	$789	$305	$484
16	$758	$306	$451	$666	$254	$412
17	$611	$243	$368	$536	$201	$335
18	$453	$177	$276	$396	$146	$250
19	$284	$109	$175	$248	$90	$158
20	$103	$39	$64	$90	$32	$57
Total	**$23,965**	**$11,757**	**$12,208**	**$21,375**	**$9,931**	**$11,444**

Loans Originated July 1, 2005

	Loans in Repayment			Loans in Grace		
Year 1/	Variable	Fixed	Difference	Variable	Fixed	Difference
1	$1,517	$1,517	$0	$1,368	$1,368	$0
2	$1,803	$1,471	$332	$1,618	$1,324	$294
3	$1,934	$1,422	$512	$1,750	$1,278	$472
4	$1,911	$1,370	$541	$1,729	$1,229	$500
5	$1,848	$1,316	$531	$1,668	$1,178	$490
6	$1,779	$1,259	$520	$1,603	$1,125	$478
7	$1,706	$1,200	$507	$1,534	$1,070	$464
8	$1,628	$1,136	$491	$1,460	$1,012	$449
9	$1,544	$1,070	$474	$1,382	$951	$431
10	$1,454	$1,000	$453	$1,298	$887	$411
11	$1,357	$927	$430	$1,209	$820	$389
12	$1,253	$850	$404	$1,113	$750	$364
13	$1,142	$768	$374	$1,012	$677	$335
14	$1,023	$682	$340	$904	$600	$304
15	$895	$592	$303	$789	$519	$270
16	$758	$497	$260	$666	$435	$231
17	$611	$398	$213	$536	$347	$188
18	$453	$292	$161	$396	$255	$142
19	$284	$182	$102	$248	$158	$90
20	$103	$65	$38	$90	$57	$33
Total	**$25,001**	**$18,015**	**$6,986**	**$22,372**	**$16,038**	**$6,334**

Source: E&Y calculations. See text for methodology and assumptions.
1/ Years from the date of loan consolidation.

The results of the above analysis are sensitive to the CBO projections of interest rates. If interest rates were to increase more than CBO projects, the student borrower costs would be higher than estimated. If interest rates do not increase as much as CBO projects, then the impact on student borrower costs would be lower. Both the U.S. Office of Management and Budget and the Blue Chip Economic Indicators currently forecast higher interest rates in the future. The current low interest rates are not projected to return again in the foreseeable future, so a switch to variable interest rates would be expected to increase student borrowing costs compared to the current law fixed rate consolidation loans. At some point in the future when interest rates trend downward variable rate loans could benefit some borrowers, but not in the foreseeable future according to the Congressional Budget Office.

QUANTITATIVE ECONOMICS
& STATISTICS

The Net Incremental Cash Flow and Budget Effects of the FFEL Consolidation Loan Program, FY2005-FY2010

Prepared for Collegiate Funding Services LLC

August 21, 2003

ERNST & YOUNG

Quality In Everything We Do

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The Net Incremental Cash Flow and Budget Effects of the FFEL Consolidation Loan Program, FY2005-FY2010

Executive Summary

Ernst & Young LLP was asked by the Collegiate Funding Services Corporation to analyze the cash flow and budget effects of the Federal Family Education Loan (FFEL) consolidation loan program, in preparation for the pending reauthorization of the Higher Education Act.

The major findings of the study are:

- Between fiscal years 1995 and 2002, FFEL consolidation loans generated positive net cash flow to the federal government of $1.4 billion.
- For fiscal years 2003 and 2004, consolidation loans are estimated to generate an additional $1 billion in net revenue.
- Consolidation loans originated during the unusually low interest rate environment of fiscal years 2003 and 2004 are estimated to have large special allowance payments in the future exceeding the fees paid. These 2003 and 2004 consolidation loans will have an adverse cash flow and deficit effect, but will have no budget scoring effect during the reauthorization.
- For purposes of the reauthorization of the Higher Education Act, the cash flow and budget effect of the consolidation loan program should be measured relative to the overall student loan program in its absence, i.e., its incremental effect.
- Consolidation loans originated post-reauthorization between fiscal years 2005 and 2010 are estimated to generate net incremental cash flow of positive $850 million during that time frame.
- The budget effect is calculated as a net present value of the future cash flows over the life of the loans under the Federal Credit Reform Act rules. The net present value of the net incremental cash flow for consolidation loans originated post reauthorization between fiscal years 2005 and 2010 is estimated to be positive $1.9 billion.

The FFEL consolidation loan program experienced significant growth in 2002 and 2003 with the student loan interest rates hitting historically low levels (currently, 3.46% for Stafford Loans in repayment and 2.86% for grace-period loans). Increased demand for the consolidation loan program, that offers a fixed interest rate and a longer repayment term, has focused attention on the budget consequences of the consolidation loan program.

The consolidation loan program generates revenue from a 0.50% origination fee paid by lenders to the federal government on new consolidated loans, plus an annual 1.05% loan holder fee on all outstanding consolidation loans. In addition, a special allowance payment (SAP) to lenders may occur as specified by a formula relating the student interest rate to a rate intended to compensate lenders for their cost of funds.

The Net Cash Flow Effect of Consolidation Loans Originated Before July 2002

The FFEL consolidation loan program has generated more revenue than costs during the past nine years. The program's fees have totaled $1.7 billion, while special allowance payments have cost only $0.3 billion, netting $1.4 billion of positive cash flow to the government to date.

The Net Incremental Cash Flow Effect of Consolidation Loans Originated Between July 2002 and June 2004

The net incremental cash flow effect of consolidation loans made between July 1, 2002 and June 30, 2004, when student loan interest rates were at their historic low, is likely to be negative in the future. These cohorts of consolidation student loans will generate significant SAP in future fiscal years based on the Congressional Budget Office's projected increase in short-term interest rates. The SAP is expected to exceed the fees generated from these cohorts.

The budget cost of these two cohorts has already been incurred under the contractual terms of the loans to both the students and the lenders, i.e., the pending reauthorization is not expected to

impact this cohort of loans. Under the Federal Credit Reform Act rules, the budget costs of these loans has been scored in fiscal years 2003 and 2004, and will not be included in the budget scoring of the pending reauthorization legislation.

The Net Incremental Cash Flow and Budget Effects of Consolidation Loans Issued After FY04

We calculated the net incremental effect of consolidation loans originated in fiscal years 2005-2010, since the existing Higher Education Act authorization runs through fiscal year 2004. We elected to focus on that time frame since it's the time frame that the pending reauthorization will most impact. Higher Education Acts are generally authorized for six-year periods, and Congress will likely take another look at the program in the anticipated 2010 reauthorization.

The cash flow and budget effects of the consolidation loan program are estimated as the additional cost over and above the cost of the Stafford student loan program. The Stafford student loan program does not generate revenue from an annual lender-paid loan holder fee, but does provide lenders with SAP. Thus, the incremental cost of the consolidation loan program is the amount of fees generated by the consolidation loans less the SAP on consolidation loans in excess of the SAP otherwise paid on the Stafford loans consolidated.

The incremental budget estimates are based on the estimated volume of consolidation loans, consistent with Department of Education forecasts from the FY2004 President's Budget, plus the Congressional Budget Office's interest rate forecast from March 2003. Other assumptions underlying the estimates are explained in the text.

Based on consolidation loans originated in FY2005-2010, the net incremental cash-flow effect of the consolidation loan program in those fiscal years is estimated to be a positive $851 million. The table below shows the different components of the net incremental cash-flow effect. Incremental fees will total $2.2 billion during the six-year period, with $0.3 billion from origination fees and $1.9 billion from consolidation loan holder fees. The incremental SAP payments will total $1.3 billion; with SAP on consolidation loans totaling $2.3 billion, offset by SAP of $1.0 billion that the Stafford loans consolidated would have generated.

FFEL Consolidation Loan Program Net Incremental Cash-Flow Effect for Loans Made After 2004, FY2005-2010
($ in millions)

	Fiscal Year						
	2005	**2006**	**2007**	**2008**	**2009**	**2010**	**2005-2010**
Incremental Fees	79	211	322	424	515	598	2,150
Incremental SAP	2	177	244	271	293	313	1,299
Net Incremental Cash Flow Effect	77	35	79	153	222	286	851
Net Incremental Budget Effect	-271	376	433	448	464	480	1,930

Source: E&Y calculations, net incremental budget effect includes the NPV of cash flows generated over the life of the loan cohort, in accordance with the Federal Credit Reform Act.

The incremental cash flow effect is positive in each of the six years and growing due to increases in consolidation loan holder fees as the outstanding balance of consolidation loans grows through fiscal year 2010.

Credit reform requires a budget score estimate, which is the estimated net present value of the future cash flows for the life of the loans. To calculate the net budget score estimate, we first calculated the net incremental cash flow for each cohort of loans, and then a net present value calculation was performed using 2004 budget assumptions discount factors from the OMB credit subsidy calculator.

The net present value of the incremental budget effect of the consolidation loan program is estimated to be -$0.3 billion for the FY05 cohort of loans, and +$0.4 billion for each of the cohort of loans from FY06-08, and then +$0.5 billion for the FY09 and FY10 cohorts. The total net present value of the incremental cash flow from the consolidation loan program was positive $1.9 billion over the FY05-10 period. The net budget cost of the FY05 cohort is negative due to the lower consolidation student loan rate, so there is greater SAP on that cohort in the future.

Once interest rates have stabilized the net budget cost of the FY06-10 cohorts are positive, with fees exceeding SAP expenses.

The FFEL consolidation loan program has had a significant positive cash flow effect with fees exceeding costs for the past eight years. The cash flow and budget cost of consolidation loans originated during FY2003 and FY2004 with historically low interest rates will be significant, but those budget costs already have been obligated. For consolidation loans originated after the pending reauthorization of the Higher Education Act, when future interest rates are projected to be stable and when Stafford Loan rates are fixed at 6.8%, the consolidation loan program is projected to have positive net incremental cash flow and positive incremental budgets effect for the federal government.

I. Description of the FFEL Consolidation Student Loan Program

The FFEL consolidation student loan program was started in the early 1980s to assist students with multiple student loans consolidate the loans into a single fixed rate, up to 30-year, loan. The consolidation loan program grew modestly during the late 1990s, but the volume of student loans increased dramatically in FY2002 when interest rates fell sharply.

Description of the FFEL Consolidation Student Loan Program

The FFEL consolidation loan program consists primarily of consolidated Stafford student loans, but other types of student loans, including Perkins, PLUS, Health Professions, Health Education Assistance, Federal Housing and Loans to Disadvantaged Students are also consolidated.

The loans can only be consolidated once, and have up to a 30-year term as determined by statute and depending on the amount of indebtedness. The interest rate is fixed for the life of the loan, set at the time of consolidation to the weighted average of the loans consolidated, rounded up to the nearest 1/8%. Currently, the consolidation loans have an interest rate cap of 8.25 percent.

Budget Effects of Consolidation Loans

The FFEL consolidation loan program generates revenue from a 0.50% origination fee paid by lenders on new consolidated loans and an annual 1.05% loan holder fee on all outstanding consolidation loans. In addition, a special allowance payment (SAP) to lenders may occur as specified by a formula relating the student interest rate to a rate intended to compensate lenders for their cost of funds.

Fees

New originations of FFEL consolidation loans require a payment of a 0.5% origination fee to the federal government by lenders generally within 150 days after the end of each fiscal quarter.

In addition, holders of FFEL consolidation loans are required to pay a 1.05% loan holder fee on the total outstanding balance of the loans. Loan holder fees are paid on the balance at the end of each month, with an approximately 30-day lag in the payment.

Special Allowance Payments

Student loan lenders receive special allowance payments from the federal government when the interest rate on the student loan is below a formula "equitable lender return" interest rate. For example, in the first quarter of 2003, the commercial paper rate was 1.27%. A student loan consolidated in the fall of 2002 could have a fixed interest rate of 4.86%, although the rate is different for each loan, depending on the particular loan's composition at the time of consolidation and the corresponding loan rates. The equitable lender return rate for this particular loan was 3.91% in the first quarter of 2003, calculated as the commercial paper rate plus 2.64%. In this case, no SAP is paid to the lender since the student rate exceeds the equitable lender return rate.

However, in the future for the same loan, the equitable lender return rate would be higher based on the Congressional Budget Office forecast of interest rates. If the commercial paper rate rose to 5.44%, for example in 2006, then the equitable lender return rate would increase to 8.08%, and the quarterly SAP payment would be 3.22% (8.08% equitable lender return rate less 4.86% student rate). The SAP paid to lenders on consolidation loans will vary greatly from loan to loan, and from year to year. Loans consolidated in stable or declining interest rate periods will generate no or minimal SAP, while those consolidated during low interest rates followed by higher interest rates will generate positive special allowance payments.

II. The Net Incremental Cash Flow Effects of the FFEL Consolidation Loan Program For Loans Made Before FY2005

The historically low interest rates available on student loans currently and during the past year have resulted in a significant increase in consolidation loans, with commensurate benefit to the student loan borrowers. These borrowers will benefit from fixed interest rates to the extent that interest rates increase, as forecast by the Congressional Budget Office.

It is important to distinguish between these current low-interest rate consolidation loans and the consolidation loans made after the pending reauthorization of the Higher Education Act. Unlike the consolidation loans made before 2002 and the consolidation loans forecast in fiscal year 2005 and beyond, which generate a positive net budget benefit, the consolidation loans made between July 1, 2002 and June 30, 2004 will benefit the student loan borrowers at a net cost to the government.

Net Cash Flow Effect of Consolidation Loans Made Prior to FY 2003

Table 1 shows the gross cash flow effect of the consolidation loan program from FY1995 to FY2002, based on actual receipts and payment numbers from the Department of Education, as well as the estimated cash flow from consolidation loans in FY2003 and FY2004.

Since FY1995, the fees and special allowance payment have resulted in a net positive cash-flow effect of $1.4 billion through fiscal year 2002. Fees have exceeded $1.7 billion, while special allowance payments have only been $0.3 billion. The cash flow from consolidation loans was positive in all eight fiscal years. This positive cash flow is understated, since some SAP would have been on the student loans if consolidation loans had not been available.

FY2003 and FY2004 will add an estimated $1.6 billion in fees and $0.5 billion in SAP for an additional positive cash flow of $1.0 billion. For the FY1995-FY2004, the total cash flow will be a positive $2.4 billion.

Table 1
Historical Cash Flow of the FFEL Loan Consolidation Program
($ in millions)

	Income			Cost	
	Lender Origination Fee	Holder Fee	Total Fees	Gross Special Allowance Payment	Net Cash Flow
1995	23	22	45	0	45
1996	22	66	88	0	88
1997	12	130	142	0	142
1998	16	131	147	53	94
1999	25	196	221	92	129
2000	27	210	237	6	231
2001	28	287	315	129	186
2002	91	383	474	34	440
Total FY 95-02	**244**	**1,425**	**1,669**	**314**	**1,355**
Estimated					
2003	85	668	753	40	713
2004	65	749	814	509	305
Total FY 95-04	**394**	**2,842**	**3,236**	**863**	**2,373**

Source: Department of Education Federal Budget Appendices, FY1996-2004

Prior to FY2003, the effect of a stable or decreasing interest rate environment was that no or minimal SAP was paid on consolidation loans, yet these consolidation loans generated

significant fees on origination and on their outstanding balance. In recent years, the SAP on Stafford loans has been 30 basis points lower than on consolidation loans, but this is offset by the rounding up of consolidation loans to the nearest 1/8th of one percent, but more importantly by the 105 basis points annual loan holder fee on consolidation loans. Thus, in a stable or declining interest rate environment, consolidation loans generate a positive cash flow due to the extra fee levied on holders of consolidation loans.

Net Cash Flow Effect of Consolidation Loans Made in Fiscal Years 2003-2004

The student loan interest rate continued to decrease in fiscal year 2003, so continued positive cash flow effects from consolidation loans are projected, since significant fees are collected while minimal SAP is paid. The Congressional Budget Office's March 2003 Economic and Fiscal Outlook projects that short term interest rates will start to rise from the low of 1.4% in 2003 to 3.5% in 2004 to 4.8% in 2005 and then 4.9% in 2006 and beyond.

