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## **Consolidation Loans: Redesign Options and Considerations**

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# Consolidation Loans: Redesign Options and Considerations

## Summary

This report provides background information on Federal Family Education Loan (FFEL) program consolidation loans and discusses options for redesigning consolidation loans. Specifically, it provides background information on the FFEL program and on the role consolidation loans play within the program. It also examines recent concerns voiced over the cost of consolidation loans, and discusses the types of consolidation loan redesign options that are receiving some consideration within the context of the reauthorization of the Higher Education Act (HEA). In brief, the report finds the following:

- Consolidation loans were initially introduced to simplify loan repayment and offer borrowers relief in the form of extended repayment. As the consolidation loan interest rate formula has been modified by Congress, consolidation loans have evolved into a refinance benefit as well.
- The current consolidation loan interest rate formula affords borrowers the opportunity to secure a fixed rate equal to the weighted average of the rates in effect on underlying (variable rate) loans being consolidated rounded up to the nearest one eighth of 1%. In the recent low interest rate environment consolidation volume has grown dramatically as borrowers have sought to lock in as permanent the favorable rates currently in effect on their variable loans. This has enabled a large number of borrowers to secure a valuable refinance benefit.
- Borrowers who lock in fixed rates through consolidation in other periods, however, can miss out on more advantageous variable rates that they would have had on underlying loans. This raises concerns with regard to those using consolidation for repayment relief who may need to consolidate in years in which the available fixed rate is high and thus disadvantageous.
- It is generally acknowledged that recent cohorts of low fixed rate consolidation loans will be costly to the federal government. This is because the government pays program lenders an interest subsidy designed to compensate lenders for the difference between the below market statutorily set rate charged to borrowers and fair market compensation on the loan. The rates being provided to borrowers on these consolidation loans, over time, are expected to be well below market rate.
- To gauge with precision the added subsidy cost associated with the consolidation refinance benefit it is necessary to look beyond the recent time period and assess comprehensively how the subsidy rates on cohorts of loans are affected by the refinance benefit.
- The central questions underlying the debate on the desirability of the existing consolidation loan rate structure seem to be: How favorable should the borrower interest rate be on a federally subsidized refinance benefit? Is the current rate structure well suited to accomplish policy aims?

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# Consolidation Loans: Redesign Options and Considerations

This report provides background information on Federal Family Education Loan (FFEL) program consolidation loans and discusses options for redesigning consolidation loans. It also discusses the aspects of two recent reports on the cost of consolidation loans that have garnered a good deal of attention. These reports, like much of the recent discourse on consolidation loans, are focused on the cost of providing a fixed interest rate on consolidation loans.

While consolidation loans are also available through the William D. Ford Direct Loan (DL) program, recent discussion of consolidation loans has largely centered on FFEL program consolidation loans. For this reason, FFEL consolidation loans will be the focus of this report.

This report is organized in the following manner. First it provides background information on the FFEL program and on consolidation loans. Then it discusses recent concerns voiced over the cost of consolidation loans. Next it examines two reports addressing this issue, and the report concludes with a brief discussion of consolidation loan redesign options and considerations.

The report discusses issues that are currently being considered within the context of Higher Education Act (HEA) reauthorization activities. It will not be updated.<sup>1</sup>

## Background

The Federal Family Education Loan program, authorized by Part B of Title IV of the HEA, provides 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.<sup>2</sup> The federal government also provides lenders with a loan subsidy known as a special allowance payment

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<sup>1</sup> An earlier version of this report was published on May 26, 2004 as a Congressional Distribution Memorandum. It is being published in report form to more easily facilitate broad Congressional access.

<sup>2</sup> For detailed information on the array of FFEL program loans, see CRS Report RL30655, *Federal Student Loans: Terms and Conditions for Borrowers*, by Adam Stoll. For a thorough discussion on how the loan program operates, see CRS Report RL30656, *The Administration of Federal Student Loan Programs: Background and Provisions*, by Adam Stoll.

(SAP). The SAP 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 SAP 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.

The FFEL program provides the following types of loans to students and their parents:

***Stafford loans (subsidized and unsubsidized):*** Low interest, variable rate loans available to undergraduate and graduate students. The interest rates on subsidized and unsubsidized Stafford loans adjust annually, based on a statutorily established market-indexed rate setting formula, and may not exceed 8.25%.

