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New Paper Shows No Difference in FFELP's, Direct Lending's Costs *Pres.'s '06 Budget Understates FDLP's Subsidy Rate, Overstates FFELP's*

Washington, D.C. – [America's Student Loan Providers](#) today released a [white paper](#) that for the first time puts a dollar figure on the impact of flaws in federal budget rules on student loan program cost estimates, concluding that no significant difference exists between the Federal Family Education Loan (FFEL) Program's costs to taxpayers and the Federal Direct Loan Program's.

Kevin Bruns, Executive Director of [America's Student Loan Providers](#), stated, "This paper should give anyone pause before making dramatic changes in the federal student loan programs. After correcting for obvious problems in how the FFEL program and Direct Loan program are scored, there really isn't any difference in how much the two programs cost taxpayers. If anything, the FFEL program has cost slightly less."

"The Federal Family Education Loan Program: A Better Deal for Students & Taxpayers" draws on official government data found in the President's FY 2006 budget proposal, as well as reports by the U.S. Government Accountability Office, the Education Department's Inspector General, and PricewaterhouseCoopers. It shows that the FY 2006 budget's comparison of program costs, which says the subsidy cost differential between the two programs is 7.64 percent, is seriously flawed and that it significantly understates the subsidy cost of the Direct Loan program and overstates that of FFEL program. Specifically, the cost estimates found on page 371 of the budget proposal:

- **Count FFEL program costs for 1992 and 1993 - years in which the Direct Loan program did not exist** – Eliminating them makes cost estimates fairer and more meaningful.

Effect on Subsidy Rates: FFEL program, reduced to 9.10 percent; Direct Loan program, increased to 1.76 percent.

- **Include cost estimates for 2002-2004, years whose loan cohorts have yet to go into repayment** – Eliminating them makes estimates more reliable and fairer.

Effect on Subsidy Rates: FFEL program, reduced to 8.66 percent; Direct Loan program, increased to 3.83 percent -- cost differential is reduced to 4.83 percent.

- **Do not include the Direct Loan program's administrative costs** – Counting them makes estimates more accurate and fairer.

Effect on Subsidy Rates: FFEL program, increased to 9.52 percent; Direct Loan program, increased to 6.23 percent -- cost differential is reduced to 3.29 percent.

- **Do not include tax revenues generated by FFEL program loan providers** – Including tax revenues makes estimates more accurate and fairer.

Effect on Subsidy Rates: FFEL program, decreased to 7.62 percent; Direct Loan program, decreased to 6.17 percent -- cost differential is reduced to 1.45 percent.

(more)

- **Do not account for the risks to direct loans from defaults, consolidations or interest rate fluctuations** – Adding a risk premium of 0.25 percent to the government’s discount rate makes estimates more accurate and fairer.

*Effect on Subsidy Rates: FFEL program, remains at 7.62 percent; Direct Loan program, increased to 7.67 percent -- **cost differential is eliminated.***

“Just correcting for these flaws,” Bruns said, “brings the debate back to earth. The reality is that the subsidy rate for the FFEL program is 7.62 percent, not 9.40 percent, as stated in the FY 2006 budget. And the Direct Loan program’s subsidy rate is 7.67 percent, not 1.76 percent.

“In other words, it may actually cost taxpayers slightly less, per dollar loaned, to provide guaranteed loans to students than it does to lend directly to students,” Bruns said. “This paper should put an end to any serious talk of moving schools into direct lending from the FFEL program to save money.”

The paper does not attempt to correct for all the biases found in budget scorekeeping. Nor does it account for the value to students, families and schools of the hundreds of college awareness, debt management, borrower benefit, anti-default and scholarship programs sponsored every year by private and nonprofit loan providers.

“If we could fix everything and quantify the value of our public service programs,” Bruns said, “there would be no doubt that the FFEL program is a better deal for everyone – students, parents and taxpayers.”

A copy of “The Federal Family Education Loan Program: A Better Deal for Students & Taxpayers” is posted on ASLP’s web site: www.studentloanfacts.org.

America’s Student Loan Providers represents more than 80 education and financial firms and organizations that provide federally guaranteed student loans through the Federal Family Education Loan Program (FFELP), a public-private partnership of schools, students, loan providers, loan guarantors, and the federal government. By leveraging private financial markets and competing for the right to lend to students, the FFELP brings value to students, schools, and taxpayers. Students benefit through lower interest rates, and simplified loan application and approval processes. More than 500 schools have switched to the FFELP since 1998 because it allows them to choose the lender that best meets the financial needs of their students. More information is available at www.studentloanfacts.org.

