America's Student Debt Explosion:

Understanding the Federal Government's Role

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Introduction

America's system for financing higher education needs to be reformed. Too many students rely excessively on loans to finance their degrees, too few borrowers can afford to repay their loans once they leave school, and hundreds of billions of dollars in student debt are sitting on federal balance sheets.

Much of the current debate about higher education financing is focused on issues of access and affordability, including reducing college costs and expanding aid, especially to low-income and minority students. While these are important public-policy challenges, this paper examines a closely related but less-discussed issue: the role that the federal loan system has played in facilitating the rapid growth of student debt and the potential long-term consequences of that growth for the federal budget. A series of well-intentioned but flawed federal policies aimed at increasing the availability and attractiveness of student loans has, in part, encouraged systemic over-reliance on debt to finance higher education in the United States.

The federal loan system is increasingly strained, evidenced by swelling debt burdens and low repayment rates. The combination of these trends has the potential to create significant budget pressure, not only for students and their families but for the federal budget and, by extension, all American taxpayers. Unfortunately, the magnitude of taxpayer exposure is difficult to estimate, due to the uncertainty associated with federal budget forecasts. The federal student loan system, however, could clearly be improved to reduce both overall reliance on student loans and the budget risks associated with them.

This paper reviews the evolution of the federal role in financing higher education and how legislative actions and the federal

budget process have led to heavy reliance on loans. It then analyzes trends in student borrowing and repayment, noting some of the potential implications for students, for the broader economy, and for the federal budget—in particular, the difficulty of estimating the cost of student loans to the federal government. Furthermore, the paper examines some of the reasons why borrowing has increased and repayment rates have decreased over time, and it presents pros and cons for several possible policy approaches that may improve the efficiency and effectiveness of the student loan programs, reducing excessive reliance on debt and easing the federal government's potential budgetary exposure.

A History of the Federal Role in Student Lending

Key Points

- A series of actions by successive Congresses and administrations, dating back to the 1960s, has steadily expanded the role of the federal government in financing access to higher education.
- Changes in the budget treatment of federal loans under the Federal Credit Reform Act of 1990 created further incentives to expand the federal role by making it appear—from a budgeting perspective—that federal loans generated net savings (positive revenue streams) for the government.
- Concerns about the availability and affordability of financing for higher education in the years after the Great Recession of 2008 led to a complete transition to direct federal lending (as opposed to the earlier system, which mostly relied on private entities to issue federally guaranteed student loans) and the introduction of a variety of income-driven student loan repayment plans.

Over the past half-century, a series of regulatory and legislative changes has heightened the attractiveness of student loans among both borrowers and the federal government. Repeated expansion of the types of loans offered, increases in loan limits, and more generous repayment terms have raised both the supply of federal financing for higher education and the demand for student loans, while changes to the federal budget process have made federal student loan projections appear to generate large savings.

In **1965**, the Higher Education Act[1] (HEA) created the first major federal student lending program. Called the Guaranteed Student Loan (GSL) program—and known today as the Federal Family Education Loan program (FFEL)[a]—this system was essentially a public-private partnership. Banks and other private financial entities issued student loans using capital raised on the private market. Though privately issued, these loans were guaranteed by the federal government, thereby ensuring that risky borrowers could borrow at the same level and interest rate as those with good credit. GSL initially guaranteed $1,000 annually in private student loans for undergraduates and $1,500 for graduate students, with interest subsidies for families making less than $15,000 per year (around twice the median family income at that time);[2,3] this income threshold was eventually increased to $25,000 the following year.[4,b]

The **1970s** saw a broad expansion of federally backed student loans. First, the Higher Education Amendments of 1972[5] raised borrowing limits to $2,500, which at the time was higher than the average cost of attendance at public, four-year universities but less than the average cost of attendance at private non-profits.[6,c] The 1976 HEA reauthorization further increased loan limits for graduate and professional students to $5,000 annually. This increase, in part, caused the GSL program to grow by around 85 percent between 1976 and 1978, from $5.5 billion in total loan volume for 1976 to $8.9 billion in 1978 (in 2016 dollars).[7,d] Subsequent legislation, the Middle Income Student Assistance Act of 1978,[8] removed the $25,000 income test, thereby making all students eligible for interest subsidies on GSL loans. Consequently, the number of guaranteed student loans rose from 1 million in 1978 to more than 3 million in 1982.[9] Finally, the 1980 HEA reauthorization introduced an entirely new loan program, Parent Loans for Undergraduate Students (PLUS), which allowed parents to borrow on behalf of their children.[10] Initially, PLUS loans were uniformly capped at $3,000 annually.

In the early **1980s**, policymakers attempted to slow the vast expansion in student lending that had occurred in the previous decade. The Omnibus Budget Reconciliation Act of 1981[11] restored GSL's family-income test for interest subsidies, this time placing it at $30,000. (At the time, median family income stood at around $22,000 annually.) Under the subsequent HEA reauthorization of 1986,[12] *all* GSL borrowers became subject to a needs-based test, with loans allocated in relation to the financial needs of a student's family. Although this worked to restrict borrowing among middle- and upper-income students,[13] the same legislation also raised annual and aggregate loan limits, which allowed for increased borrowing among those who still qualified for loans.

In the early **1990s**, policymakers once again sought to expand federal lending. The 1992 HEA reauthorization created "unsubsidized" loans, which were not subject to a needs-based test but also lacked the interest subsidies that had

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[a] Although GSL was the first major federal student loan program, it was not the first in existence. In 1958, the National Defense Education Act created a narrowly targeted direct federal lending program, which provided low-interest loans to students from low-income families who pursued an education in math, science, or foreign languages. The act was the precursor to today's Perkins Loan program, which currently comprises around 1 percent of the federal loan portfolio.

[b] At the time, average annual cost of attendance (i.e., tuition, fees, room and board) stood at around $1,100 per year at four-year, public universities. For more information, refer to: U.S. Department of Education, *Digest of Education Statistics*, Table 306, 1995. Available at: https://nces.ed.gov/programs/digest/d95/dtab306.asp.

[c] The cost of attendance includes costs associated with tuition, fees, and room and board.

[d] Inflation calculation: 1976: $1.3 billion * $4.24 = $5.5 billion. 1978: $2.4 billion * $3.70 = $8.9 billion. For more information, please refer to: http://www.bls.gov/data/inflation_calculator.htm.

characterized GSL loans up to that point. Additionally, this legislation once again increased annual and aggregate loan limits, a trend that would continue over the next several decades.[14,e]

Another major development from this decade was the passage of the Federal Credit Reform Act of 1990 (FCRA),[15] which ultimately paved the way for a renewed expansion in student lending. FCRA altered the methodology that the federal government used to project costs associated with federal credit programs, leading to the advent of federal direct loans.[f]

Before FCRA, credit programs were projected on a cash-flow basis—meaning that loans were treated as costs in the year that they were originated and as revenues in the years that they were repaid. For example, if a loan was originated in a given year, the borrowed sum would be recorded as a cost to the federal government in that year, while all the repayments made on that loan by the borrower would be recorded as revenues slowly over time. Because loans are generally issued all at once, whereas loan repayments are spread out over many years, this accounting method made federal loan programs appear costlier than they actually were.

FCRA changed this methodology by requiring that federal loan costs be projected on a net-present-value basis, which involves applying a discount rate to derive the present value of future cash flows.[16] Under FCRA, the discount rate is tied to U.S. Treasury bonds, which has the effect of making federal loans appear to generate savings for the federal government (see page 16 for more details).[g] This methodological change gave the federal government an incentive to lend directly to student borrowers rather than backing the private loans issued by banks, as under FFEL. Indeed, in 1993, Congress passed the Omnibus Reconciliation Act, which included a limited direct-lending program to operate alongside FFEL. Academic institutions had the option of participating in this direct-lending program, under which they originated loans directly to students with funds provided by the federal government.

The **2000s** brought a paradigm shift in the federal student loan system, largely driven by the global financial crisis. Prior to the Great Recession, most federal student loans were still issued through FFEL even though direct lending had been introduced in 1993. When the financial crisis hit in 2008, banks struggled to raise capital, which severely hampered private lenders' ability to supply FFEL loans. According to the Federal Reserve Bank of St. Louis, the number of FFEL lenders declined by 65 percent between 2008 and 2009. Over the same period, there was a 10 percent increase in federal student aid applications, as many who were left jobless by the Great Recession decided to return to school.[17] The confluence of these factors led policymakers to enact the Ensuring Continued Access to Student Loans Act. This legislation allowed the federal government to purchase FFEL loans from private lenders—transitioning more of the outstanding portfolio to direct loans—which increased liquidity in the student loan market and helped to ensure that borrowers could continue to access credit to attend college.[18]

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[e] The difference between "subsidized" and "unsubsidized" loans is that the U.S. Department of Education pays the interest on subsidized loans while the borrower is in school, during the borrower's six-month grace period, and if the loan goes into deferment.
For more information, please refer to: https://studentaid.ed.gov/sa/types/loans/subsidized-unsubsidized#subsidized-vs-unsubsidized.

[f] As mentioned above, Perkins Loans were actually offered directly through the federal government prior to the emergence of widespread direct lending. This portfolio, however, has remained extremely small (currently around 1 percent of the total federal loan portfolio) and is narrowly targeted toward low-income students.

[g] In 1990, ten-year Treasury yields were 8.6 percent, much higher than recent rates, which have fluctuated between 1 and 2 percent. A lower discount rate has the effect of making future cash-flows—e.g., the loan repayments—appear to be relatively more valuable today. For more information, please refer to: https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yieldYear&year=1990.

In **2010**, policymakers passed the Health Care and Education Reconciliation Act, which stopped new loans from being issued under FFEL and completed a full transition to federal direct lending. Though existing FFEL loans remained privately held, this legislation severely restricted the future role of the private sector in the federal student loan market, largely limiting its duties to loan servicing. The transition to direct lending also increased projected budgetary savings under the budget rules established by FCRA. Policymakers used these "savings" to pay for other federal initiatives, including an expansion of Pell Grants (which provide need-based aid for higher education) and to partially offset the costs of the Patient Protection and Affordable Care Act.

