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Student Loan Program: Discontent, Confessions, Perspective, and Questions

by Dennis J. Martin

Widespread concern and complaints have mounted about the cost to the federal government of the Stafford Loan program, and specifically on increasing costs of defaults and reports of fraud and abuse in the system. Policymakers are scurrying to enact change during this Reauthorization of the Higher Education Act. Indeed, change in the Higher Education Act is a long time coming.

This article will explicate the nature of our discontent with the current state of affairs, offer institutional perspectives, raise questions and key principles in the hope that amidst a highly-charged political debate, reason and common sense can find a place.

The Nature of Our Discontent

The level and cost of defaults in the federal Stafford Loan program have eroded political and fiscal support to the point of atrophy. In addition to defaults, more recently, our discontent is fueled by concerns with administrative efficiency. Criticism has been raised about the multiple layers of loan program administration and the numerous players, each with an interest to protect. As a result an overall theme of "simplicity" is emerging in this Reauthorization.

Another aspect of our discontent results from the accounting procedures for federal expenditures, and the new "scoring" procedures that make a federal, direct lending program more feasible than ever before. In other words, the new "scoring" procedure makes the current Stafford program appear as expensive, if not more so, as it would be for the federal government to raise loan capital and issue loans itself.

Paradoxically, we are terribly concerned about the grant/loan imbalance and the heavy reliance upon loans by needy students; while at the same time, we badly need to increase the annual and aggregate debt ceilings for our students and open the program up for more borrowing, especially to middle-income students. This apparent contradiction contains much of the great tension within our student aid policies today.

Given all of this, it should come as no surprise that we question the status quo and that we seek reform in a program that comprises over 60% of the nearly $20 billion in federal student aid.

It is also not surprising that consideration of the logical alternative, a centralized—federal loan system—is not new. Art Hauptman reminds us of this in his chapter "The National Student Loan Bank: Adapting an Old Idea for Future Needs" in *Radical Reform or Incremental Change* (a 1989 College Board book on student loan policy alternatives). In addition, the mid 1960s produced *both* The Guaranteed Student Loan (GSL) program and a report from President Johnson's Science Advisory Committee (known as the Zacharias Plan) calling for a federalized national student loan bank.

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Historically, the GSL has prevailed as the essential form of credit financing for college students, and as the single most important form of federally sponsored assistance for most, if not all, independent colleges and universities. Federalized, national student loan bank concepts resurface periodically; however, we have not been convinced that such an approach is either necessary or workable. Indeed, the very genesis of the GSL program—as an alternative to a massive federal program of tuition tax credits—did much to shape the direction we have taken. The path we have followed for student loans is largely a decentralized one; federal funds leverage significantly greater resources from the private sector (at better than a 2/1 ratio) using a regional, state and local delivery mechanism. In truth, this path was not the result of a conscious, well defined and articulated policy choice, but of sudden reactions to powerful societal and political events (i.e., Sputnik, the Great Society, middle income tax revolt and so on).

Today, the character and potential of the current Reauthorization are being shaped by the highly publicized Senate hearings conducted by Sam Nunn, D-GA, documenting problems with the current system; the new opportunities available because of credit reform and revised federal accounting; and widespread consensus for *change* (one always hopes, for the better). Along with new leadership and new ideas we now have the chance for significant reform and improvement to our student loan system. There is new momentum, and we should seize it.

So as we look back to the 1960s to the creation of the GSL program and the Zacharias plan for a national loan bank, indeed, we should keep in mind how much higher education and the nation as a whole have changed over these three decades. Such specific factors as inflation in college costs, changes in college-bound demographics, the advent of proprietary schools, and the erosion in purchasing power of the federal student aid dollar, for instance, have had great impact.

On another level, our federal budget deficit cannot help but define where we end up in the Reauthorization. As we think about our discontent with the current system in terms of specific proposals for reform, we should keep these large issues in mind. When all of these factors co-mingle, one gets the feeling that the Higher Education Act of 1965, as amended, has been stretched over the years to the breaking point. Whether it will snap or be buttressed, and what new forms and directions it will take have obvious and enormous importance.

Confessions and Perspectives

From an institutional perspective—only one of several to be sure—the stakes are very high.

The original House Bill, with the elimination of the Stafford Loan program and the phase-in of direct lending, presented a dilemma for college presidents, financial aid administrators, and anyone who cares about the financing of higher education. It might have been put this way:

> Is this the end of the most meaningful form of federally sponsored student assistance, or is it the beginning of a new, even more meaningful endeavor?

Unlike many other questions of this kind, the truth probably does not lie somewhere in the middle. This explains the intense interest of college presidents, particularly those from independent, non-profit institutions for whom the Stafford loan program, warts and all, is a lifeline for students. This is why presidents and trustees have engaged in discussions on what is in many ways a highly technical matter of how to "score" federal credit obligations and how delivery mechanisms now work or might work at a campus level.

