Feds take over student loan program from banks

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President Obama will sign a bill today that ends a 45-year-old program under which banks and other private-sector lenders such as Sallie Mae receive a federal subsidy for making government-guaranteed college loans.

Instead, the U.S. Department of Education - which already makes roughly a third of these loans through its direct-lending program - will make 100 percent of them starting July 1.

The change will have a big impact on some lenders and colleges but relatively little on borrowers. They will continue to get the same loans - including Stafford loans for students and Plus loans for parents and graduate students - on largely the same terms.

Students who previously had to choose a private-sector lender for their guaranteed loans will now have only one choice: the government.

Banks can continue to make private, non-guaranteed college loans, but these are generally more expensive than guaranteed loans.

With a single lender providing all guaranteed loans, some fear that customer service could deteriorate or that discounts once offered by private-sector lenders will disappear.

On the upside, the interest rate on Plus loans is only 7.9 percent in the direct-loan program versus 8.5 percent in the bank program. Mark Kantrowitz, publisher of Finaid.com, says the approval rate on Plus loans is also higher in the direct program.

The rate on Stafford loans is the same in both programs.

The change will not affect any loans made before July 1. Borrowers who already have bank loans and take out direct loans in the future will have a chance to consolidate them so they only need to make one payment.

The government estimates it will save $61 billion over 10 years because it has a lower cost of funds than the banks it is replacing and won't have to pay them a subsidy. Some of that money will go toward Pell grants for needy students, community colleges and minority-serving colleges. The rest will go to other uses including deficit reduction and health care reform.

Program history

Banks have been making government guaranteed loans under what is now called the Federal Family Education Loan Program, created in 1965.

The Education Department didn't start making direct loans until 1994.

Most colleges signed up with one of the two programs and offer students loans from that program only. The loans were essentially the same under both programs because the government sets the rates and terms.

At times, borrowers could get bigger discounts on rates (contingent on timely payment) or origination fees from banks than on direct loans. Since the credit crisis hit, those discounts have largely evaporated.

In 2006, direct loans accounted for about 20 percent of federally guaranteed loans.

When credit dried up, private-sector lenders started backing away from this market and the government stepped in. The share of direct loans grew to 25 percent in fiscal 2008-09 and to 35 percent in the first half of 2009-10, Kantrowitz says.

In reality, the government's role in the market has been much larger. Since mid-2008, it has been providing most of the capital that private-sector lenders used to make loans. After one year, the banks had a chance to either repay the capital or turn the loan over to the government. Most chose the latter.

Colleges switch

Because of the credit crisis, many colleges have already switched from the bank program to the direct program.

This year, 15 of the 23 California State University campuses participated in direct lending, five more than last year. The remaining eight campuses have made plans to adopt direct lending for 2010-11.

Among University of California campuses, only San Diego, San Francisco and Los Angeles were in the bank program. They had made plans to switch to direct lending July 1 whether this bill passed or not, says Nancy Coolidge, the UC system's coordinator of student financial support.

The Department of Education has always hired outside firms to service direct loans and will continue to do so after July 1. Some of these servicers are the same companies that originate student loans, such as Sallie Mae and Nelnet. When servicing direct loans, these companies are not allowed to use their own brand names or promote their own products.

Coolidge says her only concern about the switch to 100 percent direct lending is whether Congress will continue to provide the funding needed to provide a high level of customer service, especially for loans in repayment, which often require a lot of personal assistance.

Pell grants

The bill signed today, which includes changes to the health care bill signed last week, provides funding for Pell grants and indexes them to inflation starting in 2013.

A previous bill increased the maximum Pell grant from $5,350 this school year to $5,550 next year. Because of the recession, more students than expected qualified for Pell grants "and there was a funding shortfall," Kantrowitz says.

The new bill fills the funding shortfall. That ensures that the maximum Pell grant will be $5,550 next year and everyone who is eligible will get one. Starting in 2013-14, the maximum will be indexed to inflation for five years. Obama had proposed indexing the Pell grant to the inflation rate plus 1 percentage point but the final bill links it to the consumer price index only.

The bill also makes changes to the new income-based repayment program, which helps borrowers who have large debts relative to their income.

Under this program, loan payments are limited to 15 percent of discretionary income and any balance remaining after 25 years is forgiven. The new bill will limit payments to 10 percent of discretionary income and forgive balances after 20 years. But these changes only apply to loans taken out by new borrowers on or after July 1, 2014. They are not retroactive.

Public-service workers on the income-based repayment plan can have their remaining balances forgiven after 10 years. That does not change under the new law.