The projected sharp increase in interest rates from the historically low levels in 2002 and 2003 will result in significant future SAP payments on loans originated between July 1, 2002 and June 30, 2004. Fixed consolidation loan rates of 4.125% and 3.5% will require special allowance payments on those loans when interest rates rise, since the consolidation equitable lender rate is projected to be 8.08% in 2006 and beyond.

During the FY2005-2010 period, these fiscal year 2003-04 loans are projected, based on the methodology described in the next section, to generate $1.3 billion in fees while paying an incremental SAP of $4.8 billion, for a net cash outflow of $3.5 billion. Consolidation loans made in low interest rate environments will benefit student loan borrowers, but result in a negative cash flow to the federal government.

In summary, the cash flow effect of consolidation loans has been positive up to the current time, generating positive net cash flow through fiscal year 2003. The consolidation loans in the two-year cohort made during the low interest rate environment between July 1, 2002 and June 30, 2004 will have a future negative cash flow cost to the federal government. Prospectively after the pending reauthorization, consolidation loans after fiscal year 2004, will generate positive net incremental cash flow again as well as positive net incremental budget effects due to the CBO forecast of a future stable interest rate environment, as described in the next section.

III. The Net Incremental Cash Flow and Budget Effect of the FFEL Consolidation Loan Program Between FY2005 and FY2010

The FFEL consolidation loan program is being considered in the context of the pending reauthorization of the Higher Education Act. The reauthorization will be for FY2005 through FY2010. The consolidation loan program is part of the entire student loan program, so its effect can be measured relative to the student loan program in its absence. We present the net incremental cash flow and budget effects of the FFEL consolidation loan program for consolidation loans originated in FY2005-2010.

Methodology

The methodology used to estimate the net incremental cash flow and budget effects of the consolidation loan program after the pending reauthorization has several key points.

First, the analysis includes the cash flow and budget effect of loans made on or after October 1, 2004 through September 30, 2010, or those loans made during fiscal years 2005-2010. The budget effect of loans made before October 1, 2004 will not be changed by the reauthorization, i.e., the analysis assumes that the reauthorization will not retroactively change the contract terms on existing student loans. The analysis takes a prospective view of the cash flow and budget effects of the consolidation loan program.

Second, the analysis includes both the fees earned by the federal government on the consolidation loans as well as the special allowance payments potentially paid by the federal

government on those loans. The analysis is limited to the estimates of fees and special allowance payments. Rates of default and tax deductibility of student loan interest are not included in the analysis, since as described below the analysis estimates the incremental effect of consolidation loans over and above that which would otherwise occur on the student loans consolidated, and any differential effect would be small.

Third, the analysis estimates the incremental fees and special allowance payments relative to the fees and SAP that would otherwise occur on the student loans consolidated. The quantitative analysis assumes consolidation loans are used to refinance Stafford loans. For example, if there were $100 million fewer consolidation loans, then there would be $100 million more Stafford loans outstanding. Thus, if there were lender holder fees earned on Stafford loans, then the fees generated by the consolidation loan program would need to be net of the fees otherwise collected.[1] Similarly, the special allowance payments on consolidation loans need to be netted of the special allowance payments that would otherwise have been made on the outstanding Stafford loans.

Fourth, the analysis includes the cash flow and budget effects of new consolidation loans during FY2005-2010, the period for the next Higher Education Act reauthorization. Consolidation loans made during FY2005-10 will have terms extending beyond the six-year period, and thus will have cash flow effects beyond the six-year budget period. These long-term cash flow effects are estimated, included in the budget effects, and converted into current dollars using net present values. To calculate the net budget effect, E&Y first calculated the net incremental cash flow effects for each cohort of loans, then calculated the net present value using the OMB credit subsidy calculator, based on the Federal Credit Reform Act rules.

Fifth, the analysis uses government forecasts of projected consolidation loan volumes and projected interest rates. These may be changed as part of the annual budget process. These estimates are based on forecasts from the spring of 2003. Other modeling projections and assumptions are described in the next section. Sensitivity analysis is possible with the model, but is not presented as part of this study.

Net Incremental Cash Flow and Budget Effect Model of Consolidation Loans

The modeling of the net incremental cash flow and budget effect of consolidation loans starts with the volume of outstanding consolidation loans by year of origination (cohort) as of September 30, 2002. Supplemented by projections of future consolidation loan volume and projected repayments, the amount of outstanding consolidation loans by year of origination are projected through fiscal year 2010. Originations and balances are used to calculate the net incremental fees. Outstanding balances by the year of consolidation and initial Stafford loan origination years are used to calculate the net incremental special allowance payments. The timing of fees and special allowance payments are used to estimate the budget effect across the six fiscal years.

Outstanding Balance and New Originations of Consolidation Loans

Table 2 shows the outstanding balance of FFEL consolidation student loans at the end of the past three fiscal years. The outstanding balance grew from $29.1 billion at fiscal year end 2000, to $33.5 billion in 2001, and $50.8 billion in 2002. The table shows the composition of the outstanding consolidated loans by year of origination. Almost forty-percent ($20.3 billion) of the loans outstanding on September 30, 2002 had been originated in fiscal year 2002, while 17 percent ($8.6 billion) had been originated in fiscal year 2001.

[1] Stafford loans do have student-paid origination fees. The student-paid origination fees are paid irrespective of whether a Stafford loan is held to maturity or consolidated.

Table 2
FFEL Consolidation Loan Outstanding Balance by Year of Origination
($ in millions)

Originated in FY:	Outstanding Balance of FFEL Consolidation Loans Cohorts as of: 9/30/2000	9/30/2001	9/30/2002
2002	-	-	20,252
2001	-	7,739	8,589
2000	5,802	6,164	5,519
1999	5,120	4,435	3,863
1998	3,740	3,170	2,663
1997	4,275	3,676	3,105
1996	4,501	3,727	3,083
1995	3,606	2,941	2,430
1994	2,038	1,649	1,334
Total Outstanding	**29,081**	**33,500**	**50,838**

Source: Department of Education

Table 2 also shows the annual decline in the outstanding balance each year for at least the past seven-year cohorts of consolidation loans. The outstanding balance for an origination year grows slightly, 6-10, percent in the year immediately following the year of origination due to time lags in reporting. Subsequently, the balance declines annually between 10-20 percent, increasing slightly with each additional year. This repayment pattern is used for both current outstanding loans and projected future consolidation loans.

Table 3 shows the net new commitments and total outstanding balance by fiscal year cohort based on Department of Education forecasts as of early 2003. The volume of originations increased sharply in 2002 with the significant decline in the student loan interest rate. The volume was projected to decline to $17 billion in 2003 and $13 billion in 2004, before hitting a low of $10.5 billion in 2005, and then increasing steadily throughout the remainder of the period.

Table 3
Consolidation Loan Net Commitments and Outstanding Balance, FY2000-2010
($ in billions)

FY of Originations	Net Commitments	Outstanding Balance as of End of Fiscal Year
Projected		
2010	12.5	80.3
2009	12.0	78.5
2008	11.6	77.0
2007	11.2	75.5
2006	10.9	74.0
2005	10.5	72.5
2004	13.0	70.2
2003	17.0	63.7
Actuals		
2002	22.7	50.8
2001	9.4	33.5
2000	6.6	29.1

Source: U.S. Department of Education, plus E&Y estimates of future outstanding balances

Based on these projections, current balances, and repayment rates, the outstanding balance of consolidation loans grows from $50.8 billion in FY2002 to $80.3 billion in FY2010.

Estimate of Net Incremental Fees

Based on the originations and outstanding balances of consolidation loans, an estimate of net incremental fees is projected. Because the Stafford loans have no loan holder fee, the total fees from consolidation loans are equal to the net incremental fees.

Consolidation loans have two fees:

- Origination fees, 0.50%, are generally paid 150 days after the end of each fiscal quarter, since the lender has 90 days from quarter-end to submit the information, the Department of Education has 30 days to submit the invoice, and the lender then has 30 days to pay.
- Loan holder fees, 1.05% of the outstanding balance, are generally paid on a monthly basis.

The estimated fees for consolidation loans originated in FY2005-2010 are shown in Table 4 below. Origination fees on consolidation loans originated after FY2004 grow from $26 million in FY2005 to $57 million in FY2010, totaling $291 million over the FY2005-2010 budget period. Loan holder fees on consolidation loans originated after FY2004 grow from $53 million in FY2005 to $541 million in FY2010, totaling $1.9 billion over the F2005-2010 budget period. Total net incremental fees on these future consolidation loans will add an estimated $2.2 billion in net revenue to the federal budget over the FY2005-2010 budget period.

Table 4
FFEL Consolidation Loan Program Fees for Loans Made after FY 2004, FY2005-2010
($ in millions)

	Fiscal Year						
	2005	**2006**	**2007**	**2008**	**2009**	**2010**	**2005-2010**
Origination fees	26	49	51	53	55	57	291
Consolidation Loan Holder Fee	53	162	271	371	460	541	1,858
Incremental Fees	79	211	322	424	515	598	2,150

Source: E&Y calculations

Estimate of Net Incremental Special Allowance Payments

Both Stafford loan and consolidation loan lenders need to receive a return on their student loans that provides an equitable lender return rate sufficient to cover their cost of funds plus a return for the services provided. Because interest rates on Stafford and consolidation loans are pegged to the short-term 91-day Treasury-bill rate, the government calculates an equitable lender return rate that lenders get on a quarterly basis, based on a statutory formula. If that rate is higher than the rate lenders are getting on the Stafford and consolidation loans, then the government pays a "special allowance payment" to make up the difference. If the rate on the student loan is higher than the statutory rate, then no special allowance payment is made.

The special allowance payment is based on the relationship between the student loan rate and the statutory formula, or equitable lender return interest rate. Both the student loan rate and equitable lender return rate vary over time, by different cohorts (loans by origination year), and by type of loan. For example, student interest rates on Stafford loans originated between October 1, 1992 and June 30, 1998 were set at the 91-day T-bill plus 3.1 percentage points during repayment. For loans between July 1, 1998 and July 1, 2006, the student ban rate is the 91-day T-bill plus 2.3% for the repayment period, and the T-bill plus 1.7 percent during the time student is in school, in the 6-month grace period that follows the borrower's separation from school, and during any deferment period. The student rate is capped at 8.25%. After July 1, 2006, Stafford loan rates will be fixed at 6.8%. The student rate on FFEL consolidation loans is currently the weighted average of the loans consolidated, rounded up to the nearest 1/8th of one percent.

Table 5 shows the sharp decline in the short-term interest rate from 5.9 percent in 2000 to 1.6 percent in 2002 and a CBO projected rate of 1.4 percent in 2003. Interest rates are then projected to increase to 3.5 percent in 2004, to 4.8 percent in 2005, and to 4.9 percent in 2006 and later.

Since student loan rates are tied by formula to the short-term interest rate, they have also fallen to historically low levels at the current time, but are projected to increase in the future.

Table 5
Interest Rates: T-Bill and Student Loan Rates, 1998-2010

	3-Month Treasury Bill Rate 1/	Stafford Loans 2/	Consolidation Loans 3/
1998	4.8%	7.46%	7.500%
1999	4.7%	6.20%	6.250%
2000	5.9%	8.19%	8.250%
2001	3.5%	5.99%	6.000%
2002	1.6%	4.06%	4.125%
2003	1.4%	3.42%	3.500%
Estimates			
2004	3.5%	5.55%	5.625%
2005	4.8%	7.10%	7.125%
2006	4.9%	6.8% / 7.20%	6.8% / 7.250%
2007	4.9%	6.8% / 7.20%	6.8% / 7.250%
2008	4.9%	6.8% / 7.20%	6.8% / 7.250%
2009	4.9%	6.8% / 7.20%	6.8% / 7.250%
2010	4.9%	6.8% / 7.20%	6.8% / 7.250%

1/ Congressional Budget Office, March 2003 budget forecast
2/ Stafford loan in repayment for the July-June period starting in particular calendar year. Loans after June 30, 2006 will have a fixed rate of 6.8%. Prior variable rate loans will have an estimated 7.2% rate.
3/ Rate for loans in repayment. Loans consolidated in grace period are 60 basis points lower. Stafford loans originated and consolidated after June 30, 2006 will have a fixed rate of 6.8%. Prior variable rate Stafford loans consolidated in 2006 and beyond will have an estimated 7.25% consolidation rate.

The statutory rate for calculation of the SAP payment also differs by year and by cohort and type of loan. The statutory rate for Stafford loans originated between October 1, 1992 and June 30, 1998 is the T-bill rate plus 3.1 percent; for Stafford loans originated between July 1, 1998 and January 1, 2000, the statutory rate is the T-bill rate plus 2.8%; and for Stafford loans originated after January 1, 2000, the statutory rate is the Commercial Paper (CP) rate plus 2.34%. For consolidation loans, the statutory interest rate was T-bill plus 3.1% for loans originated between October 1, 1992 and January 1, 2000, and the CP rate plus 2.64% for loans originated after January 1, 2000.

For purposes of the estimate of the special allowance payments, the Stafford loans were grouped into four cohorts with different student loan rate formulas, while consolidation loans were grouped into two cohorts with different student loan rate formulas. In addition Stafford loans had three cohorts with different equitable lender return rate formulas, and consolidation loans had two cohorts with different equitable lender return rate formulas. The mix of Stafford loans consolidated in the consolidation loans is estimated based on the percentage of loans consolidated during the grace period, plus the timing of consolidation relative to the repayment period.

The special allowance is calculated on a quarterly basis for each quarterly cohort of consolidation loans, and the equivalent of the Stafford loans consolidated. The timing of the special allowance payment varies, but is assumed to be one quarter after the quarter of SAP accrual.

Table 6 shows the special allowance payment on future consolidation loans, plus the special allowance payment that would otherwise have been paid on the consolidated Stafford loans. The SAP on new consolidation loans is estimated to be $2.3 billion during FY2005-2010 compared to $1.0 billion of SAP that would otherwise have been paid on the consolidated Stafford loans. The SAP payments grow over the course of the six-year period as the outstanding balance of loans after FY2004 accumulate. Thus, the net incremental SAP payments from new consolidation loans are $1.3 billion during FY2005-2010.

Table 6
FFEL Consolidation Loan Program Net Incremental Special Allowance Payments for Loans Made after 2004, FY2005-2010
($ in millions)

	Fiscal Year						
	2005	**2006**	**2007**	**2008**	**2009**	**2010**	**2005-2010**
SAP on Consolidation Loans	71	266	383	466	540	614	2,341
SAP on Consolidated Stafford Loans	69	89	140	196	247	301	1,042
Incremental SAP	2	177	244	271	293	313	1,299

Source E&Y calculations

Net Incremental Cash Flow Effect of Consolidation Loans During FY2005-2010

For consolidation loans issued after the reauthorization of the Higher Education Act, after fiscal year 2004, the net incremental cash flow effect of consolidation loans is a net benefit, since the incremental fees from consolidation loans exceed the incremental expenses from the program. Table 7 shows a positive $851 million net cash flow effect during the fiscal year 2005-10 period, where fees exceed net incremental payments by $77 million in FY2005 increasing to $286 million in 2010.

Table 7
FFEL Consolidation Loan Program Net Incremental Cash Flow for Loans Made after 2004, FY2005-2010
($ in millions)

	Fiscal Year						
	2005	**2006**	**2007**	**2008**	**2009**	**2010**	**2005-2010**
Incremental Fees	79	211	322	424	515	598	2,150
Incremental Special Allowance Payments	2	177	244	271	293	313	1,299
Net Incremental Cash Flow Effect	77	35	79	153	222	286	851

Source: E&Y calculations

The cash flow effects are sensitive to the Congressional Budget Office projections of future interest rates during the fiscal year 2005-10 period. Probabilistic modeling of interest rate variability would also affect the estimates. The cash flow effects do not include the fees and payments on consolidation loans originated prior to fiscal year 2005.