Finally, a particularly noteworthy development over the past decade has been the advent of income-driven repayment (IDR) plans, which allow borrowers to limit their monthly loan payments to a portion of their disposable income, with the remaining balances forgiven after a specified number of years. The goal of IDRs is to provide flexibility to borrowers who are at risk of delinquency or default. These plans were originally introduced under the College Cost Reduction and Access Act of 2007 and were further expanded in 2010 under the Health Care and Education Reconciliation Act.[20,21] In 2012 and 2015, President Obama used executive authority to further expand IDR options, creating the Pay as You Earn (or "PAYE") and Revised Pay as You Earn (or "REPAYE") plans.[h] Each IDR plan has its own set of complicated rules, and borrowers often struggle to discern which is best for their situation (Table 1). According to the Government Accountability Office (GAO), 24 percent of direct loan borrowers in repayment were enrolled in IDR plans in 2016, up from 10 percent in 2013.[22]

TABLE 1: Income-Driven Repayment Plans Offered by the Federal Government

Pay as You Earn (PAYE)	Borrowers make monthly payments equal to 10 percent of discretionary income, with remaining balances forgiven after 20 years. For up to three years, the government pays an interest benefit that prevents the outstanding balance from growing even if interest accruals exceed monthly payments. Forgiven balances are counted as taxable income by the Internal Revenue Service (IRS).
Revised Pay as You Earn (REPAYE)	Borrowers make monthly payments equal to 10 percent of discretionary income, but this plan also caps payments so that they do not exceed the 10-year Standard Repayment Plan amount. Debt is forgiven after 20 years for undergraduate loans and 25 years for graduate loans. For the duration of repayment, the government pays an interest benefit that limits growth of the outstanding balance even if interest accruals exceed monthly payments. Forgiven balances are counted as taxable income by the IRS.
Income-Based Repayment (IBR)	Limits monthly payments to 10 percent of discretionary income for new borrowers after July 1, 2014; for borrowers who took out loans prior to this date, payments are capped at 15 percent of discretionary income. Debt is forgiven after 20 years for new borrowers after July 1, 2014, and after 25 years for previous borrowers. For up to three years, the federal government pays an interest benefit that prevents the outstanding balance from growing even if interest accruals exceed monthly payments. Forgiven balances are counted as taxable income by the IRS.
Income-Contingent Repayment (ICR)	Borrowers are required to pay the lesser of either 20 percent of discretionary income or what they would pay on a 12-year repayment plan that adjusts according to changes in the borrower's income level. Debt is forgiven after 25 years. Forgiven balances are counted as taxable income by the IRS.
Public Service Loan Forgiveness (PSLF)	Provides loan forgiveness for government and non-profit employees. Debt is forgiven after 10 years (120 monthly payments), and forgiven balances are not counted as taxable income by the IRS.

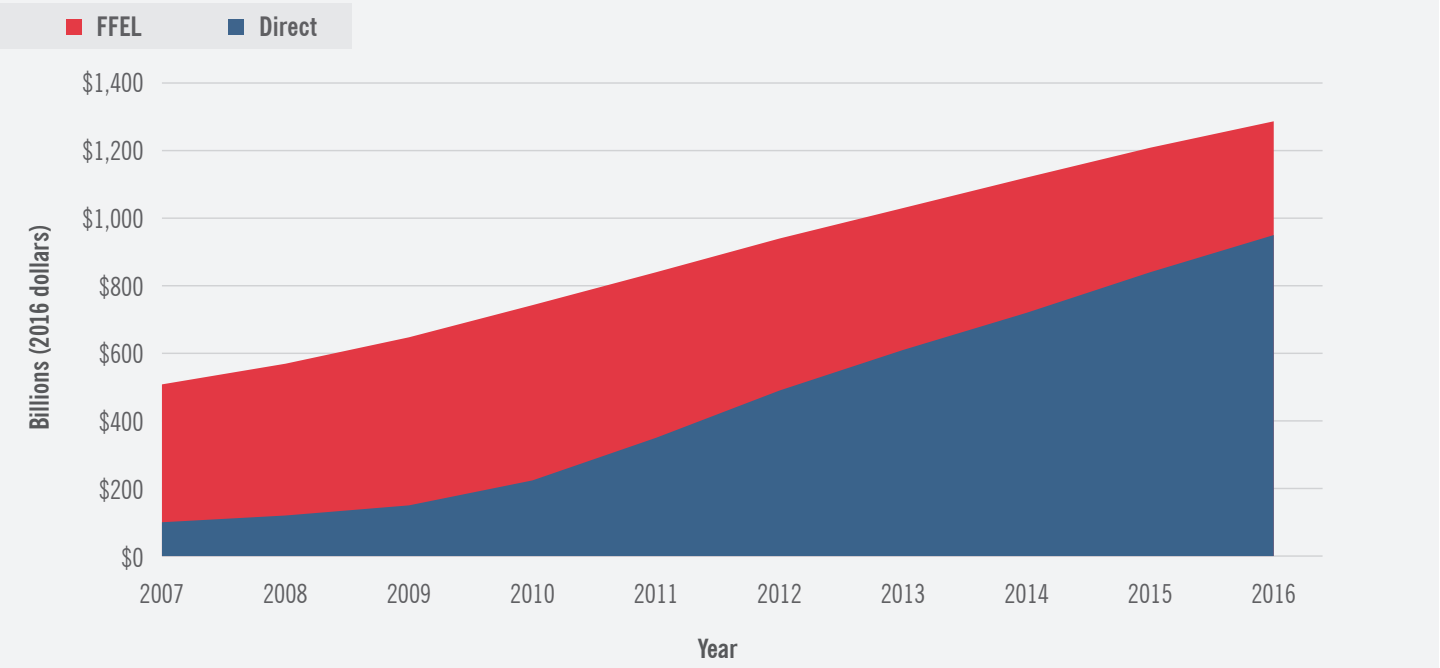
Source: U.S. Department of Education.[23]

[h] As statutory authority for these actions, the Department of Education cited long-established HEA language that allows the education secretary to administer payment plans that differ based on the income of the borrower. For more information, please refer to: U.S. Senate Committee on the Budget. "How Back-End Spending Impacts the Budget." Budget Bulletin. October 2015. Available at: http://www.budget.senate.gov/chairman/newsroom/budget-bulletins/back-end-spendings-impacts-on-the-budget.

More than 50 years after the first student loans were issued, the federal system has metastasized into a complex structure, with several different loan types and repayment options. The result can be difficult for borrowers and other actors to navigate and burdensome for government officials to manage.

Moreover, the program expansions described in this section have contributed to a growing federal loan portfolio (Figure 1) and declining repayment rates—both concerning trends for the federal budget.

Figure 1: Federal Student Loan Portfolio, Composition of FFEL and Direct Loans



Note: FFEL loans are privately issued and backed by the federal government, whereas direct loans are issued directly by the federal government. Congress eliminated FFEL issuance in 2010, which explains why direct loans have grown as a share of the total portfolio. Dollars were adjusted using the 2016 Consumer Price Index for all Urban Consumers (CPI-U).
Source: U.S. Department of Education.[19]

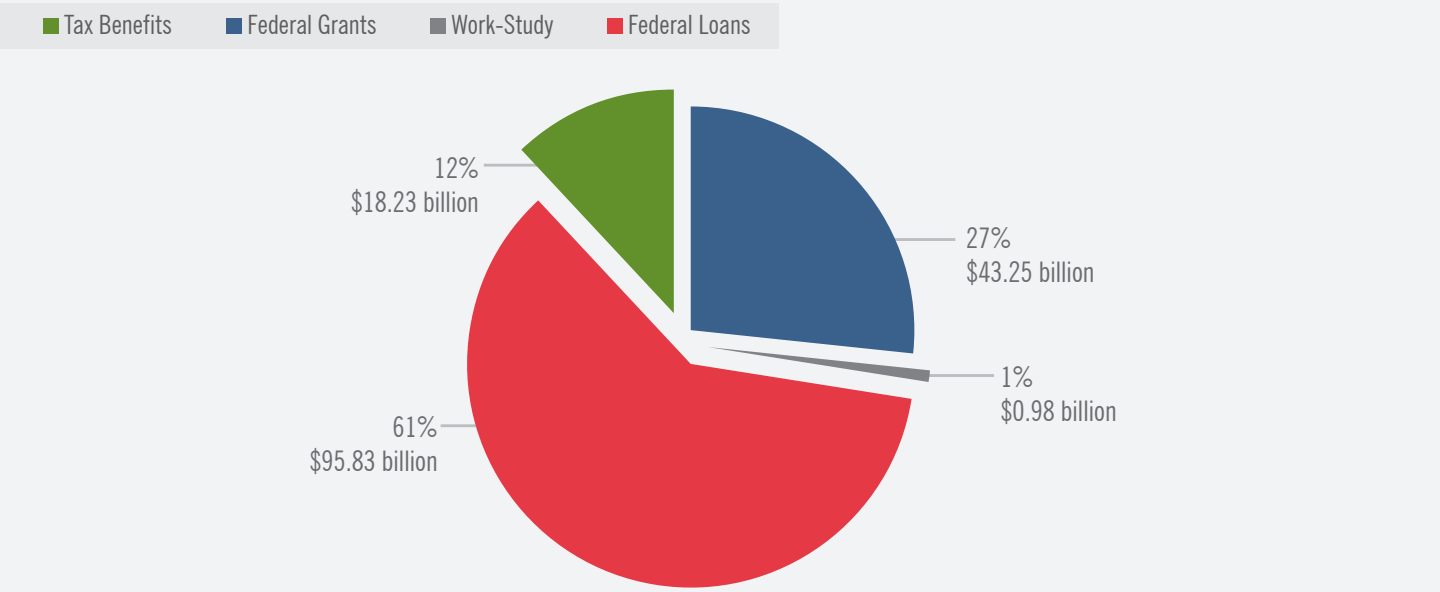
Trends in Student Lending and Repayment

Key Points

- Although new student loan issuance peaked in 2011 and has since declined, overall loan volume has doubled in less than a decade, growing from approximately $600 billion in 2007 to around $1.3 trillion at present.
- Default rates have declined modestly, but nearly 40 percent of recent undergraduate borrowers are making no progress in repaying their loans (i.e., the borrower's payments are less than the interest accrual on the loan and thus insufficient to reduce the loan principal).
- These trends are partly driven by the Obama administration's significant expansion of IDR plans. Although these plans help students who face financial difficulties, such arrangements reduce the number of students who are paying down their principal and may thus increase the federal government's long-term budget exposure.
- Progress by borrowers on repaying loans varies widely by their type of educational institution. Repayment outcomes are strongest among students who borrow to attend private, non-profit institutions and weakest among students who borrow to attend for-profit institutions.

