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February 2, 2009

Congressional Research Service

Report RS22308

Student Loans and FY2006 Budget Reconciliation

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February 14, 2006

Abstract. The Higher Education Act (HEA) reauthorization and budget reconciliation processes became intertwined during the first session of the 109th Congress. Each of the aforementioned authorizing committees marked up a comprehensive HEA reauthorization bill containing provisions that generate substantial net savings in mandatory spending on the student loan programs. Many of these savings provisions were included in committee reconciliation recommendations and in the reconciliation bills that gained passage in each chamber (H.R. 4241 and S. 1932). On December 19, 2005, the House passed the conference report (H.Rept. 109-362) on S. 1932, the Deficit Reduction Act of 2005. On December 22, 2006, the Senate passed the conference report with relatively minor amendments. The conference agreement, as amended, was passed by the House on February 1, 2006. The President signed the Deficit Reduction Act of 2005 (P.L. 109-171) into law on February 8, 2006.

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CRS Report for Congress

Student Loans and FY2006 Budget Reconciliation

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Summary

The FY2006 budget resolution (H.Con.Res. 95, H.Rept. 109-62) contains reconciliation instructions that require authorizing committees to report legislation to reduce mandatory spending by \$34.7 billion over a five-year period. Under these instructions, the House Committee on Education and the Workforce is responsible for a reduction of \$12.7 billion for FY2006 through FY2010. The Senate Committee on Health, Education, Labor, and Pensions is responsible for a reduction of \$13.7 billion over that period. These committees were required to report reconciliation recommendations to their respective budget committees, and each did so in October, 2005. The Higher Education Act (HEA) reauthorization and budget reconciliation processes became intertwined during the first session of the 109th Congress. Each of the aforementioned authorizing committees marked up a comprehensive HEA reauthorization bill containing provisions that generate substantial net savings in mandatory spending on the student loan programs. Many of these savings provisions were included in committee reconciliation recommendations and in the reconciliation bills that gained passage in each chamber (H.R. 4241 and S. 1932). On December 19, 2005, the House passed the conference report (H.Rept. 109-362) on S. 1932, the Deficit Reduction Act of 2005. On December 22, 2006, the Senate passed the conference report with relatively minor amendments. The conference agreement, as amended, was passed by the House on February 1, 2006. The President signed the Deficit Reduction Act of 2005 (P.L. 109-171) into law on February 8, 2006.

Budget Resolution

The House and Senate approved the conference report (H.Rept. 109-62) on H.Con.Res. 95, the Concurrent Resolution on the FY2006 Budget on April 28 and April 29, 2005, respectively. The annual concurrent resolution on the budget sets forth the Congressional budget. When the federal deficit is expected to be large, budget resolutions often require reductions in mandatory spending. In such instances, the budget resolution issues reconciliation instructions that require authorizing committees to report changes to legislation to reduce spending on mandatory programs under their jurisdiction.

The FY2006 budget resolution includes reconciliation instructions that direct authorizing committees to report legislation to reduce mandatory spending for the period FY2006-FY2010. Subsequently, these proposals are to be combined in a single reconciliation bill by the budget committees. Under the reconciliation instructions, the House Committee on Education and the Workforce is responsible for a reduction of \$12.7 billion overall for FY2006-FY2010; the Senate Committee on Health, Education, Labor, and Pensions is responsible for \$13.7 billion for FY2006-FY2010.

The Federal Family Education Loan (FFEL) program and the William D. Ford Direct Loan (DL) program are two of the major mandatory programs under each committee's jurisdiction. Each committee has looked to reduce mandatory spending on these federal student loan programs.

Federal Student Loan Programs

The federal government operates two major student loan programs: the Federal Family Education Loan program, authorized by Part B of Title IV of the HEA, and the William D. Ford Direct Loan program, authorized by Part D of Title IV of the HEA. These programs provide loans to undergraduate and graduate students and the parents of undergraduate students to help them meet the costs of postsecondary education.