Net Incremental Budget Effect of Consolidation Loans During FY2005-2010

Since enactment of the Federal Credit Reform Act (FCRA) in 1990, federal agencies have been required to set aside capital reserves in advance to cover the expected long-term cost to the government of issuing a direct loan or loan guarantee. This reserve is often called the "subsidy cost," "budget score," or "credit reform score."

Prior to FCRA, loan costs were recognized in the federal budget on a cash basis. The purposes of FCRA are to: (i) measure the costs of federal credit programs more accurately; (ii) place the cost of credit programs on a budgetary basis equivalent to other federal spending; (iii) encourage most appropriate form of credit assistance for the needs of recipients; and (iv) improve the allocation of resources among credit programs and between credit and other spending programs.

Credit reform requires a budget score estimate, which is the estimated long-term cost to the government of a direct loan or loan guarantee, calculated on a net present value basis, excluding administrative expenses. For the student loan programs, the subsidy cost generally represents the present value of the government's expected credit losses (net defaults), plus any interest or other subsidies/payments, net of fees paid by borrowers. Both the Stafford and consolidation loan programs are included under Federal Credit Reform, thus budget effects of changes to these programs are calculated under these guidelines. To calculate the net budget effect, we first

calculated net incremental cash flow effects, and then a net present value calculation was performed using the OMB credit subsidy calculator.

As presented in Table 8, the net present value of the incremental budget effect of the consolidation loan program is estimated to be -$0.3 billion for the FY05 cohort of loans, and +$0.4 billion for each of the cohort of loans from FY06-08, and then +$0.5 billion for the FY09 and FY10 cohorts. The total net present value of the incremental cash flow from the consolidation loan program is estimated to be positive $1.9 billion over the FY05-10 period. The net budget cost of the FY05 cohort is negative due to the lower consolidation student loan rate, so there is greater SAP on that cohort in the future. Once interest rates have stabilized the net budget cost of the FY06-10 cohorts are positive, with fees exceeding SAP expenses.

Table 8
FFEL Consolidation Loan Program Net Incremental Budget Effects for Loans Made after 2004, FY2005-2010
($ in millions)

	Fiscal Year						
	2005	**2006**	**2007**	**2008**	**2009**	**2010**	**2005-2010**
Net Incremental Budget Effect	-271	376	433	448	464	480	1,930

Source: E&Y calculations

In summary, the consolidation loan program is part of the entire student loan program, so its budget effect should be measured relative to the student loan program in its absence. The incremental cash flow effect of consolidation loans made after FY2004 will be positive over the next six years. Prospectively after the pending reauthorization, consolidation loans made during the FY2005-10 will generate positive net incremental cash flow again as well as positive net incremental budget effects. The fees generated from consolidation loans will generally more than offset the net incremental special allowance payments.

Chairman BOEHNER. Thank you, Dr. Neubig.

Dr. Shapiro.

STATEMENT OF ROBERT J. SHAPIRO, CHAIRMAN, SONECON, LLP AND SENIOR FELLOW, BROOKINGS INSTITUTION AND PROGRESSIVE POLICY INSTITUTE, WASHINGTON, D.C.

Dr. SHAPIRO. Mr. Chairman and members of the Committee, it's an honor to be here today. I have come to discuss a new study which my colleague Dr. Kevin Hassett and I conducted to analyze the long-term costs of the current student loan consolidation program.

There is no doubt that Federal student loans are a great success. More than 62 percent of high school graduates go on to higher education, and one of the reasons is that we provide more than 7 million students and parents, like Mr. Hamlett, more than $50 billion a year in Federal assistance.

The loan consolidation program, however, is different, and not only because it doesn't actually help anybody go to college.

To limit public costs, and so maintain strong public support, underlying student loans carry interest rates that are adjusted annually. This limits the subsidy and ensures a stable relationship between the price of the funds to the students and the cost of the funds to lenders.

But under the consolidation program, former student borrowers consolidate their loans at a subsidized rate that remains fixed for up to 30 years. This fixed interest rate is the source of a problem which could well cost taxpayers tens of billions of dollars over 20 years, perhaps much more.

The greatest costs occur when market interest rates have fallen sharply, as they did over the last 3 years, and then rise again.

Unless our economy enters a sustained period of economic stagnation, it is virtually certain that over the next three, five, or seven years, market interest rates will return to the levels of the 1990's, or worse, the 1980's, if serious inflation were to occur.

When that happens, those who consolidated their loans in 2002, 2003, and this year, will still pay interest based on the 1 percent Treasury bill rates of this period, while those who lent them the funds will receive payments from the government based on market rates that have become much higher. The gap between the locked-in fixed rate and the potential future commercial paper rate is what determines the additional cost of this program.

Estimating the taxpayer's liability here is straightforward—apply a baseline projection of interest rates to the stock of outstanding consolidated debt—but it's not simple.

For example, loan consolidations are not distributed evenly. They rise when interest rates are low, and decline when rates are relatively high. From 1995 to 2001, about 211,000 students a year consolidated FFELP loans. In 2002 and 2003, with low interest rates, the average jumped to 964,000 a year.

From 1995 to 2001, when the interest rate for a typical consolidation loan was 7.9 percent, consolidations averaged about $5 billion a year. As the interest rate fell to about 4 percent in 2002 and 3.5 percent in 2003, the total jumped to almost $23 billion and $35 billion, respectively, rising from $5 billion a year to $35 billion.

To analyze these costs systematically, we applied simulation procedures to generate the most likely paths of future interest rates, based on historical experience.

Let me say we would have preferred to use CBO. Unfortunately, the CBO forecast ends 5 years out, and then simply assumes a stable interest rate environment at that level.

We also constructed estimates of the likelihood of possible deviations from these paths.

The results show that the commercial paper rate will likely rise to more than 5 percent in the next 4 years, and then range from 5.6 to 5.9 percent. Let me say that for the years in which CBO was estimating, and we were estimating, our approach produced an interest rate path entirely consistent with CBO's forecast.

We also found that the stock of outstanding debt for consolidated loans is more than $100 billion today. It's expected average lifetime is nearly 21 years, and the average fixed rate is 5.52 percent.

With these results, we could calculate the cost to taxpayers.

Given the most likely future path of interest rates, taxpayers will pay almost $14 billion over the next 20 years to subsidize the interest on the existing stock of consolidated loans, and if interest rates are 2 to 3 percentage points higher than that—that is what economists call one standard deviation, an outcome consistent with historical experience—taxpayers will pay more than $48 billion to service the current stock of loans.

We can also estimate the cost of future loan consolidations, assuming that the program is unchanged. Remember that the high cost associated with the current stock of consolidated debt came about because interest rates fell after rising sharply, and then rose again. This will occur again, and it will affect future loans, and when it does, those costs will also be high.

We estimate that loans likely to be consolidated over the next 8 years will cost taxpayers another $36 billion in subsidy payments over a 20-year term.

One final point:

While student loan programs generally provide equal subsidies to all students, the consolidation program produces very large inequities.

The basic problem is that, since the interest rate on these loans rises or falls each year and then remains fixed for the life of the loan, the long-term cost of the consolidated loan to the former student depends on when he or she happens to consolidate. This produces large disparities in interest costs.

For example, $22,000 in student loans consolidated in 1995 or 1996 will cost a former student borrower $25,000 in interest over 20 years. That's three times the 20-year interest cost of $8,600 for the same debt consolidated in 2003. It simply depends on the moment you consolidate, which is usually the year you happen to graduate from college.

The current program will generate tens of billions of dollars in taxpayer costs, along with significant equities. You can address both problems by shifting the program from a fixed interest rate to annually adjusted rates, and if the program is not reformed, taxpayers may not be the only ones bearing the cost.

As government payments for consolidations rise sharply, as they certainly will, these costs could squeeze out some of the underlying loan programs. At a minimum, reforming the loan consolidation program so that the interest rates on these loans adjust annually, as they do for all other student loans, will save billions of dollars that could be available for future college students.

Thank you.

[The prepared statement of Dr. Shapiro follows:]

The Fiscal and Social Costs of Student Loan Consolidation

Robert J. Shapiro

United States House of Representatives
Committee on Education and the Workforce
March 17, 2004 Washington, D.C.

Chairman Boehner, ranking member Miller and members of the committee, it is a honor to have this opportunity to speak with you today. As you consider the reauthorization of the Higher Education Act, I come to discuss a new study which my colleague Dr. Kevin Hassett and I have released that analyzes the likely taxpayer cost of the student loan consolidation program.[1]

I. Introduction

There is no doubt that the federal financial assistance program has been a significant success in increasing access by American high school graduates to higher education. This year alone, more than 7 million students and parents will borrow more than $50 billion through various federal education loan programs. In part because of the success of these programs, we now send more than 62 percent of our young high school graduates to post-secondary institutions of higher education.

The long-term costs of the loan-consolidation program have not been a pressing public issue because falling interest rates have produced a short-term, positive net cash flow for the program. With the economy strengthening, however, it is likely that interest rates will rise; and this pattern is assumed by the Congressional Budget Office (CBO) in its latest ten-year projection. Given the likelihood of higher interest rates in the near future, we believe it is advisable to revisit the costs of the loan-consolidation program. Our findings indicate that under the current terms of the consolidation program, the massive shift of assets into consolidation has exposed the government to high levels of interest rate risk, and the potential taxpayer costs are very high.

II. The Current Student Loan Consolidation Program

To limit public costs, the *interest rates* charged for initial student loans are adjusted *annually*. This ensures that the price of the funds to the students bears a stable relationship to the cost of the funds to the lender. However, under the current student loan consolidation program, student borrowers can consolidate their previous loans into a single loan at a subsidized interest rate that remains *fixed* for up to 30 years. This fixed interest rate is the source of the problem.

While there are many student loan programs, we have focused on the Federal Family Education Loan Program (FFEL). As you know, FFEL funds are provided by private lenders who receive government payments tied to the borrower's interest costs and government guarantees in cases of default. The projected costs of the FFEL program are worrisome in their own right, but they are only one component of the long-term costs associated with post-secondary education funding. In addition, there are also significant potential costs associated with the PLUS and Direct Loan programs.

The greatest costs for taxpayers occur when market interest rates have fallen sharply, as they did over the last three years, and then rise again. Unless the economy should enter a sustained period of economic stagnation, it is highly likely that over the next three, five or seven years, market interest rates will return to the levels of the 1990s (or worse, the 1980s, if serious inflation recurs). When that happens, those who consolidated their loans in 2002 or 2003 will still pay interest based on the low Treasury-bill rates of 2002 and 2003, and those who lent them the funds will receive payments from the government based on market, commercial paper rates that are much higher. The gap between the locked-in fixed rate and the potential future commercial paper rate is the variable that determines the future budgetary outlays for which the government will be responsible.

Estimating the government's liability under these conditions is a straight-forward exercise: Apply the baseline projection of interest rates to the stock of outstanding consolidated debt. In March 2004, CBO issued its most recent forecast for commercial paper rates, estimating that the 90-day commercial paper rate will be 5.12 percent in 2007 and thereafter.[2] Assuming a long-term commercial paper rate of 5.12 percent, under the current statutory requirements of the student loan consolidation program, the government will be responsible for paying lenders the equivalent of 3.193 percent of their holdings of loans consolidated in FY 2003-2004 (July 1, 2003 to June 30, 2004):

Gross Payment to Lenders: Commercial Paper Rate (5.12 percent) + Guaranteed Return (2.64 percent) – Annual Consolidation Fee (1.05 percent) – Amortized share of One-Time 0.5 percent fee (0.017 percent) = 6.693 percent.

Less the interest rate paid by students to private consolidators: Original Treasury Bill Rate (1.12 percent this year) + Statutory 2.3 percent = 3.42 percent, rounded up to the nearest 1/8th = 3.5 percent.

Net Taxpayer Payment to Lenders:
6.693 percent – 3.5 percent = 3.193 percent.

Similarly, the average interest rate for student loans consolidated in FY 2003 was 4.14 percent. How much will these payments add up to? Given recent movements in interest rates, the government costs have been negative. In 2003, the sum of the commercial paper rate, plus the guaranteed 2.64 percent, was less the rate paid by the consolidating borrowers of 4.06

[1] Kevin A. Hassett, and Robert J. Shapiro, "The Fiscal and Social Costs of Consolidating Student Loans at Fixed Interest Rates," March 2004. The paper can be downloaded at from www.techcentralstation.com/031004J.html.
[2] Congressional Budget Office, March 2004 Baseline Forecast, Table 10

percent.[3] That left a zero government payment to consolidators, while consolidators have continued to pay the government their annual fee of 1.05 percent of the loan portfolios. Under these conditions, the government appears to profit from the loan consolidation program, during this anomalous period. Given historical interest rate patterns, however, taxpayers over the long run will have to pay tens of billions of dollars to cover the costs of this program.

The financing dynamics of the consolidation program are based not on any one year's consolidation loans, but on a continuing program that produces large portfolios of loans provided at high and low interest rates over many years. When interest rates rise, the consolidators' current cost of funds, plus his fee to the government, may exceed the payments they receive from former students who consolidated at much lower rates. When this happens, taxpayer payments to consolidators rise sharply.

Moreover, over any extended period, loan consolidation activity is not distributed evenly, across time and the interest-rate cycle. As expected, consolidations rise sharply when interest rates are especially low, and decline when interest rates are relatively high. For example, from 1994 to 2001, an average of about 211,000 students a year consolidated FFEL loans; in 2002 and 2003, with low interest rates, the average jumped nearly four-fold to 963,800 a year. From 1995 to 2001, when the interest rate for a typical consolidation loan averaged 7.9 percent, total consolidations averaged $5.085 billion a year; as the interest rate fell to 4.125 percent in 2002 and 3.5 percent in 2003, the total loans consolidated jumped to $22.9 billion and $34.9 billion respectively.[4] When interest rise again, that increase will produce large taxpayer payments to consolidators with these large portfolios of low-fixed rate loans.

Calculating the long-term costs of fixed-rate loan consolidation. To explore these issues systematically, we applied a simulation procedure to generate the likely paths of future interest rates based on historical experience. From these simulations, we constructed estimates of the probabilities of particular deviations from those paths, as well as estimates of the stock of consolidated debt subject to government payments. From these results, we calculated the future cost of the program at the mean, expected interest rate, as well as other levels in the distribution of future rates. We also compared these calculations to those that would occur under the CBO's latest interest rate forecast.

To begin, we gathered historical quarterly data on the 3-month commercial paper rate and estimated a time series model using four lags.[5] This model found that the most probable outcome over the next 18 months is interest rates close to those of the present, consistent with recent forecasts that project relatively low rates this year and next year. The model also estimated the probabilities of interest rates at various levels above or below those considered most likely.

We used this equation to produce a simulation of future interest rates starting from recent history. While interest rates usually change gradually, rapid changes also can occur. Going forward, we simulated possible future paths of interest rates by applying shocks to interest rates from a normal distribution with a standard error consistent with our time-series estimates. We repeated this process 1,000 times in order to construct the entire distribution of projected future interest rate paths consistent with historical data. Table 1 records the estimates of annual average interest rates for 3-month commercial paper (the basis for government payments to loan consolidators) and its standard deviation. If the standard deviation is small, it means that there is substantial certainty concerning the likely value of future interest rates. If the standard deviation is large, there is greater uncertainty about the likely level of future rates. The table also includes the CBO's March 2004 forecast for commercial paper. Since the life of currently consolidated debt is long, we also forecast well beyond the CBO forecast.

