

President Obama's Fiscal 2010 Budget Overview

Making Student Loans More Reliable and Funding Larger Pell Grants

Background: Most students are eligible for Federal Subsidized and Unsubsidized Stafford Loans, up to certain limits, to cover college expenses. These loans require no credit check, carry an interest rate of not more than 6.8 percent, and include helpful borrower protections and assistance during repayment. The government makes interest payments on Stafford Loans while students are in school. Credit-ready parents of dependent undergraduates are also eligible for Federal PLUS Loans with an interest rate of not more than 8.5 percent. Graduate and professional students are eligible for both Stafford and PLUS loans.

These federal loans are processed and delivered in two ways, depending on whether a school has chosen to participate in the Federal Family Education Loan (FFEL) or the Direct Loan program. FFEL operates through entitlements for lenders: a lender is able to acquire funds from investors by virtue of the promised federal guarantee on the student loans. The lender and intermediary agencies (often affiliated with states) receive entitlement subsidies at levels set by Congress. In the Direct Loan program, the federal government uses competitive Treasury auctions to acquire capital for student loans from private investors. Schools interact with the Department through the same system used to disburse Pell Grants. In the Direct Loan program, the Department of Education utilizes private-sector companies (many of which also perform services in FFEL) through the competitive contracting process to disburse, service, and collect loans.

FY 2010 Budget Proposal: The Budget proposes to end entitlement subsidies to student loan lenders on all new federal student loans starting July 1, 2010. In preparation for the transition, the Department is on track to have additional private sector loan servicers under contract by the summer of 2009 to cover increases in Direct Loan volume. A consolidated student loan program would be more efficient and less expensive, helping to finance substantially larger Pell Grant scholarships for low-income students.

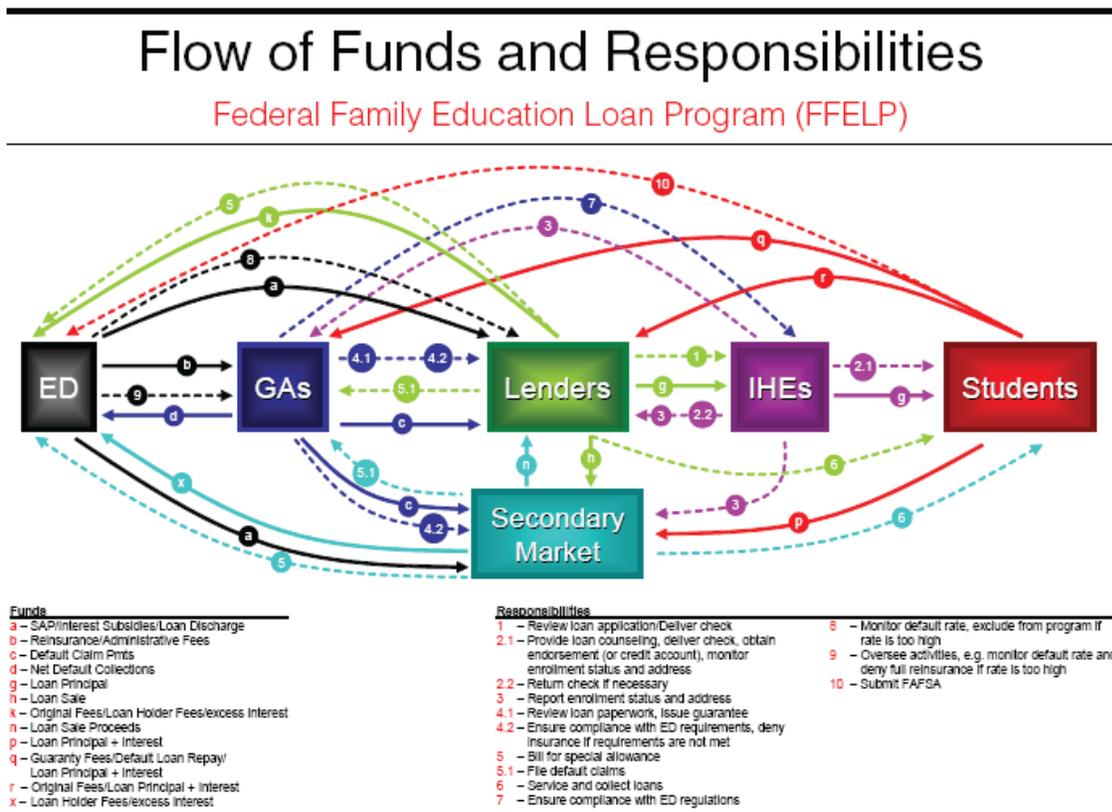
The Budget also increases the Department's administrative capacity so that it can assist colleges in making the transition from the current FFEL system to Direct Loans. FFEL processors would continue to receive federal subsidies for new loans originated in the 2009-2010 academic year and prior academic years under the regular FFEL program and the emergency programs established by the Ensuring Continued Access to Student Loans Act of 2008.

Results:

- **The turmoil in the financial markets has demonstrated the hazards of politically-determined subsidies.** FFEL subsidies were recognized by both the Clinton and Bush administrations to be excessive, but with the credit crunch they suddenly became inadequate. Congress was forced to intervene, allowing the federal government to buy loans from FFEL

lenders. In many cases, students were forced to change lenders and now will need to consolidate their loans or repay multiple loans each month.

- **The federal student loan programs will be greatly simplified.** The FFEL program has always been complex. In response to Congress’s intervention, the last administration added further complexity by creating federal financial support systems to maintain the profitability of FFEL participation. The chart below shows the needlessly complex payment streams underlying the FFEL subsidy scheme:



Source: Government Accountability Office (GAO)

- **The Direct Loan program, which uses market processes to determine subsidy payments to servicers, has suffered no disruptions and continues to function at lower cost to taxpayers.** The Administration’s goal is to continue to tap low-cost, stable sources of capital so students are ensured access to loans, while providing high-quality services for students by using private sector companies to originate and service loans.
- **Because the Direct Loan program uses competitively set payments, it involves fewer transactions, is easier to manage, and costs taxpayers much less to operate.** In 2010, a \$5,000 Direct Loan will cost the government about \$304 less than a comparable loan in FFEL. If lifetime of loan administrative costs are included, a \$5,000 Direct Loan would cost

over \$200 less than a comparable loan in FFEL. While colleges currently choose between programs, they do not pay the added costs the choice of FFEL loans imposes on taxpayers.