Under the FFEL program, loan capital is provided by private lenders, and the federal government guarantees lenders against loss through borrower default, death, permanent disability, or, in limited instances, bankruptcy. Under the DL program, operated through the U.S. Department of Education (ED), the federal government provides the loans to students and their families, using federal capital (i.e., funds from the U.S. Treasury). The two programs rely on different sources of capital and different administrative structures, but essentially disburse the same set of loans.¹

The DL program, established in 1993, was intended to streamline the student loan delivery system and achieve cost savings. While the DL program was originally introduced to gradually expand and replace the long-standing FFEL program, the 1998 HEA amendments removed the provisions of the law that referred to a "phase in" of the DL program. Currently both programs are authorized and the two programs compete for student loan business. In FY2004, these programs provided \$52.1 billion in new loans to students and their parents. In that year the FFEL program provided 9,550,000 new loans averaging approximately \$4,111 each and the DL program provided 3,001,000 new loans averaging approximately \$4,279 each.

Mandatory Spending on Student Loans

The FFEL and DL programs are entitlements; funding is provided for these programs on a permanent indefinite basis, not subject to appropriations. The fiscal year cost estimates for both programs, under terms of the Credit Reform Act of 1990, are calculated

¹ For detailed information on the array of FFEL and DL program loans, see CRS Report RL30655, *Federal Student Loans: Terms and Conditions for Borrowers*, by Adam Stoll. For a thorough discussion of how the loan programs operate, see CRS Report RL30656, *The Administration of Federal Student Loan Programs: Background and Provisions*, by Adam Stoll.

by determining the net present value of the costs to the government over the lifetime of new loans disbursed in the given fiscal year. Under credit reform, an effort is made to capture, in the year in which credit is provided, the multi-year net cash flows associated with a new cohort of direct or guaranteed loans. This calculation establishes a “subsidy cost,” which is the estimated long-term cost to the government of a direct or guaranteed loan.

In calculating the subsidy costs for the two programs, the main cost components are the interest benefits to students in the subsidized Stafford program, the special allowance payments to lenders,² and defaults. Subsidy cost calculations are highly dependent on interest rate forecasts over the life of the loans and therefore can vary significantly depending on these forecasts.

In order to achieve savings in mandatory spending on the loan programs, Congress has often cut loan subsidies or introduced fees to generate funds that offset mandatory spending.

Each year the Congressional Budget Office issues a baseline budget forecasting estimated spending over a 10-year period under current law, assuming no policy changes are enacted over that time period. The CBO baseline serves as a benchmark for budgetary analyses. When legislation that would affect mandatory spending is introduced, its budgetary impact is measured against the CBO baseline. The current CBO baseline projects that over the 2006-2010 period the federal student loan programs would guarantee or disburse about \$360 billion in new loans — costing about \$37 billion.³

House and Senate Reconciliation Provisions

The FFEL and DL programs are scheduled to be reauthorized as part of HEA reauthorization during the 109th Congress. As has been noted, these programs are being relied upon to produce much of the savings in mandatory spending required by the FY2006 budget reconciliation instructions to the House Committee on Education and the Workforce and the Senate Health, Education, Labor, and Pensions Committee.

During the first session of the 109th Congress, the House Committee on Education and the Workforce reported an HEA reauthorization bill and the Senate Health, Education, Labor, and Pensions Committee ordered reported an HEA reauthorization bill. Reconciliation provisions were included as a part of each of these HEA reauthorization bills (H.R. 609 and S. 1614). Each Committee then approved reconciliation recommendations that were sent on to the respective budget committees and included in omnibus reconciliation bills that were adopted in each chamber. The House reconciliation

² The special allowance payment amount is determined on a quarterly basis by a statutory formula which is tied to a financial index and ensures lenders receive, at a minimum, a specified level of interest income on loans. The special allowance is designed to compensate lenders for the difference between the below-market, statutorily set interest rate charged to borrowers and a market set interest rate that is intended as fair market compensation on the loan asset.

