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REVAMP THE GUARANTEED LOAN

PROGRAM — AND UNLOCK

THE BANK VAULT

Cannon R. Mayes

By what measure should a student loan program be judged? Many measures or standards could be used appropriately, but the most telling standard is the one which reflects the amount of success qualified students have when seeking loans. The record of the Federal Guaranteed/Insured Loan Program is impressive — now over six billion dollars in loans outstanding, in a program only eight years old. Those six billion dollars represent six million loans to help students in meeting the costs of their educations, so applicants have obviously had a great deal of success in their search. But in applying the measure, "success of qualified applicants in seeking loans," one must also consider the rejected applications, or only a part of the picture is revealed.



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Without any intent whatsoever to minimize the remarkable accomplishments of the Guaranteed/Insured Program during a relatively brief period of time, it must be pointed out that the volume of private lenders' dollars that *could* have been loaned but were *not* loaned to eligible applicants and the number of *rejected applications* are alarming and discouraging. No research of which I am aware has been done to determine the exact number of eligible students rejected and to determine the dollar volume of rejected requests, and I myself have not undertaken such research. It would be virtually impossible to ferret out accurate figures for several reasons, the major reason being that many eligible students are turned away upon verbal inquiry, never filing a formal application; and many others are rejected by way of the "grapevine," and are influenced not even to inquire about a loan because of the knowledge that their banks do not participate in the program. I am convinced that the rejection volume, if known exactly, would be staggering, that it would equal or possibly outstrip the volume of approvals. Be that as it may, it is safe to say that rejection volume is certainly very large. And, in view of the large rejection volume, I must say that the Guaranteed/Insured Loan Program is not yet a success. The intent of the program was to deliver loans to all eligible students requesting loans. Whatever the number of rejections, the goal of delivering loans to all eligible applicants has not been closely approached; and it will never be reached unless drastic program changes are made.

The experience of Vanderbilt University as a lending agent under the Guaranteed/Insured Program has demonstrated to me the tremendous value of a situation in which all eligible students *can receive* the loans. If a Vanderbilt student is refused by the hometown bank, the University will make the loan provided the applicant is qualified; and the flexibility given the financial aid office, the students, and their parents has resolved many problems, which, remaining unsolved, could have resulted in student withdrawal from the University. The option offered by the Insured Loan has been especially helpful with the problems of: 1) the late or mid-year aid requests; 2) the declared "independent" applicant who is not "independent" by any current criteria; and 3) the student and/or student's parents who simply feel that they cannot meet all of the educational costs beyond that portion covered by Vanderbilt's financial aid offer. BUT not all educational institutions are able to become or would choose to become lenders, and the "institution-as-lender" approach therefore would not close the need gap. Even if a great number of educational institutions were to become lenders, there would still be many students at non-participating institutions across the country who could not find Guaranteed/Insured Loans; and the program would continue as less than a total success. The experience of Vanderbilt as a lender has been brought into this paper not to encourage institutional lending but to give credence to my contention: a Guaranteed/Insured Loan Program that *actually delivers* loans to *all* eligible applicants is an aim that deserves the focus of the collective minds and energies of the financial aid community.

To achieve a Guaranteed/Insured Program that can be relied upon by every student would be to find the missing piece of the financial aid jigsaw puzzle.

zle that has eluded the financial aid community for years. A totally successful Guaranteed/Insured Program, still in a role supplementary to BEOG and the campus-based programs, would solve problems that the other programs cannot solve even though it could never (or *should* never) replace *any* of the campus-based programs. But I have digressed from the purpose of my paper and must return to the Guaranteed/Insured problems and solutions which are under discussion.

