Analyzing a Potential Change to Federal Loan Practices

Introduction:

Recent national discourse pertaining to federal student loans has been notable for both its intensity and divisiveness. The main crux of the debate is whether the Federal Family Educational Loan Program (FFELP), a public-private partnership that delivers and administers guaranteed loans to students and parents should be discontinued in favor of the William D. Ford Direct Loan Program (i.e. Direct Lending or DL), whereby the federal government would be solely responsible for the origination, delivery, and administration of educational loans for students and parents. The Connecticut Community Colleges (CCC) currently participate in the FFEL Program. The purpose of this paper is to explore and analyze the issues relevant to whether it is in the best interest of the CCCs to remain as FFELP participants or to initiate the process of converting to Direct Lending.

A Brief Historical Perspective:

The FFEL Program was established via Title IV of the Higher Education Act of 1965 (as amended). In the program, private lenders make loans to both parents and students. In return, the private lender receives subsidies from the federal government and is reimbursed a large portion of the loan should the borrower default. FFELP loans consist of both Stafford Loans for students and PLUS loans for parents. While the funding is private, eligibility is determined by individual colleges and universities in line with their respective packaging policies. In some cases, the federal government pays the interest on behalf of the loan recipient while he/she is enrolled in school or in a six-month grace period following the termination of their enrollment.

The Direct Lending initiative was established as a government pilot program during the 1992 reauthorization of the Higher Education Act and became a permanent program one year later. The principle difference between FFELP and DL is the source from which funds in each respective program are derived. Where FFELP obtains funding from banks whose own proceeds are typically derived from investors, the DL program is funded directly from the US Treasury. Another notable difference is that where FFELP loans are originated and serviced via
a third party, DL loans are typically processed via a direct relationship between the federal
government and the borrower.

Recent National Developments:

While the debate surrounding the manner by which federal student loans are administered is as
old as the programs themselves, it began to gain momentum more recently with the passage of
the College Cost Reduction and Access Act (CCRAA), signed by President Bush in September of
2007. The law looked to fund increases in the Pell Grant program by cutting federal subsidies
to lenders in the FFEL Program by more than $20 billion. The law was criticized by those who
contended it did nothing to actually reduce the cost of college, as its name would suggest. In
addition, because of the adverse effects federal subsidy cuts would have on profits for
participating lenders, many chose to withdraw from the program or at minimum to discontinue
or reduce incentives that pass along savings to students/borrowers.

Shortly after the passage of CCRAA, the United States found itself in the throes of its worst
credit crisis in decades as a result of the collapse of the housing markets. Student loans were
affected in that FFELP lenders depended upon capital markets for the cash necessary to
originate loans, which were quickly drying up in the wake of the crisis. In response, President
Bush signed into law the Ensuring Continued Access to Student Loans Act (ECASLA) on May 7,
2008. In addition to increasing both annual and aggregate Stafford Loan limits for students, the
law allowed the Department of Education to act as a secondary market for student loans
originated since 2003. In short, lenders could sell loans to the Department, but only under the
provision that capital raised in the transaction be used solely to continue to make FFELP loans.
Originally set to expire on July 1, 2009, the law was extended to July 1, 2010 in October of 2008.

In February of 2009, President Obama submitted his 2010 federal budget proposal to Congress.
Presented within a framework calling for increased access to education was the notion of
overhauling the Pell Grant program. More specifically, the president called for the Pell Grant
program to be indexed to the Consumer Price Index so that students’ awards would be aligned
more realistically with inflation. More notably, President Obama’s budget called for the Pell
Grant to become mandatory with regard to the federal budgeting process, as opposed to its
current status as a discretionary spending item subject to annual appropriations through
Congress. In order to fund these changes to the Pell Grant Program, the President proposed
the elimination of the FFELP and subsequent transition to a model in which 100% of federal
student loans are processed through Direct Lending. The Congressional Budget Office has
estimated a savings of nearly $90 billion over the next ten years as a result of this potential
transition.
On September 18, 2009, the House of Representatives passed the Student Aid and Fiscal Responsibility Act of 2009 (SAFRA), which largely supported the President’s educational agenda. It called for the termination of the FFELP as well as funding for the Pell Grant Program being designated as a mandatory federal budget item. The Senate has yet to introduce its version of the bill.

President Obama’s budget proposal calls for the transition from FFELP to DL to become effective July 1, 2010. There is much uncertainty and speculation regarding whether or not this is possible and/or likely. Conventional opinion assumes that the Senate will not fully address the issue either in the form of traditional legislation or through budget reconciliation until there is some measure of resolution to the debate surrounding health care reform. Despite the uncertainty, the Department of Education has issued several statements calling for colleges and universities to prepare themselves for the impending FFELP to DL transition. The most recent such communication was a letter dated October 26, 2009 from Department Secretary Arne Duncan in which he urged college and university presidents to prepare their institutions for Direct Lending so that they may “ensure uninterrupted access to federal student loans” during the 2010-2011 aid year. A recent analysis conducted by Student Lending Analytics (SLA) showed a 13% increase in federal loan market share for Direct Lending (and corresponding decrease for FFELP) for the quarter ending September 30, 2009 over the same quarter one year prior.

Connecticut Community College Loan Trends:

Since 2005-2006, Connecticut Community College loan volume (as measured in dollars disbursed) has increased nearly sixty (60) percent. However, since all types of financial aid have increased markedly in that time, loan volume as a proportion of overall financial aid has remained very consistent at roughly nine (9) percent. In that same period of time, there has been very little change in the ratio of CCC loans borrowed that are subsidized (i.e. need-based) or unsubsidized (i.e. non-need based). Nearly two-thirds of CCC loans disbursed since 2005-2006 are unsubsidized loans.