Table 1. Projected, Average Annual Interest Rates on 90-Day Commercial Paper

	Commercial Paper Rate	Standard Deviation	CBO CP Rate[6]
2004	1.7161%	0.9614	3.39%
2005	3.1789	2.0723	4.47
2006	4.1371	2.4488	5.10
2007	4.8029	2.7340	5.12
2008	5.2321	2.8148	5.12
2009	5.4241	2.7966	5.12
2010	5.6054	2.8908	5.12
2011	5.6782	2.8879	5.12
2012	5.7185	2.9594	5.12
2013	5.6941	2.8788	5.12
2014	5.7547	2.9897	5.12
2015	5.7892	2.9812	5.12
2016	5.7957	3.0588	5.12
2017	5.8127	3.0175	5.12
2018	5.8305	2.9343	5.12
2019	5.8954	2.9149	5.12
2020	5.8908	2.8907	5.12
2021	5.8333	2.9796	5.12
2022	5.8304	2.9025	5.12
2023	5.8791	2.9314	5.12
2024	5.8160	2.9429	5.12

These projections show that in the most likely case, the mean interest rate on commercial paper will increase to more than 5 percent in the next four years and range from 5.6 percent to 5.9 percent from 2010 to 2024. The model also suggests that the probability of rates rising above about 8 percent (one standard deviation above the mean) is low (about 16 percent). It is

[3] The consolidation rate of 4.06 percent, reported in the President's budget, was lower than 4.125 percent, because rates dropped further in the last quarter of the fiscal year.

[4] U.S. Department of Education, *Student Loan Volume Tables – FY 2005 President's Budget Loan Volumes*, "Net Commitments by Fiscal Year, Federal Family Education Loans."

[5] Federal Reserve Statistical Releases & Bloomberg

[6] *CBO*, March 2004 Baseline Forecast, Table 10.

noteworthy that our approach produced an interest rate path highly consistent with the CBO forecast. This suggests that that our analysis of potential deviations from the mean baseline interest-rate forecast is generally consistent with the reasoning and modeling used by CBO and other government forecasters.

Estimating the Volume of Consolidated Debt. To assess the costs associated with this forecast, we obtained data on the existing stock of consolidated student-loan debt, the expected lifetime of that stock of debt, and the mean interest rate for that stock. As the fiscal year 2004 is well underway, we used OMB estimates for FY 2004 for this analysis. We found that the stock of outstanding debt for FFEL loans is more than $100 billion, the expected average lifetime of that debt is nearly 21 years (20.89 years), and the average fixed rate on this stock of loans is 5.52 percent. With these data, we estimated a repayment schedule for the stock of debt assuming that principal is repaid by the last year and the pattern of repayment follows that of standard, fixed-rate debt. With these assumptions, we calculated the size of the stock of outstanding consolidated student-loan debt for each year until the current stock of debt would be fully retired.

Table 2. Projected Stock of Today's Outstanding Consolidated Debt[7]

2004	$104,621,896,306
2005	$101,863,865,150
2006	$98,932,080,624
2007	$95,815,596,430
2008	$92,502,776,662
2009	$88,981,252,363
2010	$85,237,875,346
2011	$81,258,669,096
2012	$77,028,776,594
2013	$72,532,404,842
2014	$67,752,765,898
2015	$62,672,014,194
2016	$57,271,179,911
2017	$51,530,098,146
2018	$45,427,333,628
2019	$38,940,100,685
2020	$32,044,178,166
2021	$24,713,819,013
2022	$16,921,654,125
2023	$8,638,590,177
2024	$0

Estimating the budget impact of future debt. Using our projections for interest rates and the stock of outstanding debt, we then calculated the federal costs associated with the current stock of consolidated student loans. Given the projected future path of commercial paper rates and the current fixed-rate terms of the consolidation program, the results are striking. Table 3 shows the annual taxpayer costs for the baseline case, as well as the costs if interest rates are one standard deviation or two standard deviations higher than the baseline forecast.

Table 3. Federal Costs for the Current Stock of Consolidated Student Loans

	Baseline Interest Rates	CBO Interest Rates	One Standard Deviation	Two Standard Deviations
2004	($979,713,963)	($979,713,963)	($979,713,963)	($979,713,963)
2005	($964,999,867)	$532,748,015	$1,328,521,415	$3,439,425,614
2006	$188,104,833	$1,140,686,890	$2,610,774,350	$5,033,443,866
2007	$820,120,830	$1,123,916,946	$3,439,680,886	$6,059,240,943
2008	$1,188,745,690	$1,085,057,570	$3,792,553,485	$6,396,361,280
2009	$1,314,303,350	$1,043,750,090	$3,802,758,859	$6,291,214,369
2010	$1,413,579,661	$999,840,278	$3,877,610,590	$6,341,641,520
2011	$1,406,761,090	$953,164,188	$3,753,467,960	$6,100,174,830
2012	$1,364,576,775	$903,547,549	$3,644,193,600	$5,923,810,424
2013	$1,267,190,398	$850,805,109	$3,355,247,920	$5,443,305,441
2014	$1,224,755,316	$794,739,944	$3,250,364,805	$5,275,974,295
2015	$1,154,552,150	$735,142,726	$3,022,908,019	$4,891,263,889
2016	$1,058,763,841	$671,790,940	$2,810,573,432	$4,562,383,023
2017	$961,410,426	$604,448,051	$2,516,312,999	$4,071,215,572
2018	$855,624,022	$532,862,623	$2,188,610,413	$3,521,596,804
2019	$758,694,757	$456,767,381	$1,893,771,580	$3,028,848,403
2020	$622,867,894	$375,878,210	$1,549,158,425	$2,475,448,957
2021	$466,168,637	$289,893,097	$1,202,541,137	$1,938,913,638
2022	$318,699,917	$198,491,003	$809,856,783	$1,301,013,648
2023	$166,903,814	$101,330,663	$420,132,860	$673,361,905
2024	$0	$0	$0	$0
TOTAL	**$14,607,109,572**	**$12,415,147,312**	**$48,289,325,557**	**$81,788,924,459**

If interest rates move in the most likely way, taxpayers will pay private consolidators almost $14 billion to subsidize the interest on the current stock of fixed-rate consolidated student loans over the lifetime of those loans. Moreover, there is a

[7] We assumed that the current stock was one loan at the average interest rate and paid down the debt using the Sallie Mae Loan Consolidation Calculator which is available at http://www.salliemae.com/tools/calculators/consolidation/repay1.html.

reasonable likelihood that the costs will be much higher: Over the lifetime of these loans, if interest rates are 2 to 3 percentage points higher than projected, taxpayers will pay private consolidators more than $48 billion to service the current stock of loans. These numbers may seem high, but it is likely that they are quite conservative as we assume that there will be no additional costs arising from defaults. We also assume that there are no early debt retirements, and this assumption in particular likely biases our estimates sharply downward. Student loan debts consolidated recently carry a much lower fixed rate than student loans consolidated in the 1990s, which accounts for the relatively high average interest rate on consolidated debt. Many borrowers paying the higher rates will likely retire their debt, making the effective average interest rate on future debt much lower than 5.52 percent, and consequently make payments by the government higher.

These projections do not exhaust all reasonable possibilities. Hedge funds and other financial firms often use two standard deviation negative movements to determine the level of risk associated with their investments. In the less likely but still quite conceivable case that interest rates are 4 to 6 percentage points higher than projected – for example, if we experienced an extended bout of higher inflation from a series of oil shocks – taxpayers would have to pay private consolidators more than $81 billion to service the current stock of fixed rate loans. At a minimum, this suggests that the current arrangements appear to be highly financially imprudent: With a stock of about $104 billion in outstanding FFEL loans, the current consolidation program has an enormous value at risk, relative to its capital. [8]

Up to this point, our analysis has been retrospective, covering only student loans which already have been consolidated. Assuming that the current program continues without change, we can also estimate the additional taxpayer costs going forward. These costs will be substantial in the baseline interest-rate forecast, since rates are projected to increase gradually over time. Applying the same model to estimate future loan consolidation starting in 2004, Table 4 (below) calculates the likely, year-to-year cost for new cumulative debt starting in 2004. To estimate these costs, we assumed that the consolidation interest rate would increase sharply in future years, climbing to 7 percent by the end of the decade. Even given this very generous assumption about the path of future interest rates, the cost to taxpayers of this program will be enormous.[9] We must remember that the very high costs associated with the current stock of consolidated debt occur because interest rates fell after rising sharply, and then increased again. It will undoubtedly be the case that this interest-rate pattern will occur again, and when that happens, the large budget costs associated with the current stock of consolidated debt will recur for debt consolidated in future years, under the reauthorization of the Higher Education Act. Our simulations revealed that the costs of these future consolidations could climb significantly higher if interest rates are higher than the CBO projects. The increase in costs along higher interest rate paths is similar to that revealed in the simulations reported in Table 3.

Table 4. Taxpayer Cost for New Consolidated Loans Over the Lifetime of the Loans

	Baseline Interest Rate Case
2004	*$14,607,109,573*
2005	$6,936,393,029
2006	$4,353,966,690
2007	$3,103,929,969
2008	$2,641,552,582
2009	$1,880,431,206
2010	$1,500,897,791
2011	$974,480,286
Total	**$35,998,761,126**

Taxpayers already have acquired a substantial future liability for the existing stock of consolidated debt, along with considerable risk of much greater liabilities. However, policy reforms could reduce much of the costs estimated in Table 4, since the loan consolidations assumed there have not yet occurred. In principle, if the terms of loan consolidation were the same as the underlying loans – variable rate loans adjusted annually -- the budgetary costs estimated above could in part become budgetary savings. A perfectly designed adjustable rate program in theory could recoup almost all of the costs of future consolidations estimated in this paper. Such a reform would reduce costs in expectation and, just as important, reduce the enormous risk exposure that the current program has incurred.

III. Impact of the Student Loan Consolidation Program on Borrowers

We should note that this program provides substantial subsidies to student-loan borrowers. While the subsidies for the underlying student loans increase access to higher education, the subsidies for the loan consolidation program do not directly affect educational access, since they are provided only after a student completes or leaves school. Moreover, while the student loan program provides generally equal subsidies to all students, since the interest rates on all loans are adjusted annually, the loan consolidation program incorporates basic inequities.

The fundamental inequity built into the loan consolidation program is based on the fact that the interest rate charged for consolidating student loans changes each year, based on the 91-day Treasury bill rate, but remains fixed for the life of the loan of each individual borrower. As a result, the long-term cost of a consolidated loan to a student depends on precisely when he or she happens to consolidate. For example, most students consolidating their loans in the period from July 1, 2003 to June 30, 2004 – students with FFEL or Direct loans disbursed since July 1, 1998 -- will pay an interest rate of 3.5 percent a year for up to the 20-year term of their loan. But a student who consolidated her loans one day before that period began, on June 30, 2003, will pay 4.125 percent for the life of her new loan (3.5 percent if consolidating in their grace period).

[8] It is worth noting that the budget costs associated with very high interest rates are accurate, but that the counter-factual comparison to adjustable rate debt is complicated by a cap on borrower interest rates of 8.25 percent. That adjustable rate cap would also be quite costly should interest rates rise by two standard deviations.

[9] The rates on new loans change in 2006 to 6.8% for Stafford loans and 7.9% for PLUS. These numbers assume that the future consolidation volume will be consistent with the OMB and Department of Education forecasts.

Table 5. Interest Rates on Treasury Bills, Student Loans and Consolidation Loans

	91-Day T-Bill Rate	Student Loan Rate	Consolidated Loan Rate
1992-93	3.84%	7.00%	9.00%
1993-94	3.12%	6.22%	9.00%
1994-95	4.33%	7.43%	8.00%
1995-96	5.82%	8.25%	9.00%
1996-97	5.16%	8.35%	9.00%
1997-98	5.16%	8.25%	8.25%
1998-99	5.16%	7.46%	7.50%
1999-00	4.62%	6.92%	7.00%
2000-01	5.89%	8.19%	8.25%
2001-02	3.69%	5.99%	6.00%
2002-03	1.76%	4.06%	4.125%
2003-04	1.12%	3.42%	3.500%

The average student debt consolidated from 1997 to 2002 was $22,000[10], and the term of debt at that level is 20 years.[11] As Table 6 shows, a borrower consolidating that level of student loans on June 30, 2003 will pay $10,345 in interest, 20 percent more than the $8,622 in interest costs due from students consolidating the same debt one day later on July 1, 2003.

Table 6. Interest Rates and Interest Costs for 20-Year, $22,000 Consolidation Loans

	Consolidated Loan Rate	Borrower's Monthly Payment	Total Interest Paid by Borrower
1992-93	9.00%	$197.94	$25,505
1993-94	9.00%	$197.94	$25,505
1994-95	8.00%	$184.02	$22,163
1995-96	9.00%	$197.94	$25,505
1996-97	9.00%	$197.94	$25,505
1997-98	8.25%	$187.45	$22,991
1998-99	7.50%	$177.23	$20,935
1999-00	7.00%	$170.57	$18,935
2000-01	8.25%	$187.45	$22,991
2001-02	6.00%	$157.61	$15,829
2002-03	4.125%	$134.77	$10,345
2003-04	3.500%	$127.59	$8,622

As the interest rate on T-bills moves up and down, the fixed rate for consolidation loans follows, producing very large disparities in the interest costs of borrowers in different years. For example, $22,000 in student loans consolidated in 1992 and 1993, or 1995 and 1996, will cost a borrower $25,505 in interest over the debt's 20-year term, about *three times* the interest costs on the same debt consolidated this year. Similarly, the payments on a $22,000, 20-year consolidation loan range from $198 per month for those consolidating their student loans in 1992, 1993, 1995 and 1996, to less than $128 per month for those fortunate enough to consolidate their debt this year.

Most of these differences and inequities would disappear if the interest rate on consolidation loans, like other federally-subsidized loans for higher education, were adjusted annually.

It is also notable that while consolidation reduces a borrower's monthly payment by extending the term of the loan from 10 to 20 years, that extension increases the overall cost of the loan to the borrower as well as the government. A former student with $22,000 of FFEL loans in 1992 who consolidated those loans in that year has to pay $25,505 in interest over 20 years. If the same former student had paid off those loans over the usual 10-year term without consolidating them, he would have paid only $9,475 in interest charges -- even as the interest rate on the loans was adjusted upward in many years of the repayment period (see Table 5, above).

Finally, the taxpayer costs associated with loan consolidation disproportionately benefit the largest borrowers, since former students who consolidate loans of more than $20,000 can stretch out their payments for 20 years or longer. The longer the term of the loan, the longer is the government's exposure and the greater are the taxpayers' costs. Moreover, it is likely that the largest consolidating borrowers go on to earn relatively high incomes. In FY 2003, the average consolidated loan balance was about $27,000[12]. This level exceeds the maximum amount which a dependent undergraduate is allowed to borrow, and therefore much of the taxpayer payments go to subsidize loans to borrowers studying in graduate or professional programs. Since the possible future costs of the consolidation program are enormous and could place funding pressure on the basic student loan program in the future, it is possible that heavy subsidies to relatively high lifetime income borrowers could ultimately squeeze the funding for basic student loans to the lower-lifetime-income students who are a primary subject of government loan programs.

III. Evaluating the Ernst & Young Study Funded by the Collegiate Funding Services Corporation

Supporters of the current fixed-rate arrangements for loan consolidation have recently claimed that the program will generate a positive cash flow for government for the rest of this decade. A recent study by Ernst & Young (E&Y) appeared to make that claim. For their testimony today, the representatives of E&Y have updated the cost estimates on which the claim of

[10] United States General Accounting Office (GAO), "Student Loan Programs: As Federal Costs of Loan Consolidation Rise, Other Options Should Be Examined," Report GAO-04-101, October 2003. More recent data indicate that the average debt being consolidated has risen significantly since 2002.

[11] Consolidated loans for $40,000-$60,000 have a 25-year term; those for $60,000 or more have a 30-year term.

[12] President's FY 2005 Budget Volume Tables

positive net cash flow for program depends. We received these tables yesterday and are still digesting them, but I am pleased to note that the E&Y authors have corrected a number of errors in their previous draft. Even so, the E&Y analysis still contains a number of serious errors and omissions, all of which are aligned in the direction of providing underestimates of the costs of consolidation. As a result, the analysis ultimately provides a misleading view of the costs of the current program.