Dollars enough to honor all justified requests for Guaranteed/Insured loans must somehow be pried loose from lenders. That challenge in itself is formidable, but even if program changes are implemented that do produce a vast increase in the number of dollars lenders are willing to commit, the changes would not channel loan dollars to *all* qualified applicants unless the increased dollar commitment from banks is universal in the banking industry. The dollars must be made to flow from *all areas* of the country and *all banks* in the country. The student from Dry Creek whose bank will not make a loan would not be helped by the unused \$1500 in the student loan portfolio of a giant bank in a large city far from his home. The student's bank in Dry Creek must be encouraged to participate fully. A combination of changes must be wrought in the Program which will unlock the vault of *every* bank in the country — small banks and large banks alike. All banks must be able to see their way clear to make a Guaranteed Loan to any hometown student who applies and who is eligible. Otherwise, the Program will never be totally effective. It will not suffice to retain objectionable features and simply try to make them more palatable by making minor changes. Minor changes will not solve problems but will only mask them for a brief period before they surface again, producing still more clamor for still more change. But can the Program be overhauled sufficiently to reach the ideal? I believe that it can, and I am writing this paper to offer my ideas about how it can be done.

Before I present my ideas for change, I want to first take a look at the objections raised by banks against participating fully in the Guaranteed/Insured Program. By observation and through discussions with many bankers and financial aid officers, I see the major objections of bankers to be as follows:

- 1) Capital is tied up for too long a period.
- 2) Profit is too low — cannot afford to invest heavily.
- 3) Separate administrative procedures are required to handle the reams of red tape.
- 4) Extra staff and space is needed to handle the loans, if the volume is at all large.
- 5) Regulations are changed too frequently, resulting in confusion and requiring re-training of staff.

If program changes are to be effective, they must remove these major objections of the banks. And to remove the banks' objections, program changes must remove or drastically, and favorably, alter program features that have been the stumbling blocks for banks, compelling a great number of them not to lend under the Guaranteed/Insured Program or to severely

restrict participation. I will not list separately here the program features that must be removed or altered but will bring them into the discussion in the various sections of the plan for revamping the Guaranteed/Insured Program.

THE PLAN TO IMPROVE THE PROGRAM

GENERAL EMPHASIS

The Student Loan Marketing Association (Sallie Mae) is to become operational during this 1973-74 academic year. If Sallie Mae is successful, it should provide substantial relief, though perhaps not total relief, of one problem — that of lenders' loan dollars being tied up for an impractically long time. My suggestions for revamping the Guaranteed/Insured Loan Program assume a large degree of success for Sallie Mae in that problem area, and I am not recommending further program change to cope with the difficulty of lenders' funds being frozen too long. But it is obvious that Sallie Mae will not help with the other problems I have outlined. To the contrary, Sallie Mae will compound those other problems. The Student Loan Marketing Association will bring with it additional regulations, forms, and administrative steps which will: 1) add to the existing mountain of Guaranteed/Insured paper; 2) place further demands on lender staff and space; 3) require additional staff training; 4) increase the present confusion; and 5) by virtue of the added steps and the increased demands on staff and space, reduce the already too low profit for lenders.

It is an obvious fact that banks must make a profit with the investment of their funds. And banks are, understandably I think, interested in turning as high a profit as possible. The designers of the Guaranteed/Insured Loan Program must have overlooked that reality, for too great a commitment has been expected of banks in view of the low-profit that the program can give them. The banking industry has changed a great deal in recent years, vastly widening its scope of interest and involvement. The industry and the individual banks in it are aware of the importance of the public image which they create, and they strive to serve the public when they can. I believe they would *want* to become much more deeply involved in the Guaranteed/Insured Loan Program if they could afford to do so. But the fact remains that banks are basically business enterprises. Each bank must set a limit on dollar involvement in programs which serve the public but which produce little or no profit, or which operate at a net cost to the bank. The smaller the bank, the lower the dollar limit that must be set on such services or programs. And the smaller the bank, the smaller the *percentage* of total assets that can be involved. For example, because of smaller staff, smaller assets, lesser sophistication, and lower machine capability, a bank with *one-tenth* the assets of a larger bank might have to set a public service, low-profit involvement at *one-twentieth* that of the larger bank. Faced with a choice between making student loans at little or no profit and investing funds in other ways with the prospect of much greater return, banks, especially the smaller banks,

still will be forced to hold participation in student loans to a level far below that needed to get loans to all eligible students. Sallie Mae's liquidity, welcome and helpful though it may be, will produce only token improvement in the number of student loans and the dollar volume of such loans unless still other innovations are wrought that will make student loans much more attractive financially to lenders.

