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Rethinking the Middleman

Federal Student Loan Guaranty Agencies

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Executive Summary

Each year, the federal government guarantees billions of dollars in loans disbursed through the Federal Family Education Loan (FFEL) Program, a public-private partnership that provides financial aid to students attending institutions of higher education. Despite the significant investment of taxpayer dollars, the actual administration of the FFEL Program is largely handled by participating lenders and a group of 35 non-federal guaranty agencies across the country. Guaranty agencies perform a number of administrative functions, such as disbursing federal default insurance provided to private lenders issuing FFEL loans, preventing loan default, and collecting or rehabilitating loans that borrowers have failed to repay.

The current role for guaranty agencies in the FFEL Program is a reflection of historical responsibilities given to them by federal policymakers when the first national student loan program began in 1965. Legislative changes and events over the past several decades have expanded the U.S. Department of Education's financial role in the FFEL Program, rendering many of the traditional functions of guaranty agencies unnecessary.

The compensation model under which guaranty agencies operate also raises concerns, as the current structure imposes unnecessary costs on taxpayers and creates opportunities for waste and abuse. Moreover, it contains contradictory incentives for guaranty agencies that reward them both for assisting struggling borrowers and for collecting defaulted student loans. Affiliations between many agencies and student loan companies pose further policy problems, as these relationships can undermine default prevention incentives for lenders making FFEL loans and make it impossible for guaranty agencies to carry out their required oversight functions as a neutral party. Unfortunately, meaningful debates about the problems inherent in the way guaranty agencies currently operate are obscured because the agencies often use excess federal subsidy dollars for college outreach or planning activities.

If policymakers wish to keep guaranty agencies in the federal student loan program, they should take several steps to update and reform the roles these agencies play. The U.S. Department of Education should take on guaranty agencies' default insurance administrative role, ending any subsidies associated with this function and returning federal assets held in trust for this purpose. Concerns about conflicts of interest should be addressed by terminating the relationships between lenders and guaranty agencies and tasking the U.S. Department of Education with all FFEL oversight responsibility. Competing financial incentives for default aversion versus loan collection or rehabilitation should be eliminated by assigning these duties to two separate and non-overlapping groups of competitively selected federal contractors. Finally, college outreach and planning activities performed by guaranty agencies should be funded by a separate open competitive grant structure that includes an accountability framework for measuring effectiveness. Collectively, these changes would alleviate many concerns about guaranty agencies by transforming them from middlemen into useful components of a modern student loan program.

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Each year, the federal government spends billions of taxpayer dollars to provide loans to students pursuing a postsecondary education. These funds are distributed primarily through the Federal Family Education Loan (FFEL) Program, a public-private partnership initiated in 1965. The federal government provides subsidies through the FFEL Program to student loan companies to market, originate, and service loans with more favorable borrower terms than the private market provides. Despite the large public investment, the federal government plays a small role in the daily operations of the program.

In fact, the FFEL Program is largely administered by participating lenders and a group of 35 non-federal agencies located across the country. Known as guaranty agencies, these entities perform administrative functions, such as paying the federal default insurance provided to lenders issuing FFEL loans, preventing loan default, and collecting or rehabilitating loans that borrowers have failed to repay. While these functions are essential to the successful operation of a national student loan program, the current role guaranty agencies play introduces unnecessary inefficiency and complexity, increasing the program's costs to taxpayers through needless administrative payments and opening several avenues for waste and abuse.

Guaranty agencies exist in the FFEL Program for historical reasons, not because they serve a current public policy purpose. While they were a central part of the original federal guaranteed loan program developed in the 1960s, their role has become less relevant over time. Policymakers, however, have preserved the agencies, making ad hoc, piecemeal reforms over several decades. As a result, many of the roles guaranty agencies currently play are inefficient and unnecessarily costly for federal taxpayers. Furthermore, policymakers have created incentives for guaranty agencies that run counter to the interests of students and taxpayers. Close business relationships with student loan companies have exacerbated many of these problems.

If policymakers wish to address these issues and keep guaranty agencies in the federal student loan program, they should take several steps to update and change the roles these agencies play. These changes should reflect the current policy and administrative needs of the federal government. Federal payments to guaranty agencies should be replaced with a federal contractor system that compensates guaranty agencies solely for providing neutral advice to struggling student loan borrowers. Such changes will also necessitate the elimination of ties between guaranty agencies and student loan companies. Collectively, these reforms would make guaranty agencies an important part of a modern federal student loan program, rather than an unnecessary middleman.

Federal Student Loan Guaranty Agencies: Description and History

The FFEL Program statute mandates that guaranty agencies be public or not-for-profit agencies. Their primary role is to administer federal insurance against default losses given to lenders making FFEL loans.[1] Guaranty agencies must also provide student loan borrower services on behalf of the federal government, such as assisting in default prevention and collecting or rehabilitating defaulted loans. Each state must select a designated guaranty agency to perform these functions for loans issued in the state. According to federal law, guaranty agencies must also encourage private lenders to participate in the FFEL Program and must provide lender-of-last-resort loans to borrowers who are unable to obtain a FFEL loan from a private lender.[2]

The 35 guaranty agencies operating today can be grouped into three categories. Five agencies, such as Massachusetts' American Student Assistance, are considered the most basic because they are stand-alone entities that perform only federally mandated administrative functions. Most guaranty agencies, however, serve as both a federal guaranty agency and as a state governmental agency. The 21 agencies that fall into this category perform FFEL administrative functions and typically administer state-sponsored grants or loan programs as well. Colorado's College Assist is one such example. The remaining eight agencies, such as United Student Aid Funds and the guaranty agencies in New Hampshire and South Carolina, represent a third type of federal guaranty agency: nonprofit entities that partner in some capacity with student loan companies. (See the text box for more information on two specific guaranty agencies.)

Guaranty agencies' myriad responsibilities within the FFEL Program reflect decades of federal student loan policy evolution. They began with limited roles, but legislative changes since the 1960s assigned them an increasing number of tasks. Consequently, guaranty agencies' purpose and responsibilities in the FFEL Program have become complex, unclear, and at times counterintuitive.

The first guaranty agencies predate federal efforts to create a national guaranteed student loan program. They

Guaranty Agencies at a Glance

New York State Higher Education Services Corporation

The New York State Higher Education Services Corporation (NYHESC) serves as the designated guaranty agency for the state of New York. In fiscal year 2008, NYHESC guaranteed $3.5 billion worth of federal student loans, the sixth largest amount of any guaranty agency.[1] Over that same period, the guaranty agency received a total of $120.2 million in federal payments for its FFEL roles, including issuing guarantees, maintaining its existing portfolio of FFEL loans, providing default aversion assistance to borrowers, and collecting on defaulted student loans, among other activities.[2]

Since it is a state agency, NYHESC performs other postsecondary education roles in addition to its functions as a federal guaranty agency. It oversees and disburses several state grant programs, such as the Tuition Assistance Program. It also works with the Office of the State Comptroller to administer New York's college savings programs. Though NYHESC does not issue FFEL loans, it will begin offering its own non-federal student loans in the spring of 2010.[3]

New Hampshire Higher Education Assistance Foundation

The New Hampshire Higher Education Assistance Foundation (NHHEAF) is the guaranty agency component of a group of organizations that provide loans, loan guarantees, and grants to students in New Hampshire.[4] It is one of the smallest guaranty agencies in the FFEL Program, having guaranteed only $212.0 million in the 2008 fiscal year.[5] During that same time period, NHHEAF received $4.3 million in federal payments for its role as a guaranty agency.[6]

NHHEAF is a nonprofit agency that is part of a unique corporate structure, which allows a third-party contractor to handle lending and guaranty agency functions without any separation. A nonprofit management company, Granite State Management and Resources, performs all of NHHEAF's functions through a contractual relationship.[7] That same management company has similar agreements with the New Hampshire Higher Education Loan Corporation, a FFEL lender, and the NHHEAF Network Educational Foundation, which uses its own funds to make grants to students and organizations within the state.

1 Financial Aid Professionals, *Federal Student Assistance Programs—Loan Volume Updates, 4th Quarter FY 2008*, (Washington, DC: U.S. Department of Education, 2009), www.ed.gov/finaid/prof/resources/data/08q4ffelpga.xls.

