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# THE GUARANTEED STUDENT LOAN PROGRAM: A SURVEY OF STATE-LEVEL ADMINISTRATION

*by Jane L. Johnson*

## *Introduction*

The Guaranteed Student Loan (GSL) program is federally-subsidized, but administered at the state level. Because of this decentralized administrative arrangement, the GSL program may be better understood by perceiving it as approximately fifty separate programs.

Little research has been conducted regarding these fifty separate programs. Several years ago Hansen and Feeney (1977) reviewed the development of state student loan programs. A later study conducted by Touche Ross and Company (1979), on a consulting contract with the United States Office of Education, explored some of the variance in state program administration. However, a number of new state agencies have emerged since then, the program has grown rapidly, financial conditions have changed, and recently Congress has tightened certain provisions of the program in order to reduce its cost.

In the Spring of 1981 the New York State loan guarantee agency conducted a survey of all the state agencies in the GSL program. The survey was conducted on behalf of the National Council of Higher Education Loan Programs (NCHELP), an organization whose membership consists primarily of the state agencies. The findings reported here are based on responses to the survey questionnaire.

The sections below describe the history of the program, state participation, guarantee agency structures, their finances, and their activities. The concluding section comments on the implications of these findings for future program development.

## *Program History*

The GSL program was established by the 1965 Higher Education Act, Title IV. This act also authorized other forms of federal student aid. Title IV emphasized state guarantees of student loans: the federal government was either to reinsure loans guaranteed by states or by private nonprofit corporations, or to provide direct federal guarantees in cases where students were unable to obtain loans guaranteed through state agencies or nonprofit corporations.

The former program has become known as the Guaranteed Student Loan (GSL), or guarantee agency, program and the latter as the Federal Insured Student Loan Program (FISLP), often referred to simply as the federal program. In the GSL program, state agencies or private nonprofit corporations

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guarantee loans and are reimbursed by the United States Department of Education for part or all of the insurance claims they pay to lenders. The program is subsidized by the federal government, and operated at the state level. It relies on private capital from the many banks and other lenders that offer student loans. Although the program is ultimately controlled through federal statute and regulations, guarantee agencies and program administration vary considerably among states.

FISLP operates in states not served by guarantee agencies, and in areas where a guarantee agency program does not serve all eligible students in the state. The federal government directly insures lenders against losses on FISLP loans. Although in theory both the guarantee agency program and FISLP may operate side by side within a state, in practice those states with guarantee agencies have come to be dominated by the agency programs, while the remaining few states without guarantee agencies have continued to offer only the federal program.

In 1974 the GSL program represented 46.3% of the total loan volume of $1.1 billion, and FISLP accounted for 53.7%. By 1980 the GSL program had grown to represent 89.6% of the total volume of $4.8 billion.

*State Participation in the GSL Program*

By mid-1981 guarantee agencies had been established in 48 states (all but Mississippi and North Dakota), the District of Columbia and the Virgin Islands. In the preceding year alone (since mid-1980) five new guarantee agencies had been established in states that previously offered only FISLP loans: Alabama, Arizona, Montana, Texas, and West Virginia.

Several state guarantee agencies predate the passage of the Federal Higher Education Act of 1965. The oldest agency is that in Massachusetts, which first began to guarantee loans in 1956. Fifteen other loan programs and guarantee agencies that predate the 1965 legislation are found throughout New England, the Mid-Atlantic area, and the South. These early state programs, particularly that established in New York in 1958, are commonly thought to have provided the model for the federal GSL program (Hansen and Feeney, 1977).

Over half of the fifty guarantee agencies have come into existence since 1976, when the Higher Education Amendments of that year offered significant incentives for states to establish agencies if they had not already done so. For example, the legislation provided for federal advances to agencies for paying insurance obligations, and increased to 100% (from 80%) the dollar amount of insurance claims that can be reimbursed by the federal government.