³ Congressional Budget Office Cost Estimate, *H.R. 609 College Access and Opportunities Act of 2005*, Sept. 16, 2005.

bill's student loan provisions produce \$14.3 billion in net savings over the 2006-2010 period.⁴ The principal savings provisions included in the House reconciliation bill would:

- change the formulas used to calculate borrower interest rates and lender yields on student loans;⁵
- eliminate a separate formula for lender yields for loans (known as 9.5% floor loans), which are supported with certain tax-exempt financing;
- raise a loan fee that lenders pay to the federal government on all new loans from 0.50% to 1%;
- raise an annual fee lenders pay on consolidation loans from 1.05% to 1.30% for those lenders whose consolidation loans comprise more than 90% of their student loan holdings;
- reduce the level of insurance provided to lenders from 98% to 96% for new loans made on or after July 1, 2006.⁶
- eliminate mandatory funding for DL and other federal student aid administrative costs as of FY2007;⁷
- reduce guaranty agency retention amounts from 23% to 20% of collections on defaulted loans;
- introduce a 1% borrower origination fee on consolidation loans; and
- require a 1% default fee on FFEL subsidized and unsubsidized Stafford loans that would be assessed to borrowers when a loan is disbursed.

The House reconciliation bill also includes provisions that would increase direct spending. Among these provisions, the principal increases stem from a phased-in reduction of borrower origination fees on Stafford loans (the statutory fee level is 3% in FFEL and 4% in DL, but would be reduced to 0% and 1%, respectively); increased borrower loans limits; and increased income protection for dependent students in need analysis.

⁴ See Congressional Budget Office, *Estimated Budgetary Impact of HR 4241, The Deficit Reduction Act of 2005, as Passed By the House of Representatives* Nov. 21, 2005, and for details on individual proposals see Congressional Budget Office Cost Estimate, *Reconciliation Recommendations of the House Committee on Education and the Workforce*, Oct. 31, 2005.

⁵ Under the provisions of H.R. 4241, new "excess interest" provisions would be adopted. In essence, a new formula would be in effect for new loans made on or after July 1, 2006, which would annually calculate the amount a borrower rate was above the Special Allowance Payment (SAP) rate, and the difference will be credited to the federal government. This in effect would reduce lender yields by insuring they do not receive interest income exceeding the SAP rate. In addition, H.R. 4241 would make changes to various student loan rate-setting formulas. Basically, it would retain variable rate-setting formulas currently used for Stafford and PLUS loans (which under current law would be replaced by fixed rates for loans made on or after 7/1/06), and it would introduce new interest rate options for consolidation loans.

⁶ The insurance percentage paid to lenders and loan servicers receiving "exceptional performer" designations would be reduced from 100% to 98%.

⁷ Under these provisions, mandatory funding provided through Section 458 of the HEA for guaranty agency account maintenance fees would be sustained, while other administrative activities would become discretionary spending subject to appropriations.

S. 1932, the Senate reconciliation bill, which would generate \$8.8 billion in net savings from 2006-2010, relies on many of the same mechanisms to achieve savings.⁸ However, several of the savings proposals are structured differently in the Senate bill. The principal savings provisions included in the Senate bill would:

- change the formulas used to calculate lender yields on student loans;⁹
- place limitations on (but not fully eliminate) a separate formula for lender yields for loans (known as 9.5% floor loans) which are supported with certain tax exempt financing;
- reduce the level of insurance provided to lenders from 98% to 97% for new loans made on or after January 1, 2006;
- increase the lender origination fee on consolidation loans from 0.50% to 1% for all loans made on or after April 1, 2006; and
- require a guaranty agency origination fee on FFEL Stafford loans, which may be assessed to borrowers when a loan is disbursed or paid by guaranty agencies or lenders.

Like the House bill, the Senate reconciliation bill includes provisions that would increase direct spending. Among those provisions, the principal increases stem from the introduction of the Provisional Grant Assistance Program (PROGAP) and the Science and Mathematics Access to Retain Talent (SMART) grant program (each of which would provide grants that would supplement Pell grants); a reduction of borrower origination fees on Stafford loans (the statutory fee level is 3% in FFEL and 4% in DL, but as of July 1, 2007, would be reduced to 2% in each program); increased borrower loan limits; and increased income protection for students in need analysis.