2 U.S. Office of Federal Student Aid, *Guaranty Agency Federal and Operating Fund Data (FY 2006-2008)*, (Washington, DC: U.S. Department of Education: 2009), www.fp.ed.gov/fp/attachments/publications/GAsFederal&Opfunds06-08withoutpercentdiff.pdf, 20.

3 "New York Higher Education Loan Programs," *New York State Education Services Corporation, www.hesc.com/content.nsf/SFC/4/New_York_Higher_Education_Loan_Program_NYHELPs*

4 "The NHHEAF Network Organizations," *New Hampshire Higher Education Assistance Foundation Network*, www.nhheaf.org/index.asp?page=abt.

5 Financial Aid Professionals, *Federal Student Assistance Programs—Loan Volume Updates, 4th Quarter FY 2008.*

6 U.S. Office of Federal Student Aid, *Guaranty Agency Federal and Operating Fund Data (FY 2006-2008)*, 17.

7 According to its 2007 tax filing, Granite State Management and Resources works with the NHHEAF guaranty agency, lender, and charitable foundation to administer their functions. "Fiscal Year 2007 Form 990," *Granite State Management and Resources* (Washington, DC: Guidestar.org, 2008), www.guidestar.org/FinDocuments/2008/020/404/2008-020404239-04bbbeef-9.pdf, 3.

began as state-sponsored entities when Massachusetts established the Massachusetts Higher Education Assistance Authority in 1957, an agency that was expected to use state and private funds to provide default insurance on loans made to Massachusetts students.[3] Twenty additional states established agencies over the next eight years.[4] Because these early guaranty agencies operated only within their respective states, most students still lacked access to subsidized loans.

In 1965, Congress created the Guaranteed Student Loan (GSL) Program, which offered subsidies and incentives for states to create their own loan programs run by local guaranty agencies.[5] Congress also created the Federal Insured Student Loan (FISL) Program to provide a federal guarantee on loans issued by private companies to ensure borrowers would have access to loans while states set up their loan programs or guaranty agencies. Congress expected FISL would phase out as more states created loan programs and guaranty agencies.

The state-based, federally sponsored student loan system quickly proved unsustainable, as many of the new state agencies ran out of funds. As a result, more students and loan providers relied on the FISL Program than initially expected, overwhelming its administrative capacity and funding.[6] To address these issues, federal lawmakers increased incentives for states to fund their own loan programs, and most importantly, passed legislation in 1976 that required the federal government to cover all lender default losses on loans made through the GSL Program.[7]

Subsequent congressional action in the 1970s successfully convinced states to set up guaranty agencies and loan programs. Lawmakers provided federal advances to states and encouraged them to finance federally backed student loans with tax-exempt bonds.[8] States quickly took advantage of this lucrative provision that allowed them to earn income from the interest rate differences on tax-exempt bonds and student loans.[9] As a result, the number of guaranty agencies increased from 26 to 50 between 1976 and 1981.[10] This allowed Congress to phase out FISL and replace it with a new national student loan program.[11] This program, however, did not require the state investment in guaranty agencies that was the foundation of Congress's early student loan policy designs.

The legislative changes of the 1970s had two major unintended consequences. Many states using tax-exempt bonds to issue or purchase federally backed student loans began to combine or establish close contractual arrangements between state affiliated student loan companies and their federal guaranty agencies. Though this made it easier for states to administer their own loan or scholarship offerings (separate from the federal program), these relationships would prove to be problematic in the future.

The significant spread between the financing cost of a tax-exempt bond and the interest paid by borrowers on a student loan also allowed guaranty agencies to accumulate significant monetary reserves.[12] The U.S. Department of Education expressed concerns about this matter in a 1982 letter to guaranty agencies, stating, "It seems clear that it was never the intent of the Congress that guarantee agencies should get 'rich' as a result of these incentives."[13] In 1983, guaranty agencies held reserves "greater than the agencies' total operating expenditures for fiscal year 1983 and greater than their operating expenditures for fiscal years 1981 and 1982 combined."[14] After reserve levels continued increasing despite repeated warnings, the U.S. Department of Education under the Reagan administration withheld payments to guaranty agencies and successfully recalled $25.6 million from the nearly $1 billion held by guaranty agencies in 1988.[15] The U.S. Department of Education also filed lawsuits against 22 guaranty agencies to reclaim $200 million in reserves.[16]

Concerns about reserve accumulation were set aside, however, as the tax-exempt bond issue gave way to a different policy problem for guaranty agencies: The high federal student loan default rates in the late 1980s that threatened to destabilize the entire program. Encouraged by federal subsidies and legislative changes in the 1970s that expanded the size of the student loan program by removing income caps on eligibility, guaranty agencies began to guarantee federally insured loans for riskier borrowers.[17] The Higher Education Assistance Foundation (HEAF), a national guaranty agency based in Minnesota, was one of the most aggressive agencies in this regard, guaranteeing most of its loans to students at for-profit institutions of higher education.[18] Because large percentages of students at these institutions failed to pay back their loans, HEAF's default rate rose as high as 35 percent.[19] The need for large numbers of default payments led HEAF to quickly exhaust its reserves, and in 1990 it informed the U.S. Department of Education that it was on the verge of bankruptcy.[20]

Table 1. Federal Student Loan Guaranty Agencies

Agency Name	Status	Designated States	State Grant Administrator	FFEL Lender Affiliated
American Student Assistance	Nonprofit	DC, MA		
Colorado Student Loan Program—College Assist	State	CO	√	√
Connecticut Student Loan Foundation	Nonprofit	CT		√
EdFund/California Student Aid Commission	Nonprofit	CA	√	
Education Assistance Corporation	Nonprofit	SD		√[a]
Educational Credit Management Corporation	Nonprofit	OR, VA		
Finance Authority of Maine	State	ME	√	√
Florida Office of Student Financial Assistance	State	FL	√	
Georgia Student Finance Commission	State	GA	√	√
Great Lakes Higher Education Guaranty Corporation	Nonprofit	MN, OH, WI		
Illinois Student Assistance Commission	State	IL	√	√
Iowa College Student Aid Commission[b]	State	IA	√	
Kentucky Higher Education Assistance Authority	State	AL, KY	√	√
Louisiana Office of Student Financial Assistance	State	LA	√	
Michigan Guaranty Agency	State	MI	√	√
Missouri Department of Higher Education	State	MO	√	
Montana Guaranteed Student Loan Program	State	MT	√	
Nebraska Student Loan Program	Nonprofit	NE		√[c]
New Hampshire Higher Education Assistance Foundation	Nonprofit	NH		√
New Jersey Higher Education Student Assistance Authority[d]	State	NJ	√	
New Mexico Student Loan Guarantee Corporation	Nonprofit	NM		√

Agency Name	Status	Designated States	State Grant Administrator	FFEL Lender Affiliated
New York State Higher Education Services Corporation[d]	State	NY	√	[d]
North Carolina State Education Assistance Authority	State	NC	√	√[e]
Northwest Education Loan Association	Nonprofit	ID, WA		√[f]
Oklahoma Guaranteed Student Loan Program	State	OK	√	
Pennsylvania Higher Education Assistance Agency—AES	State	DE, PA, WV	√	√
Rhode Island Higher Education Assistance Authority	State	RI	√	√[g]
South Carolina State Education Assistance Agency	Nonprofit	SC		√
Student Loan Guarantee Foundation of Arkansas	Nonprofit	AR		
Student Loans of North Dakota	State	ND		√
Tennessee Student Assistance Corporation	State	TN	√	
Texas Guaranteed Student Loan Program—TG	Nonprofit	TX		
United Student Aid Funds	Nonprofit	AZ, HI, IN, KS, MD, MS, NV, WY		√[f]
Utah Higher Education Assistance Authority	State	UT	√	√[h]
Vermont Student Assistance Corporation	State	VT	√	√

Source: New America Foundation.