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**THE FEDERAL FAMILY EDUCATION LOAN PROGRAM:
A BETTER DEAL FOR STUDENTS & TAXPAYERS**

JULY 12, 2005

Executive Summary

As Congress prepares to reauthorize the Higher Education Act, the long running debate on the relative cost of the two major student loan programs – the Federal Family Education Loan (FFEL) Program and the Federal Direct Loan Program – will once again be before legislators.

The Office of Management and Budget (OMB), as well as the Congressional Budget Office (CBO), “score” the Direct Loan program as being less expensive than the FFEL program. America’s Student Loan Providers (ASLP) can now demonstrate that the official government score is incorrect – that the FFEL program’s costs to the government are roughly the same as the Direct Loan program’s.

ASLP has long argued that OMB’s cost estimates are flawed not only because they are based on overly optimistic projections of future performance of the Direct Loan program, *but also because they omit key program costs* (e.g., administrative costs) *and credits* (e.g., tax revenues generated by private loan providers). ASLP members believe that if these projections better reflected the risks associated with *actual program performance* and omitted costs and credits were counted, OMB (and CBO) would draw a far different conclusion.

ASLP decided to perform its own analysis. Drawing on official government data found in the President’s FY 2006 budget proposal, as well as reports by the Government Accountability Office (GAO), the Department of Education’s Office of the Inspector General (IG), and PricewaterhouseCoopers (PWC), among others, the ASLP analysis demonstrates that the FFEL program costs taxpayers roughly the same or slightly less to operate than the Direct Loan program. We came to this conclusion by taking the following steps:

- ❑ ***Confine Cost Comparison To Relevant Time Frame.*** We did this by comparing only the years in which loans were made in both the FFEL program and the Direct Loan program *and* are mature enough to have actual performance histories;
- ❑ ***Adding In Missing Costs And Credits.*** We added in the administrative cost of the Direct Loan program and the taxes paid by participants in the student loan program to each program’s revenue stream; and
- ❑ ***Adding a Risk Premium To the Direct Loan Program.*** Even though the costs of the Direct Loan program are highly dependent on future interest and principal payments by borrowers, OMB scoring methodologies do not account for the considerable risk of default, consolidation or interest rate fluctuations (which private lenders are required to account for). We accounted for these risks by assigning a minimal risk premium of 0.25 percent, or 25 basis points.

After correcting for these factors, *our analysis demonstrates that the subsidy rate for the FFEL program is 7.62 percent, not 9.40 percent*, as stated in the President's FY 2006 budget. More important, *the Direct Loan program's subsidy rate is 7.67 percent*, not the 1.76 percent found in the budget. In other words, making these reasonable corrections, the cost advantage of the Direct Loan program is eliminated.

This paper reaches this conclusion, it should be pointed out, without correcting for all the biases found in the government's budget scorekeeping rules. Nor does it even begin to account for the value to students, families and schools of the hundreds of college awareness, debt management, borrower benefit, anti-default and scholarship programs sponsored every year by private and nonprofit loan providers, not to mention investments in service enhancements, quality improvements and new technologies.

Comparing Subsidy Cost Rates FFELP and Direct Lending Costs Are Virtually Identical

The federal budget determines the cost of a loan program by projecting the *average lifetime subsidy rate*. To arrive at the subsidy rate for loans originated in a fiscal year (or loan cohort), OMB *divides* the total projected costs of the loans to the government over the life of the loans (that is, the combined *net present values* of all of its loans or guarantees, including interest subsidies and payments, fees, defaults, administrative expenses, etc.) *by* total amount of loans originated that year.

When proponents of the Direct Loan program claim that direct lending costs taxpayers less than the FFEL program, and that therefore loan volume should be shifted from the FFEL program to the Direct Loan program, they base their claim primarily on the government estimates of each program's subsidy costs such as are found on page 371 of the President's FY 2006 budget. Regrettably, for many the discussion of student loan program costs begins and ends on page 371, despite mountains of analysis and evidence that the information on this page does not reflect the true costs of either program.

This paper starts with the cost comparison on page 371, identifies significant biases in both the comparison and the government's scorekeeping model, and then *quantifies the impact of these biases and other flaws on how program subsidy rates are calculated*. The biases identified in this paper include:

- ❑ Counting years when the Direct Loan program did not exist in the subsidy cost of the FFEL program,
- ❑ Counting years in which most student loans have yet to go into repayment,
- ❑ Not accounting for administrative costs of the Direct Loan program or the tax revenues generated by FFEL program loan providers, and
- ❑ Not accounting for the risks associated with projecting future repayments of loans made by the Direct Loan program, either from higher than expected defaults or consolidations or from interest rate fluctuations.