To qualify for a subsidized Stafford loan, a student must establish financial need. The federal government pays the interest on the borrower's behalf on the subsidized Stafford loans while in school (on at least a half-time basis) and during grace periods and deferment periods.

***PLUS loans:*** Variable rate loans available to parents of dependent undergraduate students. The interest rates on these loans adjust annually, based on a statutorily established, market-indexed rate-setting formula, and may not exceed 9%.

***Consolidation loans:*** Loans that provide borrowers refinancing options. Consolidation loans enable borrowers to simplify the repayment of loans by combining multiple loans into one. Consolidation loans also enable borrowers to lower monthly payments by extending the repayment period. Additionally, consolidation loans afford borrowers the opportunity to pursue a more favorable long term interest rate through locking in a fixed interest rate on their student loans, based on the weighted average of the interest rates in effect on the loans being consolidated rounded up to the nearest one-eighth of 1%, capped at 8.25%.<sup>3</sup>

**Rationale for Consolidation Loans.** Consolidation loans were introduced in the HEA Amendments of 1986 (P.L. 99-498). They were initially introduced to simplify repayment for borrowers, simplify loan repayment servicing for lenders, and to offer relief in the form of extended repayment to those borrowers seeking lower monthly payments.

**Table 1** depicts the various interest rate formulas that have been used to set rates on consolidation loans. As **Table 1** shows, the consolidation loan benefit has evolved into much more of a refinance benefit (i.e., a benefit that allows borrowers to refinance at a better rate) as the consolidation loan interest rate formula has been modified by Congress.

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<sup>3</sup> For a comprehensive description of consolidation loans' terms and conditions, see CRS Report RL31575, *Consolidation Loan Provisions in the Federal Family Education Loan and Direct Loan Programs*, by Adam Stoll.

Under the initial consolidation loan interest formula (see **Table 1**), the borrower rate was fixed at the weighted average of the loans being consolidated, with a minimum rate of 9%. For student borrowers, this meant the rate on a consolidation loan would be equal to or higher than the rates on the loans being consolidated.

The second FFEL consolidation loan rate setting formula offered borrowers the possibility of securing a better rate through consolidation. At the time this consolidation loan interest rate formula was in effect, Stafford rates were variable. Through consolidation a borrower could lock in as permanent favorable annual rates in effect on their variable rate loans (rounded up to the nearest whole percent). Furthermore, toward the end of the period in which this formula was in effect, a Stafford grace period interest rate was enacted, and consolidation borrowers were afforded the opportunity to lock in as permanent their grace period rate (which is lower than the repayment period rate).<sup>4</sup>

The third consolidation loan interest formula was the same variable rate formula available on Stafford loans.

The most recently enacted formula, which is currently in effect, offers borrowers the strongest opportunity to refinance at a better rate through consolidation. It enables borrowers to lock in as permanent favorable annual rates in effect on their variable rate loans (rounded up to the nearest one-eighth of 1%). Additionally, it affords borrowers the opportunity to lock in as permanent their grace period rate.

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<sup>4</sup> The grace period is a six-month period immediately following a student's departure from school. A lower rate is provided during the grace period because loan servicing costs are lower during this period in which no borrower payments are required. Grace period rates are .60 percentage points lower than repayment rates.

**Table 1. FFEL Consolidation Loan Interest Rate Formulas**

Disbursement period	Type of rate	FFEL consolidation loan interest rate formula in effect
October 17, 1986- June 30, 1994	Fixed	The greater of 9% or the weighted average of interest rates on the loans consolidated, rounded to the nearest whole percent.
July 1, 1994 - November 12, 1997	Fixed	The weighted average of interest rates on the loans consolidated, rounded upward to the nearest whole percent.
November 13, 1997 - September 30, 1998	Variable	91-day Treasury bill + 3.1%, capped at 8.25%
October 1, 1998 - present	Fixed	The weighted average of interest rates on the loans consolidated, rounded to the nearest higher one-eighth of 1%, capped at 8.25%.