First, the study continues to use outdated estimates of the volume of student loan consolidations, and especially for the years in which the E&Y study acknowledges that fixed-rate consolidation loans will cost taxpayers money. For FYs 2005 and 2006, the E&Y study relies on estimates of consolidation volume from the FY 2004 mid-session review, which are more than $10 billion lower than the latest estimates from the President FY 2005 budget. By underestimating the volume, the study underestimates the program costs.

Second, the study significantly overstates the likely consolidation interest rate in FYs 2005, 2006 and 2007, and so significantly underestimates the subsidy costs to taxpayers. This error could reflect an incomplete understanding of how interest rates on consolidation loans are determined: The consolidation rate is dictated by the 90-day Treasury bill rate in the May prior to the beginning of the fiscal year, not by an average T-bill rate for the fiscal year. For example, the interest rate on loans consolidated in most of 2005 will be determined by the T-bill auction rate this May, when it is not likely to be much more than 1.0-to-1.2 percent. This would imply a 2005 consolidation-loan rate of roughly 3.5 percent or less; yet, the E&Y study forecasts that the consolidation-loan rate in 2005 will be 5.35 percent. By overestimating the interest rate on consolidation loans, the study again underestimates the program costs.

Third, the study simply omits or ignores major cost factors in this program. To begin, the study simply omits in its new tables any reference or acknowledgment of the future costs of loans consolidation in 2003 and 2004, years with the largest volume and lowest consolidation-loan rate in the program's history. The taxpayer costs of the consolidation loans from those years will be very large, as our analysis shows, and should help define the terms of reform. By omitting those years, the study further underestimates the program costs.

Just as remarkably, the E&Y study also omits all costs after FY 2010 associated with previous, current or future consolidated loans. Contracting the time frame of analysis is a major obfuscation in this case, since loan consolidation stretches out the duration of the loans, shifting most of their costs into later years outside the E&Y study's analysis. In practice, nearly 80 percent of consolidation loans have terms of 20 years or more, placing most of their costs to taxpayers beyond the study's time frame. I cannot take seriously any analysis of the costs of this program limited to a selected five-year period, and neither should you. By focusing its analysis in this way, the study further underestimates the program costs.

The E&Y study also fails to acknowledge the government's financial exposure to the path of future interest rates. As our analysis shows, this exposure could lead to enormous costs for taxpayers. Instead, the E&Y study continues to suggest that a program which provides tens of billions of dollars a year in long-term, low fixed-rate loans is a free lunch for taxpayers, even when interest rates rise again.

IV. Conclusion

The current terms of the student loan consolidation program will generate tens of billions of dollars in taxpayer costs, as well as significant inequities among consolidation borrowers. Both programs could be addressed by shifting the terms of the program from a fixed interest rate to annually adjusted rates. Future American taxpayers are not the only ones who will bear the long-term costs of loans consolidated at the low fixed rates of this period. As government payments to lenders rise sharply, as they will with higher interest rates, some of those costs will probably come out of college access for future students: Unless the public commitment to support access to higher education *increases*, the rising costs in future years of subsidizing loan consolidations could cut into the funds available for college loans in the future. At a minimum, reforming the loan consolidation program so that the interest rates on these loans adjust annually, as they are with all other student loans, will save taxpayers billions of dollars that would be available for future college students.

Chairman BOEHNER. Let me thank all of our witnesses for their excellent testimony.

Mr. Hamlett, we appreciate your coming in, not feeling up to speed, and let me assure you that you will have no problem consolidating your loans. I'm sure you're getting all types of marketing phone calls already getting you all set up for the day you graduate, and you can go ahead and lock in these historically low rates.

Now, before we get too far into this, my good friend, Mr. Kildee, in his opening statement, talked about, well, we need to do a lot on access, but, you know, we also need to help all of those who are out of school, as well. While we would all like to be Santa Claus, you know, we can't be. We got elected to Congress to be decision-makers in the public policy arena, and regardless of what the size of that pie is, there is some limit to the size of the pie, and we're elected to make choices.

So if, in fact, our goal with the Higher Education Act is to help low to moderate income students attend a college or university of their choice, we need to make sure that we are meeting our goal in providing the tools for those qualified students to attend an in-

stitution that they wish to attend, and that means that we need to make choices as we begin to reauthorize this program.

Ms. Ashby, you pointed out in your testimony that these consolidated loans do, in fact, receive considerable subsidies.

Dr. Neubig, in his testimony, said, in effect, and I will paraphrase this—if I am incorrect, Dr. Neubig, certainly correct me—that the fees paid by lenders are, in the short term, outweighing the subsidies, and long-term, that it's basically a wash.

Are you in agreement with this?

Ms. ASHBY. Well, I am not sure about the wash and the long-term.

It is true that the fees—and we're talking about the annual 1.05 percent, I presume—that the annual fees do reduce the net outflow to the government and, in that way, reduce the taxpayer's ultimate cost. But based on the work we did, we didn't—we took the Department of Education's numbers, and we looked basically at loans that were consolidated in fiscal year 2003, and we looked at the difference between the subsidy cost for those and loans consolidated the prior year, prior fiscal year.

So I really can't comment on Dr. Neubig's study.

Chairman BOEHNER. Ms. Ashby, Dr. Neubig, Dr. Shapiro, do you, any of you, disagree with the fact that interest rates are likely to rise?

Dr. SHAPIRO. No. Certainly not.

Chairman BOEHNER. Dr. Neubig?

Dr. NEUBIG. I guess I don't take a position, you know, in terms of what's going to happen. I guess I am buying inflation index bonds at the moment, and clearly OMB and CBO both forecast higher interest rates.

Ms. ASHBY. I am certainly in no position to disagree with the experts.

Chairman BOEHNER. So we all agree that interest rates are going to rise, and we know that if interest rates rise, someone has to bear that risk. Nobody disagrees with that?

So the question is, who should bear the risk? And whether the loan was made in 2001, 2002, 2003, or, for that matter, 2006, there is risk that someone has to bear, and there are the three parties that could bear that risk.

They could be the government, they could be the lender, or they could be the graduate, the student—not the student, the post-student years. Those are the three categories.

Now, it will not be the lenders, because they sell off these, they are pretty well insulated, and if they are not—if they are exposed to this risk, they probably will not make the loans. So we can take them out of the equation pretty quickly.

So now we are down to two parties who are going to bear this risk. Is it going to be the Federal Government and/or, let's be honest, the taxpayers, or is it going to be people who have graduated from college bearing that risk?

Now, for those who have received student loans, let us review the bidding.

The Federal Government provided them, in many cases, a student loan, whether it be subsidized or unsubsidized. In many cases, we bore the interest for those subsidized loans during the life of

that student being in school, or at least deferred the interest for those unsubsidized loans.

After they are out of school, we provide a 6-month grace period, where there are no payments required, and if the student wants to, and has multiple loans with multiple lenders, we allow the student to consolidate those loans to make one payment.

We also provide for extended repayment in many of those cases, especially for large loans, over a longer period of time.

Not only has the Federal Government provided all of this while the student is in school and for a short time after they are at school, all the way through these guarantees—these are all guaranteed loans.

You do not have to apply for them, you do not get rejected, they are guaranteed, and there is a cost for that guarantee, so we have subsidized all of this for students until such time as we believe that most of them are out of school and into the work force.

I guess the question I am asking the panel is, is it fair to expect the student to bear that risk of what interest rates may be in the future—that graduate to bear those risks—or should the taxpayers continue to bear that risk?

Dr. Shapiro?

Dr. SHAPIRO. Well, I just want to note that students bear the risk if they happen to consolidate when interest rates are high.

That is, there are—the reason that the program has thus far shown a generally positive cash-flow is because, every year except one, the consolidation loan rate has been falling. The problems arise in this program after the rates have fallen and then they begin to rise again.

So, of course, if you only look at a period in which interest rates are falling, have been falling, and the consolidation loan rate has been falling, you're going to get a kind of rosy scenario.

The fact is, we are subsidizing consolidation loans as well as the underlying student loans. The fact is that students are not bearing an even risk today.

When Dr. Neubig said that, based on the CBO interest rate forecast, that moving to a variable rate would double the interest costs of students who are consolidating today, the implication of that is that students who consolidate later will be paying double the interest of those today, which is, indeed, what's happened in the past.

We have the interest burden paid by someone consolidating this year is one-third the level of the interest payment borne by someone who consolidated 6 years ago. So, students are bearing a risk, depending on when they happen to graduate. In fact, the risk would be equalized if everyone's consolidation loan rate were to be adjusted annually.

Chairman BOEHNER. Dr. Neubig?

Dr. NEUBIG. I guess I do not have a view, in terms of who should bear the interest rate risk. I guess I think there is the possibility that it's more than just a choice between taxpayers and the government.

Currently in the residential mortgage market, we have private sector lenders offering both variable rate and fixed rate 15-year and 30-year mortgages, and as a result of advances in the mort-

gage markets, they have been able to, you know, hedge those risks to people who are willing to accept those risks.

So I think it's more than just a choice between taxpayers and the government.

Chairman BOEHNER. Are home mortgages, are those subsidized? Are they guaranteed?

Dr. NEUBIG. No, they are not, in most cases, but even on the private sector side, there are advances in the markets, you know, that allow some of this interest rate risk to be taken by people who are willing to accept the risk.

Chairman BOEHNER. The chair recognizes the gentleman from Michigan.

Mr. KILDEE. Thank you very much, Mr. Chairman.

We have a vote going on over in the House, and I will have to leave shortly, as all of us will, but let me ask this, so we can get this on the record.

For students who will consolidate their loans in the next few years—and without using your crystal ball, just your own best guesstimate—would changing consolidation interest rates from a fixed to a variable rate make student loans more costly for students?

Let me start with Dr. Shapiro and go down.

Dr. SHAPIRO. It would make them more costly for students who consolidated today, and probably less costly for those who consolidated later, when interest rates were high, as interest rates fell again.

Mr. KILDEE. Dr. Neubig?

Dr. NEUBIG. Again, based upon the CBO projections, it would increase the cost of students taking out consolidation loans probably in 2003, 2004, and probably 2005, 2006. At some point, you know, they will stabilize.

Mr. KILDEE. Mr. Hamlett?

[No response.]

Mr. KILDEE. You can pass if you want. We do that around here, too.

Mr. HAMLETT. I'm not really an expert on this particular issue, so I'm just going to speak from my personal experience. Having a fixed low interest rate would definitely help me, in particular, and a lot of other American families.

I think that changing it from a fixed interest to a variable interest rate is going to cost families money, and to me that's just something that you wouldn't want to do to middle to lower income families.

Mr. KILDEE. Ms. Ashby?

Ms. ASHBY. In the simplest case, without considering all the various factors, and presuming that the experts are right that interest rates are not likely to go much lower than they are today, and that they will increase in the future, going to a variable rate will increase the costs for students.

But one of the other factors is the length of time the student holds that loan, and one of the advantages, for some students anyway, is a longer payment period, and of course, over a longer payment period, you're paying more interest over the life of that loan.

Mr. KILDEE. Thank you, Mr. Chairman.

I believe I will go over and cast my vote now.

Chairman BOEHNER. Well, we do have several votes on the House floor, interrupted by 10 minutes worth of debate. I would suggest that the earliest we would be back here would be about noon.

So the Committee will stand in recess until about 12.

[Recess.]

Chairman BOEHNER. The Education and the Workforce Committee will come to order.

Sorry for the delay. Unavoidable, though.

The chair recognizes the gentleman from Wisconsin, Mr. Petri.

Mr. PETRI. Thank you very much.

Thank you all for your testimony, and the work that went into your prepared statements, as well.

I wonder if it would be possible to explore an area that was hinted at in Dr. Neubig's recent answer.

We probably—do you agree or disagree that there is a problem with the consolidation in that there is a mismatch between a long-term repayment and a short-term number, and in the mortgage area and others, they peg a long-term block into a longer-term bond, so that it's anyone's guess what interest rates are going to be, but that guess is not made by the financial institution or the lender, they lay that off on the market and collect their margin to stay in business.

Would that be a more appropriate fix of this problem, or what would the implications of trying to emulate, you know, the student loan consolidation lock-in area, what is done in the rest of the world, be?

Borrowers are familiar with the options they have now with refinancing and mortgages and various periods of time.

I don't know what the average student loan repayment is, but that wouldn't be hard to determine. It's probably somewhere between—around 10 years, or something like that.

So we could pick a number in the Treasury world and add some points for overhead or whatever, and let them lock it in at that, and then, well, it wouldn't be subsidized by the Treasury or the taxpayer. We could figure out a way of it being subsidized by an insurance company or whoever buys the parallel private bond.

Would you care to comment on whether that would be an appropriate way to approach this?

Dr. NEUBIG. I think as you identified, there is some mismatching, you know, between sort of the asset and liability side in the current program which is causing, you know, the big positive, big negative, big positive, and there are ways of addressing it beyond just moving to a variable rate.

Things that are being done in the financial markets are something that I think the Committee should perhaps explore. I haven't analyzed, you know, what those might be, but I think it isn't just, you know, a win-lose situation between the Federal taxpayer and the student.

Mr. PETRI. How would you suggest we go about getting some help in doing this appropriately? Dr. Shapiro, do you have a comment?

Dr. SHAPIRO. Well, you know, I do. You know, I think your comment about the mismatch is very apt.

It is—part of what we did in our study was to look at a most likely, what we considered a most likely case, and then less likely, and nightmare scenarios—how bad can it get—and there is a range.

When it gets very bad, it is—and indeed all the costs here arise out of this mismatch—it is essentially the same problem in form that we saw in the S&L crisis, and that we saw in the Asian financial crisis, and that is borrowing short and lending long.

Over interest rate cycles, it might even out if consolidations occurred evenly, but of course, they don't.

That is, they rise enormously when the rates are very low, in order to lock in the rate, and that's what causes this disproportionate problem. It does go positive, negative, positive, negative, but the negatives are a lot bigger, because the volume is so much greater at the low rates than of consolidation than at the high rates.

Mr. PETRI. Dr. Neubig, did you have a further comment?

Dr. NEUBIG. Well, this is an area I would certainly be eager to explore, because we do have one solution, but it may not be the optimal solution from the point of view of the students and the government and the taxpayer. We are in the business of not just saving the taxpayer money, but trying to make this a user-friendly program.

I think people would understand they had to pay a higher rate for locking in a longer-term mortgage, because they face that every day in the marketplace, and they can make the choice and decide what is most appropriate in their own—given their own financial circumstances, but denying a long-term lock-in to students as one option seems to me to be giving up something that is beneficial to a lot of people.

Chairman BOEHNER. The chair recognizes Mr. Andrews.

Mr. ANDREWS. Thank you, Mr. Chairman.

I would like to thank the panel for its patience during our vote.

Mr. Hamlett, let me say you did great, you did not sound nervous at all, and as a student at the University of Maryland, I am sure that you are aware of the fact that the reason for the Terrapins' recent basketball success is because their coach, Gary Williams, grew up in South Jersey, in my congressional district.

[Laughter.]

Chairman BOEHNER. And trained as a good coach in Ohio.

[Laughter.]

Mr. ANDREWS. Well, Ohio is where you go to train, and New Jersey is where you go to excel.

[Laughter.]

Mr. ANDREWS. That may just cut my time. I am sure that does not come off my time, Mr. Chairman.

Chairman BOEHNER. If I recall, there are some games this weekend that we may want to discuss.

[Laughter.]

Mr. ANDREWS. OK. We may discuss, but never wager, because that is illegal.

Chairman BOEHNER. Not between friends, it is not.

Mr. ANDREWS. That is true, and that would be a legal wager based on that principle.

I very much appreciate the witnesses' testimony on this very complicated subject.

Ms. Ashby, I had a chance to read the GAO report that you wrote, or led the authorship of. As usual, it was exceptionally excellent from the GAO. I wanted to ask you to characterize a couple of conclusions that I think I drew.

Is it accurate to say from your report that people who consolidate their loans as a whole are higher-income, when compared to the student lending population generally? Is that correct?

