Joint Informational hearing of

Assembly Banking & Finance Committee
&
Assembly Higher Education Committee

Impact of Credit Crunch on Student Loans

The global credit crisis that started early 2007 has garnered the most attention for its impact on the home mortgage market. A prompt realization of the credit risk concerning some investment vehicles and fast deteriorating home prices have led to one of the most severe market shake-ups in recent memory. The seizure of the credit markets has made the securitization of several investment vehicles very difficult, and at times impossible. In those cases where financing is flowing in the capital markets, a steep premium is attached to those credit deals. This credit crisis has now spilled over into the student lending market. The collapse of the auction rate securities (ARS) market, a previously obscure financial market for most people, has impacted municipal bonds and the student loan market. The structure of student loan markets will be discussed in more detail later. Additionally, the subprime lending crisis has had an overlooked, and direct effect on the student loans as a borrower with a foreclosure in the last five years is ineligible for a federal PLUS loan[1]. Due to this credit crisis, private student loans will be underwritten with more restrictive terms such as requiring increased FICO scores. It is estimated that these changes alone will result in 100,000 families becoming ineligible for both PLUS and private student loans.[2]

Student lending is funded via private loan programs, the Federal Financial Education Loan Program (FFELP), or the William D. Ford Federal Direct Loan Program (Direct Loan) provided by the federal government. Direct Loans are funded from public capital originating with the U.S. Treasury. They are distributed through a channel that begins with the U.S. Treasury Department and from there passes through the USDE, then to the college or university and then to the student. Private loans and FFELP loans have been stifled, to varying degrees, by shut down in securitizations for private loans, and a

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[1] Testimony by Mark Kantrowitz, Publisher, FinAid.org. Hearing of the US Senate Committee on Banking, Housing, and Urban Affairs Turmoil in U.S. Credit Markets: Impact on the Cost and Availability of Student Loans. April 15, 2008

[2] Ibid.

57% reduction in securitizations of FFELP loans and the cost of those funds increasing 137 basis points.[3]

There are 5,966 institutions of higher education eligible to participate in the Title IV loan programs. Of that number, 4,105 institutions actively participate in the FFEL program, while 1,150 institutions actively participate in the DL program. However, since February 2008 to today, more than 288 institutions have begun the process to switch to the DL program. This compares with nine institutions switching during the same time period in 2007. Although there has been concern expressed in the community that the DL program would be unable to handle a sudden shift in loan volume, ED has assured institutions that it should be able to double its loan volume. The process for an institution to switch from the FFEL to the DL program might be difficult to accomplish in a very short period of time if a school were to suddenly determine that its students had difficulty accessing loans.

A recent *New York Times* article, "Student Loans Start to Bypass 2-Year Colleges," highlighted the exodus student loan programs at two-year colleges. Lenders are pulling out of this market based on analysis of higher default rates, low numbers of borrowers and small loan amounts that combined to make loans to these institutions less profitable. This is occurring even with 95% of the value of these loans guaranteed by the federal government. California's two-year colleges have been burdened with budget reductions and other cost cutting measures due to multiple state budget deficits. According to the College Board, 40% of the nation's undergraduates attend two-year colleges, with a third of their graduates taking out loans. Two-year colleges are often the gateway for students, often facing financial difficulties, to enter the higher education system.

Four non-profit state loan agencies, Pennsylvania Higher Education Assistance Agency (PHEAA), Massachusetts Education Financing Authority (MEFA), Michigan Higher Education Student Loan Authority (MHESLA) and Brazos (TX) have suspended all FFEL program originations. NorthStar Guarantee had suspended all activity in the FFEL program but has subsequently resumed making Stafford and PLUS loans, excluding consolidation loans.

The lenders who have exited all or part of the FFEL program account for over 12 percent of Stafford and PLUS loan origination volume and 83 percent of FFEL consolidation loan volume. These lenders originated more than $7

[3] Ibid

billion in Stafford and PLUS loans and more than $39.3 billion in consolidation loans in FY 07. All of the top ten and 38 of the top 100 consolidation lenders have stopped making consolidation loans, and 27 of the top 100 originators have stopped making Stafford and PLUS loans.