There are two ways to improve profit and thereby make the program more attractive financially to lenders and potential lenders: 1) increase income; and 2) reduce overhead, or administrative costs. Most of the seven changes which I am recommending are designed to increase lender profits in these two ways. The suggested changes are also designed to remove much of the confusion and frustration which have gone hand-in-hand with the program and which have served to further reduce the effectiveness of the program. Of paramount importance in the plan for revamping the Guaranteed/Insured Program is the goal of getting needed loan dollars into the hands of the many students whose applications will surely fail if drastic changes are not made. The loans should reach *all* eligible students who seek them.

REMOVE THE SUBSIDY OF INTEREST

One of two *key changes* which I propose is the entire removal of the Federal subsidy of interest from the Guaranteed/Insured Program. From "subsidy," and the question of who should receive the subsidy, have sprung many troublesome regulations, much of the paper work, a number of administrative headaches (for financial aid officers as well as lenders), and *most* of the confusion which is the natural result of frequent changing of regulations. Do away with the subsidy, and you do away with many administrative problems and reduce administrative costs. You thereby increase the profit of the lender and make the program more attractive to the lender. It is worth pointing out that, from the financial aid community's standpoint, deletion of the subsidy would also remove the necessity for still another, and different, "needs test" (I think that no financial aid administrator would support the idea that *more* needs tests are desirable). Even a return from the present chaos to the less hectic situation surrounding the "adjusted income under \$15,000" rule (or something similar) is not the answer. As long as there is interest subsidy, there will of necessity be regulations governing the payment of the subsidy, additional paperwork, additional administrative steps, (for example keeping separate files on the subsidized loans), and extra cost which reduces the profit *and* the enthusiasm of the lender or potential lender. Also, as long as there is interest subsidy, there will be disagreement as to who should qualify, with the result that guidelines will continue to be subject to change every year. The inconvenience, confusion, frustration and irritation which grow from such wavering *certainly* cannot serve to create in lenders the desired attitudes of confidence and cooperation. And the retraining required each time regulations are changed adds still more to lenders' costs and takes away still more from lenders' profits.

The interest subsidy, designed to protect students who have "need," has hurt many needy students by being a major contributing factor in banks'

refusals to loan. The small savings afforded the needy students who have gotten subsidized loans has not been worth the sacrifice of many other needy students who could not obtain loans.

DISCOUNT THE INTEREST

Another alteration I propose is to allow lenders to discount the interest on each loan. If lenders can secure their interest at the time they make a loan, or when they advance a segment of a loan, they will save the steps currently required in billing either the government or the student borrower for interest; and they will realize an immediate return on their investments in students.

Most students borrowing through the Guaranteed/Insured Program, if they wish to apply later for additional loans, will file their subsequent application(s) with the lender which made the first loan. At least, that will usually, and naturally, be the case if the interest subsidy feature is removed from the Guaranteed/Insured Program, thereby precluding "need tests" changes which persuade some lenders to refuse loans even to previous borrowers. When a previous borrower returns to a lender for a new loan and is approved for the loan, the lender would either receive cash payment of interest on the new loan and the loan(s) from previous year(s), or would discount from the new loan the interest on that new loan and the previous loan(s).

To handle the cases in which a student might make a loan for one year, or for two or three consecutive years, and then not request a loan in the succeeding year, the lender would need a simple activating device to bill for interest and principal on previous loans. If, for example, an undergraduate student borrowed at the freshman level and did not return to the lender with a loan request in the sophomore year, the lender's files would generate a bill roughly thirteen or perhaps fourteen months from the time the freshman loan was made, shortly after the second year's interest was due on the first loan. If loans were made at both the freshman and sophomore levels but not during the junior year, the system would generate a bill during the junior year after the same thirteen or fourteen month time span from the last loan. The thirteen or fourteen month waiting period would provide sufficient time for the student to pay interest as he files a renewal application, or to pay interest on last year's loan even if not in conjunction with a new loan request. If the borrower had made payment of interest on the previous loan(s) and certified continuation in an academic program the bill would not be generated. If the waiting period elapsed and the bill was generated, a student still in an academic program would, in response to the bill, pay interest on the previous loan(s) and certify continued enrollment to postpone payment on loan principal. A student making a loan in the final year of an academic program would have a bill generated for interest and principal through the same system after his graduation, except that for those final-year borrowers, the bill for principal repayment would be geared to begin between nine and twelve months after completion of the academic program.