Ms. ASHBY. Well, we are looking at consolidators versus non-consolidators.

Mr. ANDREWS. Right.

Ms. ASHBY. So yes, those who consolidated their loans tended to be higher income.

Mr. ANDREWS. I think I read that 39 percent of the consolidators had incomes in excess of $50,000 a year. That is in your report?

Ms. ASHBY. I don't have the numbers, but my colleague is saying yes.

Mr. ANDREWS. The other thing I think I read in your report is that consolidators are more likely to be people that went to graduate school than people who did not, relative to the rest of the lending population.

Ms. ASHBY. For consolidators, a larger percentage, yes, had gone to graduate or professional schools.

Mr. ANDREWS. I believe it was 28 percent had done some graduate school borrowing, as compared to 12 percent of the non-consolidators, if I read the report correctly. So that's a fair characterization of the people who were consolidating.

If I were writing the budget resolution, which I am not, I would have a very different set of choices here.

I would not have a tax cut nearly as big as the one that we have, and I would choose to fund a very liberal consolidation program, as well as significant increases in support for students who are in school, and if that were the budget resolution before us, that's what I would do. It isn't.

Realistically, the choice in front of us is what to do with very scarce mandatory spending higher education dollars, and I particularly want to focus on that choice with respect to minority students and the consequences of the choice we have between liberal consolidation and other choices that we might make.

Dr. Shapiro, first of all, I appreciate the great work you did in the Clinton administration over all those years, and I wonder, do you have a number on your projected cost over the 5-year future that we're legislating for for the present consolidation regime?

In other words, if we didn't change it, just left it where it was, how much do you think that costs the Federal Treasury?

Dr. SHAPIRO. Well, we have an estimate of the lifetime cost of loans which we believe will be consolidated over the following 7 years, and that estimate is about $21 billion.

Mr. ANDREWS. About $21 billion.

Is it accurate to say that if we made a change to variable rate consolidation, if, that most of that $21 billion would then, in effect, be saved, would be recaptured?

Dr. SHAPIRO. The majority, and it would depend on how you designed the variable rate program.

Depending on how you designed it and how you adjusted the fees paid by consolidators, you could go anywhere from a system which converted it all to savings to one which converted part of it to savings.

Mr. ANDREWS. If, as I suspect, we are in a position where we have to design a bill that is budget-neutral, that doesn't increase mandatory outlays for higher education, in effect that gives us a pool of money somewhere short of $21 billion that we could look at spending by making the reduction in outlays, which could be offset by an increase in outlays, one of the increases in outlays I would be interested in would be an abolition of the origination fees that students pay.

Mr. Hamlett, you have done some extensive borrowing. You are aware of the fact that there is a 3 percent origination fee each time you borrow a student loan that you tack on, which is a lot of money.

I did some research on origination fees, looking at subsidized loans, and one of the striking statistics is that 86.8 percent of African American students get a subsidized loan, and 86.8 percent of Hispanic students get a subsidized loan; so one of the consequences of eliminating origination fees is, it would have a substantially positive impact for minority students who are in school.

Dr. Shapiro, would you agree or disagree with that characterization?

Dr. SHAPIRO. I would absolutely agree with that.

It is—there are—the student loan consolidation program does not affect all kinds of students equally.

It is—consolidators tend to be people with larger student debt, as GAO established. They tend to be people who have gone to graduate school, because those are the ones who pile up the largest debt.

The average debt of the current stock of consolidated loans, which includes loans which have been half paid off, for example, is $22,000. That is greater than the maximum an undergraduate could borrow under the FFELP program.

Mr. ANDREWS. In the difficult choices the Committee faces, and there are no easy answers to this, one of the things I'm going to be looking for and paying attention to is which expenditure of these scarce dollars does the most to help moderate income students generally, minority students who have traditionally not had the access that other people have had to higher education.

I favor the abolition of origination fees. I favor the expansion of income-contingent and income-sensitive repayments, so that students like Mr. Hamlett, who may want to take a career in public service, would not be penalized for doing so, and frankly, I also think we have to look at higher loan limits as a way to help people bridge the gap between the shortfall in Pell aid and the realities of rising tuition.

You know, again, in a world that I would create, we could do both that and very liberal consolidation, but in a world where we have to choose how to allocate the scarce dollars, I think those are issues that we have to focus on.

Thank you, Mr. Chairman.

Chairman BOEHNER. The chair recognizes the gentleman from Michigan, Mr. Hoekstra.

Mr. HOEKSTRA. Thank you, Mr. Chairman.

I have a statement I would like to just submit for the record.

Chairman BOEHNER. Without objection.

[The prepared statement of Mr. Hoekstra follows:]

Statement of Hon. Pete Hoekstra, a Representative in Congress from the State of Michigan

Mr. Chairman, I want to thank you for convening this hearing today. The issue of a strong loan consolidation program has been very important to me for many years. We should make no mistake; federal loan consolidation is an essential tool for making higher education more affordable for students. It is a program with proven results for students.

As we've heard from our witnesses today, federal consolidation loans allow recent graduates to refinance their multiple underlying student loans into a single, fixed rate loan with a lower monthly payment. The federal student loan consolidation program benefits borrowers in all walks of life, and public support for this program is broad.

With the cost of higher education growing, today's college students graduate with an average student loan debt 66% greater than 6 years ago. The problem can be even more acute for those completing postgraduate and professional programs, many of whom graduate with debt in excess of $100,000. As a result, a significant number of graduates at all levels see their debt as unmanageable, and consequently, as imposing limits on their career choices. A more manageable monthly repayment obligation is an important factor both in opening up those choices and in averting student loan default. Loan consolidation is especially essential in removing the barriers that student loan debt presents to those college and professional school graduates who want to work in the public and non-profit sectors of the economy. It is noteworthy that nurses and teachers combined were the largest group taking advantage of loan consolidation during the last 5 years.

The widely popular federal student loan consolidation program (utilized last year by more than 726,000 student borrowers) has proven beneficial to the federal government as well. In the last fiscal year, the 0.5% lender-paid origination fee on consolidation loans generated $210 million to the federal government. Consolidation lenders are also required to pay a 1.05% portfolio fee/tax each year to the federal government on the outstanding principal of all consolidation loans held by the lender. That is, each outstanding consolidation loan generates a lender-paid fee each year to the federal government. This fee does not apply to other student loans. Over the past 7 years, the revenue to the federal treasury from these origination and portfolio fees has totaled nearly 2 billion dollars.

Fixed rate consolidation loans work for student borrowers. We should not attempt to change the program to variable rates without seriously considering the impact of this change on students. It is imperative that the loan consolidation program be preserved and expanded as a vital element in graduates' efforts to cope with student loan debt. I thank the Chairman for this hearing and pledge during our Reauthorization of the Higher Education Act to work closely with the Chairman and my Committee Colleagues to ensure that the Committee's legislation includes a strong federal student loan consolidation program.

Mr. HOEKSTRA. I want to build off a little bit of what Mr. Petri was talking about.

Why couldn't student loans be worked much like you work the home mortgage?

For somebody who is willing to take the risk, you get a variable rate mortgage. For those who, you know, want a lower interest fixed rate, they may go to a 15-year, and for somebody else they

go to a 30-year. Why couldn't the same kind of formula plan be put in place for student loans?

For anybody on the panel.

Yes.

Dr. SHAPIRO. You could, Congressman. It would maximize the budgetary costs.

Mr. HOEKSTRA. Why would it maximize the budgetary costs?

Dr. SHAPIRO. People consolidating at a time of high rates would choose variable rates, which would reduce their payments as interest rates came down, and those consolidating in a low interest rate environment would pick fixed rates.

Mr. HOEKSTRA. I do not think you are understanding what the—

Dr. SHAPIRO. OK.

Mr. HOEKSTRA. I mean, if you consolidated a low interest rate, where it says, "This will be your interest rate for 7 years," it is not going to be adjusted. My 15-year mortgage at home is not adjusted every year.

So that then becomes the fact of life for the person who is loaning the money, that you have agreed to the loan at this rate for 15 years.

Dr. SHAPIRO. Right.

Mr. HOEKSTRA. So why would that maximize the cost to the Federal Government? It would no longer cover the difference.

Dr. SHAPIRO. Where the Federal Government would no longer cover—if the interest rates go up, the payments to the lenders rise with interest rates. Whether or not—

Mr. HOEKSTRA. No, that is not what I am saying. They would not rise to the lender.

Dr. SHAPIRO. Oh. Well, then I think you would have—I do not know. I would guess that you would have some difficulty getting private lenders into this market.

Mr. HOEKSTRA. Why? I mean, you do not have trouble getting people into the mortgage market.

Dr. SHAPIRO. Yes, but students have traditionally, typically, very few assets—

Mr. HOEKSTRA. But it is a Federal guarantee.

Dr. SHAPIRO. —no salary history. They are not good credit risks, which is why, in the private market—which is why we subsidize it in a public market.

Mr. HOEKSTRA. But I mean, it is still a guaranteed loan, in terms of for the principal.

Chairman BOEHNER. If the gentleman would yield?

Mr. HOEKSTRA. Yes.

Chairman BOEHNER. Think about it this way.

We would still have the guarantee for the lenders, the guarantee, but if the variable rate or the fixed rate floated at market levels, it would seem to me it would take away the risk in the marketplace, and the lender could choose.

Is there a way that that would work?

Now, Ms. Ashby, maybe you could shed some light on this.

Ms. ASHBY. Well, I am speculating, of course, because no one has done a study of this, as far as I know.

I don't know. I mean, it is possible that it would work if lenders, as Dr. Shapiro said, if there were lenders that were willing to ac-

cept such a system, and to make it clear, there would be no guaranteed lender yield, then.

Is that what you are saying, that there would be the government guarantee as we currently have, but no guaranteed lender yield for the FFELP program?

I don't know. It is possible that this might work.

Mr. HOEKSTRA. I mean, what happens in mortgages is, you know, you shift the risk, and if we're interested in shifting the risk from the Federal Government, this is one way of doing it.

Ms. ASHBY. Then lenders would—yes. I mean, currently the taxpayer or the Federal Government is the only group that has risk, really.

Students with the current low interest rates have very little risk, since it is very unlikely the rates will go lower, and lenders bear almost no risk, because of the guarantee and their guaranteed yield—

Mr. HOEKSTRA. Right.

Ms. ASHBY.—and the guarantee of repayment, so it might shift the distribution somewhat.

Dr. NEUBIG. I think, Congressman, that you have a number of different policy instruments or variables that you could make adjustments to that might mitigate some of the risk.

I guess, looking over the last 16 years, we found that the current fixed rate of consolidation loans probably is cost-neutral, and the reason is because there is also a lender fee that offsets that.

Now, I thought I heard you perhaps suggesting that in the residential mortgage market, people who take out a fixed rate mortgage currently do pay maybe 100 basis points more than someone taking out a variable rate.

Mr. HOEKSTRA. Right.

Dr. NEUBIG. Currently, you know, consolidation loans only have the option of a single fixed rate, and it's exactly the same, other than the one-eighth of a percent rounding up, to the variable Stafford loan.

So I think both in terms of the rates and also, you know, the fee, you have got to factor those into the analysis and the options that you have, in terms of trying to make improvements to the program.

Mr. HOEKSTRA. Yes, but I am—yes.

I think the bottom line is, you could go to some type of more market-based access for the dollars, and students at that point in time, depending on what lenders made available, you know, they could at that point in time choose whether they wanted to go variable rate or whether they wanted to go to a fixed rate for a certain period of time.

Chairman BOEHNER. The gentleman's time has expired.

Mr. HOEKSTRA. Thank you, Mr. Chairman.

Chairman BOEHNER. Mr. Miller?

Oh, Mr. Tierney is recognized for 5 minutes.

Mr. TIERNEY. I am happy to yield to the Ranking Member, if he wants.

Thank you, Mr. Chairman.

You know, I listened to all of the conversation, and it seems that the only choice that is being presented is to cut the support for subsidies and increase the cost for students that graduate so that now

we will have, you know, students that graduate paying enormously higher loan rates on their loans over a period of time, as well as having difficulty having children or students fund their way through college to begin with.

This is a fairly profitable area. I mean, look at Sallie Mae, who deals primarily in student loans. They are a pretty big bank, and they make a lot of money.

So I am wondering a little bit why we do not look at the element of dealing with the people that are making the money as lenders, why aren't we looking at their aspect of this, so that perhaps there is money to be had there from the situation, instead of just cutting the subsidies.

What do people think about that, going at that end of it?

We can start—anybody that wants to step forward, we can start from right to left or left to right.

Sir?

Dr. NEUBIG. Well, I guess looking over the last 16 years, the lender-paid fees roughly equal the special allowance payments, and—

Mr. TIERNEY. The special what payments? I'm sorry?

Dr. NEUBIG. The special allowance payments, the interest subsidy.

So over the long term, there are lender-paid fees, and that has been profitable to the U.S. Treasury for the last 8 years and will be, you know, profitable probably for the next two or 3 years. It has sort of averaged out over the cycles.

So they already—you know, there is a potential risk, but part of the interest rate risk is that interest rates are unlikely to go up to double-digit levels for extended periods of time.

They might go up for—they did go up during the oil shocks of 1973 and 1979, but it looks like the current program, with its lender fees, does get payments that are offsetting the interest subsidies.

Mr. TIERNEY. Wouldn't we want to move in a direction to make sure that that is ensured as we go forward, and not run the risk of having that fall into a contrary situation?

Dr. NEUBIG. I guess part of the question is we are using the CBO interest rate projections in terms of looking at the future for the next 5 years, and looking at it over the life of the loans.

You know, if you think that things are going to get, you know, much worse than what CBO and OMB are predicting, then perhaps you should consider some additional things, but a lot of other things will get enormously worse if we have, you know, double-digit short-term interest rates for, you know, the next, you know, 15 or 20 years.

Ms. ASHBY. As the discussion always gets around to in this area, it depends on what you believe will happen to interest rates and what assumptions you make about various payments and what's likely to happen.

Given what you have proposed, assuming that lenders would still be—and assuming that we continue with two programs, the direct loan and a guaranteed loan program—that lenders would be willing to loan money to students and their parents in the market without, either without a guaranteed yield or with a guaranteed yield that is somewhat different than the current one, and that is—

Mr. TIERNEY. Well, given how profitable they are, I think it is a pretty fair assumption that they will continue in the game.

Ms. ASHBY. Well, that is the issue, and the work we did, of course, did not address this directly because we were not looking at that.

But we certainly, in recommending that the Department do an assessment of the consolidation programs, that is certainly an option and something that should be considered.

Mr. TIERNEY. Well, I mean, why hasn't anybody looked at that, I guess?

We are sitting here, we are testifying here today. It seems to me that that would be an area that we would hone in on. This is a profitable area.

We have one of the largest bank institutions in the world doing primarily this type of loan, and no matter how much people want to complain that it's a bad deal, it seems to be a pretty good deal, so it seems to me that we would look at that and talk about what could be done there.

If they are not willing to do it, then we could do direct loans, but my feeling is there will be more than enough people lining up for this market. Everybody is just doing what businesses do, trying to make sure they get as much profit as possible.

Mr. MILLER. Will the gentleman yield?

Mr. TIERNEY. I will yield.

Mr. MILLER. Just on that point and Mr. Hoekstra's point earlier, there have been a number of suggestions—I am sorry, I have been in and out of this hearing.

But in the time I have been here, there have been a number of suggestions from different members about, isn't there a way that the students could have more choice, or they could—this thing could look more like the mortgage market.

But what is before us, I guess, is sort of a suggestion that we are going to take this program and we are going to convert it to a variable rate program, and we are going to go on about our business, and there will be some huge savings, and that would be converted to help other students as opposed to the graduating students.

I am kind of struck each time these questions get asked.

Ms. Ashby, you keep suggesting we really do not know, because we have not looked at the particulars of the impact of this over a period of time.

You can tell us what has happened historically, but if you were to change the mix, the suggestion is that there are only two groups of people here. You can shift the cost between those in school and those out of school, and somehow that is the choice—or the taxpayer.