DEPARTMENT OF EDUCATION

OFFICE OF STUDENT FINANCIAL ASSISTANCE - General Fund Fiscal Year 2006 371

The following table shows government payments to and from lenders, guaranty agencies, and borrowers for specific years, regardless of when loans were originated. These flows do not reflect long-term costs to the government, nor the value of outstanding loan assets; these are reflected in credit reform subsidy estimates. For example, collections on defaulted FFEL loans due to Consolidation produce a current year cash inflow and a long-term cost associated with re-default risk and future lender interest subsidy payments.

The Federal Credit Reform Act of 1990 accounts for differences in the amount and timing of cash flows among direct and guaranteed loan programs to make cost estimates for those programs comparable with each other and other federal programs.

Selected Program Costs and Offsets (in thousands of dollars)

	2004 est.	2005 est.	2006 est.
FFEL			
Payments to lenders			
Direct loans	1,094,547	1,088,553	1,032,251
Direct advance payments	1,203,248	1,208,427	1,202,251
Direct costs	2,297,795	2,296,980	2,234,502
Loan charges	73,013	63,862	1,077,281
Student fee payments	15,026	12,277	20,251
Payments to guaranty agencies			
Loan guarantee fee income tax	27,900	26,800	31,100
Interest maintenance fee	20,000	20,000	20,000
Other administrative payments	20,000	20,000	20,000
Net cost to the Department of Education	3,384,486	3,384,486	3,384,486
Interest expense tax	(243,423)	(243,423)	(243,423)
Net cost to the FFEL	3,141,063	3,141,063	3,141,063
Direct Loans			
Direct loans	1,094,547	1,088,553	1,032,251
Direct advance payments	1,203,248	1,208,427	1,202,251
Direct costs	2,297,795	2,296,980	2,234,502
Loan charges	73,013	63,862	1,077,281
Student fee payments	15,026	12,277	20,251
Net cost to the Direct Loans	3,603,634	3,603,634	3,566,736

The Federal Credit Reform Act of 1990 requires the cost of existing loan cohorts to be reestimated to reflect changes in actual and assumed borrower behavior, interest rates, and other factors. The following table shows the impact of those reestimates in FFEL and Direct Loans.

Loan Determination and Safety Costs

	2004 est.	2005 est.	2006 est.
Total Subsidy Costs - 1990-2004			
Direct Loans	3,566,736	3,566,736	3,566,736
FFEL	3,141,063	3,141,063	3,141,063
Total	6,707,799	6,707,799	6,707,799

Changes in interest rate projections are a significant factor in FFEL and Direct Loan reestimates; recent declines in interest rates below historical averages have accordingly been a major driver in changes to program costs. Changes in borrower behavior (notably, prepayment of loans through consolidation and reduction in defaults) have also contributed to those reestimates. The average lifetime subsidy rate for all outstanding FFEL loans after the most recent reestimate is 0.40; the comparable Direct Loan rate is 1.76. For the oldest loan cohorts, many of the subsidy costs have been expended (e.g., reworked interest subsidies).

Direct Classification (in millions of dollars)

	2004 est.	2005 est.	2006 est.
Student Loan Program Costs, Comparative Analysis, Including Program and Administrative Activities (in thousands of dollars)			
FFEL			
Direct subsidies	1,112	1,112	1,112
Direct loans	1,010	1,010	1,010
Net defaults	1,010	1,010	1,010

In correcting for these biases found in the President's FY 2006 budget and including only loan cohorts mature enough to have actual performance history, our analysis finds that the per-loan cost of the FFEL

Funny Numbers

Why the Federal Scorekeeping Model Is Flawed

The reasons for the huge gap between official government estimates of program costs and their actual costs are found in budget scorekeeping rules. When OMB (and CBO) estimates the budget costs for federal credit programs, it follows procedures laid out in the Federal Credit Reform Act of 1990. Under this act, budget costs for loan programs are defined in terms of the *net present value* of the government's cash flows over the life of the loans or guarantees. To arrive at that number, OMB must account not only for expected defaults and consolidations, but also future interest rates – specifically, the projected relationship between short- and long-term interest rates (i.e., the shape of the yield curve).

Projecting Interest Rates: Inherently Unpredictable, Usually Unrealistic

Few things are harder to predict (and have as much import) than interest rates. Moreover, because the interest rate on the loan – the rate the borrower pays the government – is variable and changes annually (and the loan can be in repayment for up to 30 years), determining the net present value of a direct loan is especially tricky, imprecise and fraught with error.

The risk is more than theoretical. According to a 2005 PWC report, “compared to historical experience, [CBO] and the Administration understate the steepness of the yield curve in their interest rate projections,” reducing the estimated cost of the Direct Loan program relative to the FFEL program.