[a] *The Education Assistance Corporation also manages the Educational Assistance Service Company Inc., a subsidiary that originates and services FFEL loans. In February 2009, EAC announced a new partnership with Great Lakes in which that agency will take over all of its guarantees, likely phasing out the servicing division as well.*

[b] *Until 2008, the Iowa College Student Aid Commission (ICSAC) and Iowa Student Loan Liquidity Corporation, a nonprofit lender, each had a representative on the other's board of directors. The ISCAC also used to purchase defaulted private loans from the nonprofit lender.*

[c] *According to its 2008 tax filing, the Nebraska Student Loan Program paid $4.8 million to Nelnet, a for-profit loan company, for loan servicing.*

[d] *Offers alternative student loans but is not a FFEL lender.*

[e] *Partners with the College Foundation of North Carolina, which is a FFEL lender.*

[f] *Has a close existing relationship with Sallie Mae.*

[g] *Is a related party to the Rhode Island Student Loan Authority, a nonprofit lender with which it shares office space.*

[h] *Runs a secondary market in which it purchases and then services loans.*

HEAF's lack of reserves created problems because program rules did not allow lenders to receive reimbursement for defaulted student loans directly from the U.S. Department of Education. It could only reimburse HEAF for any claim payments HEAF actually made to lenders, rather than provide funds for payments the guaranty agency owed. Since HEAF had no remaining funds to make reimbursement payments, the default insurance on every federal student loan it guaranteed became worthless. If the federal government had allowed HEAF to fail, private lenders would likely have abandoned the guaranteed loan program, causing it to collapse.

In response to HEAF's insolvency and the crisis a failing guaranty agency posed for the loan program, federal policymakers agreed to pay lender default claims, regardless of whether the guaranty agency used its own holdings to make the initial payment.[21] Although this move restored confidence in the program, it meant that guaranty agencies were no longer necessary to provide default insurance—their most important role in the program. This policy change represented the final break with the initial state-based vision of a federal student loan program.

After tightening accounting rules for guaranty agencies in the wake of the HEAF failure, Congress further increased federal oversight in 1998. This move cemented guaranty agencies' role in the student loan program as passive trustees of federal dollars. The agencies were now required to segregate their funds into two separate accounts: a federal fund and an operating fund. The federal fund is used to pay lender default claims and is considered a federal asset.[22] Its uses are strictly controlled by federal statute, and the funds held in it are subject to recall by Congress.[23] By contrast, the operating fund is owned by the guaranty agency, and it supports all other FFEL administrative activities, such as borrower assistance and defaulted loan collection.[24] Payments the agency receives from the federal government for services it provides are held in this account.[25] Table 2 shows the cumulative federal and operating fund amounts for guaranty agencies at the end of the 2008 fiscal year.

The 1998 legislative changes also altered the structure of guaranty agencies' federal compensation for default prevention. All guaranty agencies became eligible for a new default aversion fee, which pays 1 percent of the outstanding balance of a loan in exchange for assisting borrowers who fall behind on payments.[26] Separately, a handful of agencies significantly reformed their federal compensation structure through the Voluntary Flexible Agreement (VFA) pilot program. The participating agencies, which included guaranty agencies based in Massachusetts, Texas, and Wisconsin, turned lender default insurance responsibilities over to the U.S. Department of Education by returning federal fund holdings and instead received greater compensation for preventing student loans from defaulting.[27] The VFA program operated until January 1, 2008, when the U.S. Department of Education terminated the initiative on the grounds that it was not cost neutral to the government.[28]

This long and complicated policy history has resulted in a frequently inefficient and unnecessarily costly role for guaranty agencies. These issues are exacerbated by the fact

Table 2. Guaranty Agency Federal and Operating Fund Amounts
Fiscal Year 2008 ($ in billions)

Account	Amount
Federal Fund	$1.63
Operating Fund	$1.80

Source: U.S. Department of Education.

Table 3. Guaranty Agency Fees and Payments
Fiscal Year 2008 ($ in millions)

Fee or Payment	Amount
Loan Processing and Issuance	$203.9
Account Maintenance	$237.9
Default Aversion	$177.3
Collections	$948.8

Source: U.S. Department of Education.

Table 4. Lender and Guaranty Agency Defaulted Student Loan Reimbursement (%)

Loan Disbursement Date	Lender Reimbursement	Guaranty Agency Reimbursement[a]		
		Default rate less than 5 percent	Default rate between 5 percent and 9 percent	Default rate greater than or equal to 9 percent
Before 10/1/93	100	100	90	80
10/1/93–9/30/98	100	98	88	78
10/1/98–6/30/06	98	95	85	75
7/1/06–9/30/12	97	95	85	75
On or after 10/1/12	95	95	85	75

Source: New America Foundation; U.S. Department of Education.

[a]*Guaranty agency reimbursements are percentage of the reimbursement payment made to the lender.*

that policymakers have repeatedly created incentives and fees for guaranty agencies that run counter to the interests of both borrowers and taxpayers.

Guaranty Agency Functions, Fees, and Payments: Inefficiencies and Poorly Designed Incentives

Federal policymakers have tied the many roles performed by guaranty agencies in the FFEL Program to a complex compensation system. These fees and payments are poorly structured, compensating guaranty agencies for antiquated functions and rewarding them for contradictory activities. Table 3 shows the size of the subsidies and payments paid to all guaranty agencies in the 2008 fiscal year.

Default Insurance: An Unnecessary Historical Subsidy

Guaranty agencies were initially expected to insure student loans against default so that a private company would be willing to offer favorable loan terms to borrowers.[29] Although that model persists today, the federal government funds the insurance, while guaranty agencies serve as a trustee of these federal funds and are exposed to minimal financial risk. Policymakers have preserved guaranty agencies' historical role without requiring risk or cost sharing, effectively making them well-compensated middlemen. This system results in unnecessary federal subsidies and inefficiency. It also means that taxpayers are still subject to nearly all losses on a defaulted federal student loan.

Today, when a borrower fails to repay his or her federal student loan for over 270 days, private lenders can file an insurance claim with a guaranty agency to recover 97 percent of the outstanding balance.[30] The guaranty agency then issues a claim payment to the loan holder through its federal fund—a discrete account that holds federal assets. The president's budget request for the 2010 fiscal year estimated that the 35 guaranty agencies hold a total of $1.63 billion in these funds.[31] The U.S. Department of Education then reimburses the guaranty agency for a percentage of the claim payment made, a process called reinsurance.[32] Guaranty agencies may receive lower reimbursement rates if a high percentage of their guaranteed loans default. Table 4 shows lender and guaranty agency reimbursement rates based upon loan disbursement date and guaranty agency default rate.[33] Lower reimbursement rates are meant to prevent agencies from shirking default prevention tasks, but ultimately have little effect because these penalties are more than offset by the payments guaranty agencies receive for the separate activities of collecting or rehabilitating defaulted student loans.[34]

In addition to reimbursement, the federal government pays guaranty agencies two fees for administering default claim payments. They include a loan processing and issuance fee, a one-time payment for each new loan equal to 0.4 percent of the principal, and an account maintenance fee, an annual payment of 0.06 percent of all outstanding federal student loan balances.[35] Payment rates are set by federal statute and totaled $441.8 million in fiscal year 2008.[36] These two fees compensate guaranty agencies for historical administrative functions that could now be handled by the U.S. Department of Education.[37] Moreover, these subsidies are based on an arbitrary percentage of the loan value, meaning that they do not reflect the true cost to a guaranty agency of providing loan guarantee services.

Default Aversion Activities: Vague and Contradictory

Guaranty agencies participating in the FFEL Program must help prevent borrowers from defaulting. Although this mandated assistance promotes a desirable goal (lower default rates cost borrowers and taxpayers less), guaranty agencies as currently designed are not appropriate for this role.

Guaranty agencies must provide default aversion assistance to borrowers who fall 60 to 120 days behind on payments.[38] Once a guaranty agency agrees to provide default aversion assistance, the federal government pays the agency a fee equal to 1 percent of the loan's unpaid principal and interest.[39] An agency is required to repay this fee (which may be greater than what it received if interest has accrued on the loan) if its efforts are unsuccessful and the loan defaults.[40] Guaranty agencies received a total of $177.3 million in default aversion assistance fees during the 2008 fiscal year.[41]

While the default aversion fee appears appropriately designed—it compensates agencies for performing a desirable task and penalizes them for poor performance—policymakers have not indicated what activities are expected.[42] In fact, the policy does not specify that borrowers must resume making loan payments for a successful default aversion. This gives guaranty agencies an incentive to grant forbearances, which allow borrowers to postpone payments without penalty while interest accrues, rather than engage in costlier efforts to help borrowers make payments on their loans.[43] Additionally, federal payments that guaranty agencies receive for collecting a defaulted FFEL loan on behalf of the federal government are far more lucrative than the payments for preventing a default.