But there is also, as Mr. Tierney pointed out, there is the question of the fee structure. Should that be modified or not modified?

It's modified so a student can have a choice and make those decisions and decide, based upon what they think their career opportunities are going to be, or what their immediate lifestyle. They can take a choice. One might be higher than another, one fee might be different than the other. I do not know.

All I see is, I think the group of lenders are saying, "We want to hold onto this the way it is, and it will not work any other way."

Well, you are just deciding to dump thousands of dollars of additional interest cost on the backs of people, depending on where they show up, which is a decision they do not make.

That, you know, that is not just a "Well, I am out of school now, so now I am going to make a fresh decision," when people look at, "Am I going to school, what is my lifetime cost, what is my lifetime opportunity, what is my lifetime revenues, does this make sense for me?"

So to pretend like these are two different audiences, these are just the same people at a different place in their life, and they have got to make those adjustments.

We spend a huge amount of time here talking about forgiving loans to people because they can't make choices to become policemen, firemen, teachers, nurses, and what have you—we really do not do that, we talk about it more than we do it—but we recognize that the cost of paying off loans impacts people's decisions and works against the public interest.

So why is it we are just now, without a lot of evidence, suggesting we are just going to throw this onto these people after they graduate?

And I think the answer is, we do not know. Maybe we should be asking the department or somebody else.

I mean, we sort of have dueling studies here, both of which each side can raise questions about, but we ought to be asking something else before we decide we are going to saddle these students with, with apparently very little notice, that all the sudden the cost of their education could increase dramatically.

As you pointed out, you are buying interest index bonds. You know, somebody thinks this is going in the other direction, and so their costs are going up. They have already incurred the debt. We are now just restructuring what the cost of that debt is going to be to them.

I think we ought to know a lot more about this before we just dive off this cliff and we start ruling out who is a participant and who is not a participant. We do not know enough about this, at least from what I see, in terms of the questions from the members.

Maybe you do, and maybe I am wrong, but it seems to me the answers keep coming back from that side of the table, "We need more information. We would have to know more about this if you want to structure it this way or not."

That is a comment, you do not have to respond to it, but I think this hearing has pointed out a real dearth of information here that could be helpful to the members.

Chairman BOEHNER. The chair recognizes the gentleman from California, Mr. McKeon.

Mr. MCKEON. Thank you, Mr. Chairman.

Actually, the students that graduate this year, probably when they started school four or 5 years ago, were looking at an 8 percent interest rate. Now they are looking at a much lower interest rate. So this varies with time and with the cycle of lending and borrowing.

Back to that mortgage comparison again. I think we need to clarify that a little bit.

If you tried to compare a student loan with a—that is a subsidized loan that is a government loan, for the most part—with a mortgage that really is free market, I mean, any of us can go out at any time and refinance our mortgage.

We might have to pay points, depending on what we get, and we could get a fixed rate or we could get a variable rate, and again, that would vary. There are all kinds of options, but there is no government subsidy on any of that.

Now, when we talk about a student that graduates and then wants to refinance or consolidate his loan, then it just seems like there is not much of a comparison there.

Can you address that?

Dr. SHAPIRO. Well, the reason the comparison is hard to make is that the interest rate, the fixed interest rate for consolidated loans is not set by the market, it is set by the government, it is set by law, and then there is, in addition, a guarantee and a subsidy built into that rate.

Mr. MCKEON. It has a rate and it has a top that it cannot—

Dr. SHAPIRO. Yes.

So that if I understood the proposal which was described 10 minutes ago by your colleague, sir, that you would have a choice of a fixed or a variable rate, but that the subsidy to the lender for the fixed rate would be reduced or eliminated, then the lender would simply charge the borrower a higher fixed rate.

Mr. MCKEON. I am not sure I understood that, either. I do not think he was—I cannot speak for him, but I do not think he meant to eliminate the subsidy, but if you eliminate the subsidy, then you are just going out and refinancing your loan on the open market.

Dr. SHAPIRO. Right. Then it is a market.

Mr. MCKEON. And then—

Chairman BOEHNER. Will the gentleman yield?

Do not forget, there is a guarantee here. There is a guarantee on the part of the government to the lender that they are going to get paid. Now, that is worth something.

Mr. MCKEON. Yes, but what I was getting at is, if you eliminate that guarantee, then you should be able to, you know, go to the open market and refinance your loan; and I don't think anybody has any quarrel with that. It is where you want to refinance that loan and keep the guarantee and keep the lower rate.

In other words, then the government and the taxpayers are left on the hook for that cost.

Dr. SHAPIRO. We can certainly provide the guarantee and the subsidy and a very, very low fixed rate. There is no way to provide that without it having significant cost consequences.

I do want to make one point, and that is that—one additional point.

We have not really been through a full interest rate cycle with the consolidation program. We have only been—we have—with 1 year of the last 8 years, the rate has been consistently falling, so we have not had the experience yet of what happens when you have very large rates of consolidation at very low rates, what happens when the rates rise.

So when the—I guess I do not agree that we have seen that there is a wash over the cycle, because we have not had the whole cycle. We are about to enter it over the next three to 4 years.

Mr. MCKEON. That was a question I wanted to ask Dr. Neubig.

We have had—the chart that we had up here from GAO showed that as the interest rates have gone down, consolidation has been really a big thing these last couple of years, and I was wondering how you can guarantee these numbers going out into the future.

Say that it is going to cost the government a lot in the next couple of years, but then it will change. I guess that is what you were talking about, Dr. Shapiro, about we have not gone through that cycle and we really do not know how these numbers are going to be until we complete that cycle.

Dr. NEUBIG. I definitely cannot guarantee these numbers.

I can tell you that they are based on the, you know, volume forecasts of the consolidation loans, you know, from the Department of Education and the CBO's interest rate projections, and so it is linked to what the government is assuming, and those assumptions affect a lot of other programs besides the Consolidation Loan Program.

This is sort of the best estimate, based upon the CBO interest projections. Clearly, interest rates do fluctuate, and CBO does keep their rates stable at historical levels out beyond 2010, 2011, and we know that they are going to bounce around.

I guess, you know, part of a sensitivity analysis is showing not only what happens on the upside, or the bad news, but also what would happen on the downside, the good news, and there is sort of a 50 percent chance that things would go worse than the CBO projects and a 50 percent chance things would go better than CBO projects, and so these numbers going out into the future might be both too low, if things go south on us, or, you know, the cost might be too high, you know, for these current loans if interest rates were to stay at rates below what CBO is projecting.

And you know, there are some forces in the economy, in terms of, you know, concern about deflation, that might make the, you know, interest rates be lower than what CBO—

Mr. MCKEON. Wouldn't that argument lend itself, then, to go to a variable rate, which would fluctuate with those changes?

Dr. NEUBIG. Well, that is one of the possibilities that you have.

Chairman BOEHNER. The chair recognizes Mr. Miller.

Mr. MILLER. Thank you, Mr. Chairman.

Ms. Ashby, in your testimony on if you consolidate through the direct student loan program, that we earn—what is it, for every $100 the government earns $1.12, or something? Is that right?

Ms. ASHBY. Yes. We did have an example in the testimony. I have to look at it to get the exact numbers. Are you referring to Table 2 in our testimony?

Mr. MILLER. I had it here, but I do not have it.

Ms. ASHBY. And we have updated the numbers in the testimony, so they will be slightly different than what is in the report.

Mr. MILLER. Are we better off directing students to consolidate through the direct program?

Ms. ASHBY. Are we better off in terms of the taxpayer, the government? Well, as with everything else, it depends on what is going

to happen with interest rates. It looks like today we are, but depending on what happens in the future, in terms of—and with the direct loan program, there are a number of variables. There is the rate that the government pays to borrow from the Treasury. There is the rate that is charged to students.

I cannot give you a definitive answer on that. It would depend on what happens with these various rates and how much the interest spread is, and so forth. But with this example, yes, $1.22 is lower than $1.59, but this is only for one cohort at one point in time.

Mr. MILLER. You are saying that to read your information correctly, again, we have to know a lot more about the various moveable parts in terms of the cost of borrowing money, and the rest of that?

Ms. ASHBY. Correct.

Mr. MILLER. But potentially, in some environments, interest rate environments, it would appear that it is better for the taxpayer to have people consolidate through the direct program?

Ms. ASHBY. Well, given the current interest rates and what the rate was to borrow from Treasury at the time that these numbers were calculated—and this is based on a Department of Education re-estimate, we should have a report in October—that would appear to be true, but as I said, the volume of loans makes a difference. There are at least two interest rates that come into play here.

So there is not a definitive answer to your question.

Mr. MILLER. No, and I appreciate that.

I think that is part of the point I am trying to make here, is that to make this single sort of dramatic shift, I am just not convinced that we have the evidence that suggests that that is the—that that should be done without further examination of what truly makes sense for all the parties involved.

We are each presenting the scenario from one point of view, saying, "This is kind of the good way to go, based upon our needs here and our needs here."

But I think at some point the policymaker has got to kind of look at all the parties and play out a number of different scenarios. If low interest rates continue for a decade, or if the interest rates move back to—if they tend back to norm, I guess which they will over various periods of time, you would want to know that.

Ms. ASHBY. That's right, and that is why we recommended that the Department do an assessment of the consolidated loan program—

Mr. MILLER. We are getting the bill ahead of the assessment a little bit here. That is my problem.

Thank you.

Chairman BOEHNER. The chair recognizes the gentleman from Florida, Mr. Keller.

Mr. KELLER. Thank you, Mr. Chairman.

I kind of watch this debate as sort of like an umpire here. I don't have a dog in this fight. I have kind of dedicated myself on this Committee to focusing on Pell Grant-related issues, and after reading your complicated testimony, I think I am going to stay with the Pell Grant-related issues.

[Laughter.]

Mr. KELLER. But as I sit here as sort of a layman, I kind of see three issues from where I sit.

One, do we allow consolidation or not? Two, if so, should it be fixed or variable? And three, will there be a second bite of the apple through reconsolidation?

And to tell you my two cents analysis, having sat through this—and I do not pretend it to be worth that—on the first issue, do we allow consolidation, I know that there is some powerful interest against it. I am near certain that we are going to allow consolidation. That is just too valuable a tool.

As someone who is in his thirties and not that far removed from college and law school, I remember how valuable a tool that is to be able to take various diverse loans and put them into one source and extend the payments. That is really helpful to a young person when you are first coming out of college, when you can least afford it. So that is going to happen.

We are not going to—I can't imagine, I am not leadership here, but I cannot imagine that we are not going to allow consolidation.

The second issue, fixed versus variable, if I was sitting where Mr. Hamlett is and someone told me the choices between a long-term fixed rate or an unlimited variable rate, I of course would say essentially what he said. I would like the long-term fixed rate. On the surface, that seems to be the best thing.

But I think what we are looking at is the scenario on the variable side, where you would give young people the benefit of the low variable rates. Like right now, they are at 3.42 percent, but you would cap their exposure at, like, 8.25 percent, so you are never going to pay the super jacked-up rate.

If you look at, in fact, what the law is, that effective 2006 the fixed rates are going to go to 6.8 percent, and you are faced with 6.8 percent versus the variable rate of 3.42 percent with a cap slightly above the 6.8 percent, you may well be better off with a variable rate.

So I do not know what we are going to do there, but I am pretty sure it is going to be in the strike zone. Either we are going to give you a pretty good fixed rate, or we are not going to expose you to unlimited rates, we are going to cap it at some amount.

On the reconsolidation, the second bite of the apple, I do not know what the Committee is going to do there, but even if the Committee does not allow the second bite of the apple on reconsolidation, you still have the option to go to your private sources.

If you have a home, you may be better off getting a home equity loan and paying off that student loan so you can write off your home equity loan.

So I think there is good news, no matter what we do for students here in the future. I am not pessimistic at all. But again, I look at this as sort of an amateur here.

Let me start with you, Dr. Shapiro.

Isn't it the current situation that we are set to go to a fixed rate, effective 2006, of 6.8 percent?

Dr. SHAPIRO. We are set to go to a cap. That is not a—that is the capped rate, not the—yes, as I understand it.

Chairman BOEHNER. Well, that is in a basic program he is referring to.

Mr. KELLER. Yes.

Dr. SHAPIRO. Right.

Mr. KELLER. The basic loan, yes, of 6.8 percent.

So if you were a student and you had to choose between a variable rate of essentially half that versus the 6.8 percent cap, there could be scenarios where it is beneficial to go with a variable rate. Is that right?

Dr. SHAPIRO. Yes, certainly.

Mr. KELLER. Dr. Neubig, I know you have had kind of competing reports.

What is your opinion on that same question?

Dr. NEUBIG. My understanding of the 6.8 percent fixed rate is that that would be for loans that are taken out in 2006—

Mr. KELLER. Right.

Dr. NEUBIG.—and beyond. If someone is taking out a loan in 2003, you know, they are—or in 2004—they are going to lock in the 3.5 percent, you know, for the life of that loan, and it is only if they take out a loan after 2006 that it would be 6.8 percent.

Mr. KELLER. Well, as I understood your testimony, it is essentially you believe it's better for the existing graduates now to go with a long-term fixed rate, that they would save more money than if you switched to variable, but my question to you, what about the students who graduate or who are in college after 2006?

If they were faced with the fixed rate of 6.8 percent versus whatever the market is for variable rates—and at 3.42 now—wouldn't there be scenarios that they would be better off with a variable rate, provided there is a cap?

Dr. NEUBIG. We are definitely seeing CBO interest rate projections, the variable rate would be very close to the 6.8 percent in 2006 and beyond.

Mr. KELLER. OK. Mr. Chairman, I will yield back.

Chairman BOEHNER. The chair recognizes the gentleman from Oregon, Mr. Wu.

Mr. WU. Thank you very much, Mr. Chairman.

I am going to make a couple of general comments, probably inquiring as much of the Chairman and the staff as of our witnesses.

We perhaps—or I, perhaps—along with others had, you know, brought up a concept of permitting variable rates under certain scenarios, partially to address inequities going forward, and partially to address inequities looking backward, and so like Mr. Keller referred to, in multiple bites of the apples and in reconsolidation, and the desire was to eliminate or to permit people who had consolidated once at high interest rates to reconsolidate, and to reconsolidate perhaps multiple times, and as a quid pro quo for that reconsolidation, to reconsolidate at a variable rate to reduce the cost to the Federal taxpayer going forward.

Sitting where I am today, I do not know if this reconsolidation or potential multiple reconsolidation concept is on life support, or beyond consideration.

Chairman BOEHNER. Will the gentleman yield?

Mr. WU. I certainly would.

Chairman BOEHNER. It is deader than a doornail, and let me explain why.

We allowed people who had consolidated their loans to make that choice, to consolidate them at a fixed rate, and they made that decision based on their own economic viability.

Now that paper is issued. It is out there in the marketplace, at some rate, you know?

We've got a staffer over here who did hers at 9 percent. She would probably like to have—sorry, Kathleen—she would probably like to have another bite at the apple at 3.42 percent, but she made that election herself. But somebody holds that paper.

Now, when you talk about reconsolidation at a lower rate—fixed rate, market rate, pick your rate—somebody loses, somebody. Either we stick the investor, who has loaned the money to the loan program, we stick it to the lender, or we stick it to the taxpayer. Those are the three options, and I, frankly, do not understand why.

If you look at your proposal, $6 billion, $8 billion, $10 billion cost, who is going to pay that?

I do not think we want the lenders to do it, because if they do, guess what? They are not going to loan money to the program. We will run them away. I do not think we want to stick the taxpayers with that.

And the fact is that those graduates made those choices when, in fact, they took out their consolidation loan.

Probably another argument why we ought to be looking at something more like a variable rate is, because if we had had a variable rate over the last eight or 9 years we would not have this problem with people making an election to consolidate at 9 percent, 8 percent, et cetera.