ESTABLISH A CENTRAL CLEARING HOUSE

As I have stated, repeat borrowers tend to return to their original lenders. But some few students might shift from one lender to another. A central clearing house, operated by the Federal Government, would be needed to assure prior lenders that interest on their loans would be paid on schedule. The clearing house, which will have other duties to be outlined later, would serve as a screen for the few repeat borrowers that would be shifting from one lender to another. The clearing house would have a record of all previous borrowers, showing the previous lender (s) and the amount (s) of the previous loan (s). Lenders in the Guaranteed/Insured Loan Program would submit to the clearing house the name of *any loan applicant beyond the first year in a post-secondary program unless that applicant had borrowed from that same lender in each of the student's previous academic years*. The new loan application would not be cleared for processing until the clearing house verified either that no previous loan had been made by the applicant or that payment to the other lender (s) of interest on the previous loan (s) had been made. The volume of students attempting to change lenders would be low, and the clearing house would be able to operate at a nominal cost to the Federal Government compared to the Government's costs in *processing* requests for interest subsidy (processing costs *only* — *not* including actual subsidy payments). The lenders' responsibilities and costs with the clearing house would also be trivial when viewed beside their present involvement and expense in collection of Federal subsidy and collection of interest directly from student borrowers.

The three recommendations I have discussed would, if implemented, very substantially reduce the administrative expenses and the administrative headaches of lenders under the Federal Guaranteed/Insured Loan Program. Although the thrust here is to reduce lenders' costs and to improve lenders' profit, it is worth noting that the changes would also reduce Federal headaches and costs and institutional headaches and costs. By reducing lender expenses, the changes would increase profit and make participation more appealing financially to lenders and potential lenders. By reducing headaches, they would help to create among lenders a greater willingness to cooperate. But I feel that profit must be further improved by increasing lender income.

INCREASE SPECIAL ALLOWANCE TO LENDERS

This recommendation is the *second of two key recommendations* I am making, the other "key" being the removal of the interest subsidy. I would not be in favor of raising the seven percent simple interest to students. But I would urge that the range of the special allowance for lenders (formerly termed "incentive payment") be increased from the present "0% to 3%" to a "1% to 4%" range. The amount of the allowance to each lender would continue to be figured on the average dollar amount of Guaranteed/Insured Loans outstanding with the lender during the previous quarter. I am aware that during the existence of the Guaranteed/Insured Loan Program nearly all of the quarterly special allowance rates that have been set under the 0% to 3%

formula fall within the 1% to 4% range I am now proposing. But I am not suggesting that a new formula simply preclude the possibility of those quarterly rates below 1%. Instead, I am recommending that a new formula be established that would set a rate each quarter 1% higher than would be the rate under the present formula. The 1¼% rate currently in effect would then be 2¼% under the proposed change. Or a 1% quarterly rate under the present formula would of course be 2% under the suggested formula. If the 1% to 4% range I am suggesting is not high enough to encourage all banks, large and small alike, to participate in the Guaranteed/Insured Program, I contend that the range should be made even higher, perhaps 2% to 5%. I am convinced that banks will participate fully at a profit level substantially below their average profit. But the Guaranteed/Insured profit level must be brought *closer to the minimum profit* which banks can expect to realize from their usual investments. Otherwise, the Government's hope and the financial aid community's hope that banks will negotiate loans with all eligible students is unrealistic and in vain.