Provisions Included in (P.L. 109-171)

The Deficit Reduction Act of 2005 (P.L. 109-171) reduces mandatory spending by \$38.8 billion over a five-year period. Student loan provisions generate \$11.9 billion in mandatory savings over that period.¹⁰ The principal savings provisions included in P.L. 109-171 would:

⁸ See Congressional Budget Office, *Estimated Budgetary Impact of S. 1932, The Deficit Reduction Omnibus Reconciliation Act of 2005, as Passed By the Senate*, Nov. 21, 2005, and for details on individual proposals see Congressional Budget Office Cost Estimate, *Reconciliation Recommendations of the Senate Committee on Health, Education, Labor and Pensions*, Oct. 24, 2005.

⁹ While in principle the excess interest provisions included in the Senate bill parallel those in the House bill, the borrower interest rates (with one exception) are not changed in the Senate bill as they are in the House bill. Under the Senate bill, the lone altered rate is the PLUS loan borrower interest rate set to take effect for loans made on or after July 1, 2006 that would be increased from a fixed rate of 7.9% to 8.5%. Since the borrower rate is a central facet of the excess interest calculations, the differing borrower rate-setting formulas relied on in the two bills constitutes a significant difference in the two savings approaches.

¹⁰ Congressional Budget Office, *Cost Estimate, S. 1932, The Deficit Reduction Act of 2005, Conference Agreement as Amended and Passed by the Senate on Dec. 21, 2005*. Some of the student aid provisions in the act reduce direct spending while others increase costs, \$11.9 billion reflects the projected net savings after new costs are accounted for.

- change the formulas used to calculate lender yields on student loans;¹¹
- change the FFEL PLUS loan borrower interest rate set to take effect for loans made on or after July 1, 2006, from a fixed rate of 7.9% to 8.5%;
- eliminate the use of a separate lender yield formula that provides a minimum of 9.5% in interest income for new loans for for-profit lenders and for non-profit lenders with more than \$100 million in holdings of such loans; the formula would still apply to certain new loans made through recycling by other nonprofit lenders through 2010;
- reduce the level of insurance provided to lenders from 98% to 97% for new loans made on or after July 1, 2006;¹²
- eliminate mandatory funding for DL and other federal student aid administrative costs as of FY2007;¹³
- require a 1% default fee on FFEL subsidized and unsubsidized Stafford loans that could be assessed to borrowers when a loan is disbursed or paid by non-federal sources; and
- specify that guarantors may assess an 18.5% borrower collection fee on loans consolidated out of default, 8.5% must be remitted to the federal government.

P.L. 109-171 also includes provisions that increase direct spending. Among those provisions, the principal increases stem from the introduction of the Academic Competitiveness and Science and Mathematics Access to Retain Talent (SMART) grant programs (which would provide grants that would supplement Pell grants); a phased-in reduction of borrower origination fees on Stafford loans (the statutory fee level is 3% in FFEL and 4% in DL, but would be reduced over time to 0% and 1%, respectively); increased Stafford loan annual borrowing limits for first- and second-year undergraduates and for graduate students;¹⁴ an extension of the expanded loan forgiveness for teachers authorized in P.L. 108-409; increased income protection for dependent students and for independent students without dependents other than a spouse in need analysis, and lower asset assessment rates for all students in need analysis.

Other changes to the student loan programs include the introduction of a moratorium on additional schools entering into FFEL “school as lender” arrangements effective April 1, 2006, new loan deferments for military service, and the extension of PLUS loan eligibility to graduate students. Other changes to student aid programs include the repeal of the 50% rule for distance education and alterations of the simplified needs test and automatic zero rules used in need analysis.

¹¹ New “excess interest” provisions would be adopted for new loans made on or after 7/1/06. This in effect would reduce lender yields by insuring they do not receive interest income exceeding the SAP rate.

¹² The insurance percentage paid to lenders and loan servicers receiving “exceptional performer” designations would be reduced from 100% to 99%.

¹³ Under these provisions, mandatory funding provided through Section 458 of the HEA for guaranty agency account maintenance fees would be sustained, while other administrative activities would become discretionary spending subject to appropriations.

¹⁴ Subsidized Stafford loan limits are increased from \$2,625 to \$3,500 for first-year undergraduates and from \$3,500 to \$4,500 for second-year undergraduates, and Unsubsidized Stafford loan limits are increased from \$10,000 to \$12,000.