**Source:** Higher Education Act, Sections 427A (20 U.S.C. § 1077a) and 428C (20 U.S.C. § 1078-3).

**Concerns About the Cost of Consolidation Loans.** The recent discourse on consolidation loans has centered on the desirability of preserving the existing fixed interest rate formula. Concerns about the cost of preserving the existing fixed rate benefit have surfaced in light of the prevailing rates on variable rate Stafford loans. Stafford loans, which are the primary “underlying loans” incorporated into consolidation loans, carry a variable rate that adjusts annually and is determined by a statutory rate-setting formula. The borrower rate on Stafford loans has been quite low in recent years. Consolidation loans afford Stafford borrowers a refinance mechanism enabling them to lock in low rates permanently. When borrowers exercise this option the federal government is potentially exposed to high subsidy costs because the government has guaranteed the lenders a market rate of return, and must make up the difference between the rate the borrower is paying and the rate the lender is guaranteed (i.e., the SAP).

As one might expect, federal consolidation loans have become increasingly popular in the recent low interest rate environment. Most of the underlying loans being consolidated are variable rate Stafford loans offering historically low annual rates which can be locked in permanently through consolidation. As the shaded area in **Table 2** shows, the rates on Stafford loans in the last two years have been quite low.

**Table 2. FFEL Stafford Loan Interest Rates**

Disbursement period	Interest rate formula in effect <sup>a, b</sup>	Interest rate in effect <sup>c</sup>											
		92-93	93-94	94-95	95-96	96-97	97-98	98-99	99-00	00-01	01-02	02-03	03-04
11/8/65 - 8/2/68	6% fixed rate	6% fixed rate											
8/3/68 - 12/31/81	7% fixed rate	7% fixed rate											
1/1/81 - 6/30/88	9% fixed rate	9% fixed rate											
7/1/88 - 9/30/92	8% fixed rate for first 48 months; 10% fixed rate for remaining repayment period <sup>d</sup>	8% fixed rate											
		10% fixed rate											
10/1/92 - 6/30/94	91-day T-bill + 3.1%; capped at 9%	6.94	6.22	7.43	8.92	8.26	8.26	8.26	7.72	8.99	6.79	4.86	4.22
7/1/94 - 6/30/95	91-day T-bill + 3.1%; capped at 8.25%	6.94	6.22	7.43	8.25	8.25	8.25	8.25	7.72	8.25	6.79	4.86	4.22
7/1/ 95 - 6/30/98	91-day T-bill + 2.5% for in-school, grace or deferment periods				8.25	7.66	7.66	7.66	7.12	8.25	6.19	4.26	3.62
	91-day T-bill + 3.1% for repayment periods; capped at 8.25%				8.25	8.25	8.25	8.25	7.72	8.25	6.79	4.86	4.22
7/1/ 98 - 6/30/06	91-day T-bill + 1.7% for in-school, grace or deferment periods							6.86	6.32	7.59	5.39	3.46	2.82
	91-day T-bill + 2.3% for repayment periods; capped at 8.25%							7.46	6.92	8.19	5.99	4.06	3.42

**Source:** CRS review of historical Treasury bill rates and archival material.

**How to read Table 2:** The first and second columns in this table present the interest rate formulas that are used to determine interest rates for loans disbursed in different time periods. The information in the other columns present actual interest rates in effect on loans in the years since they have been disbursed.

- Variable rates adjust annually based on the bond equivalent rate of the 91-day Treasury bill at the final auction held prior to June 1. Rates become effective July 1 through the following 12-month period.
- Prior to July 1, 1994, borrowers with outstanding loans received new loans at the fixed rates they were charged on their initial outstanding loan.
- Table 2** presents the actual interest rates in effect from “award year” 1992-1993 onward (i.e., it begins to report rates from the period when variable rates were introduced). The rates in effect on earlier Stafford loans are the fixed rates specified in the applicable formula. An award year constitutes the 12-month period (July 1-June 30) an annual rate on a variable rate loan is in effect.
- Certain loans disbursed in this period which were subject to excess interest provisions under HEA Sections 427A(i)(3) or 427A(i)(1) have been converted to variable rate.



