Federal Student Loans:
An Introduction to Federal Family Education Loans & Direct Lending

I. Federal Student Aid: Overview

Since the enactment of the Higher Education Act of 1965, the federal government has helped make college more accessible to American students through its student aid mechanisms, including grants, loans, and tax deductions.

- **Grants** are given primarily to *low-income students* and do not have to be repaid. (*Approximately $18.2 billion distributed in 2004.)*

- **Loans** are made available to *all students* who have completed a FAFSA and must be repaid starting 6 months after leaving school. (*Approximately $62 billion originated in 2004.)*

- **Tax deductions** were created in the 1990s to help middle-class families with college tuition. *(Approx. $8 billion in tax benefits claimed in 2004.)*

II. Federal Loan Programs: An Introduction & Key Differences

A. Starting in 1965, the federal government made student loans available to students through its ***Federal Family Education Loan Program (FFELP)***. This federal program uses *student loan lenders* to originate and service loans, while providing taxpayer subsidies to cover risk and ensuring a profit for lenders.*($46.7 billion/77% originated)*

B. In 1994, the ***William D. Ford Direct Loan Program (DL)*** was created as an alternative lending program in response to borrower and college concerns with FFELP. The *Department of Education* originates and services loans directly rather than subsidizing lenders to perform these tasks. *($13.8 billion/23% loans originated)*

C. Differences in Characteristics:
Both loan programs fall under Title IV of the Higher Education Act and serve the same population of borrowers. Both programs lend the same size loans:

	FFELP	**Direct Loans (DL)**
Loans Offered[i]	Subsidized Stafford, Unsubsidized Stafford, and Parent "PLUS" Loans	Subsidized Stafford, Unsubsidized Stafford, and Parent "PLUS" Loans
Loan Limits/Rates: **Stafford** **PLUS**	Same Loan Limits 6.8% *(fixed rate)* 8.5% *(fixed rate)*	Same Loan Limits 6.8% *(fixed rate)* 7.9% *(fixed rate)*
Loans Originated	Originated by lenders at the market Commercial Paper (CP) rate	Borrowed directly from the Treasury at 10 year Treasury (T-bill) rate.

	FFELP, cont.	Direct Loans, cont.
Loans Serviced by	Multiple Loan Servicing Agents, Secondary Market Purchasers	Single (competitively-bid) private contractor for the Department of Education
Costs to Taxpayers/Subsidies ***(See Section D)***	Guaranteed Rate of Return, Subsidy Payments Guarantee Agency Fees, Defaults, Collection Fees	Administration, Defaults
Repayment Plans	Standard, Graduated, Extended, and Income-Sensitive	Standard, Graduated, Extended, and Income-Contingent
Actual Cost to Taxpayers:	**$10.74 / per $100 Loaned***	**$3.67 / per $100 Loaned***

D. Key Differences in Subsidies:

Despite the structural differences between the two, **both are government programs**. However, there are critical differences in the costs to taxpayers:

COST OF MONEY:

FFELP: Lenders borrow capital at the Commercial Paper (CP) rate . (*ex*. Today: 5.24%)
DL: Department borrows capital at the 10 year T-Bill rate. (*ex*. Today: 4.90%)

Difference: *The Direct Loan program can originate loans for less than FFELP lenders.*

GUARANTEED RATES OF RETURN:

FFELP: Lenders are guaranteed a certain rate of return, or profit, for their participation in the federal loan program.

When the market rate is higher than the federal loan interest rate, the government makes quarterly subsidy payments to make up the difference between the payments from the borrower and what the lender could be earning outside of the federal loan program.

DL: As there is no guaranteed rate of return needed for the Department, there is no comparable subsidy.

Difference: *With no comparable subsidy in the DL program, this is where the bulk of the difference in cost lies between the two programs.*

ORIGINATION/GUARANTEE FEES:

FFELP: 2% Origination Fee
\+ 1% Guarantee Fee = Cost to Borrowers: 3%

DL: 2% Origination Fee = Cost to Borrowers: 2%

Difference: *There is no guarantee fee in the DL program, meaning it costs borrowers 1% less than FFELP. Unfortunately, the 2% origination fees are passed on to borrowers in both programs.*

FEDERAL REINSURANCE/DEFAULT:

FFELP: The federal government reinsures 97% of a student loan to reduce nearly all risk of default to the lender or secondary loan-holder.

DL: As the government holds the obligation, it is responsible for 99% of the liability in the case of default.

Difference: *Under both programs, taxpayers carry the liability in the case of default. The "market-based" FFELP requires taxpayers to insure nearly as much as government-held loans.*

CONCLUSION:

Total Student Loan Subsidy Costs, 1992 - 2006*

FFELP:	$56.0 billion
DL:	$ 6.3 billion

Program Cost Differences*

Current Structure Cost (FFELP&DL):	$5.5 billion
If All Loans Were DL *(Same Volume of Loans Originated):*	$2.2 billion
Total Annual Savings *(If All Loans DL):*	$2.8 billion

Difference: *The numbers are clear: greater use of the Direct Loan program would save taxpayers billions in unnecessary subsidies each year.*

President's FY2007 Budget Appendix, page 367.

Calculating Federal Loan Costs:

Under the Credit Reform Act of 1990, fiscal year costs are determined by the net present value of the costs to the government over the lifetime of new loans.

In other words, the costs you see on this document do not represent the amount of loans originated, but rather the final cost to taxpayers over the life of the loan.

III. Summary:

Unfortunately under the current structure, there is no market competition in FFELP, which nullifies the primary argument for subsidizing lenders to originate and service loans at a greater cost to taxpayers. Furthermore, the current structure offers no incentive for FFELP lenders to be more competitive, which would benefit borrowers and taxpayers.

- All lenders are guaranteed identical subsidies, regardless of their costs, efficiency, etc.

- All lenders compete among themselves for market share, but not to the benefit of taxpayers.

- All lenders offer the same rates on federal student loans. The only variation between lenders is in minor rate reductions for e-filing and on-time payments - but even these are fairly standard between lenders.

IV: Conclusion:

The DL program borrows funds at a less expensive rate and needs only to recover the initial investment, not ensure a profit in the process, making it fundamentally more efficient for taxpayers than FFELP.

Prepared by the Office of Representative Tom Petri (R-WI)
For more information, please contact Thomas Culligan at 202-225-2476

[i] There is also a small discretionary loan program called Perkins that involves matching funds from the colleges.