Student debt has risen steeply over the past several decades. At the same time, large numbers of student borrowers are failing to put a dent in their principal balances. The combination of rising debt levels and low repayment rates suggests that reliance on debt to finance higher education has reached unsustainable levels in the United States and could create long-term strains on the federal budget. While the federal government offers many other forms of aid to college students—such as tax incentives and need-based grants—student loans represent by far the largest federal intervention aimed at helping Americans access higher education (Figure 2).[24,i] In total, around 40 million Americans have at least one federal student loan, up from around 28 million in 2007.[25]

Figure 2. Composition of Federal Student Aid, 2015-2016 Academic Year



Note: Numbers may not add due to rounding.
Source: The College Board.[26]

Rising Student Borrowing

Today, the federal government offers various types of subsidized and unsubsidized loans to undergraduates, graduate students, and parents. There are four primary types of loans: subsidized Stafford, unsubsidized Stafford (both for graduate/professional and undergraduate students), Parent PLUS, and Grad PLUS. As displayed in Table 2, PLUS loans have the highest interest rates (6.31 percent), followed by Graduate Stafford loans (5.31 percent), and Undergraduate Stafford loans (3.76 percent).[j] Debt per borrower is highest among Grad PLUS borrowers, who shouldered an average of $23,494 in the 2015-2016 academic year, followed by Graduate Stafford loans ($18,633), Parent PLUS loans ($15,254), and Undergraduate Stafford loans ($4,121 for unsubsidized and $3,801 for subsidized).[27]

[i] Although federal loans comprise 61 percent of annual federal student aid spending, many of these loans will be repaid. As such, the figure considerably over-weights the true burden of student loans to the federal government.

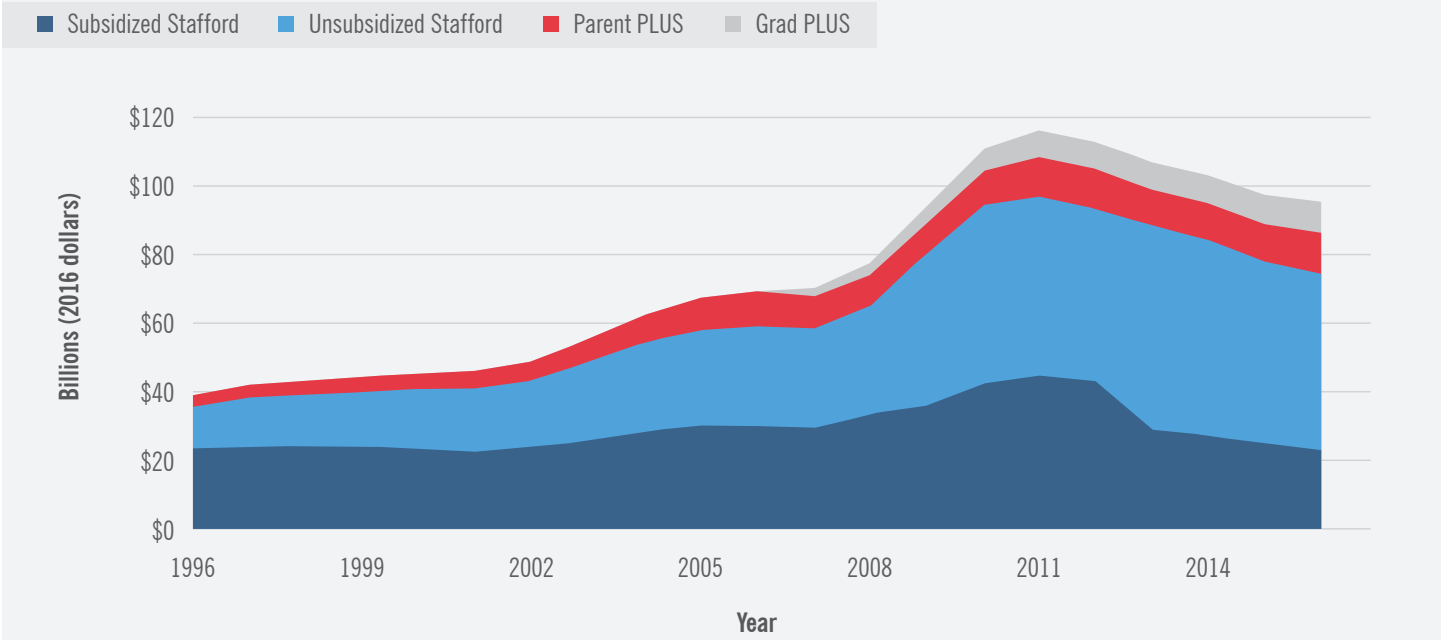
[j] The difference between "subsidized" and "unsubsidized" loans is that the U.S. Department of Education pays the interest on subsidized loans while the borrower is in school, during the borrower's six-month grace period, and if the loan goes into deferment. For more information, please refer to: https://studentaid.ed.gov/sa/types/loans/subsidized-unsubsidized#subsidized-vs-unsubsidized.

TABLE 2: Federal Student Loan Characteristics, 2015-2016 Academic Year					
Loan Type	Borrower Type	Interest Rate (2016-2017)	Number of Loans Issued	Volume Issued (in billions)	Average Loan Size
Subsidized Stafford	Undergraduate	3.76%	6,953,524	$23.0	$3,801
Unsubsidized Stafford	Undergraduate	3.76%	6,909,830	$24.1	$4,121
Unsubsidized Stafford	Graduate, Professional	5.31%	1,895,861	$26.7	$18,633
PLUS	Graduate, Professional	6.31%	541,616	$8.9	$23,494
PLUS	Parents	6.31%	976,833	$12.0	$15,254

Note: All figures reflect the 2015-2016 academic year except for interest rates, which are from the 2016-2017 academic year.
Source: The College Board and U.S. Department of Education.[28]

Although somewhat down from recent all-time highs, the past several decades have brought an explosion in student lending. Annual loan volume has more than doubled in real dollars since the 1995-1996 academic year, rising from $38.9 billion to $94.7 billion in the 2015-2016 academic year (Figure 3).[29,k] This increase has been driven primarily by growth in the issuance of unsubsidized Stafford loans, which jumped from $12.1 billion to $50.8 billion over this 20-year span. Grad PLUS loans, which were first introduced in the 2005-2006 academic year, have also recently pushed up annual loan volume.

Figure 3: Annual Volume of Student Loans Issued, by Loan Type



Note: Dollars were adjusted using the 2016 Consumer Price Index for all Urban Consumers (CPI-U).
Source: The College Board.[30]

[k] For purposes of comparison, all historical loan volumes in this section have been converted into constant dollars.

Roughly parallel to annual loan volume, yearly loan issuance grew cumulatively by 141 percent from 1996 to 2016, increasing from around 7.2 million to 17.3 million.[31] What's more, total debt per borrower grew in real terms by 18 percent between 2005 and 2015—from $23,800 to $28,100.[32]

Notably, annual figures for loan volume and number of loans issued have declined considerably since the peak year of 2011. The reasons for this trend are still somewhat unclear, and whether it will continue remains largely unknown. Despite these recent declines, however, the total outstanding federal student loan balance has doubled since 2007, from approximately $600 billion to around $1.3 trillion (in inflation-adjusted dollars).[33]

Low Repayment Rates

Rising loan balances would not necessarily be a strain on the federal budget so long as the vast majority of borrowers are making their monthly payments. Unfortunately, this is not the case. The current system is plagued by low repayment rates.

When a student takes out a loan, it does not enter repayment until after the student has left the institution and a six-month grace period has elapsed. Repayment rates measure the percentage of borrowers who are able to reduce the principal portion of their loan balance by at least $1 over a given period of time after entering repayment.[l] U.S. Department of Education data show that just 45 percent of undergraduate borrowers who entered repayment in 2010 or 2011 were able to make payments sufficient to reduce their principal balance over their first three years in repayment.[34] This means that fully 55 percent of students who borrowed money to attend U.S. undergraduate institutions were unable to make any progress in paying down their debt.[m] Many of these borrowers are either in deferment or forbearance of their student loans or enrolled in IDR plans (explained on the following page).

Borrower repayment rates vary greatly by type of educational institution (Tables 3A and 3B). In general, private non-profit institutions enjoy the highest repayment rates, at 59 percent on average, compared with a 47 percent rate at two- and four-year public schools, and a 31 percent rate at for-profit colleges. Similarly, 22 percent of private non-profits boast at least a 76 percent repayment rate among their borrowers, compared with a paltry 6 percent of two- and four-year public institutions and *not a single for-profit institution*.[35]

TABLE 3A: Three-Year Federal Student Loan Repayment Rates, by Institution Type

	0-25%	25-50%	51-75%	76-100%
Public	8%	54%	33%	6%
Private Non-Profit	8%	22%	49%	22%
For-Profit	45%	46%	9%	0%
All Institutions	26%	42%	25%	7%

Note: The three-year repayment rate measures the percentage of a cohort that is able to make at least a $1 principal reduction on their loan balance within three years of entering repayment. Numbers may not add due to rounding.
Source: U.S. Department of Education.[36]

TABLE 3B: Average Three-Year Federal Student Loan Repayment Rates, by Institution Type

All Institutions	Public (2-year and 4-year)	Private Non-Profit	For-Profit
42%	47%	59%	31%

Note: Whereas Table 3A displays the repayment rate by institution type, placing the institutions in repayment quartiles, Table 3B displays the average repayment rate by institution type. It uses unweighted averages, which explains why the rate for "all institutions" diverges from the Administration's official weighted three-year repayment rate of 45 percent.
Source: U.S. Department of Education.[37]

[l] Borrowers in default are considered to fail this metric (even if, for example, they paid down principal in their first year and then defaulted).

[m] The 45 percent figure is the combined three-year repayment rate for the 2010 and 2011 cohorts. The metric includes borrowers in default, forbearance, deferment, and IDR plans; it excludes students who are in deferment due to school enrollment. This repayment figure was revised significantly downward in 2017 due to a coding error that was discovered by ED. The previously published three-year repayment rate stood at 63 percent. For more information, please refer to: Paul Fain, "College Scorecard Screwup," *Inside Higher Ed*, January 16, 2017. Available at: https://www.insidehighered.com/news/2017/01/16/feds-data-error-inflated-loan-repayment-rates-college-scorecard.

As mentioned, a borrower can fall into the non-repayment category for several reasons: repeatedly failing to meet required monthly payments (and eventually defaulting); qualifying for one of the options that allows for a temporary hiatus from monthly payments; or enrolling in an IDR plan where the calculated monthly payments are less than the accrued interest.

If a borrower simply fails to meet his or her monthly payment, the loan falls into delinquency. Currently, around 2.9 million student borrowers (out of 30.5 million) with direct federal loans are between 31 and 360 days delinquent on their payments.[38,39] Student loan default rates among recent borrowers, however, are declining. After 270 days in delinquency, a borrower is considered in default and is referred to a collection agency.[40] For any given year, the cohort default rate (CDR) measures the percentage of students entering repayment status that defaults on a loan balance within three years. Comparing the group of borrowers who began repayment in 2010 with those who began in 2013, the CDR has dropped by 3.4 percentage points—from 14.7 percent to 11.3 percent.[41]

But at the same time, repayment rates seem to be falling.[42] What explains this divergence? The increasing prevalence of borrowers who are technically in good standing (or "current") but not making any progress on paying down their principal balances.

