

An Analysis of Guaranteed Student Loans

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In order to finance a college education, a student may need to borrow money from a bank, credit union, savings and loan, or the government. The types of loans available to students include Direct Loans and Federal Family Education Program Loans. These loans are subsidized or unsubsidized. In the Federal Direct Student Loan Program the government finances the student's education by lending money through schools, while in the Federal Family Education Loan Program (FFELP) the education is financed with the help of loans from banks, credit unions, and savings and loans (U.S., 1995, p. 25). If the loan is subsidized, it is given based on financial need, and the government pays the interest until the student finishes schooling (U.S., 1995, p. 27). This way the student is not held accountable for the interest that accrues on the loan while he or she is in school. If the loan is unsubsidized, it is not given based on need, and the student has to pay interest from its origination (U.S., 1995, p. 27). The student is then responsible for paying the interest that accrues while he or she is attending school. The FFELP provides many loans including the subsidized Federal Stafford Loan and the unsubsidized Federal Stafford Loan which have an effect on the students and banks (*Federal*, 1994). This paper discusses the pros and cons of the Stafford Loan Program to the students and the commercial lenders and the probable effects of the program's termination.

The government has set up the Stafford Loan Program, also known as the Guaranteed Student Loan Program, which has three main principles. The first of three main principles is the default guarantee (Hungerford and Upshaw, 1994, p. 236). The loan is guaranteed one hundred percent from default by the federal government if the lender follows

the correct guidelines in servicing the loan (Hungerford and Upshaw, 1994, p. 236). The second feature is the special allowance payment to banks (Hungerford and Upshaw, 1994, p. 236). "[It] introduces a wedge between the rate received by lenders and that paid by borrowers" (Hungerford and Upshaw, 1994, p. 236). The federal government reduces the wedge by paying the commercial lenders the difference between what the borrowers pay and the market rate which is set by "the bond equivalent yield on 91-day Treasury bills plus an additional interest supplement legislatively set at 3.10%" (Hungerford and Upshaw, 1994, p. 236). The third feature is secondary market creation for guaranteed student loans (Hungerford and Upshaw, 1994, p. 236). For this goal Congress created the Student Loan Marketing Association, also known as Sallie Mae. The goal of this government-sponsored enterprise was to be an incentive for lenders to make student loans by allowing these loans to be sold any time after origination to create more liquidity for the lender (Hungerford and Upshaw, 1994, p. 236).

In order to perform its function, Sallie Mae must have a supply of funding. It does this by selling debt securities through the Federal Financing Bank (Woefel, 1994, p. 1097). "In Sallie Mae's case, it is viewed as a prime credit for investors and often has traded with the smallest spread on its borrowings over U.S. Treasury securities of any of the other agencies, Ginnie Mae included" (Geisst, 1990, p. 130). Even though Sallie Mae deals with a risky purchase, its government guarantee makes a good investment. The structure of this secondary market is complex; it begins at the state level with a student loan agency. This agency secures the loan to the originator

(Geisst, 1990, p. 127). "The state agency... then 'reinsures' the loan with Sallie Mae to protect the lender against default" (Geisst, 1990, p. 127).

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How is the student affected by guaranteed student loans? A guaranteed loan positively affects the student borrower. Student loans make a college education accessible to those who could otherwise not afford one. Students have no collateral, credit history, or income which makes it difficult to obtain a loan (Knapp and Seaks, 1992, p. 404). Students do not own homes, eliminating the mortgage or home equity options. The Guaranteed Student Loan Program provides loans to students even without collateral, income, or credit history, which creates a great risk. Because the government guarantees these loans, the risk is almost eliminated from the banks.

Also, the student borrower is given flexibility in repayment based on financial ability. There is usually a grace period of about six months after the schooling has terminated in which the student does not begin to repay the loan. This gives the student some time to become more financially stable before the repayment system begins. A student borrower may also defer repayment of his or her loan if they meet "certain criteria" (Before, 1994, p. 12). A forbearance is also available which adjusts payments due to financial ability during times of financial difficulty (Before, 1994, p. 13). This flexibility helps the student if he or she decides to go back to school, loses a job, or is unable to find employment.

In addition, if a student has a loan which has been purchased by Sallie Mae or any other private agency, then there are many repayment options available to him. The SMART loan program by Sallie Mae allows the borrower to consolidate all his or her student loans into one reducing the first few payments and extending the pay back term (SMART, 1994). This means that instead of paying back three loans at one time, a student can consolidate them and pay all three off with one, smaller payment per month for a longer period of time. Sallie Mae's Select Step Account allows the borrower to make smaller initial payments which increase as the borrower's ability to pay increases (Select, 1994). This helps the student become more financially stable with the smaller payments which in turn makes the borrower more able to pay the larger payments later. The Great Rewards Program reduces the borrower's interest rate by two percentage points if the first forty-eight scheduled Stafford Loan payments are on time (Three, 1995). So, a borrower who is able to make all payments will not have to pay back as much because the interest rate will decrease.