Not surprisingly, FFEL program consolidation volume has nearly quadrupled in recent years, going from approximately \$8.3 billion in award year (AY) 2000-2001 to an estimated \$31.1 billion in AY2003-AY2004. **Table 3** shows recent trends in FFEL consolidation volume. Of particular interest is the growth in volume over the last couple of years which shows the effects of the low rates on Stafford loans.

**Table 3. FFEL Consolidation Loan Volume**

Award year	Consolidation loan volume
1993-1994	1,817,000,000
1994-1995	2,948,000,000
1995-1996	3,980,000,000
1996-1997	4,049,000,000
1997-1998	3,460,000,000
1998-1999	4,495,000,000
1999-2000	5,653,000,000
2000-2001	8,261,000,000
2001-2002	16,953,000,000
2002-2003	32,290,000,000
2003-2004 <sup>a</sup>	31,114,000,000

**Source:** FY2005 President's Budget.

a. Loan volume is projected for AY2003-2004, which spans July 1, 2003-June 30, 2004 and is not yet completed.

**Table 4** displays the effect of the recent spike in consolidation volume on the composition of the outstanding portfolio of consolidation loans through the end of FY2003. It has led to a growing concentration of consolidation loans with low fixed interest rates. As **Table 4** reveals, at the end of FY2003 more than 44% of outstanding consolidation loans had fixed interest rates of 5% or below. It should be noted that much of the consolidation volume projected for AY2003-AY2004 (see **Table 3**) is not captured in the FY2003 data. Due to this and projections calling for low rates in AY2004-AY2005, low interest rate fixed loans are expected to constitute a considerably larger share of the outstanding portfolio in upcoming years.

That said, it is also noteworthy that at present, roughly one quarter of all outstanding consolidation loans have relatively high fixed interest rates — above 7.75%. Roughly 18% have fixed rates at or above 8.25%. These loans are likely to be less costly to the government than they would have been had they retained their variable rate.

This also introduces a facet of the fixed rate benefit some find troubling — some borrowers fare worse under the high fixed rate they lock in than they would have had they retained their variable rate. This raises concern, particularly with regard to those using consolidation for repayment relief (i.e., extended repayment), because these borrowers may have to consolidate in years in which the fixed rate is disadvantageous.

**Table 4. End of Fiscal Year 2003 FFEL Lender Held Outstanding Consolidation Portfolio<sup>a</sup>**

Interest rate range <sup>b</sup>	Volume outstanding	Percent of total portfolio
3.5 and below	6,305,947,005	7.98%
3.51 - 3.75	4,033,058,902	5.10%
3.76 - 4.0	2,881,137,608	3.65%
4.01 - 4.25	8,108,619,896	10.26%
4.26 - 4.5	4,612,711,751	5.84%
4.51 - 4.75	3,084,520,994	3.90%
4.76 - 5.0	6,062,160,305	7.67%
5.01 - 5.25	1,056,901,087	1.34%
5.26 - 5.5	275,988,171	0.35%
5.51 - 5.75	2,169,920,175	2.75%
5.76 - 6.0	1,839,704,089	2.33%
6.01 - 6.25	2,259,302,871	2.86%
6.26 - 6.5	2,779,265,635	3.52%
6.51 - 6.75	2,942,535,001	3.72%
6.76 - 7.0	4,134,495,710	5.23%
7.01 - 7.25	863,937,057	1.09%
7.26 - 7.5	1,424,129,006	1.80%
7.51 - 7.75	2,783,575,181	3.52%
7.76 - 8.0	5,051,613,270	6.39%
8.01 - 8.24	781,479,281	0.99%
8.25	6,591,059,219	8.34%
8.26 and above	7,332,472,725	9.28%
FY2003 variable rate consolidation loans 4.22	1,642,549,607	2.08%
<b>Totals</b>	<b>79,017,084,546</b>	<b>100%</b>

**Source:** Unpublished data from the US Department of Education. End of FY2003 data were compiled from LARS lender reports and are accurate as of Apr. 4, 2004 but may be subject to some subsequent revision.

- a. Includes only performing loans (i.e., loans originated, in repayment, in school, in grace or in deferment).
- b. Unless otherwise noted, consolidation loan rate ranges apply to fixed rate loans.