CONTRACT FOR "LAST RESORT" LOANS

I think it would be naive to expect that *all* eligible applicants for Guaranteed/Insured Loans would be able to obtain the loans from their local banks even if *all* of the recommendations I have already made were implemented. I do believe, however, that if those recommendations were implemented, a very significant reduction in loan refusals would result; and I believe, further, that the fewer the recommendations implemented, the greater the number of applicants who would continue to be rejected by the banks, in spite of Sallie Mae's influence for good. But there must be an alternate route for the rejected loan application to follow: one that makes certain that an eligible student can obtain a Guaranteed/Insured Loan.

My first thought was to suggest that a central agency, a Federal agency, directly make "last resort" loans to students rejected by their local banks. But the Federal Government would more than likely not wish to become involved directly in lending to and collecting from individual students, so I am recommending that the Government contract with some of the giant banks (or insurance companies) in each region of the country to make such loans. Contracts would be firm, with a definite commitment on the part of each of the "last resort" lenders to make loans to all eligible students whose applications reached them. Each refused application, accompanied by a very brief rejection note from an officer of the rejecting local bank, would be channeled through the Federal Government's Central Clearing House, which would monitor the re-routing and re-processing of the once-rejected application. A reasonable fee would be paid (in addition to the special allowance) by the Government to the "last resort" lenders for each previously rejected loan applicant to whom the lenders made a loan.

If the Guaranteed/Insured Program is revamped and improved, the number of "last resort" loans would not be overwhelming, even initially; and I think the number of such loans would decrease each year as the banks across the country learned that the program was more profitable and less fraught

with problems than before. Contributing to the expected decline in "last resort" loans would be the system of channeling rejected applications, accompanied by a rejection note, through the Central Clearing House to a contracting bank. The system would isolate the names of banks which were not participating and would open the way for specific public relations efforts to encourage their involvement. Banks cannot be coerced to make loans, or a certain type of loan, but a file on non-participating banks could be the first step in a public relations program to convince all banks to participate in a vastly improved program. The "last resort" loan system, by helping to pinpoint banks rejecting requests of eligible applicants, could contribute to its own gradual demise.

EXPAND THE DEFINITION OF "COST OF EDUCATION"

I have proposed that interest subsidy be eliminated from the Guaranteed/Insured Loan Program and also that lenders be allowed to discount interest on loans. To accommodate those two recommendations and at the same time to insure that a student's net loan proceeds would not be lower than under present regulations, I am also suggesting that the definition of "cost of education" must be expanded. It must include, as an allowable student expense, each year's payment of interest by the student on the Guaranteed Loan under negotiation as well as current interest on previous loans.

The applicant would then qualify for a larger loan than under present regulations. When the lender discounted the interest, the student borrower would receive the same loan proceeds, or "net loan," as he would have received under the cost of education formula now in effect.

GIVE LIMITED FLEXIBILITY TO THE LOAN MAXIMUM

This final recommendation is another one needed to accommodate elimination of interest subsidy and discounting of interest as possible program changes, yet protect the student from reduction of net loan proceeds. I would like to believe that not many students would need to make \$2500 Guaranteed Loans, but a substantial number have been negotiated already. Almost beyond doubt many more students will need \$2500 loans in the future. I am proposing that the loan ceiling be established as "\$2500 net," anticipating that discount payment of interest from a loan request in some amount above \$2500 would reduce the loan proceeds to the \$2500 amount the applicant needs to receive. The actual amount of any student's loan request beyond \$2500 would depend upon the amount of interest that student needed to pay on the loan being processed and on previous loans.

SUMMARY

In wrestling with the topic of the Guaranteed/Insured Loan Program, its problems, and possible solutions, I have attempted to weigh advantages against disadvantages in considering each possible solution or set of solutions which came to mind. The idea of removing the interest subsidy and requir-

ing even the low-income students to pay interest was especially difficult to handle. But the overriding thought in all of my recommendations was: "Whatever is necessary to get the loans to the students is what must be done." All students, including low-income students, will fare better by being able to receive loans, even though required to pay interest, than they would fare under conditions that make loans unavailable to many.

The recommendations I am making in this paper include only those ideas which, from my own point of view, offer far more advantages than disadvantages. I am convinced that the plan for change I am presenting would, if implemented in its entirety, move the Guaranteed/Insured Program to the point that every qualified applicant for a loan could indeed obtain the loan.