Additionally, for every cohort since 1995, except one, government projections for direct lending have worsened over time – that is, originally projected losses have been revised upward and projected gains revised downward or eliminated. As of 2004, OMB is projecting a loss of \$3 billion, a swing of more than \$6 billion.

Projections of savings based on the direction of future interest rates, therefore, should be viewed warily. Besides PWC, other experts have reached the same conclusion.

- The Education Department IG has concluded that “in any given year either FFELP or FDLP total costs ... may be greater, given the impact of prevailing economic conditions on subsidy costs.”
- In 2001 the GAO concluded that it “cannot predict with any certainty the future prospects for the continued estimated negative subsidy for [Direct Loans] because it is a relatively new program with limited historical data and is very sensitive to fluctuations in interest rates and other factors.”

Other Scorekeeping Biases Favor Direct Lending

The PWC report also identifies other scorekeeping biases: the failure to take into account tax revenues produced by FFEL program loan providers, and the omission of direct lending's administrative costs. The report ultimately concludes that, “*under certain economic circumstances either program can be the more expensive of the two.*”

Sources: PWC, “The Limitations of Budget Score-keeping in Comparing the Federal Student Loan Programs,” March 3, 2005; U.S. Department of Education Office of the IG, “Study of Cost Issues: FFELP and FDLP,” March 1999, p.1; GAO, “Key Aspects of the Federal Direct Loan Program's Cost Estimates,” GAO-01-197, p. 37.

program is roughly equal to that of the Direct Loan program. Specifically, *our analysis demonstrates that the subsidy rate for the FFEL program is 7.62 percent, not 9.40 percent, as stated in the President's FY 2006 budget. More important, the Direct Loan program's subsidy rate is more than four times greater than stated in the budget – closer to 7.67 percent, not the 1.76 percent found in the budget.*

In other words, it has cost the federal government as much, on a per-dollar loaned basis, to provide loans to students through the FFEL program as it has through direct lending.

This paper reaches this conclusion, it should be pointed out, without correcting for all biases found in the government's scorekeeping rules. Nor does it even begin to place a value on the millions of dollars private and nonprofit loan providers spend each year on college awareness, debt management, anti-default and scholarship programs, not to mention investments in service enhancements, quality improvements and new technologies.

Starting Point: Page 371 of the FY 2006 Budget

The President's FY 2006 budget appendix serves as a useful starting point for this analysis because it sets the stage for formulating a true cost comparison of the two loan programs. The 2006 budget includes new tables that attempt to incorporate previously omitted variables – loan re-estimates – into the cost equation. The budget appendix contains information on the cost of the annual cohorts of loans made by the FFEL program and the Direct Loan program during the period from 1992 through 2004.¹ Information on page 371 is often cited as the “proof” by direct lending advocates that direct lending is cheaper than the FFEL program. Yet, after examining what is included in the numbers and what is excluded, it is clear that page 371 provides no such proof.

Loan Disbursement and Subsidy Costs			
Total Subsidy Costs—1992-2004			
	FFEL	Direct Loans	
Original Subsidy Costs	+\$46 billion	-\$2 billion	
Cumulative Reestimates	-\$7 billion	+\$5 billion	
1992-2004 Subsidy Costs	+\$39 billion	+\$3 billion	
Total Disbursements	\$413 billion	\$146 billion	

The historical information on page 371 incorporates the *cumulative* budget cost re-estimates to date for these loan cohorts and shows the subsidy cost differential of the two programs to be 7.64 percent. These re-estimates were based on changes in actual and assumed borrower behavior, interest rates, and other factors.² In the aggregate, the re-estimates to date have reduced the original estimates of the cost of FFEL program loans and increased the original estimates of the cost of Direct Loan program loans. This information from

	FFEL Program	Direct Loan Program	Difference
President's Budget			
1992 to 2004 Subsidy Costs	39	3	36
Total Disbursements	413	146	267
Subsidy Rate	9.40%	1.76%	7.64%

the budget, our starting point, is summarized in Table 1.

¹ Budget of the United States Government, Fiscal Year 2006 – Appendix, p. 371.

² It should be noted that even after being “re-estimated,” loan cohort costs remain “estimates” of what the loans disbursed in those years will cost. In its January 2001 report, the GAO found that the Department of Education did not track loan performance by loan cohort. GAO-01-197, p. 23. This means that the department had no ability to determine the actual costs of the loans disbursed in those years. It was using a model to “estimate” what was actually spent. GAO’s follow-up report last year found that the Department had improved its estimating capability but still did not compare what it had forecast for loans disbursed in each year with what those loans actually cost. GAO, “FDLP Cost Estimates,” GAO-04-567R, p. 34.