It is generally acknowledged that the recent cohorts of consolidation loans will be costly to the federal government. This point is easily illustrated by examining the key determinant of the interest subsidy cost — the spread between the lender rate<sup>5</sup> and the borrower rate. Two scenarios presented in **Table 5** examine this relationship.

Both of the scenarios presented in **Table 5** assume that a borrower chooses to consolidate outstanding Stafford loans (all of which have been disbursed since July 1, 1998) and repay the consolidation loan over a 10-year repayment term.<sup>6</sup> Under the first scenario examined in **Table 5** it is assumed the borrower consolidates loans in the current year while still in the grace period and secures a fixed interest rate of 2.88% on a consolidation loan. This is the most favorable rate scenario that has been available to borrowers who have borrowed since the current Stafford rate setting formula has been in effect.

Under the second scenario, the borrower consolidates loans early in July 2000 securing a fixed interest rate of 8.25% on a consolidation loan. This is the least favorable rate scenario that has been available since the current Stafford rate setting formula has been in effect.

These two scenarios present boundaries within which most recent consolidations fall. However, as the data in **Tables 3 and 4** suggest, recent consolidations have been much more likely to resemble the first scenario (projected consolidation volume for that year is nearly four times as large as the year in which the second scenario's consolidation occurred).

For each scenario, a spread between the lender rate and borrower rate on consolidation loans is provided. For comparative purposes, another spread — between the lender rate and a variable Stafford borrower rate is provided. The two spreads presented for each scenario illustrate the potential additional cost associated with providing the fixed rate benefit. In other words, they allow for a comparison of how the lender rate relates to a locked-in fixed rate or a variable Stafford rate that the borrower could have chosen to retain.

For each of the examples, the lender rates were constructed by using actual Commercial Paper (CP) rates where available for past periods (if applicable) and the Congressional Budget Office's (CBO's) projected CP rates for future periods. The variable borrower rates were constructed by using actual loan interest rates where available for past periods and CBO's projected T-bill rates for future periods.<sup>7</sup> Since the lender rates are being presented to illustrate the interest subsidy on consolidation

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<sup>5</sup> For the purposes of this memorandum the lender rate is the Commercial Paper based component of the SAP calculation net of the payment lenders make back to the government on consolidation loans.

<sup>6</sup> A 10-year repayment term has been chosen to allow for easy comparisons between interest subsidies on a new consolidation loan as opposed to the underlying loans had they not been consolidated.

<sup>7</sup> Projections of bond equivalent rates of 91-day Treasury bill rates and three-month Commercial Paper rates from CBO's Mar. 2004 baseline projections for student loan programs have been used to calculate borrower and lender rates for future years.

loans they are adjusted downward for the annual 1.05% fee lenders pay the government on consolidation loans.

**Table 5. Illustration of Effect of the Spread Between Lender Rates and Borrower Rates**

<b>Scenario 1: borrower consolidating at 2.88% fixed rate</b>	<b>Scenario 2: borrower consolidating at 8.25% fixed rate</b>
Estimated annualized lender rate = 6.49	Estimated annualized lender rate = 5.21
Borrower rate = 2.88	Borrower rate = 8.25
Estimated annualized SAP rate = 3.72 <sup>a</sup>	Estimated annualized SAP rate = 0 <sup>a</sup>
<b>If the loan remained a variable rate Stafford loan</b>	<b>If the loan remained a variable rate Stafford loan</b>
Estimated annualized lender rate = 7.23	Estimated annualized lender rate = 5.95
Estimated borrower rate = 5.93 <sup>b</sup>	Estimated borrower rate = 5.63 <sup>b</sup>
Estimated annualized SAP rate = .80 <sup>a</sup>	Estimated annualized SAP rate = .78 <sup>a</sup>

**Source:** CRS estimates.

**Note:** The estimated annualized lender rates and SAP rates in **Table 5** are offered as approximations. Due to limitations in the data upon which these calculations are based, they should not be viewed as precise projections.