*Agency Structure*

Among the states participating in the GSL program, three rather different agency structural configurations predominate: the state may be designated as the guarantor, and a state agency, board, public corporation, commission or department administers the program; all responsibility for guarantee and administration may be assigned to a nonprofit corporation; or the state may be designated as the guarantor, with program administration contracted out to a nonprofit corporation.

Approximately half of the states function entirely as their own guarantor and administrator, with several agency organizational types evident. The vast major-

ity of these guarantee agencies are part of their respective state governments, organized as either separate agencies or operating out of state education departments or postsecondary coordinating boards. The remaining few guarantee agencies are organized as public authorities or state-chartered corporations created by statute.

In about a quarter of the states all responsibility is assigned to a nonprofit corporation. One of these, the Higher Education Assistance Foundation based in St. Paul with regional office in Kansas City, guarantees and services loans for five states and the District of Columbia. Another nonprofit corporation, United Student Aid Funds (USAF) of New York City with regional offices in Indianapolis and suburban San Francisco, guarantees and services loans for Hawaii. (USAF also provides only loan servicing for thirteen other states.) In the remaining states with this structural configuration, the nonprofit corporation is locally established and operates within each state.

The advantage of complete management by a nonprofit corporation is that the state government need not establish a separate agency or expose itself financially in meeting the costs of a loan program. This arrangement may work well, for example, where constitutional or statutory restrictions prohibit the state from pledging its full faith and credit or taxing power to student loan obligations.

The remaining quarter of states have established their own guarantee agencies, but contract loan servicing functions out to a nonprofit corporation. United Student Aid Funds provides such loan servicing to thirteen states. The advantage of this configuration is that the state government retains some responsibility for the guarantee function itself, but need not hire additional personnel for computer services and other administrative matters.

In a number of states the loan guarantee function has been assigned to the state agency that administers other forms of student financial aid. For example, nearly half of the loan guarantee agencies also administer state student grant, scholarship, and/or work-study programs. The Pennsylvania guarantee agency also administers the federal College Work-Study program, as well as processing Pell Grant applications as a contractor with the United States Department of Education.

Several guarantee agencies also administer state-guaranteed loan programs. These programs are typically designed for special student populations, such as those enrolled for first-professional degrees in health fields where borrowing needs can exceed federal GSL limits, or those enrolled in vocational schools that are not federally-approved to participate in the federal GSL program.

A telling indication of the administrative overlap between loan guarantee and other student aid programs is joint membership in the organizations of state loan agencies and grant agencies, respectively. Fully half of the loan guarantee agencies, which are members of NCHELP, also belong to the National Association of State Scholarship and Grant Programs (NASSGP).

### *Agency Finances*

In addition to operating their loan programs from a variety of structural configurations, guarantee agencies report that they receive operating funds from a

variety of sources. A major funding source for all agencies is the federal administrative cost allowance, set in statute at one percent of the total principal amount of new loans guaranteed each year. For example, at a level of $5 billion in new loans guaranteed annually, the cost allowance provides a total of $50 million for the fifty guarantee agencies.

About one quarter of the guarantee agencies also receive state legislative appropriations for program operations. Other sources of funds include interest on investments (reported by over 80% of the agencies) and student insurance premiums (reported by 90% of agencies). The latter fees are charged borrowers at the time of loan disbursement, although the terms vary among the agencies that levy the premium. The majority of these agencies charge one percent of the principal amount guaranteed (the maximum allowed by federal regulation), for each year the student is to be in school plus the grace period (usually a total of five years). But six states charge 1/2%, three charge 3/4%, and five states charge no premium at all. Furthermore, a few states levy the charge for the life of the loan (typically ten years), and a few only make a one-time charge (for one year).

From these sources of income, guarantee agencies pay for the costs of operating their loan programs. Although most of the agencies have similar cost patterns, expenses vary for many functions and activities. For example, expenses for lender promotion efforts with financial institutions vary, depending on how well-established the GSL program is in the state, and how well-informed about the program the financial community is. Thus the newer agencies can typically expect to spend rather heavily for this activity, whereas the older established agencies need spend less.