Confine Cost Comparison To Relevant Time Frame

We begin our analysis by narrowing the calculation of program costs to years in which both programs were actually operating, and to those loan cohorts for which actual performance data exists. The first problem with the budget data information set forth in Table 1 is that it includes FFEL program information for 1992 and 1993, fiscal years which *predate the launch of the Direct Loan program*. FFEL program loans made in these years also had different terms than what both programs offered in subsequent years. Since no comparable loans made by the Direct Loan program are included in the comparison, it is deceptive to include those years in any comparison. To correct this flaw, the following table deletes information for these two years in which no loans were made by the Direct Loan program:

	FFEL Program	Direct Loan Program	<i>Difference</i>
1994 to 2004 Subsidy Costs	35	3	32
Total Disbursements	382	146	237
Subsidy Rate	9.10%	1.76%	7.32%

A second problem with the budget data found in Tables 1 and 2 is that they include information on loans made in FY 2002, 2003, and 2004. These in fact are the only years in which the current subsidy cost estimates for direct lending show the government making a “profit”³ – something that has never occurred in the history of the Direct Loan program.⁴ The loans from these years are still early in the aging process, and many loans made since 2002 have not yet even entered repayment. Many of these borrowers are still in school and/or can be expected to consolidate their loans at lower rates than are currently forecast by OMB (which will increase subsidy rates in the Direct Loan program). Based on experience, as loans in the Direct Loan program mature, subsidy estimates are revised upward.

While OMB’s presentation on page 371 intends to account for the effect of re-estimates of outstanding loan cohorts, the re-estimates of these new cohorts have barely begun to occur. If re-estimates are important (and history shows they are), then lumping cohorts lacking a re-estimate history in with those that have such a history results in an apples and oranges comparison. Therefore, to make an accurate comparison between the cost of the FFEL program and the Direct Loan program, loans made in 2002-2004 must be excluded from any comparison made between the two programs. Taking this action leaves only those years where there is at

³ Budget of the United States Government, Fiscal Year 2006 - Federal Credit Supplement, p. 34.

⁴ Budget of the United States Government, Fiscal Year 2006 - Federal Credit Supplement, p. 34.

least some performance data.⁵ This simple adjustment reduces the difference in subsidy costs to 4.83 percent, as shown in the following table:

	FFEL Program	Direct Loan Program	<i>Difference</i>
1994 to 2001 Subsidy Costs	17	3	14
Disbursements	200	91	110
Subsidy Rate	8.66%	3.83%	4.83%

By simply correcting a pair of methodological flaws, the difference in subsidy costs between the two programs is reduced by 35 percent.

Adding Missing Costs and Credits

The next steps in this analysis take into account the scorekeeping biases identified by PWC (and others) – biases OMB have not been able to address because of the dictates of credit reform accounting. Although the OMB’s costs estimates for the Direct Loan program omit administrative costs, the President’s budget this year includes for the first time *an estimate* of the unaccounted-for administrative costs. This estimate, offered for informational and analytical purposes only, is inaccurate and understates direct lending’s operating costs. How? By including forward-looking estimates, based on the new Common Services for Borrowers contract that will be fully implemented over the FY 2004-2008 period.

To accurately account for the lifetime costs of administration for loans made from 1994 to 2001, the cost of administration under *previous* contractual arrangements needs to be taken into consideration for the time period those contracts were in place. Current costs can then be taken into consideration for the remaining life of each of the loan cohorts. A 1999 Department of Education study found that the administrative cost of direct lending was 3.62 percent on a net present value basis, while that of the FFEL program was 1.02 percent.⁶ Thus, for each of the loan cohorts, we have calculated administrative costs for the period such cohorts were administered under the old arrangements as well as for their expected life under the new contract. As shown in Table 4, the effect of correcting for this bias in the FY 2006 budget is to reduce the differential between the two programs’ subsidy rates by another 1.54 percent.

⁵ It should be noted that the remaining loan cohorts all have a remaining life expectancy. All therefore are subject to continuing reestimation. Based on our experience to date, we can expect that the cost of these existing cohorts will, on average, continue to be reestimated upward.

⁶ U.S. Department of Education, “Incorporating Federal Administrative Costs into FFEL and Direct Loan Program Cost Estimates,” November 1999, p. 6.