- a. Lender rates have been constructed through the use of actual three-month CP rates where applicable and CBO projections of CP rates for future periods. For past periods, the lender rate is based on an average of quarterly CP rates used in actual SAP calculations plus an add on (1.59<sup>8</sup> for consolidation loans and 2.34 for Stafford loans). For future years, lender rates are constructed based upon CBO's annual CP rate projections plus an add on. To construct the estimated annualized SAP rate the annual borrower rate is subtracted from the annual lender rate and then the differences (with negative values treated as zeroes) averaged across all relevant years.
- b. The variable rate borrower interest rates are presented in APR form. APR is the estimated annual percentage rate paid under the variable rate formula.

The 2.88% consolidation loan in the first scenario illustrates the type of spread that has generated concern over the cost associated with the fixed interest benefit. Under this scenario, the estimated rate for lenders is well above the borrower rate, meaning the federal government has a large difference to make up. As the estimated SAP rate suggests, under this scenario the government may end up paying more interest on the loan than the borrower does.

By looking at the relationship between the borrower — lender rate spread on the fixed rate consolidation loan compared to the spread had the loan remained a Stafford loan one gets a sense of the additional cost to the federal government associated with the fixed rate benefit. The loan has been transformed from a below market rate to a

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<sup>8</sup> The 1.59 add-on reflects the actual 2.64 add-on minus the 1.05 basis point annual fee.

well below market rate for the borrower, but has a high subsidy cost for the federal government.

The second scenario illustrates a situation in which the government may have no SAP related subsidy cost under consolidation loans. The borrower is already paying more than the rate the government guarantees lenders when it calculates and pays SAPs, so no SAP is necessary. The amount of income lenders receive above the government rate is often called floor income (discussed more later).

Additionally, the estimated SAP rate of zero on the fixed rate consolidation loan is less than the estimated SAP rate applicable had the loan retained its Stafford variable rate. This illustrates the savings to the federal government as well as the relatively high costs to borrowers, associated with the fixed rate benefit on loans refinanced at a high fixed rate.

## **Considering the Debate on the Fixed Rate Benefit**

Contrasting conclusions have been reached in two recently released high profile reports on the cost of providing a fixed interest rate on consolidation loans. In the text below an attempt is made to examine why the reports reach dissimilar conclusions.

The first such study is *The Net Incremental Cash Flow and Budget Effects of the FFEL Consolidation Loan Program, FY2005-FY2010*, by Ernst and Young. This study examines the budgetary effects of FFEL Consolidation loans by studying historical cash flows in the FFEL consolidation loan program to and from the federal government within a discrete time period (fiscal years 1995-2002) and by estimating the net present value of future cash flows for certain cohorts of consolidation loans. The study primarily profiles positive historical cash flows for the federal government on consolidation loans and projected positive budgetary effects for future cohorts of consolidation loans. It does, however, find that two recent cohorts of consolidation loans have substantial federal interest subsidy costs.

The Ernst and Young study suggests that in the recent historical time period examined consolidation loans have produced a positive net cash flow for the federal government. Because the study does not attempt to capture lifetime costs associated with the consolidation loans examined here, these findings are of limited value. Given the influence rate fluctuations across time periods have on the cost of subsidizing loans, there is no reason to believe that a chosen discrete time period will be reflective of costs over the life of a loan. For this reason, it is common to gauge the lifetime cost of credit, and not to isolate particular time periods for analysis.

The Ernst and Young study presents estimates of the budget effect of future cash flows of the recent large cohorts of consolidation loans (i.e., those made in fiscal years 2003 and 2004) in the period from FY2005-FY2010. These consolidation loans are estimated to add \$3.5 billion in federal interest subsidy cost in that time period. These findings are adversely affected by the timing of the study. The FY2004 cohort is much larger than was projected at the time, and interest rates are lower than projected, meaning the subsidy cost for these loans is likely underestimated.