In addition, a number of institutions are reporting anecdotally on email lists that some FFEL lenders have informed them that they will no longer offer loans to the institution's students, usually because the volume of loans from that college or university is too low.

According to the National Association of College and University Business Officers, as of May 22, 2008, eighty-nine education lenders have exited or suspended their participation in all or part of the FFEL program. Seventy-two lenders have suspended participation in the entire FFEL program, 17 lenders have suspended participation in the consolidation loan program only, and 26 lenders have suspended their private student loan programs. This reduction in lending has occurred in spite of Asset Backed Securities (ABS) associated with student loans being AAA rated. Around 7.5 million borrowers took out $91.8 billion in FFELP loans during the current school year at 4,500 institutions.[4]

Student Lending Marketplace.

The majority of student loans are originated via the FFELP or the Direct Loan program with colleges and universities generally participating in either one or the other.

- Under the FFELP the loan is originated by a private lending institution but guaranteed by the federal government. Furthermore, these loans contain interest rates caps with subsidies to the lenders and guarantors that ensure the student borrower is able to get the most cost effective loan possible.
- The Direct Loan program is a loan that is made by and repaid to the federal USDE. These two lending programs are not available at every educational institutions.

These programs offer two types of undergraduate loans:

- Subsidized Stafford Loans: These are needs-based loans that cover the difference between a student's resources and the cost of attending

[4] Robert Tomsho. Tough Assignment: Find College Loans, *Wall Street Journal*. June 1, 2008

a college or university, up to $13,500. The federal government pays the interest while the student is attending the college or university and subsidizes the interest throughout the life of the loan.

- Unsubsidized Stafford Loans: Not based on financial need, these loans generally cover the difference between the subsidized Stafford Loan and the total cost of attending college. Loans are made by private lending institutions and repayment is guaranteed by the federal government. The federal government sets the interest rates and fees.

It is estimated that three quarters of postsecondary schools participate in the FFELP, while only 25% participate in the Direct Loan program. The differences in participation for these programs vary due to differences in subsidies and support offered for depending on the loan program. For example, more generous subsidies are offered to lenders in the FFEL program, and schools received administrative assistance that is not available through the Direct Loan program. Furthermore, the Direct Loan limits have not kept pace with the cost of education; however, one could also argue that neither grants nor loans are able to keep pace with increasing costs of education in general.

Another loan program, designed for credit worthy parents of dependent students, are PLUS Loans. These are not needs-based and are federally guaranteed. Federal student loans to parents: Usually these are PLUS loans (formerly standing for "Parent Loan for Undergraduate Students"). Unlike loans made to students, parents can borrow much more — usually enough to cover any gap in the cost of education. However, there is no grace period as payments start immediately. Parents are responsible for repayment on these loans, not the student. The parents have signed the master promissory note to pay and, if they do not do so, it is their credit rating that suffers. As mentioned in the opening of this document, the foreclosure crisis has had a direct impact on these types of loans as foreclosures have a sever impact on credit ratings, and can completely eliminate eligibility to receive these types of loans.

Another option for students is access to the private student loan market. These are loans that are not guaranteed by a government agency and are made to students by banks or finance companies. Advocates of private student loans suggest that they combine the best elements of the different government loans into one: They generally offer higher loan limits than direct-to-student federal loans, ensuring the student is not left with a budget

gap. However, unlike to-the-parent government loans, they generally offer a grace period with no payments due until after graduation. This grace period ranges as high as 12 months after graduation, though most private lenders offer six months.