	FFEL Program	Direct Loan Program	Difference
1994-2001 Subsidy Costs*	17	3	14
Subsidy Rate	8.66%	3.83%	4.83%
Administrative costs			
Future, under new contract	0.33%	0.81%	-0.48%
Past, under old contract	0.53%	1.59%	-1.06%
Total Administrative costs	0.86%	2.40%	-1.54%
New Subsidy Rate	9.52%	6.23%	3.29%

** In billions of dollars*

Another item left out of the President’s budget is the tax revenue generated by both programs. A key finding of the PWC report is that the participants in the FFEL program paid \$650 million in federal taxes in 2004.⁷ The report uses IRS data and industry sources to project the difference in the federal tax revenues generated from the two programs. The PWC report estimates that the federal government collects 0.23 percent to 0.30 percent in taxes for every outstanding dollar of FFEL program loan, while collecting less than 0.01 percent for every dollar of outstanding direct loan. The Direct Loan program generates very little tax revenue. Virtually all of the expected “profit” made by the program is already considered in budget scoring projections as revenue to the government.

Applying these percentages to the FFEL program and Direct Loan cohorts over their estimated lives demonstrates that, on a net present value basis, the amount of federal taxes generated as a result of FFEL program lending is about \$0.019, or 1.90 percent, of every dollar loaned, while that of direct lending is about \$0.0006, or 0.06 percent, of every dollar loaned.

	FFEL Program	Direct Loan Program	Difference
1994 to 2001 Subsidy Costs*	17	3	14
Subsidy Rate	9.52%	6.23%	3.29%
Tax impact	-1.90%	-0.06%	-1.84%
New Subsidy Rate	7.62%	6.17%	1.45%

** In billions of dollars*

⁷ The PWC report was co-authored by Linden C. Smith, Managing Director with PWC’s National Economics Consulting group and former economist responsible for revenue estimating and scorekeeping work for the Joint Committee on Taxation and, before that, for the U.S. Department of Treasury; and John Stell, Senior Manager for National Economics Consulting group and former analyst for the Congressional Budget Office.

Remarkably, by simply adding the administrative costs and the tax revenues to OMB's cost estimates for the years 1994 to 2001, most of the cost differential between the two programs disappears. The final step will close the gap entirely.

Use a Discount Rate That Reflects Risk

Even though the costs of the Direct Loan program are highly dependent on future interest and principal payments by borrowers, OMB scoring methodologies do not account for the considerable risk of default, consolidation or interest rate fluctuations (which private lenders are required to account for). The government does not address these risks, and the evidence is clear that this process does not work well.

In fact, OMB has had to raise the Direct Loan program's subsidy costs every year as actual interest rates have replaced earlier projections. Moreover, the GAO concluded in 2004 that the Direct Loan program could not accurately estimate future interest income on student loans, as evidenced by the program's overestimating interest income by 67 percent between 1994 and 2003. The PWC report also shows that the government's inaccurate interest rate projections have had the effect of underestimating the Direct Loan program's costs and overestimating the FFEL program's.

There is another, well-established way, however, to account for the risk associated with loans made by the Direct Loan program and its effects on the program's subsidy costs.

In recent testimony before the Senate Budget Committee, CBO Director Douglas Holz-Eakin stated that there is a shortcoming with the Credit Reform Act, since "it appears to understate the economic cost of federal credit programs, because the discounting of expected cash flows at the government's risk-free borrowing rate ignores certain costs of risk." The director stated that a "market-based rate" should be used to discount cash flows for these programs.⁸ This rate would by definition be higher than the risk-free rate of government bonds, which is what is currently used to discount these cash flows.

"It may be time to revisit the credit-reform model and its application. One shortcoming of the current approach is that it appears to understate the economic cost of federal credit programs, because the discounting of expected cash flows at the government's risk-free borrowing rate ignores certain costs of risk."

CBO Director Douglas Holz-Eakin
Before the Senate Budget Committee
February 16, 2005

In the case of the Direct Loan program, not accounting for risk through the discount rates assures that the budget subsidy amounts overvalue the future cash flows and that the government fails to set aside sufficient

⁸ Statement of Douglas Holz-Eakin, "The Economic Costs of Long Term Federal Obligations," testimony before the Senate Budget Committee, February 16, 2005, p. 8.

funds to pay for the loans originated in that year. In the private sector, companies are required to discount future cash flows, such as residual cash flows from securitizations at higher rates. If they did not, they would be accused of inflating their earnings. There is a risk associated with the Direct Loan program, which can be demonstrated by the large amount of adjustments made retroactively to loan cohorts made in prior years. Prudent budgeting requires a higher discount rate, especially when projecting future interest earnings on loan cohorts.

Determining an appropriate discount rate raises many issues. We estimate that current budget procedure omits, *at a minimum*, a risk premium of about 0.25 percent from the annual borrowing cost of the Direct Loan program. Applying this factor to the remaining lives of the outstanding direct loans translates into an increase of approximately 1.50 percent in the subsidy cost of direct lending (since the average life of a loan is about six years).⁹ It is certainly possible that this adjustment is not sufficient to capture the risk inherent in the cash flows for interest and principal payments in the Direct Loan program. We strongly recommend this as an area for additional study and action.