For example, non-repayment can also occur as a result of the many options borrowers have for avoiding monthly payments without risking delinquency or default. Borrowers who encounter economic hardship, return to school, or pursue military service can enter forbearance or deferment. Under these programs, monthly payments are suspended, though interest continues to accrue. Currently, 21 percent of the total federal student loan balance, equaling approximately $260 billion, is in deferment or forbearance.[43,n]

Similarly, borrowers who face financial hardship can enroll in various IDR plans, which tie a borrower's monthly payment to his or her income level and provide loan forgiveness after a specified number of years. Under IDR, non-repayment can occur if the assigned monthly payment is less than the accruing interest on the loan balance. The loan is still considered current, even though the borrower is unable to bring down the principal balance. As discussed previously, the Obama Administration greatly expanded IDR plans over the past several years, a development that may be weighing down repayment rates. In contrast, expanded IDR options have likely also contributed to the recent decline in default rates, as these plans have made monthly payments more affordable for struggling borrowers.

If student loan balances continue to rise as a result of stagnant repayment rates, the portfolio could, over time, impose growing strains on the federal budget. This is especially true if IDR uptake proves higher than anticipated and the government ends up forgiving a significant percentage of these balances. Unfortunately, for reasons that are explained in the next section, the long-term budget impacts of federal student loan programs are extremely difficult to predict with accuracy. This means that if rising costs are indeed poised to strain federal coffers, legislators might not even know it.

[n] Due to data limitations, it is not known how much of this balance is the result of financial hardship.

Assessing Long-Term Budget Impacts and Risks from the Federal Student Loan Portfolio

Key Points

- Projecting the long-term budget impacts of the federal student loan portfolio is difficult for several reasons, including disparate accounting methodologies, varying subsidy rates, and unpredictable loan repayment and interest rates.
- Costs (or savings) from the current portfolio vary widely—by roughly $260 billion over ten years—depending on the accounting method used. If the estimate is made with a focus on the federal government's ability to borrow risk-free, significant savings are projected. On the other hand, if the risk of default by borrowers is incorporated similarly to how it would be in the private sector, the portfolio will entail major budgetary costs. This is a critical disagreement, with strong proponents on each side.
- Further complicating the issue is that, regardless of the accounting methodology, the federal student loan portfolio has several different types of loans that carry different interest rates by statute. This means that the expected subsidy rate—or cost/gain to the budget—is unique for each type.

- Finally, both future loan repayment rates and market interest rates are inherently hard to predict with accuracy. In recent years, the costs of the federal student loan portfolio have been adjusted upward multiple times. If future repayment rates continue to fall—for example, because growing numbers of borrowers take advantage of IDR plans—this trend is likely to continue. Questionable forecasting assumptions being used by ED have exacerbated this projection challenge.

The student loan trends discussed in the previous section are concerning. From a federal budget perspective, however, determining the magnitude of the challenge is difficult. For one, federal loan projections can show either large costs or substantial savings depending on the methodology. By statute, various types of loans (as introduced in Table 2) also have different subsidy rates. Finally, any budgetary estimates depend in part on forecasts of future loan repayment patterns, which in turn depend on a variety of social and economic factors and are hard to predict—especially due to the expansion of IDR plans over the past several years.

Disparate Accounting Methodologies

The Congressional Budget Office uses two competing methodologies to forecast the ten-year costs of the federal student loan portfolio. The official method adheres to the rules laid out under FCRA, which record the costs over the lifetime of a loan in the year that it is made, and then offsets that with the projected present value of future cash flows to repay the loan.[44] FCRA ties the discount rate to the interest rate on U.S. Treasury bonds.[45,o]

An alternative method for projecting costs is known as fair-value accounting, which operates in much the same way as FCRA but with one important distinction: Rather than tying the discount rate to Treasury bond interest rates, fair-value accounting ties the discount rate to the market-value interest rate, which is essentially the interest rate that borrowers would receive for a comparable loan on the private market.

This seemingly small adjustment leads to drastically different cost projections. Under FCRA, the federal student loan portfolio is projected to generate $84 billion in savings from 2016 to 2026. Applying fair-value accounting, however, the portfolio is forecast to produce $174 billion in costs over this same period (Figure 4).[46,p]

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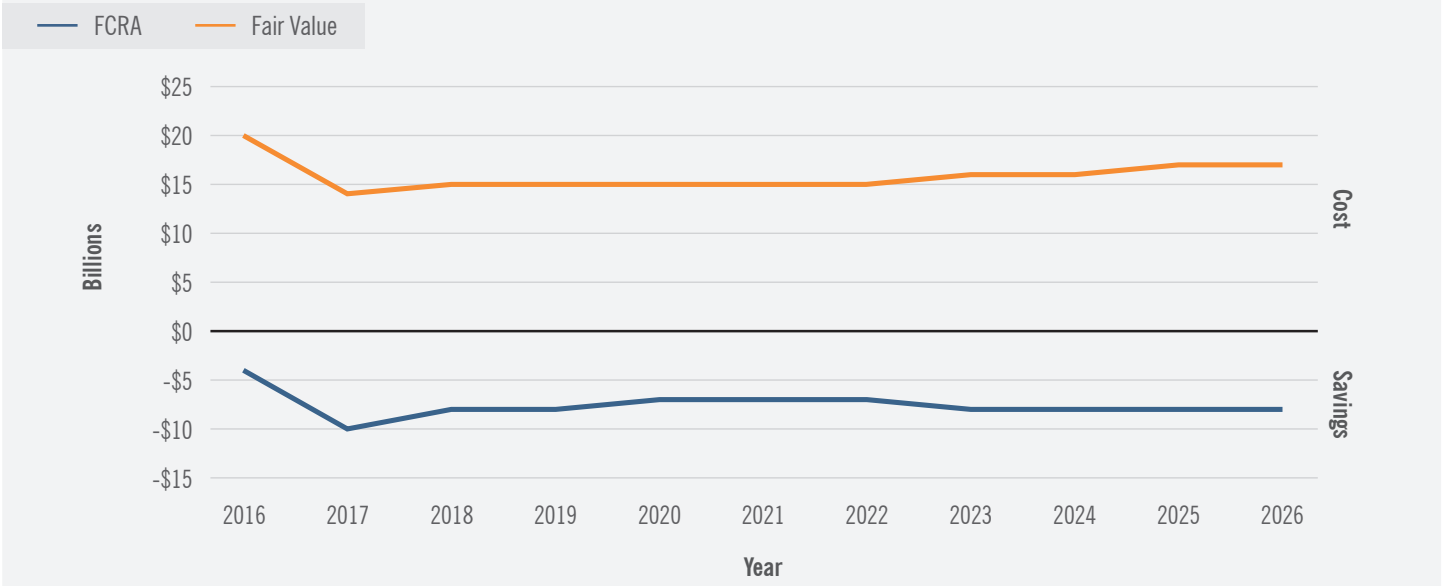
[o] For further information on the differences between FCRA and fair-value accounting, please refer to: Douglas Holtz-Eakin, American Action Forum, "FCRA vs. Fair Value Accounting: A Comparison and Recommendation," 2015. Available at: https://www.americanactionforum.org/testimony/fcra-vs-fair-value-accounting-a-comparison-and-recommendation/. See also: Richard Kogan, Center on Budget and Policy Priorities, "GAO Agrees: Current Accounting Method Beats Fair Value Approach," 2016. Available at: http://www.cbpp.org/blog/gao-agrees-current-accounting-method-beats-fair-value-approach.

[p] These forecasts measure total subsidy costs if all eligible loan applications in a given year are made. In reality, however, only about 90 percent of eligible loan applications in each year are distributed, as some prospective borrowers end up not taking all or part of the loan. For more information, please refer to: "CBO's March 2016 Baseline Projections for the Student Loan Program," 2016. Available at: https://www.cbo.gov/sites/default/files/51310-2016-03-StudentLoan.pdf.

Figure 4: Annual Federal Budgetary Projections of Newly Issued Student Loans



Note: Under the Federal Credit Reform Act (FCRA), the discount rate—used to quantify the present value of future cash flows—is tied to the interest rate on U.S. Treasury bonds. Under fair-value accounting, the discount rate is tied to market interest rates.
Source: Congressional Budget Office.[47]

The Congressional Budget Office finds that fair-value accounting provides a more comprehensive assessment of the costs associated with federal credit programs, as it fully incorporates *market risk* into the projections. Market risk is the threat that shifting macroeconomic conditions can result in losses to even a well-diversified portfolio. For example, an economic recession that raises unemployment could result in increasing student loan defaults.

To account for this risk, fair-value accounting assigns a higher discount rate—as the private lending market would demand—to future cash flows. This *risk premium* leads to a lower present value of expected loan repayments and thus a higher projected cost to the lender—the federal government.[48]

Conversely, proponents of the FCRA accounting method—such as GAO—contend that this risk premium is unnecessary. Private financial institutions have higher borrowing costs than the federal government, and the market-value discount rate under fair-value accounting is partly a reflection of those costs. In addition, federal student loans are extremely difficult to discharge in bankruptcy; the federal government has the unique ability to garnish Social Security benefits and tax refunds to collect defaulted balances.[49]

Varying Subsidy Rates

The projected costs of the federal loan portfolio also vary by loan type. For example, subsidized Stafford loans are expected to incur a cost under both the FCRA and fair-value accounting methods. This makes sense, given that the federal government covers interest payments on these loans while the borrowers are in school; these loans also carry a lower interest rate than others in the portfolio. In contrast, Parent PLUS loans are forecast to generate savings under both methods. This type of loan carries a higher interest rate as well as credit requirements for borrowers (whereas other loans in the federal portfolio have no such requirements).[50]

Table 4 displays the projected *subsidy rate* in 2016 for each type of loan in the federal portfolio under both the FCRA and fair-value accounting methods. The subsidy rate can be used

to estimate how much the federal government will gain or lose on a given loan over its lifetime. For example, a 10 percent subsidy rate means that the government will ultimately lose 10 cents for every dollar it issues in loans.[51] Negative subsidy rates indicate federal savings, whereas positive subsidy rates indicate federal costs. These large differences between the FCRA and fair-value subsidy rates demonstrate the difficulty in predicting whether the federal loan portfolio will generate savings over time.

TABLE 4: Projected Student Loan Subsidy Rate, by Loan Type (2016)

Loan Type	FCRA	Fair Value
Subsidized Stafford, Undergraduate	0.4%	25.6%
Unsubsidized Stafford, Undergraduate	-9.3%	18.7%
Unsubsidized Stafford, Graduate	-19.2%	5.6%
PLUS, Graduate	-18.9%	5.8%
PLUS, Parent	-35.1%	-14.8%
All Loans	**-13.9%**	**11.3%**

Source: Congressional Budget Office.[52]

Unpredictable Loan Repayment and Market Interest Rates

Congress and the president have the power to alter student loan interest rates and repayment schemes, which can have a large effect on loan repayment and subsidy rates. Even under the assumptions of current law, however, there are considerable uncertainties surrounding future repayment trends and market interest rates. Both of these are difficult for forecasters to predict, which poses challenges in projecting student loan costs to the federal budget.