A major expense is insurance claims for losses resulting from student defaults. Again, this can vary depending on default prevention and aversion techniques practiced by the agency, and on efforts by both lenders and postsecondary institutions to impress students with their obligation to repay their loans. In order to cover the insurance claim payments, nearly all guarantee agencies maintain reserve funds. The size of these reserves ranges from at little as 1% of outstanding loans, to as high as 10%, with the majority at the lower range. These rates vary, in turn, with differences in state financial conditions and traditions, with the highest rates found in the more fiscally conservative southern and midwestern states.

After the guarantee agency pays off the insurance claims filed by lenders, the federal government reimburses the agency for all or part of the principal amount of the losses. The rate of federal reinsurance depends upon the agency's loss rate: 100% reimbursement if claims are no more than 5% of loans in repayment; 90% if claims are between 5% and 9%; 80% if claims are over 9% of the amount of loans in repayment. This statutory graduated reinsurance rate provides an incentive for guarantee agencies to attempt to keep losses as low as possible. Many retain private collection agencies to track down defaulters.

### *Guarantee and Lending Activities*

In order to qualify for a GSL loan, a student must attend a federally-approved postsecondary institution. Data from the United States Department of Educa-

tion indicate that over 7,500 institutions are eligible to participate in the GSL program. About half of these are collegiate degree-granting institutions, and half are vocational, nursing, and other nondegree-granting institutions. An additional 800 foreign schools are eligible to participate.

Students must also meet minimum eligibility requirements specified in the federal statute (for example, at least half-time attendance). But state guarantee agencies may impose their own eligibility criteria, and many do. Such restrictions include, for example, no loans to freshmen students, no loans to correspondence students, no loans to non-residents attending college in-state, and no loans to residents attending foreign institutions. These restrictions have been cited as one explanation of different loan access and utilization among states.

Over 20,000 lenders are eligible to participate, most of which are commercial lenders such as banks, savings and loans, and credit unions. In the majority of states, these commercial financial institutions provide virtually all of the loan capital. But in several states all capital is supplied by one central state lender. Over 100 postsecondary educational institutions are also eligible to participate as lenders. These institutional lenders are distributed throughout the nation, but only in several states are they major sources of loan capital.

Guaranteed loans have typically been made to students, with parents occasionally co-signing the notes. Legislation passed in 1980 authorized a program of Parent Loans for Undergraduate Students (PLUS). However, more than two-thirds of the guarantee agencies indicated that they would still need legislative or executive authority to guarantee these parent loans, and only a few agencies are presently guaranteeing them.

In order to increase student access to loan capital, a number of states recently have established two other types of organizations, in addition to, and separate from, the guarantee agency. Twenty-one states now have direct lending agencies, and seventeen states have secondary market agencies. Many of these are private nonprofit corporations, and in a number of states the same organization provides both direct lending and secondary market services. In only a few states are these separate agencies organized under the same governing board or commission as the guarantee agency.

Direct lending agencies, as the designation implies, provide loans directly to students, obviating complete reliance on private lenders. In many of the states with direct lending agencies, any student meeting GSL requirements can qualify for a direct loan, but some of these agencies lend only to students refused by private lenders, thus providing a "lender of last resort" service. Loans made by direct lending agencies have been eligible for federal guarantees and subsidies since Congress extended this coverage in 1972.

Secondary market agencies purchase student loan notes from the originating lenders, thus freeing up capital for additional borrowing and other needs. These agencies are most often found in states and regions of the country where financial institutions are small or underdeveloped, or where capital is periodically required by other industries like agriculture. The Student Loan Marketing Association (Sallie Mae) also functions as a secondary market, but fewer

than half of the agencies use this service. In other states the originating lenders sell student loan notes directly to Sallie Mae.