However, the guaranteed student loan also has negative effects on the student borrower. There is always a chance that the student will default because the targeted group for student loans are those who could not afford to pay for an education. It is obvious that if a student did not have the money to pay for school before he or she started college, there is no guarantee that he or she will be able to pay back this money after he or she finishes college. The study done using data from the National Postsecondary Student Aid Study by Mark Dynarski finds that "default rates were higher for minorities, high school dropouts or GED recipients, borrowers at proprietary or two-year schools, borrowers who did not complete their post secondary program, and borrowers with low earnings after leaving their post secondary institutions" (1994, p. 58). Another study done by Laura Greene Knapp and Terry G. Seaks using data from the

student loans guaranteed by Pennsylvania Higher Education Assistance Agency finds that student graduation reduces default, and employment with increases in earnings will also lower default. "However, it is also plausible that the tenacity and internal motivations that cause some students to complete a degree may also be operating to reduce their default rate" (Knapp and Seaks, 1992, p. 410). Characteristics of individuals, not of institutions, are factors of default like family status, parents' income, student's graduation, and race (Knapp and Seaks, 1992, pp. 408-410). Since there are so many factors that cause default, it is not surprising that so many students do default on the student loan payments.

If a student borrower defaults, it affects more than just his or her credit history (*Before*, 1994, p. 12). If a borrower defaults, the following events may occur:

Holds may be placed on [the borrower's] college records. [The borrower] may be ineligible for future financial aid. [The borrower's] federal income tax refunds may be seized. [The borrower's] wages may be garnished. [The borrower's] account may be assigned to a guaranty agency which will continue to collect the balance due from [him or her]. [The borrower] may be charged attorney's fees and other costs of collecting [his or her] debt (*Before*, 1994, p. 12).

The effects of the default can detrimentally affect the student lender for a long time and in many aspects of his or her life.

How is the commercial lender affected? Providing guaranteed student loans can be beneficial to the commercial lender. The default guarantee protects the bank from the risk of a student defaulting on his or her loan. The secondary market for guaranteed student loans provides liquidity to the bank. The special allowance payment makes guaranteed student loans appealing to a bank. If it were

not for this program banks would not lend to students because students are risky investments. However, this program does exist, so loans to students are not as risky to banks. Student loans do not take away from the bank's liquidity, and they do not make the bank take a loss when they are repaid because of the lower interest rate on student loans.

Yet, providing guaranteed loans can also be detrimental to the commercial lender. Because of the cost to the government of the special allowance payment, the commercial lenders might worry about the threat of government taking over lending to students (Hungerford and Upshaw, 1994, p. 241). If the government provided loans to students then the Guaranteed Student Loan Program would cease to exist. This would make lending by banks to students very risky. Therefore, banks would no longer make students loans causing them to lose this business. Also, even though the loans are guaranteed, the time is longer for a student loan to be declared in default than a non-guaranteed consumer loan which shows the bank's opportunity cost of lending to students (Geisst, 1990, p. 127). This would cause the banks to incur a loss for the time period between the original default and the repayment by the government.

What if the government took over by lending to students directly and terminating the Stafford Loan Program? There are advantages in terminating the Stafford Loan Program. This would eliminate the banks, credit unions, savings and loans, and state student loan agencies as intermediaries. This would also reduce the need for a secondary market for student loans. This would reduce costs since there would be no special allowance payments to banks or payments for defaulted loans. These losses would be strictly felt by the government. The government would not need to keep reserves like a bank does for the loan. This would increase the money in circulation because there would not be the amount of money held up in reserves that there is now.

Also, Sallie Mae has had a decrease in performance, so a suggestion was to allow it to branch into other markets ("Sallie," 1995, p. 70). This would allow Sallie Mae to stay in business even if there is no more need for a secondary market for student loans.

There are also disadvantages to terminating the Stafford Loan Program. The costs would be placed on the schools for the administrative tasks that banks usually handle (Foust, 1993, p. 74). This would increase tuition because there would be a need for more clerical help, more financial aid administrators, and more form processing costs. The government would need to learn to use new software to service loans as quickly and efficiently as banks do (Foust, 1993, p. 74). Banks have devised quick and efficient systems after years of practice. The government would be taking on so many loans that it would require time to develop an efficient way of processing them. And, Sallie Mae is a functioning company that has done well in the past. In 1993, its costs were down by 21% and profits were up by 172% since 1986 (Foust, 1993, p. 74). Putting an end to the secondary market for student loans would put an end to a business with potential. This secondary market is already up and running; eliminating it may have an impact on the economy. If the program is left the way it is, the reduction in government payment to lenders by a half a point would save taxpayers \$970 million over five years (Foust, 1993, p. 74). So, just this small change in the special allowance payment would reduce the cost of the Guaranteed Student Loan Program.

The Stafford Loan Program is both beneficial and detrimental to the students and banks. Having all student loans made directly from the government also has pros and cons. So taking all of this into consideration, should student loans be made directly from the government, avoiding all the intermediaries like banks and Sallie Mae? Student loans will always be risky because the only collateral available is a promise to repay. Although

banks are reluctant to lend to students during times where default is expected due to a poor economy, Sallie Mae is there to provide liquidity to the bank, and the government is there to guarantee the loan (Geisst, 1990, p. 133). So, this process takes some of the risk away from the bank, the state agency, and Sallie Mae and gives more risk to the government. If the government lent directly, it would take on all the risk. With student loans there is always a high amount of risk in the economy, and switching to government direct lending just shifts the risks completely to the government. When evaluating the amount of risk involved in each lending practice, one could not be chosen as better than the other because of the similar amount of risk involved. Taking this into consideration, the best idea is to leave the Stafford Loan Program in place instead of instigating a new program composed of all direct student loans.

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The SMART LOAN Account from Sallie Mae.

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