Indeed, over the past several years, budget forecasts have understated the costs associated with the federal loan portfolio, as higher-than-expected uptake in IDR plans have forced upward revisions.[q] This process, which is known as re-estimating, occurs when budget projections are altered due to changing circumstances. Since Fiscal Year (FY) 2010, the federal loan portfolio has been re-estimated upward in four of the president's budget requests, resulting in approximately $16 billion in net costs that were previously unforeseen.[53] These upward re-estimates are added to the federal deficit automatically and are not subject to the appropriations process or congressional approval.

Some of these revisions have been the result of forecasting inaccuracies stemming from flawed assumptions used by ED to project the future costs of IDR. According to GAO, the department continues to use an outdated model that was built when the federal government offered only one IDR plan. As such, the model treats all of the IDR plans identically, even though each carries significantly different terms. Furthermore, the model fails to tie wage growth to inflation, and—perhaps most importantly—it assumes that every borrower will remain in their current repayment plan for the entire repayment period. ED is thus failing to account for borrowers

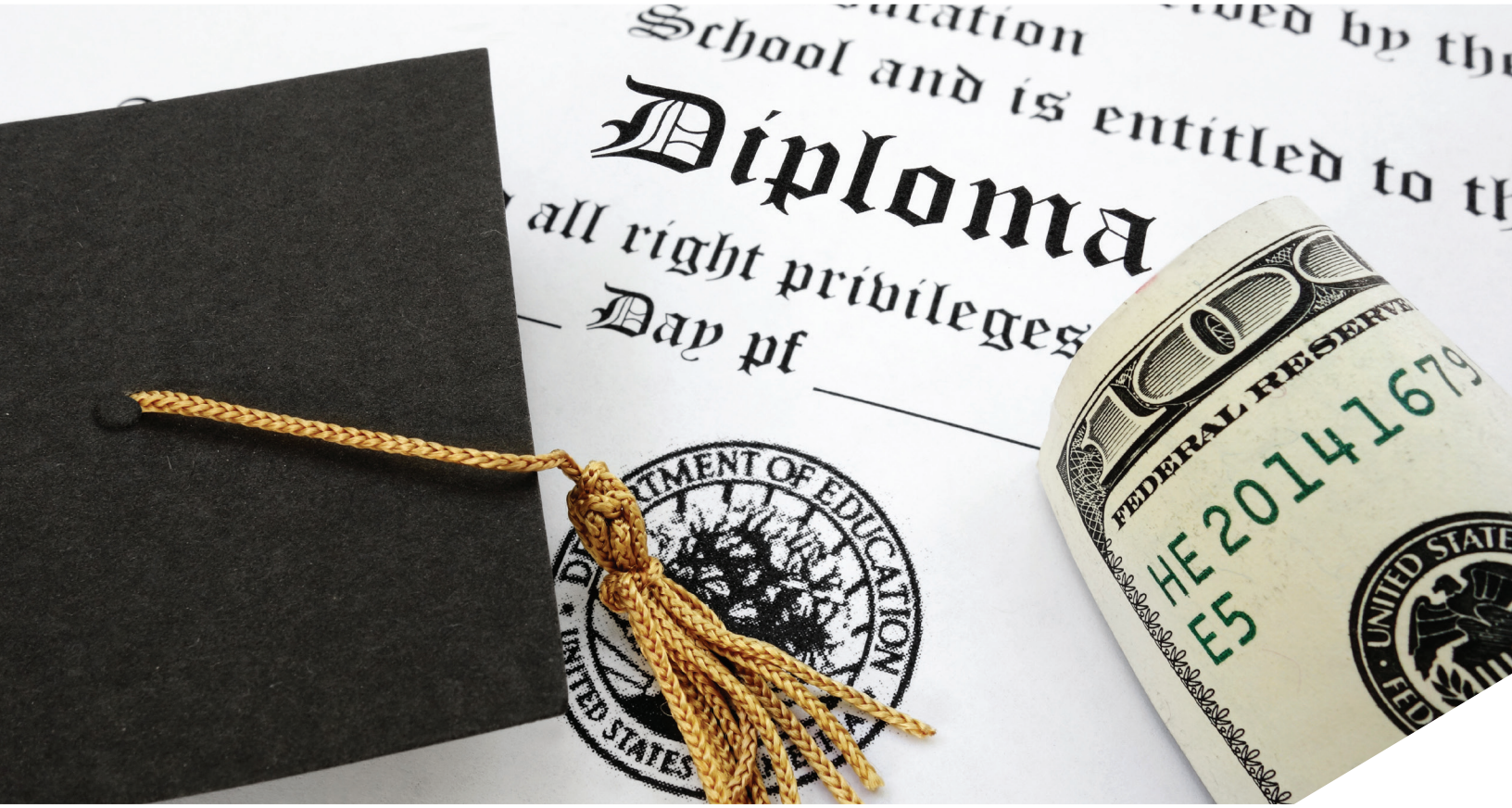
[q] Declining market interest rates over this same time period have partially offset the IDR plan impact.

who begin repayment on the standard ten-year plan and then later move onto IDR, and vice-versa. This omission is especially problematic given ED's considerable efforts to raise public awareness about IDR, as well as the Obama administration's specific goal of enrolling an additional 2 million borrowers into these plans over the past year.[54,r]

In sum, conflicting budget-scoring methods paired with uncertainty and questionable forecasting assumptions obscure the long-term fiscal effects of the federal loan portfolio. Indisputably, however, swelling loan balances carry the potential to cause long-term federal budget strains, particularly in the context of increasingly generous IDR plans.

[r] Increased IDR uptake is not guaranteed to produce long-term budgetary strains. IDR enrollees who eventually realize wage gains and, as a result, return to a standard repayment plan will have accrued additional interest while they were enrolled in IDR. On those loans, the federal government may very well realize greater savings than anticipated.

Factors Driving the Rapid Growth in Student Debt



Key Points

- Soaring college prices are the most obvious factor behind rising student loan balances, but federal policy has exacerbated the problem by encouraging borrowing and easing repayment requirements. Similarly, federal budget accounting methods have provided lawmakers with little incentive to stem growing debt levels.
- Extensive borrowing for remedial coursework is also contributing to high levels of student loan debt. This extra borrowing covers courses that usually do not count toward graduation requirements, which can translate into a higher overall cost of attendance.
- The transition to direct federal lending has brought unintended consequences, both in terms of increasing overall reliance on student loans and in terms of exposing the federal government to long-term budget risks. Specific concerns include a decline in the quality and effectiveness of loan counseling, perverse incentives resulting from flaws in the way that the federal government contracts with loan-servicing providers, and the consequences of allowing institutions of higher education—including those with poor student outcomes—to act as loan originators.

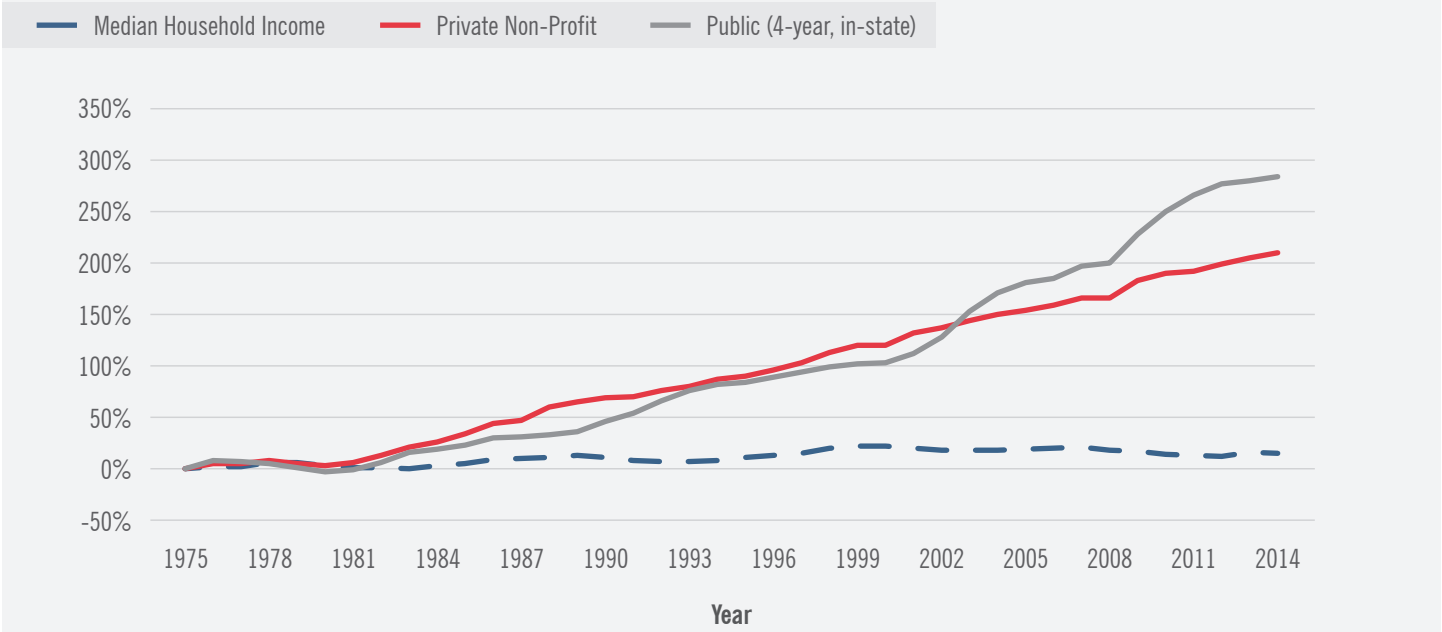
Rising student loan balances can be attributed to numerous factors, the most obvious of which is the fact that college prices have shot up in recent years. At the same time, well-intentioned federal policies aimed at expanding access to higher education have encouraged borrowing by raising loan limits and easing repayment requirements, including through the introduction of generous IDR plans. Meanwhile, changes in federal budget accounting methods under FCRA have made the student loan portfolio appear to generate large savings, providing policymakers with little incentive to rein in rising debt levels.

This section discusses additional factors, some of them involving the unintended consequences of the shift to direct federal lending, which may be further contributing to high levels of borrowing and increasing the federal government's long-term budget exposure. Key examples include an erosion in high-quality loan counseling and servicing, and the new role of educational institutions in originating loans, which creates potential conflicts of interest. Colleges lack an incentive to advise against over-borrowing, in part because they are largely insulated from the negative consequences of rising debt and declining repayment rates.