The Confession

Let's look at it from the perspective of an institution (Washington University, in St. Louis) that graduates 86% of its students; 40 to 50% of whom will have borrowed a student loan. These students repay Stafford loans at a rate of 98.3% (the opposite of our 1.7% latest Department of Education cohort default rate for the Stafford program). When these borrowers in repayment are asked, they report that they very much appreciate the opportunity to have borrowed a Stafford loan which had particular importance in their ability to choose an independent college and to finance its cost. In lieu of all this, it would be very hard to swallow the dismantling of the Stafford loan program. It is the single most important form of federal assistance for our students.

Having said this, nevertheless it is uncomfortable to be aligned with the so-called "banking interests"; to be cast as supportive of "lucrative" secondary loan markets with clear self-interests in this debate; to be seen as taking partisan sides on an issue that demands the bi-partisan support characteristic of past reauthorizations; and to be in a position, for one of the few times in recent memory, to be agreeing with the Secretary of Education's position. These are strange times. . .

So what is it about the original Direct Lending proposal in the House Bill—or other proposals for reform that would replace the Stafford loan program for that matter—that is appealing, even to those who feel the current system works quite well? The answer: there is much about these proposals that excites us. Originating the loan at the campus-level; significantly increased annual and aggregate loan limits (especially when considered in the context of students who have greater debt capacity); streamlined administrative procedures; and easy, open access to capital: this is powerful stuff for any campus administrator. But there are many unanswered questions and some puzzlement as to why the current system might not benefit from such clearly desirable objectives. Why not seek to improve upon what is known rather than wiping the blackboard clean and starting all over again? When the stakes are so high, we should expect the most from our policy debate and a resolution that allows us to step forward into light rather than darkness. We need to be educated.

Some Questions

The November/December 1991 issue of *Change* includes an excellent review by Terry Hartle and Joseph Kusnam titled "Direct Loans To Students: An Idea Whose Time Has (Finally) Come?" The arguments against direct lending are compelling ones. There has also been thoughtful analysis done by financial aid administrators at Harvard and

Colorado State, who favor Direct Lending on the one hand and at Notre Dame and Eastern Michigan University, who are skeptical on the other. This point-counterpoint exchange is most illuminating, and suggests the strength of differing opinions.

Three primary questions for any proposal for student loan reform are:

1) Can it work?
2) What is the nature of "savings"?
3) What's best, in terms of securing capital: a centralized, federal system or a privatized, decentralized system?

"The level and cost of defaults in the federal Stafford Loan program have eroded political and fiscal support to the point of atrophy."

One perspective on the "Can it work?" question applies to the original House proposal for direct lending, in which the U.S. Department of Education serves the central roles of fund raiser, fund distributor and fund collector. It is hard to imagine the following scenario: a week or so before fall semester classes begin, a financial aid office at a high cost, independent university, asks the Secretary of Education for $16 million or so of federal funds to be electronically transmitted so that student accounts may be credited and checks issued for living expenses. The request is made on the simple basis of a) collected promissory notes from students, or b) estimated need, or c) some combination of both.

This kind of money moving nationwide is unthinkable, not for a lack of imagination or vision but because of the bureaucratic trenches of federal student aid administration. Somewhere along the way, (be it the Office of Management and Budget, Treasury, the Department of Education, or Congress itself) a significant level of oversight, checks and balances will be demanded. Who will bear the liability and administrative burdens? The first logical answer: schools. Suddenly administrative ease and simplicity, key policy objectives of the direct lending proposal, take on new meanings. Is there a trade-off, justifying this kind of new bureaucratic machinery for such benefits as higher loan limits, for instance? There is only one truthful answer: *maybe.* If the new bureaucracy, for instance, fails to deliver its promises, the system may collapse of its own weight.

In a policy sense, if concerns arise about the level of federal money flowing unfettered in the system, then our creation recreates, as something new. . .an experiment gone awry. Rationing—the worst nightmare—looms large when the politics of annual appropriations and increased debt ceilings come into play. The most analogous program for direct lending is the Pell program and there is much agreement that the great promise of the federal government's largest grant program goes unfulfilled because of the strain created by rationing. There are legitimate questions and concerns about how a federalized loan system might be rationed by state formula, sector, or student type. And while this is not in the plan at the outset, there are numerous examples of federal programs undergoing transformation from conception to end result. The stakes are high.

Can it work? Despite how badly we might want it to, there are legitimate, reasonable grounds for skepticism. Should we not get some

sense of this before we are asked to make a collective, enormous, counter-intuitive leap of faith?