Both direct lenders and secondary market agencies typically obtain funds through tax-exempt revenue bonds sold through the municipal bond market, although a few of the direct loan programs operate on capital from state legislative appropriations. The issuance of student loan revenue bonds has proliferated in recent years, with major Wall Street firms and regional investment banks underwriting the issues. By 1979 direct lender and secondary market agencies realized they could take advantage of the spread between high market interest rates and lower rates on tax-exempt municipal bonds. They issue their revenue bonds at the lower rates, use the proceeds to make direct loans or purchase outstanding student loans, and then collect the federal subsidies on these loans that they hold. The difference between the interest paid to revenue bond holders, and the interest plus special allowance earned on the subsidized student loans, can produce a tidy profit for those state agencies that use this financing technique (Congressional Budget Office, 1980; Rosenbaum, 1980).

### *Implications of Survey Findings*

These survey results focus only on differences among states in their administration of the federal GSL program. Many of these distinctions obviously result from underlying differences in state banking laws, regulation of financial institutions, historical development, postsecondary financing patterns, industrial activity and competing credit demands.

The federal statute authorizing the GSL program is complex, and constituents of the program are numerous: students, parents, postsecondary institutions, private lenders, state and private nonprofit loan guarantee agencies, direct lending agencies, secondary market agencies, private collection agencies, investment and underwriting firms. As the survey results reported here indicate, the program is particularly complicated by the system of decentralized state-level administration. It is also subject to numerous external federal laws, such as the equal credit opportunity act, truth-in-lending, and the right to financial privacy, as well as any state laws addressing these issues.

Program costs have grown dramatically in recent years; GSL is the only federal student aid program for which no spending limits or award reduction formulae are specified in current statute or regulation. With increased numbers of student borrowers and volume of loans guaranteed, the government's expenditures for in-school interest subsidies and guarantee agency administrative cost allowances have grown; with rising market interest rates, special allowance payments to lenders have risen; and with any increase in student loan defaults, reimbursement payments to guarantee agencies have increased. These expenditures – student interest subsidies, administrative cost allowances, lender special allowances, and guarantee agency insurance claims – are the major program costs for the federal government. The interest subsidy and special allowance together now account for at least 75% of total program costs, overshadowing the more widely publicized cost of defaults.

Recent changes designed to control these costs have been made at the federal level, with little account taken of the decentralized program administration

across the nation. Students with family income over $30,000 must now demonstrate financial need in order to obtain a loan; a 5% origination fee is now assessed against the loan amount in order to defray the cost of the interest subsidy; and the interest rate has risen from 9% to 14% on Parental Loans, which are renamed Auxiliary Loans to Assist Students and are now available to independent and graduate students as well as to parents.

Clearly any reductions in GSL program magnitude resulting from these recent federal changes will impact students (and other constituents) most in those states that have traditionally subsidized postsecondary education via student financial aid rather than in the form of low (or no) tuition at public institutions. Guarantee agencies in six states alone — Connecticut, Illinois, Massachusetts, New Jersey, New York, and Pennsylvania — accounted for over half of the loans guaranteed in 1980. These guarantee agencies are among the most well-established in the nation; students in these states are most accustomed to borrowing for college expenses, and financial institutions in these states have long participated in the program. Public sector tuitions in these states are also above the national average (National Association of State Universities and Land Grant Colleges, 1980), and these states allocate the most funds to state student financial aid programs (National Association of State Scholarship and Grant Programs, 1980).

One conclusion can be drawn from the survey results reported here: that a federally-subsidized program that has developed differently across the nation, and is now administered differently among states, will necessarily respond differently across the nation as the program parameters change at the federal level.

Recent GSL program changes appear to have resulted from *de facto* efforts to reduce federal subsidy costs, rather than from deliberate *de jure* policy intentions to modify this social program. If the survey results reported here support the conclusion drawn above, however, the modifications being implemented now will affect the future of student loans across the nation.

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