Today's Competitive Loan System Is Already Filled With Market Mechanisms

A proposal prepared for the Study Group On Market Mechanisms In Federal Student Loan Programs

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May 5, 2000

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We recommend that one of the three or more systems of market mechanisms included in the General Accounting Office/Department of Education report to Congress under Section 801 of the Higher Education Amendments of 1998 should be the current student loan system. The current system involves intense competition for business among thousands of private organizations, with additional competition from state government agencies and the federal Direct Loan program.

Under any scenario that preserves the basic mission of the Higher Education Act, Congress will always be involved in setting prices for at least some segments of borrowers. We believe the alternative is unacceptable -- reducing access to higher education for students. Today's prices are ceilings, which Congress could lift if it wished. Given the level of competition, prices of loans for most borrowers might not rise. Prices for some categories of borrowers probably would -- such as borrowers attending high-default schools with low loan balances. Any federally supported student loan system will always have intensive Congressional oversight. No system is perfect. Imperfection will always invite attempts at improvement by lawmakers and administrators.

Market mechanisms currently exist in every aspect of the FFEL Program.

Loan origination: Lenders compete to offer schools the fastest, most efficient, most reliable origination of loans. Students demand this, and school financial aid administrators in turn also demand the best quality service. Loan delivery must be accomplished within hours of the receipt of an application. Anything more will send students and schools elsewhere. A characteristic of the FFEL Program is that there are many alternatives. Once a school has entered direct lending, the only choice if there are service problems is to convert to FFELP, a process that requires the school to forsake the investment it has made in systems that process direct loans. The federal government should not take steps to make FFELP more like direct lending, winnowing participation down to a few huge players offering basically the same products, leaving schools and borrowers with few choices.

Loan Servicing: Private lenders must follow due diligence procedures in servicing loans or they lose the 98% federal guaranty. Some lenders, such as EFC members, only exist to make student loans. If they displease students and schools, they will be out of business. Even in large diverse lending organizations, the student loan department is usually a specialized area where the jobs of its employees depend on success in student lending.

In addition, a number of financial considerations motivate lenders of all types to provide top quality service, in addition to the necessity of complying with federal regulations. Lenders not only lose 2% of their principal when loans default. They also have cash flow issues, because they have to keep repaying their investors whether or

not they are receiving payments on the underlying loans. When a loan defaults, there is a delay before insurance is paid, causing cash flow problems that, if severe, could cause a default on bond payments. Bond issues are structured with reserves and other methods to make a default highly unlikely for the majority of an issue. This brings a high rating from credit rating agencies, reducing borrowing costs. Low borrowing costs translate to low interest rates, lots of competition for business, including borrower benefit programs for students and their families. One of the key factors that rating agencies check is the track record of the company that will service the student loans that form the collateral for a securities issue.

High quality loan servicing holds a rank of highest importance in the federally backed loan programs. The penalties for problems are severe. Borrowers are tracked down and punished by seizure of income tax refunds, wage garnishment, lawsuits, loss of professional licenses and destruction of credit ratings. Bankruptcy usually doesn't help since a student loan generally cannot be discharged. Schools face bad publicity at a minimum and closure at a maximum if their students' default rates rise too high. Guaranty agencies lose money at increasing rates if their borrowers' default rates rise too high. The Education Department and Congress face the wrath of the public and a potential loss of confidence in the loan programs if default losses rise again, like they did in the late 1980's. In other words, everyone involved in the loan program has an incentive to make sure that if a loan does default, it is not because of servicing problems. There are strong incentives to do everything possible to avoid loan defaults and to cure them if they do default.

Liquidity: As loan volume has grown in recent years, there never has been a problem with finding adequate funds for college. A healthy secondary market for loans ensures liquidity in the student loan market. That means that funds are available at reasonable cost. As it has become apparent that the FFEL Program will survive and grow, more investors, including international investors, have been willing to invest in student lending. This is good for American students. It shows the health of the loan program. It is something that should be encouraged. Proposals that disrupt the system or cause uncertainty and instability will result in reduced interest in investing the tens of billions of dollars needed every year to finance student loans. At a minimum, this loss of liquidity will increase lending costs, meaning more money will go into paying off bonds, leaving less for improvements in technology and for borrower benefits.