Rising Costs for Higher Education

The exponential rise in the cost of higher education is among the most direct factors driving student loan growth. Between 1975 and 2015, real median household income grew by just 20 percent, while college prices more than tripled.[55] Average annual in-state tuition and fees at public, four-year institutions grew by 295 percent over this span, in inflation-adjusted dollars. At private, non-profit universities, these costs grew by 221 percent (Figure 5).[56]

Figure 5: Cumulative Change in Average Tuition & Fees, and Median Household Income



Note: Percentage change is measured from 1975 and using 2016 dollars, which were adjusted using the 2016 Consumer Price Index for all Urban Consumers (CPI-U).
Source: Congressional Budget Office.[57]

Although public four-year schools have seen the largest price hikes in recent years, private non-profit institutions have also consistently raised tuition rates. In the 2016-2017 academic year, average tuition and fees at private non-profits stood at $33,480 per year, compared with $9,650 per year for in-state students at public four-year institutions.[58]

Room-and-board prices are also on the rise. Since the 1975-1976 academic year, average annual prices for dormitory rooms at four-year institutions have increased by 138 percent (in constant dollars), from $2,459 to $5,851, while average meal plan prices have increased by 53 percent, from $3,011 to $4,602.[s]

Why college prices continue to grow at such a rapid rate is a critical question, one that is central to any discussion of how to continue expanding access to higher education while also addressing concerns about high levels of student debt. Rising sticker prices are indisputably an important component of growing loan reliance and federal budgetary exposure. Identifying and analyzing the various causes of ballooning higher-education prices, however, is a large and complex topic (see box on the next page).

Generous Loan Policies

As discussed on page 5, legislative and regulatory changes over the past half-century have increased the availability and attractiveness of student loans. By loosening loan limits and enacting various IDR plans with generous forgiveness options, the federal government has both incentivized and facilitated borrowing. Increasing loan availability has likely helped to expand access to higher education for Americans across the income spectrum.[59] IDR plans have helped struggling borrowers avoid delinquency by making their monthly payments more affordable.

But these policies have also produced unintended consequences by contributing to today's high level of student indebtedness. The advent of the PLUS programs, which allow graduate students and the parents of undergraduates to borrow all the way up to their schools' cost of attendance, has been particularly notable. The cost of attendance is set by institutions, and it includes not only the prices associated with tuition and fees but also room and board. Both the Parent and Grad PLUS programs have grown multifold since they were first introduced (in the early 1980s and 1990s, respectively). In terms of annual loans issued, the Parent PLUS program has reached roughly $12 billion and the Grad PLUS program stands at around $9 billion.[60]

Growth in loan availability has coincided with the rise in IDR plans, which lower the risks for borrowers. Knowing both that their monthly payments under IDR will be affordable (regardless of the size of the loan) and that their outstanding loan balance may be forgiven after some number of years provides an incentive for students to take on the maximum loan for which they are eligible. This is particularly true under the Public Service Loan Forgiveness (PSLF) program, which provides loan forgiveness after just ten years for government and non-profit employees. Research from the New America Foundation found that once PSLF borrowers reach a certain threshold of debt, they face no marginal cost associated with taking on additional debt. Furthermore, this threshold level of debt is lower than the cost of many professional degrees. For example, teachers earning at the 75th percentile of income for their profession reach this "zero-marginal-cost threshold" after incurring just $32,000 in federal loans.[61] The offer of additional borrowing at no cost is an awfully tempting proposition.

[s] Data for 1986-1987 and later years reflect a standard meal plan of 20 meals per week. Earlier data are for meals served seven days a week, with the daily number of meals varying (and often less than three). Due to this revision, these data are not entirely comparable. For more information, please refer to: https://nces.ed.gov/programs/digest/d15/tables/dt15_330.10.asp.

The Role of Federal Student Loans in Driving Up College Prices

Ironically, the increasing generosity of federal loan programs has likely played a role in the escalation of college prices (tuition and other student charges) in recent years. Growing loan availability and flexible repayment options have increased students' willingness to pay for higher education, which in turn has likely given institutions greater latitude to set tuition prices. In this way, policies designed to promote college affordability could be having the perverse effect of also making college more expensive.

In 2015, the Federal Reserve Bank of New York analyzed the relationship between college prices and federal aid availability. The study found that a one-dollar increase in the subsidized-loan maximum is associated with a 60-cent increase in an institution's sticker price, while a one-dollar increase in the unsubsidized loan maximum is correlated with a 15-cent increase in the sticker price.[62] Similarly, researchers at the Cornell Higher Education Research Institute demonstrated that public institutions specifically increase in-state tuition rates based on the availability of federal Pell Grants, subsidized loans, and state need-based grant aid.[63]

Additionally, a 2012 study published by the National Bureau of Economic Research found that aid-eligible, for-profit institutions charge tuition at a 78 percent higher rate than comparable non-eligible institutions. These tuition differentials are roughly equal to the amount of federal aid that students receive, which suggests that pricing discrepancies are at least partly a byproduct of maneuvering by eligible institutions to capture federal student aid subsidies.[64]

Without question, tuition prices are also driven by many other factors, including changes in state funding, macroeconomic conditions, and labor costs.[t] Analyzing the specific role of different cost drivers is difficult and further complicated by inconsistent data reporting among institutions.[65] Such a breakdown is beyond the scope of this paper. Despite these confounding factors, however, existing research provides considerable evidence that the increased availability of student loans has influenced the prices that institutions of higher education can charge.

Borrowing for Remediation

Borrowing for remedial coursework is another contributing factor to high levels of student loan debt. Colleges generally do not grant credit for remedial courses, as they are intended to prepare students for college-level coursework. (Typically, students are prompted to take these courses due to failed placement tests or poor academic records.) Given the lack of credit for such courses, remediation can extend students' time to graduation beyond four years, thus increasing the amount of debt incurred.

Nearly 60 percent of students at two-year colleges and 20 percent of students at four-year colleges are placed in remedial courses.[66] This evidence suggests that there is a significant disconnect between high-school requirements and college readiness, leaving many students unprepared for college coursework.[u] In 2011, more than half a million

[t] Colleges often note that higher education is labor-intensive and therefore naturally prone to cost increases.

[u] In 2015, only 41.9 percent of students who took the SAT met college-readiness standards. For more information, please refer to: The College Board, *College Board Program Results*, 2015. Available at: https://secure-media.collegeboard.org/digitalServices/pdf/2015-college-board-results-national-report.pdf.

students were enrolled in remedial courses at a total out-of-pocket cost of $1.5 billion, with an additional $380 million borrowed.[67,v] Adding insult to injury is the fact that this borrowing is to pay for an education that was supposed to be attained previously.

Unintended Consequences of the Transition to Direct Lending

The full transition to direct federal lending in 2010 was intended to reduce government costs and expand access to financing for students. But when combined with the introduction of generous repayment policies, the change to direct lending has also unintentionally increased both overall reliance on loans and the federal government's exposure to budget risks.

There are several reasons why this is the case. Although more than 90 percent of the financing provided under FFEL was backed by the federal government, private lenders and guaranty agencies still stood to lose on student loan defaults and thus were motivated to prevent over-borrowing. Under direct lending, however, loan counseling and loan servicing have been contracted out to third-party entities that do not face similar financial incentives. Not only has loan counseling become less-individualized than it was under FFEL, the quality of loan servicing has declined due to disincentives embedded in the government's contracts with direct-loan service providers. Finally, direct lending has allowed a wide range of institutions of higher education, of varying quality, to act as loan originators. Many schools have a financial interest in increasing enrollment, but little incentive to stem over-borrowing. Each of these concerns—and the implications for the effectiveness and cost of the federal student loan portfolio—is discussed below.

Inadequate Information and Counseling

Federal student loan borrowers are required to undergo entrance counseling before loans are disbursed and exit counseling once loans enter repayment.[68] Counseling by universities was originally mandated under the 1986 HEA Reauthorization. Over time, the Department of Education (ED) has expanded the subjects that must be covered by counseling. Today, the list includes the consequences of accruing debt, the terms of the loan, repayment options, estimated monthly payments, deferment, forbearance, and a range of other topics.[69]

Loan counseling has become increasingly depersonalized over time, substituting online platforms in place of face-to-face borrower interactions. In 2000, ED rolled out an online-counseling tool that satisfied the growing list of federal requirements. This platform has been adopted by an estimated 70 percent of student financial-aid offices.[70]

The transition to direct lending accelerated this digitization. Under FFEL, loans were privately originated by financial institutions, secured in the secondary market, and generally serviced by state non-profit agencies with a public mission.[w] Under this arrangement, relevant stakeholders had an interest in promoting financial literacy among student borrowers. Financial institutions often counseled against over-borrowing, and many state non-profit agencies invested a portion of loan proceeds into financial education, working with students to ensure that they understood the consequences and responsibilities of taking on debt. The transition to direct lending eliminated this incentive structure and likely contributed to the decline in personalized counseling.

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[v] Statistics on remediation can vary by source, with different estimates of the number of students who enroll in remediation and the total costs of remedial coursework.

[w] Under FFEL, financial institutions originated loans and federally backed guaranty agencies insured the loans against default. The secondary market purchased loans from lenders to provide capital for new loan originations. For more information, please refer to: http://www.finaid.org/loans/studentloans.phtml.

Some analysts also point to serious shortfalls in the effectiveness of ED's online counseling. In a qualitative study of this issue, a non-profit, student-loan corporation monitored and recorded feedback from a diverse group of borrowers during entrance counseling.[71] Based on the results, it was concluded that the online tool was difficult to navigate, provided content that was text-heavy and difficult to understand, and included subject matter that was irrelevant for first-time borrowers.[72] Forty percent of users indicated that they had difficulty understanding the module's explanations and descriptions of basic loan concepts. Ultimately, the study found that the online module falls short by assuming that students are "tireless text processors" with the ability and willingness to not only read and comprehend everything that appears on the screen, but also use the information to make optimal borrowing decisions.[73]

The decline in personalized counseling appears to have produced some unfortunate effects, as research indicates that many of today's borrowers are confused about their loans. A study of student borrowing at Iowa State University, for example, found that 13 percent of students mistakenly believed that they did not have any student debt, and 37 percent underestimated the size of their loan balances.[74] Similarly, researchers at the Brookings Institution found that around half of first-year students underestimated what they owed in federal student loans.[75] This lack of awareness is almost certainly leading to both greater borrowing and lower repayment rates.

Flawed Loan-Servicing Rules

A series of flawed incentives embedded in federal direct-loan servicing contracts is also contributing to low repayment rates. The performance metrics in these contracts are proving insufficient to motivate servicers to work with delinquent borrowers to bring their loans current.

Under the federal direct-loan program, loan-servicing duties are contracted out to both for-profit and non-profit entities that are charged with managing borrowers' accounts, processing payments, and communicating with borrowers about various repayment options.[76] Servicers also help delinquent borrowers avoid default by enrolling them in an IDR plan or by moving their accounts into forbearance or deferment.