The study presents projections of the net present value of lifetime costs of future cohorts of consolidation loans — those disbursed from FY2005-FY2010. This part of the study focuses on the lifetime cost of consolidation loans over and above the interest subsidy on the underlying loans. The Ernst and Young study projects these consolidations to have positive budgetary effect for the government. The net present value of the incremental cash flow from these consolidation loans is projected to be \$1.9 billion. The long term projections assume a 6.8% fixed borrower rate takes effect for new Stafford loans as of July 2006. This is a reasonable assumption (based on existing statutory provisions) but does not address the difference between a fixed and variable rate. It should be noted that several projections were updated by Ernst and Young for its March 17, 2004 congressional testimony, however, insufficient details were available to enable the updated information to be considered here.<sup>9</sup>

The second study is *The Fiscal and Social Costs of Consolidating Student Loans at Fixed Interest Rates*, by Kevin Hassett and Robert Shapiro. This study examines the budgetary effects of FFEL consolidation loans by studying the projected lifetime costs of outstanding consolidation loans. It concludes, based upon a series of modeling assumptions that the lifetime cost of subsidizing all outstanding consolidation loans may range from \$14 billion to \$48 billion. It is important to note, however, that the study is focused on consolidation loans' "total" subsidy cost as opposed to the "additive" subsidy cost associated with the fixed rate benefit. In other words, underlying loans (e.g., unsubsidized Stafford loans) already carry an interest subsidy — the key question in the eyes of many observers, though unanswered in this report, is: How much more expensive do they become when they are converted to fixed rate loans?

Additionally, the methodology Hassett and Shapiro used for arriving at budgetary cost approaches the issue analytically at a very high level of aggregation. Characteristics taken from across the entire portfolio of outstanding consolidation loans (i.e., mean values for interest rates and repayment terms) are used to model costs for the entire portfolio. This approach lacks the precision that would be derived from assessing costs of each outstanding cohort of consolidation loans.

The Hassett and Shapiro cost projections are also reliant upon their own forecasting of CP rates over the next 20 years. All rate projections, and especially long term rate projections, contain some real degree of imprecision.<sup>10</sup>

Each of these studies has limitations. What would be needed to gauge added cost with more precision are analyses that comprehensively assess costs associated with providing the fixed rate refinance benefit across the varied cohorts of

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<sup>9</sup> Testimony of Dr. Thomas S. Newbig, Ernst and Young, for U.S. Congress, House Committee on Education and the Workforce, *Fiscal Responsibility and Federal Consolidation Loans: Examining Cost Implications for Taxpayers, Students, and Borrowers*, 108<sup>th</sup> Congress, 2<sup>nd</sup> sess., Mar. 17, 2004.

<sup>10</sup> A recent CBO analysis of its own forecast record and that of OMB and the Blue Chip consensus finds that the difference between two-year forecasts and actual outcomes over the past 20 years was one percentage point or more for each entity. It is reasonable to assume that longer term projections would be less precise.

outstanding Stafford loans. The subsidy rate on Stafford loans is affected by the available refinance benefit. It would be helpful to examine the way in which these subsidy rates are affected by fixed rate and/or alternative refinance benefits.

## **Underlying Issues and Redesign Considerations**

Several issues underlie the debate on consolidation loan interest rates. However, the debate seems to be centrally focused on the following issues:

- How favorable should the borrower interest rate be on a federally subsidized refinance benefit?
- Is it desirable to offer the current fixed rate option on consolidation loans?

Those in favor of the existing fixed rate setting formula assert that in the current low interest rate environment the fixed rate amounts to a valuable benefit to borrowers. At a time of escalating student loan debt it provides important repayment relief and sends a signal to students and potential students that repayment will be manageable. Further, proponents of the existing rate setting formula suggest that eliminating the opportunity to lock in a fixed rate would be tantamount to taking away a benefit that was available when borrowers received their Stafford loans and that they are counting on utilizing once they enter repayment. The removal of this benefit in today's interest environment would amount to dropping roughly half the interest subsidy currently available to borrowers.

Proponents of offering a fixed rate on consolidation loans suggest it provides borrowers with a level of certainty about their repayment amount which is not available through the variable rate. They also suggest it is optimal to allow borrowers a choice between fixed and variable rate options.

Those opposed to sustaining the existing rate setting formula suggest it offers an overly generous borrower benefit that is costly to the point of placing future aid in jeopardy. Further they question whether a benefit received in the years after postsecondary schooling contributes in any way to students' postsecondary access, persistence, or choice. They note the repayment period subsidy is provided without regard to need, over a lengthy period potentially extending up to 30 years beyond schooling, and disproportionately benefits students who attended four-year private institutions and/or graduate programs.