The lure of federal savings is a powerful one. In his proposal, Congressman Andrews, D-NJ, has seized upon an unarguable, commendable, federal policy initiative. If a direct lending approach can significantly save taxpayers funds that would be redirected to better help students, then who among us would not stand and applaud? The amount of savings has been questioned and a range has been reported by various groups who have studied the question. Of course, we will not have the definitive word until we have such a program up and running but it is certainly worth speculating how this might evolve.

"Our discontent is fueled by concerns with administrative efficiency."

Although there are savings by making loans directly rather than via commercial lenders, there will also be significant costs for tooling-up a new student loan industry, starting from scratch. *Maybe* there will be a role for current participants in the process but obviously much of this depends on whom you ask. Banks, state and non-profit agencies, and secondary markets, will tell you one thing. . .cutting through their vested self-interest, the fact is, we really don't know for sure. Undoubtedly there will be a new role for the Department of Education (which has clearly voiced its objection and for which, in any case, there is simply no basis to assume it can deliver). And the role beyond the origination function for colleges and universities looms as a major question. Whether it is handled internally by a mammoth infusion of staff and resources at the Department of Education, or subcontracted out to vendors, such a new loan program will have major cost implications. Importantly, the costs are of such a nature that they cannot be truly projected until a specific structure itself is set in place. Until that point, those who favor direct lending will say the savings are considerable; those opposed will say they are nonexistent; and those sitting uncomfortably on the fence, being unhappily skeptical, will continue to scratch their heads.

Furthermore, in addition to program administration costs, we should all have concerns about passing costs on to students. Higher interest rates for borrowing, the removal of interest subsidies (floated but later removed in a Senate proposal for federalized loan reform) are aspects of loan reform of which we should be leery and attentive. Good intentions notwithstanding, our primary objective should be to maintain the currently attractive terms of student loans, *from the borrower's perspective*, and to make sure that we emerge with nothing less than we now have.

Another question posed earlier deals with a fundamental philosophical matter: should the loan system acquire capital via a centralized, entirely federal system, or should it do so via a private, decentralized approach, using federal *and* private capital on a partnership basis with one leveraging greater amounts of the other?

In some respects, this issue concentrates on the special allowance payment (SAP) the federal government now provides to commercial lenders as an incentive to make high risk loans to college students. The $1.4 billion or so paid out each year by the federal government for this

purpose becomes the tempting apple, dangling on the tree, waiting to be plucked.

In one sense, the SAP is an unnecessary, wasteful, perverse form of federal subsidy. Why should commercial banks profit from a system designed to help students pay for college?

The value of using federal funds to leverage greater amounts of private capital is that potentially more students can be helped than with an absolutely federalized system. *Where* the capital for loans comes from is a key issue that cuts to the quick in the partnership and risk sharing of our student aid system. The current model uses federal capital to leverage private funds which then are provided to students. From that point on, the federal commitment is then focused on student interest subsidies, attractive repayment features, and defaults.

From the perspective of many independent colleges and universities, the bang for the federal buck in the Stafford loan program far exceeds that of every other Title IV program. The ultimate uncertainty, which we would be foolish and naive to ignore, concerns the flow of capital, access to it and control of it. An entirely federalized loan system, dependent upon huge and growing levels of increased federal debt ($10 to $20 billion per year), deserves our attention.

Key Principles for Student Loan Reform

As we press ahead to find improvements in the federal student loan system, it may be useful from time to time to stand back, to listen to what we have heard, and to review what we have learned. In this spirit, several key principles are emerging from this debate:

- Whatever loan program we establish, it must provide reasonable assurances for access to capital, for both immediate and long-term needs. In this regard, as a public policy matter, the federal government has the *primary* responsibility, but it need not have and should not have the *sole* responsibility. Partnership is a powerful engine. *All* potential sources of capital for student loans should be explored including families who, by virtue of a federally endorsed college savings program, may potentially generate significant capital. Secondary loan markets represent another meaningful player in the capital formation process with college and university partnerships that extend lines of credit to meet the needs of student borrowers.
- The terms of interest and repayment must be geared to students and must, at a minimum, be as attractive as is now the case. In this regard, students—especially those capable of repayment—should be permitted to borrow significantly more than is currently permissible.
- The program should promote academic choice for students. Whether it be for selection of a college or selection of a major, student loan programs should enable students to make good choices.
- To the extent practical, loans should be originated at the campus level.
- Greater risk sharing, including on the part of colleges and universities, might do much to restore integrity to the programs and meaningfully lower the federal government's exposure to default costs.

- To better serve students, application procedures as well as institutional requirements should be standardized, streamlined and made more efficient.
- Optional repayment provisions (geared to borrower choice) should be provided to create optimal repayment opportunities.