Rehabilitation and Collection Incentives Undermine Other Policy Goals

The largest government payments guaranty agencies receive are for their work collecting or rehabilitating defaulted federal student loans—a total of $948.8 million in the 2008 fiscal year.[44] This amount is more than five times greater than the $177.3 million paid to guaranty agencies for default aversion activities over the same time period.[45] The financial incentives associated with these subsidies outweigh those provided for default aversion and reward agencies for increasing (rather than decreasing) borrowers' loan balances. In short, it is inherently contradictory to expect guaranty agencies to help students avoid default while compensating them more generously through collection or rehabilitation fees when borrowers do default.

The payments provided to guaranty agencies for rehabilitating a defaulted federal student loan are substantial. In order to receive this compensation, the guaranty agency must get the borrower to agree to and meet a new repayment plan by making nine out of 10 payments on time.[46] After that, the guaranty agency sells the loan to a private FFEL lender and the agency keeps 18.5 percent of the rehabilitated loan's principal and interest at the time of default.[47] Any interest that accumulated on the loan between the time of default and the loan sale, typically 1.5 percent of the loan's balance, is also retained.[48] Finally, guaranty agencies also retain all collection costs charged to the borrower, which for rehabilitation loans are capped at 18.5 percent of the loan's balance at the time of default. Amounts remaining from a rehabilitation loan sale after the guaranty agency receives its share are distributed to the federal government either by remitting funds to the secretary of education or placing them in an agency's federal fund.[49]

Borrowers also benefit from the rehabilitation process because their credit records are cleared and their loans are placed back into repayment status. But this mutually beneficial policy has two flaws. First, the rehabilitation payment a guaranty agency receives can be as large as 38.5

percent of the loan's balance (a combination of the payments described earlier), much greater than the 1 percent fee they receive for default aversion. Second, the agencies receive the same rehabilitation compensation regardless of their success at preventing loan defaults. As a result, guaranty agencies have a greater financial incentive to let a loan default and then collect the larger rehabilitation payment without any penalty for doing so. While guaranty agencies receive significant compensation for loan rehabilitation, the borrowers with those defaulted loans are assessed significant financial penalties.

Table 5 shows how the proceeds from rehabilitation loan sales are distributed between guaranty agencies and the U.S. Department of Education.

The federal payments provided for collecting defaulted federal student loans serve as a major source of revenue for guaranty agencies. Similar to payments for rehabilitation loans, revenue from loan collection is significantly greater than what a guaranty agency receives for default aversion. Moreover, no penalties are levied for failing to prevent a default in the first place—an explicit legislative goal for guaranty agencies.

Table 5. Rehabilitation Loan Sale Distribution (%)

Agency Reimbursement Rate	Department of Education[a]	Agency Operating Fund[b]	Agency Federal Fund[c]
100	81.5	18.5	0.0
95	77.4	18.5	4.1
85	69.3	18.5	12.2
75	61.1	18.5	20.4

Source: New America Foundation.

[a] *The U.S. Department of Education receives 81.5 percent of the loan's balance multiplied by the reimbursement rate it paid when the loan defaulted.*

[b] *Rehabilitation loans are sold for 118.5 percent of their balance at the time of default. The amount above 100 percent is kept by guaranty agencies as collection costs and is not shown.*

[c] *This payment is the amount remaining after the Department of Education and the guaranty agency receive their shares.*

Guaranty agencies pursue loan collection on behalf of the federal government if they cannot work out a rehabilitation repayment plan with a borrower. Individuals in collection are immediately assessed collection costs that are typically over 20 percent and can be as high as 25 percent of the outstanding value of the loan.[50] Guaranty agencies are given significant discretion in determining how much to charge for collection costs and are not obligated to disclose this amount to borrowers beforehand.[51] Moreover, regulations require that borrower payments on defaulted loans be applied to collection costs before reducing the principal or interest owed, ensuring that guaranty agency costs are the first to be repaid.[52]

Guaranty agencies are also substantially compensated for collecting on a defaulted federal student loan. In addition to collection costs, guaranty agencies retain 16 percent of any amount they collect. The remainder of any amount collected is distributed to the federal government by remittances to the secretary of education and by transfers to an agency's federal fund.[53] In fact, there is some evidence that these large payments are sufficient to influence the types of borrowers that guaranty agencies pursue. A former employee from the designated guaranty agency for Kentucky and Arizona said the organization used to seek out borrowers from the poorest parts of those states "knowing that many if not all of these students would end up paying...large default collection fees over the long haul."[54]

Table 6 shows the percentage distribution between the U.S. Department of Education and guaranty agencies of amounts collected from a defaulted student loan.

Similar to loan rehabilitation, the payments provided for loan collection suffer from several inefficiencies. Allowing guaranty agencies to keep 16 percent of amounts collected means their potential compensation for this activity is far greater than the 1 percent they receive for default prevention efforts. Further, using an arbitrarily set percentage calculation means that amounts retained by the guaranty agency are unaffected by its default prevention record and do not reflect actual expenses.[55]

Not only is the compensation provided to guaranty agencies for rehabilitation or collection far greater than the default aversion assistance fee, the interaction between these payments could allow an agency to increase its revenue while also growing the balance a borrower owes. This could occur if a guaranty agency placed a borrower into forbearance as a default aversion activity. Doing so allows a borrower to postpone payment without penalty while his or her debt grows with the accrual and compounding of interest. Because loan collection and rehabilitation subsidies are calculated as a percentage of the loan balance, the guaranty agency could receive larger payments if a borrower in forbearance later defaults than if the loan had initially defaulted. Such a scenario would require the guaranty agency to pay the 1 percent penalty fee for unsuccessful default aversion, but the corresponding increase in revenue for collection costs would more than offset the penalty, contradicting the policy intent.[56]

Non-FFEL Program Activities

Most guaranty agencies do not limit their activities to those required and compensated under the FFEL Program. Instead, they provide services such as financial literacy and college preparation programming for students and families. Guaranty agencies fund these activities with revenue earned from federal payments under the FFEL Program and from other sources. Guaranty agencies connected to a state government, for example, may also receive state funding to provide college-planning advice. By contrast, private, nonprofit guaranty agencies rely solely on revenue from the FFEL Program to administer these types of programs.

Table 6. Loan Collection Distribution (%)

Reimbursement Rate[a]	Reinsurance Complement[b]	Guaranty Agency Retention	Department of Education Share[c]
100	0	16	84
95	5	16	79
85	15	16	69
75	25	16	59

Source: New America Foundation; U.S. Department of Education.

[a] *Based on the agency's default rate.*

[b] *The complement is the share of the loan equal to 100 minus the reimbursement rate provided to the guaranty agency. It is placed in an agency's federal fund.*

[c] *The Department of Education keeps anything remaining after the guaranty agency's share and the complement are deducted. This does not include collection costs charged to a borrower, which are first deducted from any payments made.*

Because the funding for non-FFEL programming is not based on a specific metric or activity, there is no way to measure its effectiveness. Moreover, non-FFEL activities are hard to evaluate because they vary widely across agencies. For example, the Northwest Education Loan Association, the designated guaranty agency for Washington and Idaho, maintains two Centers for Student Success in Oregon and Washington, physical facilities that students can visit for more information on how to plan and prepare for college. Meanwhile, the designated guaranty agency for Texas, TG, maintains a college information Web site and provides $2 million in scholarships each year.[57] Neither agency has an obligation to produce sufficient data on or assess the outcomes of these programs.

A second concern about college planning, scholarship, and other related activities is that this programming often complicates policy discussions about guaranty agencies. A 2008 briefing for congressional staff on the role of guaranty agencies in the FFEL Program, for example, focused almost entirely on college access activities that they conduct with only a brief mention of their role in the FFEL Program.[58] Such rhetoric has successfully influenced some lawmakers' impressions of guaranty agencies. In a May 2009 hearing on options for reforming the federal student loan programs, one New Hampshire Democrat extolled her state's guaranty agency, the New Hampshire Higher Education Assistance Foundation, for its charitable and college planning activities without mentioning the agency's actual FFEL role.[59] Similar comments were also offered by a Democratic representative from Texas about the Texas guaranty agency.[60]

Finally, the activities guaranty agencies perform in the FFEL Program may create conflicts of interest when they provide college financial planning assistance to students and families. Guaranty agencies' compensation is structured such that they earn more money for administering a larger number of loans. This direct connection between financial incentives and student borrowing makes it impossible for an agency to serve as an impartial source of information on all options for financing a college education, including those that do not involve student loans. Biased advice could lead students to borrow unnecessarily or take on more debt than they otherwise need, increasing government costs in the form of additional subsidies and putting these individuals at risk of defaulting.