Loan servicers are subject to performance-based contracts, which are designed to reward servicers based on a set of metrics. Under the contracts, compensation depends on the number of borrowers serviced and payments are highest for balances that are current. As loans slip into delinquency, compensation to servicers declines on a sliding scale (Table 5).

TABLE 5: Monthly Student-Loan-Servicer Compensation, by Loan Status

Borrower Status	Rate Per Borrower
In School	$1.05
In Grace Period	$1.68
In Repayment	$2.85
Deferment	$1.68
Forbearance	$1.05
Delinquent 6-30 Days	$2.11
Delinquent 31-90 Days	$1.46
Delinquent 91-150 Days	$1.35
Delinquent 151-270 Days	$1.23
Delinquent 271-360 Days	$0.45
Delinquent 361 or More Days	$0.45

Source: U.S. Government Accountability Office.[77]

ED also evaluates its contracted loan servicers on a quarterly basis, using data on delinquency and default rates, as well as survey results that gauge the satisfaction with the servicers among both borrowers and employees of ED's Office of Federal Student Aid. These evaluations are used to allocate new loan

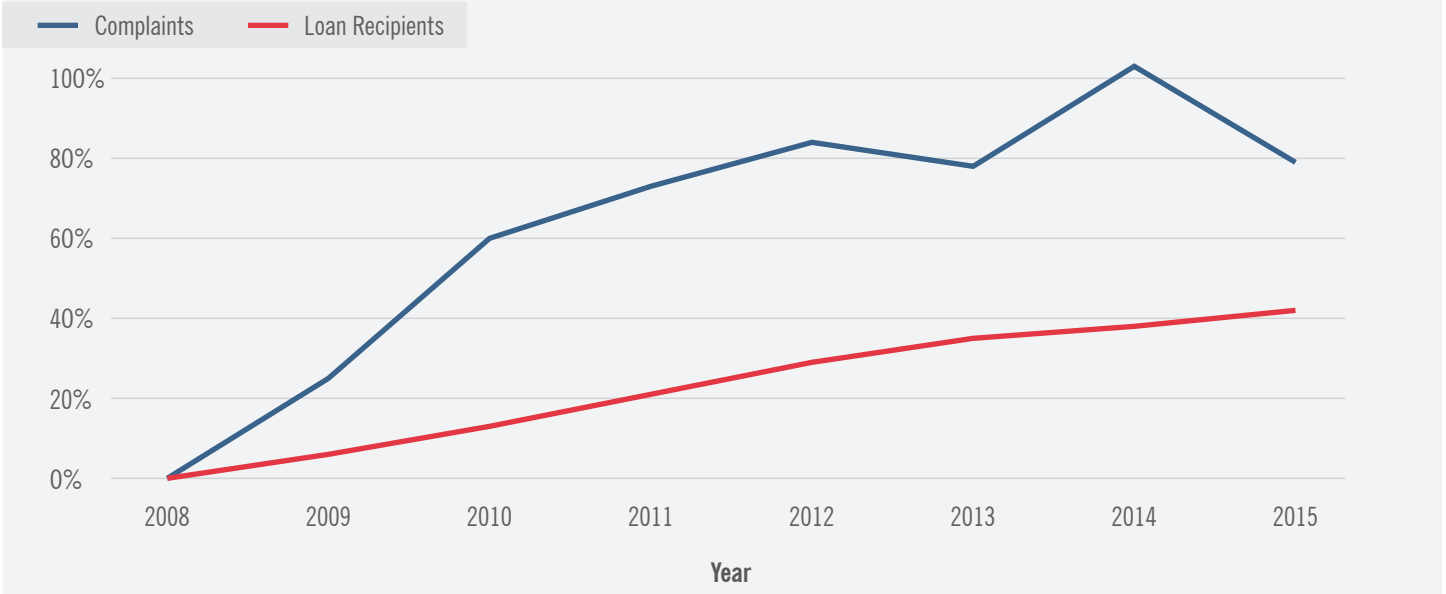
[x] In addition, for-profit servicers are eligible for bonus compensation if delinquencies are maintained below a certain threshold. Specifically, servicers can earn a maximum of $500,000 in additional compensation per quarter if delinquencies both comprise less than 21 percent of their portfolio and are lower than they were in the previous quarter. For more information, refer to: https://studentaid.ed.gov/sa/sites/default/files/fsawg/datacenter/library/ED-FSA-09-D-0015_MOD_0085_Navient.pdf.

accounts among servicers: Better-performing servicers are rewarded with a larger proportion of contracts.[78,79] Borrowers are assigned to one of nine servicers, and neither the borrower nor the servicer has a say in the assignment.

ED's performance contracts with third-party servicers were designed to incent quality customer service and to reduce delinquency and default rates. Unfortunately, the results have been lackluster.[y] The delinquent share of the total federal direct-loan balance has remained roughly flat at 7 percent since the third quarter of FY 2013 (the earliest data available).[80] Borrower complaints, however, have risen steeply. In 2009, the first year in which these contracts were implemented, the number of borrower complaints increased by 25 percent from the previous year.[z] (By contrast, complaints rose by just 9 percent in 2008.)[81] Between 2008 and 2015, the volume of annual complaints grew by 79 percent, far outpacing the growth in total loan recipients, which increased by 42 percent over the same period (Figure 6).[82]

These poor outcomes are partly due to flaws in the performance-based contracts. Because loan servicers are paid based on a flat rate per borrower—rather than on their quality of service or the number of times delinquent borrowers are contacted—they have little incentive to provide high-level service. The current structure also creates incentives for servicers to prolong borrowers' payment plans: Since compensation is based on the number of accounts, servicers may be less willing to help borrowers pay off their loans early or to even publicize the benefits of making payments greater than the minimum.[84]

Figure 6: Cumulative Growth in Total Student Loan Recipients and Borrower Complaints



Note: Data for total loan recipients uses calendar years, whereas data for number of complaints uses fiscal years. Cumulative growth is measured from 2008.
Source: U.S. Department of Education.[83]

[y] For information related to problems with service—namely, borrower difficulties in contacting customer service hotlines—please refer to: U.S Government Accountability Office, *Federal Student Loans: Education Could Improve Direct Loan Program Customer Service and Oversight*, GAO-16-523, 2016. Available at: http://www.gao.gov/assets/680/677287.pdf. For information on borrower complaints, please refer to: Consumer Financial Protection Bureau, *Student Loan Servicing: Analysis of Public Input and Recommendations for Reform*, 2015. Available at: http://files.consumerfinance.gov/f/201509_cfpb_student-loan-servicing-report.pdf.

[z] The majority of direct-loan servicing was originally handled by one firm: ACS, Inc. In 2009, the Office of Federal Student Aid began contracting with multiple servicers and implemented performance contracts. For more information, please refer to: http://www.consumerfinance.gov/policy-compliance/rulemaking/final-rules/defining-larger-participants-student-loan-servicing-market/.

Although servicers do receive a higher rate of compensation per borrower for accounts that are current, increased complaints and delinquencies imply that this incentive structure is insufficient. Contacting and counseling delinquent borrowers can be labor-intensive, requiring numerous mailings and phone calls. If incentives for keeping accounts current were stronger, servicers might invest more heavily in these activities, which would likely improve outcomes for borrowers.[85]

Another problem with current contracts is that new accounts are allocated based on performance relative to other servicers, not relative to an objective standard. Servicers compete for new accounts based on the metrics used in the quarterly ED evaluation (described previously), but the industry lacks a uniform regulatory framework to stipulate the minimum level of assistance that servicers should provide.[86] This means that even the worst-performing servicers are guaranteed to receive some new contracts (albeit fewer than their better-performing peers). Thus, borrowers can receive vastly different levels of service based on their assigned servicer.[87]

ED has acknowledged these problems and, in 2015, announced its intent to overhaul the entire system, including plans to roll out a single platform for servicing every borrower. Rather than having borrowers assigned to one of nine servicers—with separate websites, payment systems, and practices—the single platform will allow all borrowers to have the same experience with their loan servicing. Under the proposal, ED would act as the sole front-facing servicer, but it would contract out specific customer-service and administrative functions to private servicers on the back end. ED has yet to provide details on how the single platform will operate, but it will involve the creation of a series of new performance metrics for private-sector servicers, with the goals of equalizing and improving customer service, reducing delinquencies, and enhancing efficiency by eliminating duplicative practices.[88]

Lack of Accountability

Another consequence of direct lending is that institutions of higher education, rather than financial institutions, now act as originators of federal student loans, providing colleges with broad latitude to determine how much students can borrow (up to a specified cap for Stafford loans and up to the cost of attendance for PLUS loans). At the same time, schools remain largely insulated from the consequences of non-repayment and therefore have little incentive to counsel students to borrow less than the maximum loan amount.

The federal government attempts to limit its budgetary exposure through an accountability metric based upon the CDR. Schools that produce a high number of defaults are restricted from federal borrowing. As mentioned earlier, the CDR measures the percentage of an institution's borrowers that default on their federal loan balance within three years of entering repayment.[aa] If an institution has a CDR that exceeds 40 percent for a single cohort or 30 percent for three consecutive cohorts, the school can lose eligibility for federal aid (meaning it will no longer be able to offer students federal loans and grants). Although the metric is designed to limit borrowing at low-performing schools, its narrow focus on defaults makes it toothless, as borrowers have many options to avoid default—namely, forbearance, deferment, and enrollment in IDR plans. The weakness of this system is evidenced by the fact that just ten institutions out of more than 5,000 were sanctioned for high default rates in 2016.[89]

The result is a financing environment that is almost entirely devoid of accountability with regard to institutions of higher education. Schools can raise prices and facilitate the large student loans needed to cover those prices without any real risk of consequence if borrowers are unable to make loan payments after they graduate. Though the federal government does have a mechanism in place to punish schools with high borrower-default rates, the mechanism is weak and appears to be doing little to address the larger trend of declining repayment.

[aa] CDR is calculated by cohort (i.e., grouping those borrowers who enter repayment status in a given year).

Policy Options

Key Points

- Opportunities exist to improve the efficiency and effectiveness of the student loan system in ways that would discourage unsustainable levels of borrowing and, in doing so, also reduce potential federal budget exposure.
- Changes to loan limits (for example, adding borrowing limits to the PLUS program), together with changes in the mechanisms used to finance remedial coursework, could be used to directly slow growth in future borrowing. These options, however, are in tension with the goal of expanding access to higher education (other than to the extent that borrowing limits lead to reductions in college prices over time). Moreover, under current accounting methods, lawmakers have little incentive to limit federal lending.
- Improving loan counseling and restructuring loan-servicing contracts to promote better customer service could enhance the overall efficiency and performance of the student loan system and boost future repayment rates. Possible opportunities include improving ED's online-counseling tool and giving states greater flexibility to customize counseling services. Similarly, incentives for loan servicers to improve customer service and help delinquent borrowers could be strengthened as part of ongoing efforts to overhaul the federal loan-servicing contracts.