Mr. WU. Well, reclaiming my time, Mr. Chairman. The proposal we had would have substantially—first of all, we have not been able to get an accurate scoring, so I do not know how much it costs, and I am not sure that anyone does, but with the origination fees and reconsolidating at a variable rate, all of that was intended to reduce the cost of reconsolidation, and the variable had a cap on it of 6.8 percent.

We are looking at a proposal today of a cap which is higher than that, and part of the argument for having this variable rate is to prevent inequity by cohort, depending on when you fixed, and if you permit a variable rate instead, then you eliminate that inequality by cohort, by when you fixed, and I, as one member, would find it more appealing to try to fix the future inequality, while at the same time addressing some of the past inequality, based on when someone chose to consolidate that one time, and perhaps if your staffer at 9 percent wants to move over to this side of the aisle, she would be very, very welcome.

Chairman BOEHNER. Would the gentleman yield?

Mr. WU. Yes, absolutely.

Chairman BOEHNER. I appreciate the gentleman yielding.

And the way your proposal is structured to allow for a reconsolidation—or we will call it a second bite at the apple—and going to a variable rate, the variable rate part of it I think makes a great deal of sense.

The problem is—you have got two problems. You have got there is a cost associated with it, and I would suggest to you there is a real cost, you know, the paper that is out there and who is going to lose.

Secondly—and I think maybe even the bigger cost you cannot quite calculate—and that is the undermining of the paper for the student loan program in itself. If you look at the student loan program and the capital that comes to it, it is a very thin market, as opposed to home mortgages. There are very few players out there that are—I am talking about investors—that bring capital into this loan program, and frankly, we are dependent upon that capital in order to lend out to students.

Over the last two higher ed reauthorizations, there were serious cuts in fees and yields to lenders. There was a lot of money saved going after the lenders and after the servicers in order to spend it somewhere else.

I have to tell you, I have grave concerns. It came up earlier about going after lender yields. I think Mr. Miller brought up the subject.

You don't see people clamoring to get into this business. As a matter of fact, since the last reauthorization, you have seen an awful lot of people leave. You have seen an awful lot of originators—originators, people who originate loans—leaving the system. Of course, there are a lot of people in the consolidation business there today. But we have to be concerned about undermining the very paper, or the very foundation of the loan program, and that is the real huge under-estimated cost of reconsolidation.

I have to tell you, I have looked at—I have been looking for 2 years, trying to find a way to deal with reconsolidation. Now, I have not found one. I have not found one that does not cost billions and billions of dollars. As a result, really, I am kind of at a standstill.

Now again, I said this earlier, but let us go back to who these people are. These are the people that we guaranteed them a loan, guaranteed. There is a cost associated there.

It could have been a guaranteed subsidized loan, where we ate the interest for four or 5 years, or at least we deferred the interest for four or 5 years.

We gave them a deferment after they were out of school for 6 months. We gave them a chance to extend their payments based on their income. We gave them a chance to consolidate, if they wanted to. And now we are suggested THAT maybe we want to give them another bite at the apple.

My question is, what is fair?

If we are going to spend a lot of money at the back end of this program to reconsolidate at the expense of poor kids and moderate income kids who are trying to get into school, you know, as a public policymaker I would suggest that that does not seem to be fair, and as you all know, what we are trying to do here is to find a fair balance for students and those who are out of school. It is a tough choice. Go ahead.

Mr. WU. Mr. Chairman, reclaiming my time.

We have tried to propose this in a workable, responsible way, which holds costs down as much as possible to the taxpayer with a sense that that is ultimately where the cost is going to go. That

is why the origination fee is there, that is why the proposal is made with a variable rate and with a cap.

If we wanted to take a further step toward limiting the cost of reconsolidation or multiple reconsolidations, another concept that we could put on the table is limiting the multiple reconsolidations to those who have loans above a certain interest rate.

My understanding is that those cohorts are relatively small—that is, those people who have a big difference between the loans that they are holding and what is currently available on the market.

By doing that, we certainly hold down the cost, and I think that it is, in many situations, difficult to justify large inequities in the system, and for that consideration alone, perhaps we should look at those folks who have large deltas, large margins between what they are currently holding and what the market is, and that would further reduce the cost.

Chairman BOEHNER. Well, if the gentleman will yield?

Mr. WU. Yes.

Chairman BOEHNER. There is nothing that prevents someone who has already consolidated and does not like their interest rate, there is nothing to prevent them from going out and borrowing money in the real world, whether it be a home equity loan, borrowing any—there are all kinds of ways of financing all kinds of products.

But what you are suggesting is a Federal guaranteed loan. That means money, because our guarantee means that we are guaranteeing the lender they are going to get paid, and do not forget the serious problem we have of undermining the existing paper that is out in the market place, and I'm not sure anybody could calculate what that is worth.

The last point I would make is this. Let us say it cost $1. Let us just say it cost $1. That is $1 that could go to lowering origination fees, increasing loan limits, maybe something even on an enhanced Pell for kids.

It is—again, let us get back to this fairness question, as to what is fair for all who are part of the system. The chair would recognize Mr. Miller.

Mr. MILLER. No, I would just say you can argue this round or square, but the point is—I think Mr. Wu has raised it—if we are going to argue the fairness question, I think you have also got to incorporate in that the cost of the program.

You know, we have increased the subsidy in this program. We guarantee the loans. You know, I think if we are really going to talk about changing the program, we've got to lay all of the costs, all of the benefits down on the table—

Chairman BOEHNER. Which program?

Mr. MILLER.—and decide how you want to apportion this—

Chairman BOEHNER. Which program are we talking about?

Mr. MILLER.—between the cost of all the programs, whether it is the reconsolidation or it is the person getting out and making a choice of where they are going to enter. I mean, that is what has got to be done. I do not think you can look at one segment of this program and say, "Well, the costs of this are such that we are going to shift them over onto this population," you know.

Chairman BOEHNER. Well, if the gentleman will yield, you know, the proposal that—as most of you know—that I have been looking at is going to a variable rate for both the consolidation programs and the basic program itself. That is the marketplace.

The idea that the government can fix a rate, we can, but because it is guaranteed we take all of the risk, and the fact is that most of the marketplace is the variable rates for everything.

Yes, you can get a fixed rate on your mortgage, your home mortgage, and if you do, you are going to pay a much higher percentage, a much higher interest rate, because you want a fixed rate, and you want to lock it in.

But my goal here is to try to put this program, the entire student loan program, on a solid financial foundation for the long term, where we can control what our costs are, we know what our costs are, we know what the benefits are, and I think we can do that, but if there are other proposals that people want to pursue, I am happy to look at them.

I think the idea offered by Mr. Hoekstra, and personally, by Mr. Petri, to say in a consolidation program, "All right, you can have a choice, you can have fixed or you can have variable without the subsidy," and that fixed would be based on a market rate, means that someone who wanted to consolidate on a fixed basis, there would be a different rate, I'm sure, for 10 years, probably a little higher rate for 15, and maybe even a little higher rate for 30.

That is what the marketplace would probably dictate, because the longer you go, the more risk that you take and the higher the rate is going to be, and they may decide that makes sense. They may decide, "Well, let's go with a variable."

But the market should set the rates, and if the market sets the rates and people make choices, I think in the long run students, graduates, the government, and taxpayers are all better off.

I'm sorry. I forget that Mr. Wilson had not asked any questions yet. Would you like to ask questions, Mr. Wilson? You are recognized for 5 minutes.

Mr. WILSON. Thank you, Mr. Chairman. I, at this time, would like to submit a statement for the record.

[The prepared statement of Hon. Joe Wilson follows:]

Statement of Hon. Joe Wilson, a Representative in Congress from the State of South Carolina

Mr. Chairman, I want to thank you for convening this hearing today and I commend you for examining solutions on how to make college more affordable for every American. Many parents and high school students in South Carolina and around this great country are concerned that college is no longer affordable and students leave school with too much debt. The consolidation program alleviates much of this concern.

As we all well know, the cost of higher education has grown and today's college students will graduate with significantly more debt than when we last examined this issue 6 years ago. As a result, a number of graduates see their debt as unmanageable, and consequently, as imposing limits on their career choices, further depleting the pool who want to work in the public and non-profit sectors of the economy.

The federal student loan consolidation program benefits borrowers from a wide spectrum of professions. It is especially attractive to those graduates wishing to enter into public service, as evidenced by the fact that nearly 20% of student loan borrowers who choose to consolidate their student loans are nurses, teachers and civil servants. Further, by lowering monthly payments, the program gives the borrower more flexibility and decreases the probability of default.

This widely popular program has proven beneficial to the federal government as well. While consolidation loans are less profitable to lenders than the underlying student loans, the 0.5% origination fee and 1.05% portfolio fee paid to the federal government by consolidation companies have generated significant revenue for the federal treasury. These fees do not apply to other student loans.

Fixed rate consolidation loans provide a great benefit to recent college graduates. For many students, the cost of college is only realized after they graduate and start repaying their student loans. Changing the program to variable rates could double the cost of a college education. I thank the Chairman for this hearing, and I pledge during our Reauthorization of the Higher Education Act to work closely with him and my Committee Colleagues on this Consolidation portion of the legislation.

Mr. WILSON. Additionally, I would like to thank all of you for being here today, and Mr. Hamlett, in particular, I want to commend you, at your age, for being here. I am excited for you, as an undergraduate student, to be with such distinguished persons as you have to your right and to your left, and so thank you for coming.

Additionally, I have enjoyed the topic. I was a real estate attorney for 25 years, until 2 years ago when I was elected, so these issues—I have been at closings and seen the discussions, and with contracts of sale for decades now, and it is interesting to see how this relates, and I appreciate the Chairman educating me on the difference between a mortgage and a student loan which is subsidized.

So with that in mind, Dr. Shapiro, in your study—direct quote—"As a general proposition, economists usually favor adjustable interest rate debt instruments over fixed interest rate instruments because they make the economy more efficient." And can you just tell us what would be the decision factors as to which route to go, say as an economist, as a consumer, or as an individual?

Dr. SHAPIRO. The reason that economists generally prefer variable interest rate instruments over fixed rate instruments is that they reduce certain kinds of risk, and in particular, they reduce what economists call the wealth risk—that is, the value of the asset, of the loan, which changes if inflation changes in unexpected ways.

We have a projection of inflation which we build into long-term interest rates. Those are our inflationary expectations. We are sometimes surprised, and inflation is greater or less.

We had the kind of positive inflationary surprise in much of the 1990's, when we had less inflation than we expected, for various reasons. A variable rate instrument eliminates that risk, because it is adjusting at some regular interval to changes, whether they were anticipated or not, and consequently, it means that the resources can be distributed more efficiently.

Mr. WILSON. And how does this relate, say, to the consumer? What should they be looking at? Obviously, the short-term monthly payment, but how would the consumer look at this, or student?

Dr. SHAPIRO. Well, for a student, there is a—we say there is a risk associated with variable rates as well. It is called an income risk, rather than a wealth risk.

I think for a student, a student getting out of school, the most important economic consideration with respect to a consolidation loan is, frankly, not whether the rate is fixed or variable.

The most important consideration is that the loan, the duration of the loan is increased significantly, and that reduces the monthly payment; and most students, most new graduates are most concerned with their monthly payments, as are most new homeowners.

What is most attractive about a consolidation loan is it takes a 10-year loan and makes it a 15 or a 20, or a 25, or a 30-year loan, depending on the size of the total debt being consolidated. That advantage, from the point of view of the student, is there at any time.

I think the advantage of a variable rate, as opposed to a fixed rate for a student, there is an obvious advantage if they are consolidating at a time of high interest rates. When the interest rate goes down, their payment is going to go down.

The other advantage is that it is a—it means that the burden is, in some sense, predictable.

That is, it will increase or fall with the entire economy, and if changes in interest rates reflect changes in economic activity, which reflect—which lead to changes in income, then a variable rate allows an individual to feel some security that they will be able to adjust, that as conditions change they will be able to afford the interest payment on their loan.

Mr. WILSON. One final question, and it would relate again to variable interest rate loans. Is there a concern there may be more borrower defaults with the variable rate, or how would you address that?

Dr. SHAPIRO. Well, one of the primary purposes of the consolidation program was to reduce defaults, and the way it primarily did that, again, was by reducing the monthly payment by stretching, by extending the duration of the loan, and I think that it depends on when you consolidate it, sir.

Mr. WILSON. Right.

Dr. SHAPIRO. If you consolidated at 9 percent or 8.25 percent, which is the cap since 1997, you may be much more inclined to default in an interest rate environment of 3 percent. You are continuing to carry relatively high payments.

If, look, if we offer, you know, large numbers of people the opportunity to consolidate a large amount of loans at 3.5 or less, I mean, if you do it in the 6-month grace period today, something I would recommend to Mr. Hamlett, you get another benefit, and it is actually, the interest rate is about 2.8 percent on current consolidated loans if you do it in the first 6 months after leaving school.

Chairman BOEHNER. Mr. Hamlett, have you got that?

Mr. WILSON. Thank you very much. And I noticed Mr. Hamlett wrote notes.

Chairman BOEHNER. OK. Well, let me thank our witnesses for their patience and their valuable information, and all of those who have come today for your patience. It was a long day, but I think that the information that was presented was very helpful to the Committee, and I thank you.

This hearing is adjourned.

[Whereupon, at 1:38 p.m., the Committee was adjourned.]

[Additional material submitted for the record follows:]

Statement of Hon. Charlie Norwood, a Representative in Congress from the State of Georgia

Mr. Chairman I thank you for holding today's hearing to examine the future of the Federal Consolidation Loan Program. I look forward to the testimony of our witnesses, and as always, I appreciate their expertise in shedding light on this critical issue the Committee must consider as we continue to strengthen American Higher Education policy.

More and more students each year are attending institutions of higher learning. As a result, the demand for student loans and financial assistance to help pay for the rising cost of an education at an American university is increasing as well. This rising demand for assistance in an era of economic change has created new challenges for the federal government, and we must therefore examine all aspects of our policy regarding federal aid; including the Consolidation Loan Program (CLP).

Born during the reauthorization of the Higher Education Act in 1986, the CLP provides an opportunity for borrowers with more than one loan holder and a high debt level to consolidate that debt into one monthly payment under one lender. This gives borrowers the ability to stretch out a loan repayment period to a maximum of 30 years, which lowers their monthly payment, at a fixed interest rate determined by the weighted average of the loans being consolidated.

Since the inception of the CLP in 1986, and especially since 1994, graduates have increasingly taken advantage of the program as interest rates have declined—spurred on by new organizations that exist specifically to aggressively market consolidated loans by way of mail, phone, and the Internet.

And while the proliferation of the consolidated student loan certainly has allowed borrowers to save considerable sums over their loan repayment period at a low fixed rate, the savings do not come without cost to the American taxpayer. In fact, the government pays subsidies (in the form of deferments interest paid on behalf of the borrower and allowances paid directly to vendors) to cover the cost of these consolidated loans over the life of their repayment period. This amounts to yet another burden on the American taxpayer to cover the cost of consolidated loans, even when it is unclear that a borrower needs to consolidate their loans.

Mr. Chairman it is important for this Committee to take these considerations to heart as we continue the Reauthorization process for the Higher Education Act. Is the CLP fulfilling its original intent in light of recent trends in light of recent trends? Should the taxpayer continue to finance and subsidize the CLP at a fixed rate; or should Congress explore a variable rate structure to make the system more equitable? More importantly, should taxpayers continue to subsidize borrowers at a low fixed rate at the expense of providing access to students entering and attending post secondary education?

It is critical to find commonsense answers to these questions if Congress is to ensure the future of the CLP in a fiscally responsible way. Borrowers must continue to enjoy access to consolidated loans over the lifetime of a long-term repayment period; but Congress must also ensure that students seeking access to higher education have the resources necessary to achieve their dreams.

Mr. Chairman I look forward to hearing our witness' thoughts on how Congress can achieve both of these worthy goals as we continue to work towards Reauthorization of the Higher Education Act, and thank you for providing continued leadership on this very important issue.

I respectfully yield back the remainder of my time.

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