Student Loan Company Affiliations

Guaranty agencies have specific roles outlined in federal statute and regulations but are not prohibited from forming affiliations with student loan companies. These relationships benefit agencies in several ways. Guaranty agencies with a strong connection to a student loan company can present themselves as full-service financial aid organizations, an advantage when marketing financial aid products to schools and their students.[61] These affiliations can also give guaranty agencies an administrative capacity advantage, providing more resources and additional sources of revenue to fund scholarships, college informational programming, and other activities that build favorable recognition and attract business.

Lenders and guaranty agencies, however, face competing financial incentives that, when combined, can encourage lenders to act against the best interests of federal student loan borrowers and taxpayers—a concern that the U.S. Government Accountability Office first raised in 1993.[62] Of the 35 guaranty agencies now in the program, at least 23 have some relationship with a student loan company. These guaranty agencies make loans themselves, work closely with a loan company, or serve as a secondary market for loans. (See Table 1 for a complete list.) In 13 of these agencies, there is little to no separation between the guaranty agency and the lender, allowing these entities to serve as "one-stop" financial aid providers that can help students with every component of planning and paying for a postsecondary education.

Lender-guaranty agency relationships arose out of legislative changes in the 1970s that allowed states to finance federally backed student loans with tax-exempt bonds.[63] To take advantage of the significant revenue opportunity this policy change created, states established their own nonprofit lenders and paired them with the federal guaranty agencies in their states or expanded the operations of existing guaranty agencies to include lending functions.[64] This allowed states to operate one integrated agency instead of two, a more efficient arrangement. States also could establish the guaranty agency as a public entity and then partner it with a nonprofit lender, or vice versa. States seeking to streamline higher education aid also tasked guaranty agencies and nonprofit lenders with this role, giving them control over all student financial assistance.

Instead of serving an important role in ensuring loan availability, these now vestigial connections weaken oversight and accountability, distort financial incentives, and create the potential for abuse.

Lender Affiliations Weaken Oversight

In addition to their lender insurance role, guaranty agencies are expected to play a significant role in overseeing the FFEL Program.[65] They must conduct "comprehensive biennial on-site program reviews" of the lenders whose borrowers' loans are guaranteed by the agency.[66] Audits aim to identify misconduct or illicit activities and ensure lenders are properly performing required tasks, such as disbursing or servicing loans.[67] The guaranty agency has authority under federal regulations to limit or suspend a loan company's participation if that lender does not fulfill its obligations under the FFEL Program. Ties that exist today between guaranty agencies and lenders, however, fundamentally weaken this oversight role.

This is most evident with respect to Sallie Mae and United Student Aid Funds (USA Funds), the nation's largest lender and biggest guaranty agency, respectively. Since 2000, both businesses have operated under an agreement in which USA Funds pays Sallie Mae to perform all of its functions under the FFEL Program.[68] The arrangement effectively allows a FFEL lender, Sallie Mae, to police itself—a situation that has led to several allegations of wrongdoing. A recent lawsuit has alleged that Sallie Mae engaged in fraudulent loan collection activities that allowed the lender and guaranty agency to grow borrower student loan debts (and the associated federal subsidies), and that USA Funds knowingly assisted in the scheme.[69]

Lender Affiliations Distort Incentives

Guaranty agency affiliations introduce competing policy goals that may cause a federal student loan company to shift its behavior with respect to borrowers. Three federal guaranty agency functions—loan rehabilitation and collection, default aversion, and lender-of-last-resort loans—cause significant policy problems and adverse incentives when lenders and guaranty agencies enter into business relationships.

Sharing business interests is problematic because the ultimate goals for guaranty agencies and lenders are at odds. FFEL lenders earn their greatest profits on borrowers who stay in repayment because each defaulted loan represents a loss of 2 percent or 3 percent of the outstanding balance, plus any future subsidy payments. The payment structure is inverted for guaranty agencies, which receive their greatest compensation, as much as 38.5 percent of a loan's value, for collecting or rehabilitating defaulted student loans.[70] These competing incentive structures could create situations where it is more profitable for an affiliated lender and guaranty agency to allow struggling borrowers to default than to keep them in repayment. Under these circumstances, taxpayers provide unnecessary federal default payments to lenders, while defaulted borrowers are assessed large fees and credit record damage.

The guaranty agency default aversion fee also can weaken lender incentives to prevent borrower default. Because the fee contains no requirement to return borrowers to repayment, guaranty agencies could use it to place loans into forbearance, increasing the borrower's balance and, as a result, quarterly lender subsidies. Lenders without guaranty agency connections may be reluctant to put borrowers into forbearance (despite the higher subsidies) because borrowers with larger loan balances are more likely to go into default. The potential for large subsidies from collection or rehabilitation, however, may be more than enough to offset these losses.

The final problematic payment structure is the lender-of-last-resort program. Unlike the other examples, which result from distorting already flawed subsidies, excessive use of this program creates the potential for lenders and guaranty agencies to engage in illicit activity and impose unnecessary taxpayer costs.

The lender-of-last-resort program exists to ensure that all qualified FFEL borrowers have access to a federal student loan.[71] Lender-of-last-resort loans made either by a guaranty agency or a designated lender have the same borrower terms and receive the same subsidies as a FFEL loan. However, they also lower the lender's risk because they carry a 100 percent federal guarantee against default losses and are excluded from the default rate calculations used to determine federal guaranty agency claim payment reimbursement rates.[72]

Because guaranty agencies administer the lender-of-last-resort loan program, they are given significant leeway in determining certain eligibility and participatory requirements in any state for which they serve as the designated guaranty agency. But as the following case of a nonprofit lender and guaranty agency in South Carolina demonstrates, such a setup can result in abuse when excessive numbers of lender-of-last-resort loans are issued.

The South Carolina lender operates under a contractual relationship in which it administers the activities of the state guaranty agency. The two companies also share office space, a Web site, and bond proceeds.[73] Because of this relationship, the South Carolina guaranty agency appears to have designed its lender-of-last-resort loan program in such a way that both it and its affiliated lender could benefit.

Lenders and guaranty agencies face competing financial incentives that can cause them to act against the interests of borrowers and taxpayers.

For over a decade, the South Carolina nonprofit loan company has agreed to make all lender-of-last-resort loans on behalf of the guaranty agency.[74] In addition, the guaranty agency only requires borrowers to receive a single lender denial (rather than the legislative maximum of two) to become eligible for a lender-of-last-resort loan.[75] This setup appears to allow the South Carolina loan company to deny students' applications and instead give them a lender-of-last-resort loan. Doing so would allow the lender and guaranty agency to receive higher subsidies by shifting the loan's risk entirely to taxpayers. It also weakens accountability measures by excluding the loan from default rate calculations used to judge a guaranty agency's success at helping borrowers stay in repayment.

Clearly, connections between lenders and guaranty agencies significantly weaken the integrity and goals of the FFEL Program. Guaranty agencies affiliated with lenders cannot be expected to properly carry out their legislatively required oversight responsibilities, creating opportunities for abuse or fraud in the program.[76] Moreover, shared business interests between lenders and guaranty agencies can undermine a lender's incentive to keep borrowers out of default, leading to increased federal insurance payments, and tarnished credit records and increased debt burdens for borrowers. Eliminating the relationships between guaranty agencies and lenders is just one of several actions that must be taken if lawmakers want guaranty agencies to start serving as a worthwhile component of the federal student loan program.

Policy Recommendations

Guaranty agencies' subsidies, responsibilities, and relationships are better suited for a different era of federal student aid policy. In some cases, these outdated roles lead to inefficient use of taxpayer dollars. In other instances, such as the connections between guaranty agencies and lenders, they undermine policy goals and taxpayers and harm student loan borrowers. Congress and the U.S. Department of Education should fundamentally reshape these agencies to better address current policy needs and priorities. They should do so in the following ways:

Eliminate the Guaranty Agency Insurance Role

The initial purpose of guaranty agencies was to cover the costs incurred by student lenders when a borrower defaults on a loan, with some assistance from the federal government. Today, guaranty agencies perform that role by making payments to lenders entirely with federal funds held in trust.[77] The vast majority of these funds are reimbursed by the U.S. Department of Education, making guaranty agencies a middleman with minimal stake in the FFEL Program.