- Greater institutional risk sharing would strengthen accountability throughout the student loan system. One option is to require all institutions to pay a fee tied to the loan repayment rates of recent borrowers. In addition, institutions that consistently produce borrowers who are unable to pay down their principal balances could be penalized by restricting their access to federal loans and grants. Reforms to strengthen accountability, however, must be carefully designed to avoid unintended consequences, such as disadvantaging institutions that disproportionately serve poor, minority, or first-generation students.
- Another option for reducing the volume of student debt on federal balance sheets is to auction some portion of the federal student loan portfolio to private-sector financial institutions and not-for-profit student loan agencies. This could have some benefits in terms of renewing the public-private partnership in student lending that existed under FFEL, but care would have to be taken to ensure that private entities don't cherry-pick the safest loans.

This section discusses policy options that might either reduce the reliance on borrowing to finance higher education or manage federal budget risks associated with the student loan system, or both. Strategies that directly target college sticker prices are not the main focus, though reining in those prices is clearly a key aspect of maintaining affordability.[bb] Simply expanding other, non-repayable forms of direct federal aid, such as Pell Grants, is also not explored. While these types of assistance play an important role in helping many Americans access higher education, they are costlier to the government than student loans and must compete for funding with other federal programs and budget priorities.

Thus, this discussion focuses on opportunities to strengthen institutional accountability and to improve the efficiency and effectiveness of the federal student loan system. To be clear, this paper does not endorse any particular policy approaches or program reforms—the aim here is merely to identify several options and explore their pros and cons.

Loan Limits

Tightening loan limits would be among the most direct and effective ways to reduce reliance on borrowing, as it would directly reduce the amount of federal loans students could borrow. Unfortunately, however, this approach also has important and obvious drawbacks in terms of reducing access to higher education and making college less affordable for some students, particularly in the short run. Restricting federal loans could also increase reliance on private loans, which tend to have higher interest rates.

Although beyond the scope of this report, it is worth mentioning that increased federal loan availability has likely been a factor in escalating tuition prices as it enables institutions to consistently increase their cost of attendance. As such, limiting loans could also work to drive down prices.

One specific way to restrict lending would be to place borrowing limits on PLUS loans. Currently, graduate students and the parents of undergraduates can use PLUS loans to finance higher-education costs up to the cost of attendance. Because these loans are uncapped, they provide an unlimited source of financing that leaves educational institutions with little incentive to restrain prices.

From a federal budget perspective, one potential concern with capping PLUS loans is that the Parent PLUS program is

[bb] Rising college prices will be explored more comprehensively in a separate, forthcoming BPC report.

projected to generate savings under both FCRA and fair-value projections. This is because Parent PLUS loans have higher interest rates and borrowers cannot have an adverse credit history.[90,cc] Thus, restricting these loans could actually reduce savings in the federal loan portfolio, though again, this would depend on future repayment trends.

As with any approach that involves reducing loan limits or restricting borrowing, the chief argument against capping PLUS loans is that it would address the problem of affordability only indirectly—by potentially exerting downward pressure on college prices over time—while clearly exacerbating the problem of access in the short run. If less financing is available through this and other federal programs, some students who would otherwise rely on PLUS loans to fill financing gaps might be unable to attend the institution of their choice, or might be forced to rely on private loans, which often charge higher interest rates and offer less flexibility than federal loans. Thus, policymakers would need to consider pairing stricter limits in the PLUS program with other forms of financing or assistance for low-income students.

Another option that could reduce borrowing is to restructure the way remediation is funded. Students often take remedial coursework due to failures in the K-12 system. Because these courses generally do not count for college credit, remediation can significantly delay a student's progress toward a degree. More importantly from a cost perspective, many students are forced to borrow for these courses, adding to the total financial burden associated with a higher education. One way to reduce loan reliance would therefore be to eliminate borrowing for remediation, and instead fund it via other means. For example, remedial courses could be funded by a more-direct allocation of need-based grants (e.g., Pell), or by using a performance-based metric determined at the state or federal level. The fact that such changes would shift remediation costs away from the student and onto the institution, the state, or the federal government is both the main advantage and the chief drawback of this approach.

Loan Counseling

The fact that the current system of loan counseling is underperforming should be of concern to all parties in the current debate about student loan debt and college access. Raising awareness of the costs of borrowing and ensuring that borrowers have a clear understanding of their repayment options before their loans become due are both ways to reduce financial risks to students and the government, without diminishing college access or affordability.

This underperformance is partly the result of flaws in ED's online-counseling module, which is dense and difficult for borrowers to understand. ED could embark on an overhaul of the counseling system, working with relevant stakeholders and experts—such as financial-aid experts, digital-media specialists, and borrower advocates—to craft a platform that is user-friendly and presents information in a manner that is clear, compelling, and easy for students and their families to understand.

Another option is for the federal government to eliminate its online module and instead shift resources and responsibility for loan counseling to the state or local level. ED could give states more flexibility to customize counseling systems by eliminating the long list of required subjects and allowing states and/or localities to craft counseling messages based on the needs of the local population of borrowers. The drawbacks of this approach are that it could be expensive for those governments to administer and could result in wide variations in the quality of loan-counseling services provided in different states.

[cc] Currently, PLUS loans carry a 6.31 percent interest rate, compared with 3.76 percent for subsidized Stafford loans and 5.31 percent for unsubsidized Stafford loans. For more information, please refer to Table 2 of this paper.

Institutional Accountability

Currently, institutions of higher education lack skin in the game when it comes to loan repayment. Though schools can lose access to federal loans and grants if a high percentage of their borrowers default on federal loan balances, this accountability system is weak due to the many options available to borrowers for avoiding default, such as IDR enrollment.

Lack of accountability means that schools have little incentive to prevent over-borrowing. Indeed, the fact that schools both set the cost of attendance and act as loan originators means that they can raise tuition and fees and expect to cover much of the gap with uncapped PLUS loans.

One way to strengthen accountability and give schools a greater incentive to discourage over-borrowing would be to make institutions responsible for a percentage of the outstanding loan balance that is not being repaid by their borrowers. For example, schools could be charged a fee based on the portion of each borrower cohort's outstanding principal balance that has not decreased after a given number of years in repayment.

Another possibility would be to replace the federal government's CDR metric with one tied to loan repayment rates. Under this system, institutions that consistently produce borrowers who are unable to pay down their principal balances would be unable to access federal loans and grants. This would incentivize schools, not only to discourage excessive reliance on borrowing, but also to hold costs down, improve loan counseling, and invest further in improving graduation rates so that students are better-positioned to find gainful employment and repay their loans in the future.

It is worth noting that strengthened accountability systems could produce unintended consequences if they are crafted poorly. For example, institutions could choose to limit enrollment to the students who are most likely to graduate—and thus more likely to pay back their loans. This could hurt specific demographic groups—such as first-generation students—that are likely to be most in need of assistance. The rules might also disadvantage minority-serving institutions, such as historically black colleges and universities and Hispanic-serving institutions, as well as community colleges. These schools serve a disproportionate percentage of first-generation college students, and the loans they issue would likely have lower repayment rates than the higher-education system as a whole.

Role of the Private Sector

One way that the federal government could potentially reduce its budgetary exposure would be to shift its direct-loan portfolio back to the private sector and thus renew the public-private partnership that characterized the student loan system under FFEL. For example, the federal government could convene an auction in which private-sector financial institutions and not-for-profit student loan agencies could bid on loans in the government's portfolio. With a direct interest in avoiding defaults, private financial entities would have incentives to boost the quality of loan counseling and servicing and to work with borrowers to bring delinquent accounts current.[dd]

Auctioning a portion of the federal direct-loan portfolio, however, also carries risks. Private-sector entities would have an incentive to cherry-pick the loans with the highest probability of being repaid—such as the PLUS loans. Private firms would also be less likely to purchase balances on IDR

[dd] Much like under FFEL, this system would remain backed by the federal government, which would likely have to guarantee upward of 90 percent of defaulted student loans to ensure broad access to the federal student loan system.

plans due to the added uncertainty associated with future payments on these plans. If the private sector only purchased the safest loans, then the federal government's budget exposure could actually increase, since the government would lose the loans that are most likely to generate savings.

Federal accounting practices further complicate this option. Under FCRA accounting, only subsidized loans are projected to incur a cost to the federal government—all other loan types are projected to produce savings over a ten-year budget window. Therefore, shifting the loan portfolio back toward private entities would actually seem to increase costs to the government.

Loan Servicing

Plagued with rising delinquencies and declining borrower satisfaction, federal student loan servicing is in need of repair. Much of the problem can be attributed to flaws in current servicing contracts, which provide inadequate incentives to improve performance and invest in bringing delinquent accounts current. ED is in the process of overhauling the system, and although the details have yet to be released, the expectation is that ED will move to a single platform and act as the sole servicer, while contracting out functions on the back end to private-sector servicers.

This new platform could be structured to maintain elements of competition while also addressing the flawed incentives embedded in current contracts. For example, ED could use a competitive process to subcontract out specific functions and duties. If certain servicers have expertise in customer service, those servicers could handle correspondence with borrowers. If other servicers excel at moving borrowers out of delinquency, then they could handle this function. Furthermore, new contracts could reward servicers for bringing delinquent accounts current (rather than punishing them for allowing accounts to become delinquent) and include more-robust metrics on customer service (such as the number of times servicers contact delinquent borrowers). Currently, comparisons of customer-service performance rely solely on borrower-satisfaction surveys.

Of course, efforts to restructure loan-servicing contracts would have to be cognizant of the potential for creating new incentives that could have perverse effects. A system that rewards success in bringing delinquent accounts current, for instance, would have to be crafted to avoid creating incentives for allowing accounts to fall into delinquency in the first place. Otherwise, loan servicers might welcome delinquencies because of the opportunities they create to capture rewards for bringing the accounts current again.

Conclusion

America's higher-education-financing system faces an array of challenges. With hundreds of billions of dollars of student debt on federal balance sheets, rising loan balances and low repayment rates could impose significant strains on the federal budget. Although the long-term costs of the system remain largely unknown—due to a combination of uncertainty and ambiguities associated with budget-forecasting methods—the student loan system is already proving costlier than anticipated. If current trends continue, federal taxpayers could well be forced to pick up the bill, while colleges remain largely insulated from poor outcomes among borrowers.

Without endorsing any specific approach, this paper has laid out several policy options that could enhance the performance of the current system. Changing loan limits could reduce over-borrowing and put downward pressure on college attendance costs. Increasing private-sector involvement could upgrade loan counseling and servicing. And holding academic institutions accountable for low loan repayment rates could lead to lower prices and improve student outcomes. While these prescriptions are by no means a panacea for the mounting problems created by skyrocketing higher-education prices and low graduation rates, they could improve the efficiency and effectiveness of a system that is in urgent need of reform.

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