As a result of taking this final step of adjusting subsidy costs to reflect the risks associated with direct lending, the cost differential between both programs not only disappears, but the FFEL program’s subsidy cost is 0.05 percent less than direct lending’s.

	FFEL Program	Direct Loan Program	<i>Difference</i>
Subsidy Costs (after adjustments)	15	7	8
Disbursements	200	91	110
Subsidy Rate (after adjustments)	7.62%	7.67%	-0.05%

Conclusion

For years, proponents of the Direct Loan program have argued that the program has saved taxpayers “billions.” This argument has always been based on future projections of savings – savings that have not in fact materialized in the 11-year history of the Direct Loan program.

⁹ Because most of the FFEL program costs are early in the loans’ lives (in-school interest payments and defaults), FFEL program subsidy estimates are far less sensitive to discount rates and are not affected by the higher rate.

After correcting the flaws in the budget comparisons and scorekeeping, our paper shows that the average lifetime subsidy rates of the two programs are roughly equivalent. A complete tabulation of these results, contained in Appendix 1, lays out how the rosy projections of the benefits of the Direct Loan program disappear when the biases are corrected.

And there are at least two other considerations, not factored in, that would tend to make the FFEL program even cheaper. First, no attempt was made to quantify the full impact of the government's use of problematic interest rate projections. Second, no attempt was made to adjust for programmatic changes currently under consideration by the Congress (e.g., those contained in HR 609), all of which would further reduce the cost of the FFEL program relative to direct lending.

There is one other factor which we address in Appendix 2. While this paper has looked at the costs of the two programs from a subsidy cost perspective, we believe the performance of the two programs on a cash basis cannot be ignored. On a cash basis, the FFEL program has performed far better than the Direct Loan program.

As Congress prepares to consider reauthorization of the Higher Education Act, we believe that the analysis we have prepared presents policymakers with a far more accurate estimate of the true costs of both student loan programs. We also believe it is imperative that OMB and CBO address the flaws in the scoring models that continue to create the impression that direct lending somehow generates profits for the federal government and is significantly cheaper than the private-sector based student loan program.

Appendix 1

Loan Disbursement and Subsidy Costs Total Subsidy Costs – 1992 to 2004

	<u>FFELP</u>	<u>FDLP</u>	<u>Difference</u>
President's Budget			
1992-2004 Subsidy Costs	39	3	36
Total Disbursements	413	146	267
Subsidy Rate	9.40%	1.76%	7.64%
Adjusted for Years before Direct Lending			
1994 to 2004 Subsidy Costs	35	3	32
Disbursements	382	146	237
Subsidy Rate	9.10%	1.78%	7.32%
Adjusted for Years with Little/No Performance Data			
1994 to 2001 Subsidy Costs	17	3	14
Disbursements	200	91	110
Subsidy Rate	8.66%	3.83%	4.83%
Adjusted to Reflect PWC Findings			
Administrative costs			
Future, under new contract	0.33%	0.81%	-0.48%
Past, under old contract	0.53%	1.59%	-1.06%
Total Administrative Costs	0.86%	2.40%	-1.54%
Tax impact	-1.90%	-0.06%	-1.84%
Interest rate adjustments	--	1.50%	-1.50%
Total missing costs	-1.40%	3.84%	-4.88%
Subsidy Costs (after adjustments)			
Subsidy Costs (after adjustments)	15	7	8
Disbursements	200	91	110
Subsidy Rate (after adjustments)	7.62%	7.67%	-0.05%

*Subsidy costs and loan disbursement are in billions of dollars

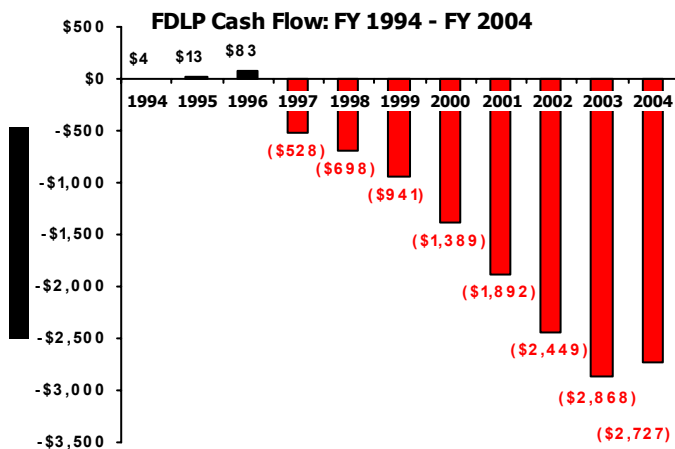
Appendix 2

As Measured by Cash Flow, FFELP Costs Less

Although the primary purpose of this paper is to demonstrate the true subsidy costs of the FFEL program and the Direct Loan program, it's important to recognize that the FFEL program has been significantly less expensive using another, important measurement – cash flow.