Federal policymakers should remove guaranty agencies from this process altogether. Any claims lenders file for loan default reimbursement should go directly to the U.S. Department of Education, which can then make claim payments using the same process it employs now to provide quarterly interest rate subsidies to lenders. Under this arrangement, guaranty agencies should be required to return the $1.63 billion in federal assets they hold.

Prohibit Guaranty Agency and Lender Partnerships

The relationships between lenders and guaranty agencies are largely a product of incentives from the 1970s that today distort subsidies provided to both. Although not every relationship between a lender and guaranty agency leads to unwanted outcomes, the opportunity for such activities is increased whenever these two types of agencies share common financial interests. To ensure that the missions of guaranty agencies and lenders are not compromised by their connections, the federal government should establish a strong firewall between the two. For existing lender-guaranty agencies, the secretary of education should exercise current regulatory authority separate these entities from one another because doing so is in the federal fiscal interest and would "ensure sufficient separation of responsibility and authority between its lender claims processing as a guaranty agency and its lending or loan servicing activities."[78] This authority should be used in cases where the guaranty agency and lender are part of the same organization or they have a contract in which one outsources some or all of its responsibilities to the other.

Eliminate Guaranty Agencies' FFEL Program Oversight Role

Guaranty agencies are expected to serve as a neutral third party to monitor and audit participating lenders in the FFEL Program. Several lawsuits and reports by the U.S. Department of Education's inspector general have demonstrated these agencies are not capable of playing this role in a way that protects student borrowers and taxpayers. The oversight role prescribed for guaranty agencies is also somewhat duplicative given that the U.S. Department of Education is expected to conduct its own program reviews and oversight of the FFEL Program as well.

> Connections between lenders and guaranty agencies significantly weaken the integrity and goals of the FFEL Program.

Given these factors, guaranty agencies should no longer be expected to carry out any oversight functions. Any auditing responsibilities should be transferred to the U.S. Department of Education.

Balance Incentives for Borrower Assistance versus Loan Collection

The federal payments provided to guaranty agencies attempt to achieve competing policy outcomes: (1) preventing student loan default and (2) rehabilitating or collecting on a borrower's loan that has not been successfully repaid. Because the compensation for the latter goal is greater than for the former, there is tension within agencies between pursuing activities that are better for their financial interests or for those of borrowers.

These competing policy goals should be resolved by assigning the duties currently performed by guaranty agencies to two separate groups of competitively determined federal contractors. One set of contractors would handle the collection of defaulted student loans, while a different group would provide default aversion assistance to borrowers. Guaranty agencies and other companies could bid on the default aversion contract, but no entity or related affiliate could perform both functions. Rehabilitating loans would be handled by the contractors that provide default aversion assistance.

Improve the Default Aversion Role

Assisting struggling student loan borrowers is a worthwhile policy goal that is currently executed poorly through the default aversion assistance fee. Rather than the current structure, in which the fee can be used to place borrowers in forbearance, default aversion should be handled by federal contractors whose compensation is based on successfully returning borrowers to repayment. Not only would this prevent excessive use of forbearances, but it would alleviate concerns about using this fee to gain greater federal subsidies. This change in the default aversion fee would also encourage more active interventions with struggling borrowers because greater work is required to return borrowers to repayment.

Alternatively, the default aversion fee could be turned into competitively bid block grants, in which any agency—including those not currently participating in the federal student loan program—would be eligible to submit a proposal for providing default aversion activities for all borrowers in a given state or region. This process would ensure that any agency performing default aversion activities would not have an incentive to manipulate a given borrower's balance. A competitively bid contract would also create competition among agencies to prove their success at quality default aversion activities.

Make the U.S. Department of Education the Lender of Last Resort

The lender-of-last-resort loan program is a necessity because lenders are not required to make loans to all eligible borrowers. But the current construction of the lender-of-last-resort program creates opportunities for exploitation by guaranty agencies that have close relationships with federal student loan companies. Because of these concerns, the U.S. Department of Education should take over providing lender-of-last-resort loans in any situation where they may be needed. Loans could be provided through the same common origination and disbursement system that handles Pell Grant payments to schools. They could then be administered as part of the Direct Loan Program, a competing distribution system for federal student loans that involves the government issuing loans directly to students using U.S. Treasury funds.

Demand Accountability and Results for Other Activities

Guaranty agencies engage in a number of college planning and outreach activities in addition to the FFEL roles for which they receive explicit federal subsidies. This programming is often funded by excess federal revenue. Unlike the activities for which they are explicitly paid, this programming is not subject to any accountability measures designed to ensure that it is well executed and worthwhile.

To ensure that excess federal revenue is being used for quality purposes, guaranty agencies' college planning and other similar programming should be subject to annual review by the U.S. Department of Education and the annual congressional discretionary appropriations process. Doing so would both ensure that these activities were well executed and provide an opportunity to share best practices research by carefully evaluating what works. Guaranty agencies that offer less successful programming would either return excess subsidies or alter their offerings to encompass more effective activities offered by other agencies.

A 21st-Century Guaranty Agency

Guaranty agencies have played some role in federal student loan programs since their inception. But while these agencies have taken on new responsibilities during the ensuing decades, they have not abandoned roles that are now irrelevant. In addition, they have been forming relationships with lenders that create potential conflicts of interest. To address these concerns, guaranty agencies' participation in the federal student loan program should only continue in a contractor capacity in which they are charged with helping struggling borrowers avoid default. Focusing on this role should force guaranty agencies to give up other existing responsibilities, such as providing lender default insurance, FFEL oversight, and collection and rehabilitation work. They would also abandon existing relationships between guaranty agencies and lenders that make it impossible to serve as neutral parties. Enacting these changes would turn guaranty agencies into a useful part of a system for postsecondary education access, rather than unnecessary middlemen.

Notes

1. *Definitions,* 34 C.F.R. 682.200 (2008), http://edocket.access.gpo.gov/cfr_2008/julqtr/pdf/34cfr682.200.pdf, 663.

2. *Federal Advances for Claim Payments*, 34 C.F.R. 682.403 (2008), http://edocket.access.gpo.gov/cfr_2008/julqtr/pdf/34cfr682.403.pdf , 768; *Basic Program Agreement*, 34 C.F.R. 682.401 (2008), http://edocket.access.gpo.gov/cfr_2008/julqtr/pdf/34cfr682.401.pdf, 736..

3. Today, the Massachusetts Higher Education Authority is known as American Student Assistance. American Student Assistance, "About Us," www.amsa.com/about/ (accessed May 21, 2009); Brita Anderson, *Guide to Student Loan Issues* (Indianapolis, IN: USA Funds, 2007), www.usafunds.org/forms/school_lender/guide_student_loan_issue.pdf, 12.

4. Fred Galloway and Hoke Wilson, *Reframing the Student Loan Costing Debate: The Benefits of Competition* (Virginia Beach, VA: Educational Policy Institute, 2005), www.educationalpolicy.org/pdf/loandebate.pdf, 2.

5. Charlotte Fraas, *The Guaranteed Student Loan Programs: Current Status and Issues,* (Washington, DC: Congressional Research Service, 1991), 39.

6. Anderson, *Guide to Student Loan Issues*, 13.

7. "Appendix II-Legislative History," *Federal Student Loan Data Book FY94-FY96* (Washington, DC: U.S. Department of Education, 1997), www.ed.gov/finaid/prof/resources/data/fslpdata94-96/append2.html.

8. States have the ability to issue tax-exempt bonds to finance specific activities. These bonds are usually exempt from both state and federal tax for purchasers. Because bond returns are not diminished by tax payments, states pay lower interest rates than a private company would on similar debt. Tax-exempt bonds issued for student loans thus earned significant profits for states because of the large spread between the interest rate states had to pay on the bonds and the interest rate charged to borrowers on the student loans. See *An Act to extend the Higher Education Act of 1965, to extend and revise the Vocational Education Act of 1963, and for other purposes,* Public Law No. 94-182 (October 12, 1976), http://thomas.loc.gov/cgi-bin/bdquery/z?d094:HR14070:@@@D&summ2=m&; Congressional Budget Office, *State Profits on Tax-Exempt Student Loan Bonds: Analysis and Options* (Washington, DC, 1980), x.

9. In March 1980, the Congressional Budget Office estimated that the average financing cost for states was below 7 percent, while the yield on student loans was between 11 percent and 16 percent. Congressional Budget Office, *The Tax-Exempt Financing of Student Loans,* (Washington, DC, 1986), 8.