Since the aforementioned passage of the ECASLA, which increased the annual amounts individual students are allowed to borrow, the amount of loan dollars disbursed per CCC student has increased 47%, from $2149 in 2005-2006 to $3189 as projected for 2009-2010.

Analyzing a Potential Transition to Direct Lending:

The issues surrounding whether or not the CCCs should transition from FFELP to Direct Lending remains consistent regardless of whether the transition is voluntary or the result of a federal mandate. In order to fully analyze the issue, it is important to identify factors most significantly
affected by a systemic movement in either direction. For the purposes of this paper those factors follow in no particular order:

Administrative/Technical Considerations:

Loan Processing

Beginning with the 2008-2009 financial aid year, the CCC’s undertook the task of centralizing their FFELP processes. As a means of doing so, the System Office contracted with Electronic Loan Management (ELM) Resources as its common online data exchange platform. ELM serves as the portal through which data files are transmitted between the twelve colleges and various FFELP lenders and/or servicers. Although ELM acts as a conduit with regard to the sharing of information, the student/borrower communicates primarily with the lender/servicer in order to complete the steps necessary for the loan transaction to occur (often via that particular lender’s website), such as signing the promissory note for the loan.

Under a Direct Lending model, the CCCs would be communicating information regarding loan processes directly with the federal government. This is accomplished via the sharing of data files through Common Origination and Disbursement, or COD. COD is the federal government’s streamlined system responsible for the awarding, disbursement, and reconciliation of specific federal funds. The CCC’s currently utilize the COD system for Pell Grant and Academic Competitiveness Grant (ACG) processing. Utilizing the COD system for Direct Lending would require initial set-up for all twelve colleges, including a formal request to participate in the program and having assigned to them a federal Direct Lending ID. Furthermore, campus financial aid personnel would need to coordinate with their respective Business Offices to ensure appropriate expanded access to the federal government’s banking portal (G5). This is necessary to make certain that loan disbursements would be properly accessible to the colleges, much in the same way as Pell Grants and other federal monies are currently via the same process.

In addition to the aforementioned set-up considerations, the Banner Financial Aid Functional Team, in conjunction with its IT counterparts, will be required to designate significant resources to prepare for the use of the SunGard Higher Education Banner Financial Aid System in processing Direct Loans. This process would likely include significant customizations of the SunGard product so that it may be most effectively utilized by all twelve colleges. Also, considerable training for end users would be required.
Recommended Lender Selection

In an effort to comply with various federal and state mandates, in addition to its own Board of Trustees (BOT) Code of Conduct, the CCCs objectively identify its list of Recommended FFELP lenders on an annual basis. The process by which this occurs includes an industry-wide dissemination of a Request for Information (RFI), a subsequent committee review and quantitative scoring of all RFI submissions, and ultimately a selection of recommended lenders for a given financial aid year. This process typically occurs over the course of three to four months and involves a commitment of resources from both the System Office as well as several campus representatives. In theory, the process is meant to differentiate between a diverse cross section of potential lenders as a means of identifying differences that prove most beneficial to students. These differences (which often include financial incentives to borrowers) have been tempered of late due to economic factors previously outlined.

Once selected, information concerning the recommended lenders is housed on a website maintained on the CCCs’ behalf by ELM Resources. Students may visit this page to both review lender information as well as initiate a request for a loan via an online environment.

A systemic conversion to Direct Lending would render all recommended lender selection processes obsolete.

Benefits to Students:

Advantages of FFELP

The foundational argument regarding how the FFEL Program benefits students focuses on choice. The student, as the borrower, has the ability to choose any lender that they believe offers the best loan terms. In turn, lenders will theoretically compete for borrowers by making their terms as attractive and as beneficial to the borrowers as possible. As noted previously, this perceived benefit has suffered lately due to a relative homogeneity with regard to FFELP borrower benefit born out of economic necessity.

Advantages of Direct Lending

The main argument revolving around Direct Lending pertains to simplicity. The borrower does not have to evaluate multiple lenders for the purposes of choosing one over another. In addition, the student can be relatively assured that their loan will not be sold on a secondary market thereby confusing the method with which they repay the debt. Also, should the student choose to consolidate their loans, they will not be required to gather information from multiple sources, as the entirety of their debt will be serviced by the federal government rather than by disparate banks and loan servicers.
Timing Considerations:

Much uncertainty exists at various levels regarding a potential transition to Direct Lending. At the federal level, little is known about when the Senate will fully address the issue legislatively and/or to what degree. Additionally, whether the credit markets will be able to provide adequate capital to FFELP lenders upon the July, 2010 expiration of ECASLA remains to be seen. At the state level, Connecticut continues to deal with an expanding budget deficit, casting some measure of doubt upon the level of administrative support the CCCs will be able to provide for an endeavor of this nature.

Given the aforementioned factors, it is recommended that a decision be made by such time that it leaves adequate opportunity for the successful transition to Direct Lending (should that be the decision). In order for any transition to be effective July 1, 2010 it is recommended that a decision be made no later than March 1, 2010.

Conclusion:

The decision as to whether the Connecticut Community Colleges remain as a FFELP entity or transition to a Direct Lending entity affects hundreds of students and their families and should be considered with requisite care. The issue at hand is complex in that it would change fundamentally a process that has been in place for many years and ripple across many facets of its respective twelve colleges. However, impartial analysis coupled with prudent preparation can help ensure that a transition, whether voluntary or otherwise, occurs seamlessly and serves well the constituents of the Connecticut Community Colleges.