Opponents of offering a fixed rate option suggest such an option is inherently flawed if it bears no relationship to loan financing or subsidy costs, and argue it results in cost to either the federal government or the borrower. If the borrower locks in a low fixed rate, federal subsidy costs escalate. If the borrower locks in a high fixed rate, the borrower pays an above market rate over the life of the loan. Further, they suggest the variable rate formula (with a cap) provides borrowers with protection from exceedingly high rates, and reduces risk for the borrower and the government.

## Consolidation Loan Design Options and Considerations

This report concludes with a brief discussion on consolidation loan design options and considerations. As a backdrop to this discussion it is important to consider the structure of existing subsidies. In the text that follows several options for setting the rate on consolidation loans are considered. The discussion is limited to some of the major options having received attention in the recent debate. In general the policy discourse has been centered on the desirability of offering a fixed versus a variable rate on consolidation loans. CRS, of course, takes no position on any option presented.

The interest subsidies supporting Stafford borrowers can be divided into three categories: (1) The need-based interest benefit on subsidized Stafford loans through which the government pays the borrower's interest during periods in school, grace, or deferment; (2) The SAP on all Stafford loans which guarantees a borrower rate based upon a statutory rate setting formula with an interest cap — designed to be a below market rate; and (3) The SAP on consolidation loans which offers the borrower an opportunity to lock in an even better rate. It is this last category of subsidy that is under debate.

Possible options include:

**Preserve the Existing Rate Structure.**<sup>11</sup> Under this approach the additional interest subsidy would remain available to borrowers who consolidate in a low interest rate environment. Borrowers who consolidate in a high interest rate environment (e.g., those who are consolidating due to a need to extend their repayment period in order to reduce monthly payments) would likely pay a higher rate on their consolidation loan than they would have on a Stafford loan. Concerns about added federal subsidy costs associated with future high volume consolidation periods when interest rates are low would not be alleviated.

**Eliminate the Fixed Interest Rate Benefit on Consolidation Loans.** Under this approach borrowers would retain their Stafford interest rate and receive no additional interest subsidy when they consolidate. Consolidation would cease to offer an additional interest benefit, but would retain its role in simplifying repayment and providing extended repayment. Concerns about added federal subsidy costs associated with consolidation would be alleviated, and federal subsidy costs may be reduced, but borrowers would lose a potential benefit they now enjoy.

**Offer a Refinance Benefit That Is Income Sensitive.** Under this conceptual approach borrowers could still be offered a more generous interest subsidy on a refinanced loan, but the additional interest subsidy would be offered on a selective basis contingent upon need. Depending on how such a benefit were structured it could reduce federal subsidy costs by conferring subsidies on fewer recipients over shorter intervals. It could also bestow heavier subsidies than are

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<sup>11</sup> This discussion on this option and subsequent options assumes that Stafford loan interest rates are variable.



currently available during periods of need (which could reduce or eliminate savings in subsidy costs).

**Offer a Fixed Rate Set by the Market.** Under this approach borrowers could choose to retain their Stafford variable interest rate and would receive no additional interest subsidy when they consolidate. For borrowers making this choice, consolidation would offer no additional interest benefit, but would retain its role in providing relief in the form of extended repayment. Alternatively, those borrowers seeking a certain monthly payment could choose to select a fixed rate set by lenders (presumably on a loan that would cease to carry a SAP). Under this scenario the fixed rate would likely cost the borrower more (which would be reflective of the loan's higher finance costs), but the fixed and variable rate options would be available. This would provide borrowers fixed and variable rate options, and may be cost neutral to the federal government.

**Offset Consolidation Costs by Capturing Floor Income.** Under most of the approaches discussed above federal interest subsidies could be reduced by having lenders' floor income on consolidation loans refunded to the federal government. The floor income is income lenders earn in quarters when the borrower rate is above the SAP rate (which is designed to approximate fair market interest income for lenders).

**Offset Consolidation Costs by Increasing Lender Fees.** It may be possible to reduce federal subsidy costs associated with any of the rate structures proposed above by increasing lender fees on consolidation loans. If lender fees can be increased without jeopardizing lender participation in the consolidation loan program, this is another option.