10. U.S. General Accounting Office, *Financial Audit: Guaranteed Student Loan Program's Internal Controls and Structure Need Improvement* (Washington, DC, 1993), www.eric.ed.gov/ERICDocs/data/ericdocs2sql/content_storage_01/0000019b/80/13/b4/4d.pdf ,11-12.

11. "Appendix III: Glossary," *Federal Student Loan Programs Data Book FY 1997-FY 2000)* (Washington, DC: U.S. Department of Education), www.ed.gov/finaid/prof/resources/data/fslpdata97-01/Part_5/edlite-appC.html.

12. Galloway and Wilson, *Reframing the Student Loan Costing Debate: The Benefits of Competition*, 9.

13. U.S. General Accounting Office, *Guaranteed Student Loans: Better Criteria Needed for Financing Guarantee Agencies* (Washington, DC, 1986), www.eric.ed.gov/ERICDocs/data/ericdocs2sql/content_storage_01/0000019b/80/2f/68/6d.pdf, 27.

14. Ibid.

15. Ibid., 18; Galloway and Wilson, *Reframing the Student Loan Costing Debate*, 13

16. Ibid, 14.

17. The Middle Income Student Assistance Act of 1978 eliminated existing caps on income that had previously restricted student eligibility for federal student loans. The legislation, however, stated that only borrowers from families earning less than $40,000 annually would be eligible for interest rate subsidies. See Galloway and Wilson, *Reframing the Student Loan Costing Debate*, 8.

18. Senate Committee on Labor and Human Resources, Subcommittee on Education, Arts, and Humanities, *Problems Confronting the Higher Education Assistance Foundation: Hearing,* 102nd Cong., 1st sess., August 3, 1991, http://eric.ed.gov/ERICDocs/data/ericdocs2sql/content_storage_01/0000019b/80/22/f4/a6.pdf, 22.

19. U.S. General Accounting Office, *Guaranteed Student Loans: Comparisons of Single State and Multistate Guaranty Agencies* (Washington, DC, 1989) www.eric.ed.gov/ERICDocs/data/ericdocs2sql/content_storage_01/0000019b/80/1f/8b/36.pdf, 11.

20. Thomas DeLoughry, "Crisis at Nation's Largest Guarantor Raises Fears for the Soundness of Student-Loan Programs," *Chronicle of Higher Education,* August 1, 1990, http://chronicle.com/che-data/articles.dir/articles-36.dir/issue-46.dir/46a01601.htm.

21. Thomas DeLoughry, "U.S. Says it Will Dissolve Troubled Loan Guarantor, Transfer $9-Billion Portfolio to Stable Agencies," *Chronicle of Higher Education,* October 10, 1990, http://chronicle.com/che-data/articles.dir/articles-37.dir/issue-06.dir/06a02001.htm.

22. *Guaranty Agency Federal Fund,* 34 C.F.R. 682.419 (2008), http://edocket.access.gpo.gov/cfr_2008/julqtr/pdf/34cfr682.419.pdf, 811.

23. House Committee on Education and the Workforce, *Higher Education Amendments of 1998: H.R. 6,* 105th Cong., 2nd sess., April 17, 1998, Report 105-481, http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=105_cong_reports&docid=f:hr481.105.pdf, 128.

24. *Guaranty Agency Operating Fund*, 34 C.F.R. 682.423 (2008), http://edocket.access.gpo.gov/cfr_2008/julqtr/pdf/34cfr682.423.pdf, 814.

25. Ibid.

26. If a loan on which a guaranty agency performed default aversion later defaults, then the guaranty agency has to pay an amount equal to 1 percent of the loan's balance at the time of default. See Stephen Burd, "Education Department Experiment Will Give Loan-Guarantee Agencies More Flexibility," *Chronicle of Higher Education,* August, 6, 1999, http://chronicle.com/weekly/v45/i48/48a04001.htm.

27. All told, five agencies received Voluntary Flexible Agreements, but only three—the guaranty agencies from Texas, Massachusetts, and Wisconsin—agreed to return their federal funds in exchange for a new subsidy structure. See U.S. General Accounting Office, *Federal Student Loans: Flexible Agreements with Guaranty Agencies Warrant Careful Evaluation* (Washington, DC, 2002), 6.

28. Doug Lederman, "Ending an Experiment," *Inside Higher Ed,* October 16, 2007, www.insidehighered.com/news/2007/10/16/vfa.

29. Fraas, *The Guaranteed Student Loan Programs: Current Status and Issues*, 39.

30. Lenders must submit a default claim on loans that are between 271 and 360 days delinquent. Claims that are submitted after that may not be reimbursed. See Common Manual Guarantors, *Common Manual: Unified Student Loan Policy 2008 Annual Update,* (July 2008), http://nchelp.org/elibrary/CommonManual/ECM2008.pdf, 451-452.

31. *Guaranty Agency Federal Fund,* 34 C.F.R. 682.419 (2008), 811; Office of Management and Budget, *Fiscal Year 2010 Appendix: Department of Education* (Washington, DC, 2009), www.whitehouse.gov/omb/budget/fy2010/assets/edu.pdf, 384.

32. If a guaranty agency has a low default rate, the U.S. Department of Education reimburses it for 95 percent of a claim payment. Since claim payments are typically 97 percent of the defaulted loan's amount, this means that the guaranty agency is compensated for 92.2 percent of the overall defaulted loan amount.

33. The U.S. Department of Education's reimbursement rate will decrease from 95 percent to 85 percent of a claim payment if the guaranty agency has to make claim payments on more than 5 percent of its guaranteed loan volume in repayment in a given year. A claim rate of 9 percent causes the reimbursement rate to drop to 75 percent.

34. Guaranty agencies share in the cost of federal student loan defaults because of the reinsurance fee they must pay to have their lender claim payments reimbursed by the U.S. Department of Education. For guaranty agencies with low default rates, this fee is equal to 0.25 of the principal of all new loans. Agencies with high default rates must

pay 0.50 percent of all new loan amounts, reflecting the increased cost to the government of having to pay more lender claims. See *Federal Reinsurance Agreement*, 34 C.F.R. 682.404 (2008), http://edocket.access.gpo.gov/cfr_2008/julqtr/pdf/34cfr682.404.pdf, 771.

35. *Reinsurance Agreement*, 34 C.F.R. 682.404 (2008), 772.

36. U.S. Office of Federal Student Aid, *Guaranty Agency Federal and Operating Fund Data (FY 2006-2008)* (Washington, DC: U.S. Department of Education: 2009), www.fp.ed.gov/fp/attachments/publications/GAsFederal&Opfunds06-08withoutpercentdiff.pdf, 37.

37. The U.S. Department of Education currently handles all loan administrative responsibilities in the second federal student loan distribution system, the Direct Loan Program, in which it originates, disburses, and services loans that are made directly to students using U.S. Treasury dollars.

38. *Reinsurance Agreement*, 34 C.F.R. 682.404 (2008), 772.

39. Ibid. This payment is made nearly instantaneously because the guaranty agency transfers it from its federal fund into its operating fund. The default aversion assistance fee may only be paid once on any loan and is used to cover costs incurred by working with a borrower to prevent default.

40. Ibid.

41. U.S. Office of Federal Student Aid, *Guaranty Agency Federal and Operating Fund Data (FY 2006-2008)*, 37.

42. *Reinsurance Agreement*, 34 C.F.R. 682.404 (2008), 769.

43. There are situations in which forbearance may be the best course of action for a borrower, but the concern is that sometimes individuals are placed into it when the better alternative would be a more flexible repayment plan.

44. U.S. Office of Federal Student Aid, *Guaranty Agency Federal and Operating Fund Data (FY 2006-2008)*, 37.

45. Ibid. The U.S. Department of Education does not separately report guaranty agency collection and rehabilitation compensation, so it is not possible to know how much guaranty agencies specifically received for these two separate functions.

46. Unlike standard repayment plans, which require a minimum payment of at least $50 a month, this new agreement solely mandates that a borrower repay a monthly amount that considers his or her income and expenses. See "Repayment Plans," *U.S. Department of Education*, www.ed.gov/offices/OSFAP/DirectLoan/RepayCalc/dlindex2.html. *Loan Rehabilitation Agreement,* 34 C.F.R. 682.405 (2008), http://edocket.access.gpo.gov/cfr_2008/julqtr/34cfr682.405.htm, 773.