Reasonable people express strongly differing opinions when it comes to particular proposals for reform. Either way, some believe that we must wipe the blackboard clean and start anew; others see great potential for achieving such reforms within the current structure. Perhaps a set of principles such as these could help enrich and inform the debate and keep it focused.

Thoughts on a Pilot Program

Given all of this, the only responsible position that we can take on federal student loan reform would be to endorse, support, advance, promote and otherwise strive for reforms that:

A. Improve and enhance the *current* Part B loan structure in Title IV of the Higher Education Act and,

B. Create a carefully crafted, honest pilot program that will resolve unanswered questions about direct lending in terms of capital supply, delivery system infrastructure, program integrity and service to students.

We will miss a wonderful opportunity if we do not take advantage of the reform movement to improve the current Stafford Loan system. A direct lending pilot program would help us all learn what we must know. Skeptics could be converted.

How might a pilot work? We should begin by identifying what it is we wish to know:

> How will the federal government raise the capital required? What are the Treasury-related mechanisms? What congressional and executive interests beyond those who sponsor the initiative, for instance, will come to bear?
>
> *How* will money will be delivered to the student?
>
> What must schools do to determine eligibility, to make awards, to draw down funds?
>
> Who will service the loan while the student is in school? What is involved in this? How will the servicer be kept appraised of enrollment status? What happens when a loan enters repayment?

At a minimum, these are basic administrative issues to be worked out. There are more for sure and more will arise as the structure takes shape.

There's been a fair amount of discussion about how large a pilot program should be: 500 schools, 300, 200, 20. . . The size of the pilot program is not the real issue. In fact, one could argue the smaller the better. To make a pilot of this kind work, the focus should be narrow, the scope clearly defined rather than unwieldy, a laboratory setting

rather than a loose random structure. The pilot should include only those institutions who are prepared to make a fundamental commitment: *to make this work.*

There are institutions ready to embrace direct lending. We all could learn much from them. Indeed, if properly structured and supported not only by Congress but by the Department of Education, some of the reluctant skeptics would be drawn to such a pilot. For instance, a pilot program that would establish parallel programs operating on a campus, with loan options of identical terms for students to assess the pro's and con's of a Stafford structure on the one hand and direct loans on the other, would best resolve our questions. In the public policy interest, this is how we will create greater potential for the attractive elements in a direct lending program to become a reality.

Repayment and Defaults

In addition to direct lending, other policy options emerging in this Reauthorization include income contingent repayment programs and the use of the IRS to collect loans. At the time of this writing, a Senate proposal submitted to the Senate Finance Committee advances these very features. Much of this leads us back to where we began: student loan defaults and how they might be remedied.

The reality is that student loan defaults will never go away, unless of course we narrow the loan programs so specifically to ensure that only those who can repay will borrow.

The question really is: who pays for the loan when the borrower does not? In a literal sense, we have an income contingent loan structure right now. Ample data exists showing that the greatest reason for default is a borrower's unemployment. Those who find and keep jobs, find a way to repay. Default today, since it is paid for by income taxpayers, represents the ultimate income contingent program. We could shift this around—for reasons that can be argued—and make borrowers rather than citizens pay for defaults, via surcharges, insurance premiums or "progressive" repayment rates geared to the income of borrowers once they have finished their studies and begin to pursue their careers (higher income borrowers pay for the failure of low or zero income borrowers to meet their obligations). This is true whether loans are directly or indirectly supplied and we can extend the loan payment period to 20–25 years. The point is, someone will pay.

One ironic advantage to the new "scoring" procedures of credit reform applied to the Stafford Loan structure may be that default costs are kept more in focus, even more in the forefront of our policy consideration. Since, under the new rules, the cost of each dollar lent is equal to the total cost of providing that one dollar in capital over the life of the loan, the frequency and likelihood of default must be part of the calculation. Efforts on the part of institutions to minimize default rates by providing sound and worthwhile educational offerings, coupled with a firm commitment to student financial aid (which, for most if not all independent colleges and universities ensures a grant loan *balance* despite the federal government's inability to do so) may have more powerful implications as a result. Who knows, perhaps federal policies may someday recognize and promote such efforts.

There is reason to be skeptical about using the IRS as a collection agent. Perhaps if the billions of dollars of uncollected taxes we hear about from time to time were, in fact, collected by the IRS, we would be in the happier position of thinking about how we might take better advantage of considerably more federal money available to help college students fulfill their education dreams.

Regardless, there is no doubt that this Reauthorization offers us the opportunity to achieve major changes in federal student aid and in particular, student loan reform. Whether we will enhance or diminish the opportunities for students to fulfill their dreams and, in turn, better our nation, remains the ultimate question.

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