Subsidies for Borrowers: Subsidies from various sources are in place to help reduce borrowers' costs. As a result, student loans are some of the lowest cost loans available anywhere. The federal government has put a ceiling on interest rates and capped that ceiling to make sure they stay low. The government lowers rates further by paying interest for borrowers at various times. Lower-income borrowers have their Stafford Loan interest paid while in school and during periods of deferment. All borrowers, including parents, are guaranteed that their interest payments will not rise above a low level, no matter what the Federal Reserve does. These caps have saved borrowers millions of dollars. Recent Stafford Loan borrowers have a portion of their interest costs -- 0.5 percentage point -- paid by the government at all times. On top of that, interest payments are deductible from federal income taxes for many borrowers.

The combination of subsidies leaves a net interest cost for subsidized Stafford loans of less than 4% -- the lowest-cost consumer loans available. On top of that, most borrowers can reduce their costs even further thanks to lender-offered borrower benefits programs. The system is set up to keep borrowing costs as low as possible.

Access: Much of the discussion of market mechanisms in the student loan programs and of ways to set interest rates seems to ignore the fundamental purpose of the federally backed student loan programs -- to ensure that all Americans have a way to pay for higher education. A corollary purpose of the programs, also important, is to keep the cost of borrowing as low as possible. There are various philosophical points of view about borrowing. Some, including many in other countries, believe that the nation should provide a higher education to all who wish it or all who qualify. For many years, the state of California followed that policy, not charging tuition to in-state residents attending state universities, although significant "fees" were charged. Others believe that governmental assistance to pay for higher education should be concentrated on students with the greatest need. Another approach treats assistance as a reward for students who demonstrate merit. Policy in the United States has included all three approaches, with need-based aid the predominant approach since 1965. Increasingly in recent years, states and schools have put resources into merit-based grant aid. But the loan programs have always been either based on need or open to all, without regard to grades or other merit factors. Given the trend towards merit-based grants, the FFEL Program will become more critical to ensuring that every American can pay for college. Whether this trend changes or not, this country will need a large loan program for the foreseeable future.

Summary and Conclusions: Experimentation with massive restructuring of the FFEL Program could threaten its viability. Any major changes must be weighed against the strength of the existing program. The best decision for Congress may be to do nothing rather than continuing the turmoil that has kept program participants on edge for the past 10 years. Constant upheaval is costly and eventually wears down loan providers, financial aid administrators, and others who are involved in the loan programs. Competitive pressure and the technological revolution of the 1990's have brought significantly reduced borrowing costs for students, their families and taxpayers. This is a good thing. It should be encouraged.

Competition with direct lending is no longer a central issue for lenders, although the competition with FFELP does seem to be a major concern for schools in the Direct Loan Program. Lenders are much more focused on doing battle in the marketplace with their FFELP competitors.

Currently, the largest lenders are increasing market share. Still, the smaller state and regional lenders serve to provide alternatives to the big national companies, keeping prices low and service high. Many times they are able to meet local needs and provide specialized service to schools thanks to longstanding relationships. This allows customization of products to fit the needs of particular schools, particular students and particular states. It would be a mistake to encourage development of an effective cartel or oligopoly by altering the loan program so that only the largest participants remain viable.

Beware of arguments about competition being "unfair." Such statements always suffer from tunnel vision -- only looking at one of many factors that affect the competition. For example, should it be considered unfair for an organization to have access to interest-free funds? Is it unfair for one company to be able to offer its student loan customers other financial products that a competing company (or program) cannot offer? Probably not.

Student loan programs should not be dumbed down, with the federal government picking the lowest common denominator for loan programs and forcing everyone else to reduce their services and raise their prices to that level. The program should remain flexible enough to encourage excellence, innovation and the use of the latest technology.

Market mechanisms already dominate the way prices are set and services are provided in today's FFEL Program. Any study of market mechanisms should include a look at how competition works in today's program, which is effectively delivering $22 billion in new loans this year while servicing a $150 billion portfolio with increasing efficiency and decreasing defaults.