47. *Loan Rehabilitation Agreement,* 34 C.F.R. 682.405 (2008), http://edocket.access.gpo.gov/cfr_2008/julqtr/34cfr682.405.htm, 773–74.

48. Figure obtained from e-mail correspondence on April 28, 2009 with an official from American Student Assistance, the designated guaranty agency for Massachusetts and the District of Columbia.

49. This percentage calculation excludes any fees, such as those for collection, an attorney, or late payments, which are handled separately.

50. "Consequences of Default," *Texas Guaranteed Student Loan Corporation,* www.tgslc.org/borrowers/default/consequences.cfm#costs. Although collection costs are assigned right away, they do not compound. Rather, each time the delinquent payment is calculated, the costs are reassessed on top of the balance.

51. Regulations state that guarantors may charge a borrower "an amount equal to reasonable costs incurred by the agency in collecting on a loan," even if "not provided for in the borrower's promissory note," and that the amount charged must be comparable to what the Department assesses under direct lending. See *Fiscal, Administrative, and Enforcement Requirements,* 34 C.F.R. 682.410 (2008), http://edocket.access.gpo.gov/cfr_2008/julqtr/pdf/34cfr682.410.pdf, 788. Or it can be the lesser of the formula contained in *What Costs Does the Secretary Impose on Delinquent Debtors?* 34 C.F.R. 30.60, http://edocket.access.gpo.gov/cfr_2008/julqtr/pdf/34cfr30.60.pdf, 56.

52. See *Reinsurance Agreement*, 34 C.F.R. 682.404 (2008), 771.

53. Office of Federal Student Aid, *Guaranty Agency Financial Report: ED Form 2000 Instruction Guide* (Washington, DC: U.S. Department of Education, March 2009), www.fp.ed.gov/fp/attachments/fms_data_nslds/GAFRGuide_03.2009.pdf, 58-60.

54. Alan Michael Collinge, *The Student Loan Scam* (Boston, MA: Beacon Press, 2009), 48.

55. Were the retained share calculated after deducting the complement, guaranty agencies with a higher default rate would receive less compensation from collection. Consider the following example. If a loan had a 95 percent reimbursement rate, the complement would be 5 percent. If the retention share were calculated after removing the complement, the guaranty agency would receive 16 percent of the remaining 95 percent of funds, or 15.2 percent of the total loan amount. If the reimbursement rate were 85 percent, the complement would be 15.2 percent. The guaranty agency would then receive 16 percent of the remaining 85 percent, which is 13.6 percent. The higher default rate would thus have caused the guaranty agency to receive a smaller share of collection proceeds.

56. Consider the following example of a hypothetical $10,000 loan. If a lender requests default aversion assistance on this loan, the guaranty agency would receive $100. Now the guaranty agency places the borrower into forbearance for two years at a 5 percent annualized interest rate that is compounded monthly. If the loan were to default at the end of those two years, the balance owed would be $11,025, meaning the guaranty agency would have to return $110.25—a loss of $10.25. But now the guaranty agency collects on that loan and gets to keep 16 percent of that balance, or $1,764. Add in collection costs of 20 percent, or $2,205, and the agency has been paid $3,969 for that loan. By contrast, had the loan defaulted right at $10,000, the guaranty agency would have retained $1,600 and received $2,000 in collection costs, for a total of $3,600. The loss of $10.25 has thus translated into a gain of $369 for a guaranty agency, yielding a net profit of $358.75.

57. "TG Designates $2 Million to Its Signature Charley Woottan Grant Program for School Year 2009–10," *Texas Guaranteed Student Loan Corporation,* press release, April 1, 2009, *www*.tgslc.org/newsroom/news/2009/press090401.cfm.

58. Ben Miller, "Guaranty Agencies: A Middleman in College Access Clothing," *Higher Ed Watch* (Washington, DC: New America Foundation, July 16, 2008).

59. House Committee on Education and Labor, *Increasing Student Aid Through Loan Reform,* 111th Cong., 1st sess., 2009, http://edlabor.house.gov/hearings/2009/05/increasing-student-aid-through.shtml.

60. Ibid.

61. While each state selects a designated guaranty agency, individual institutions can select specific guaranty agencies. Lenders can also strongly suggest a specific guaranty agency.

62. In its 1993 report, *Guaranteed Student Loan Program's Internal Controls and Structure Need Improvement*, the U.S. Government Accounting Office noted: "Many guaranty agencies have expanded their operations to activities that create serious conflicts of interest with their stewardship responsibilities in the program, and federal laws and regulations do not prohibit guaranty agencies from engaging in such activities."

63. Congressional Budget Office, *The Tax-Exempt Financing of Student Loans*, 7.

64. Congressional Budget Office, *State Profits on Tax-Exempt Student Loan Bonds: Analysis and Options,* x.

65. When the initial version of the FFEL Program began in 1965, there was no U.S. Department of Education and technological limitations would have made it difficult for a single entity to monitor a nationwide program. As a result, guaranty agencies were given the role of performing local program oversight.

66. In addition to lenders, guaranty agencies are also expected to conduct audits of schools with which they do business. See *Fiscal, Administrative, and Enforcement Requirements,* 34 C.F.R. 682.410 (2008), 788.

67. *Basic Program Agreement,* 34 C.F.R. 682.401 (2008), 734.

68. Paul Basken, "Contract Raises New Concern over Sallie Mae's Ties to Guarantor," *Chronicle of Higher Education,* June 26, 2008, http://chronicle.com/temp/reprint.php?id =zs6w28zgyq9l9900250xzl42s0mdzrny.

69. Paul Basken, "Suit Alleges Fraud in 'Resolving' Troubled Student Loans," *Chronicle of Higher Education,* October 23, 2008, http://chronicle.com/daily/2008/10/5550n.htm.

70. A guaranty agency could receive up to 16 percent of a loan through collection or 18.5 percent through rehabilitation, plus collection costs of at least 18.5 percent. Those earnings are significantly greater than the potential 3 percent loss for a lender when a loan defaults.

71. There are very few limitations on a student's eligibility for a federal student loan, but lenders are not required to provide such loans. As a result, there are some eligible borrowers who must take out a lender-of-last-resort loan because they cannot obtain a FFEL loan from a lender.

72. Financial Partner Services, *Cohort Default Rate Guide for Guaranty Agencies and Lenders: Fiscal Year 2006* (Washington, DC: U.S. Department of Education, September 16, 2008), www.ifap.ed.gov/drmaterials/attachments/FY06CohortGuide2a.pdf, 4; *Federal Reinsurance Agreement,* 34 C.F.R. 682.404 (2008), 3.

73. South Carolina Student Loan Corporation, *Financial and Compliance Report* (Columbia, SC, June 30, 2008), www.scstudentloan.org/UserFiles/File/PDF/Audited%20 Financial%20Statements%20as%20of%20June%20 30%202008.pdf, 9.

74. South Carolina State Education Assistance Authority, "South Carolina State Education Assistance Authority Lender of Last Resort Procedures" (Columbia, SC, March 3, 1994), www.newamerica.net/blog/files/SEAA%20 LLR%20.pdf, 1.

75. Ibid., 2.

76. Both the U.S. Government Accountability Office (GAO) and the Office of the Inspector General at the U.S. Department of Education have published several audits or reports that raise concerns about how close relationships between lenders and guaranty agencies could create unnecessary conflicts of interest. These documents also question the U.S. Department of Education's oversight over these relationships. For more on this topic, see Office of Inspector General, *Federal Student Aid's Oversight and Monitoring of Guaranty Agencies, Lenders, and Servicers Needs Improvement* (Washington, DC: U.S. Department of Education, April 2009); Office of Inspector General, *Review of Financial Partners' Monitoring and Oversight of Guaranty Agencies, Lenders, and Servicers* (Washington, DC: U.S. Department of Education, September 2006). For more on the Government Accountability Office's review of this topic, see U.S. General Accounting Office, *Financial Audit: Guaranteed Student Loan Program's Internal Controls and Structure Need Improvement* (Washington, DC, March 1993); U.S. General Accounting Office, *Federal Student Loans: Flexible Agreements with Guaranty Agencies Warrant Careful Evaluation* (Washington, DC, January 2002).

77. Office of Management and Budget, *Fiscal Year 2010 Appendix: Department of Education*, 384.

78. *Fiscal, Administrative, and Enforcement Requirements,* 34 C.F.R. 682.410 (2008), 793.

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