According to the GAO, the Department of Education has since 1994 received almost \$14 billion less in fees and interest payments from Direct Loan borrowers than it has paid the Treasury Department in interest. This number has been a negative number every year since 1997.¹⁰

An even more powerful conclusion emerges when one looks at all the cash costs of the two programs. Using official sources, the following table compiles these costs and offsets for each year since 1995. As a percentage of loans outstanding, the table shows that there has been only one year in which the net cash cost of the Direct Loan program was less than that for the FFEL program. And, since 2000, the total cash cost of the FFEL program has been less in each year than that of the Direct Loan program, despite the fact that total FFEL program loans outstanding are roughly three times that for direct lending.



Source: GAO-04-567R FDLP Cost Estimates measured on a cash basis

This cash flow analysis supports the conclusion of this paper that the rosy subsidy cost predictions for the direct lending are erroneous. Ultimately, the cash and subsidy cost numbers will need to reconcile. Given the actual cash flow history, current subsidy cost projections will not be able to stand up over time.

¹⁰ GAO report, GAO-04-567R FDLP Cost Estimates, updated by the President's FY 2006 Budget Appendix.

Selected Program Costs and Offsets (in millions of dollars)

	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
FFEL:										
Payments to lenders										
Interest benefits	2,171	2,522	2,237	3,198	3,658	1,943	1,946	2,171	1,224	1,495
Special allowance payments	159	380	272	642	858	976	945	221	452	1,205
Default claims	1,306	2,574	3,320	2,056	3,639	1,647	3,069	2,874	2,874	2,943
Loan discharges	24	252	303	287	530	310	323	446	634	736
Teacher loan forgiveness	0	0	0	0	0	0	0	0	6	10
Payments to guaranty agencies										
Loan processing and issuance fees	0	0	0	0	253	150	150	194	173	176
Account maintenance fees	220	167	150	170	177	180	180	180	195	195
Other administrative payments	8	43	21	91	7	0	94	135	232	242
Fees paid to the Department of Education										
Borrower origination fees	-710	-583	-277	-924	-637	-750	-832	-776	-933	-1,060
Lender origination fees	-115	-105	-46	-154	-106	-125	-28	-211	-327	-362
Sallie Mae offset fees	-10	-53	-35	-102	-26	-45	-51	-41	-45	-25
Loan holder fees	-57	-64	-130	-233	-196	-210	-287	-383	-743	-1,016
Other Major Transactions										
Net default collections	-210	-2,265	-1,751	-1,892	-4,421	-4,158	-4,332	-4,292	-3,973	-4,001
Contract collection costs	7	145	97	104	93	81	43	102	172	126
Federal administrative costs	101	116	145	150	170	211	228	230	225	232
Net Cash Flow, FFEL	2,894	3,128	4,308	3,392	3,999	210	1,448	850	166	896
COST AS % OF OUTSTANDING LOANS	3.4%	3.2%	4.1%	3.0%	3.2%	0.2%	0.9%	0.5%	0.1%	0.4%
Direct Loans										
Borrower interest payments	-14	-113	-300	-606	-1,067	-1,463	-1,868	-1,961	-1,720	-1,643
Borrower origination fees	-85	-318	-352	-382	-387	-359	-283	-334	-366	-392
Contract collection costs/payments for orig	14	15	---	1	---	29	87	56	89	81
Federal administrative costs	169	195	243	252	286	354	383	386	377	389
Net interest payments to Treasury	86	348	1,180	1,686	2,395	3,211	4,043	4,744	4,954	4,763
Net Cash Flow, FDLP	170	127	771	951	1,227	1,772	2,362	2,891	3,334	3,198
COST AS % OF OUTSTANDING LOANS	12.0%	1.8%	4.7%	3.6%	3.2%	3.5%	3.7%	3.8%	4.0%	3.7%

Source: FFELP Costs from Student Loan Accounts from the President's Budget Appendix, "Summary of Program Costs and Offsets" from the budgets for fiscal 1997 to 2005; "Selected Program Costs and Offsets" from fiscal 2006 budget; FDLP Costs: GAO-04-567R FDLP Cost Estimates; fiscal 2004 amounts from p. 371, Fiscal 2006 President's Budget Appendix; administrative expenses only reported in FY 2006 Appendix, other years' administrative expenses estimated based on 2004 share of total administrative expenses.