Private loans generally come in two types: school-channel and direct-to-consumer. School-channel loans offer borrowers lower interest rates but generally take longer to process. School-channel loans are 'certified' by the school, which means the school signs off on the borrowing amount, and the funds for school-channel loans are disbursed directly to the school. Direct-to-consumer private loans are not certified by the school; schools don't interact with a direct-to-consumer private loan at all. The student simply supplies enrollment verification to the lender, and the loan proceeds are disbursed directly to the student. While direct-to-consumer loans generally carry higher interest rates than school-channel loans, they do allow families to get access to funds very quickly — in some cases, in a matter of days. Some argue that this convenience is off-set by the risk of student over-borrowing and/or use of funds for inappropriate purposes, since there is no third-party certification that the amount of the loan is appropriate for the education finance needs of the student in question. Direct-to-consumer private loans are the fastest growing segment of education finance and, as such, a number of providers are introducing products. Loan providers range from large education finance companies to specialty companies that focus exclusively on this niche. Such loans will often be distinguished by the indication that "no FAFSA is required" or "Funds disbursed directly to you."

Lenders that participate in the federal program may also offer private loans.

Capital Markets & Student Loans:

Not-for-profit lenders and state-based student loan secondary market organizations and non-traditional lenders (e.g., Sallie Mae) use a variety of strategies to raise capital in the marketplace, which is, in turn, offered as student loans. All of these types of organizations may participate in both the FFEL program and the private loan market, with varying levels of participation by each affiliated organization. Many traditional deposit banks (e.g., Chase, Bank of America, Wachovia, Citibank) have participated in the FFEL program and offer private loans. In FY 06, traditional banks held nearly 24 percent of outstanding volume while non-banks held over 76 percent of volume.

Like mortgage lending, student lending is also funded and operated through complex secondary market transactions and investment vehicles. Secondary markets include Sallie Mae, commercial banks, state guaranty agencies, non-profits and non-depository banking entities. These secondary market participants either keep the loans on their books or fund them through the issuance of ARS or ABS. In selling the loans to the secondary market, banks free up their capital and are able to make additional loans to students. Many of the not-for-profit lenders also buy loans from the banks on the secondary markets, which means that if the not-for-profit lenders are facing a short-term liquidity problem, the banks may face a long-term liquidity problem when the secondary market is not available to buy their loans.

Sallie Mae is the largest purchaser of secondary market student loans in the market. However, the recent market turmoil has caused Sallie Mae to scale back its overall market participation with a complete exit from the loan consolidation market. Sallie Mae was created in 1972 via congressional action as a Government Sponsored Enterprise (GSE), much like Fannie Mae and Freddie Mac, to provide a secondary market to encourage the origination of loans to students who were considered a credit risk. In 2004, Congress terminated its charter and it became a private company.

Approximately, 85% of FFELP loans have been financed through issuance of ABS, however since September 30, 2007, no loan originated has been funded through securitization[5]. In the first quarter of 2008 only $8.4 billion of student loan ABS was issued, compared to $21.7 billion in the first quarter of 2007.[6] According to statistics from Sallie Mae, the total outstanding amount of student loans from both FFELP and the private market is $405 billion. The ARS market, in 2007 held $80 billion with $230 billion held in the ABS market. Sallie Mae does most of its funding through the ABS market.

In the standard ABS financing, student loans are transferred from lenders into a bankruptcy remote securitization trust that then issues securities to investors. In these trusts, the underlying loan is the collateral for repayment of the investment, and with a FFELP guarantee up to 97% of the loan, these securities are relatively stable and safe investments. The ABS backed by the loans are divided up into tranches based on quality of the underlying asset ranging and rated by credit rating agencies from AAA to AA.

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[5] Testimony of Tom Deutsch, American Securitization Forum. Hearing of the US Senate Committee on Banking, Housing, and Urban Affairs Turmoil in U.S. Credit Markets: Impact on the Cost and Availability of Student Loans. April 15, 2008

[6] Ibid.

ABS backed by loans from the FFELP are usually rated AAA due to the large federal guarantee in the event of default. Investors in these securities receive various floating rates of interest based on the rating and maturity of the security. The recent market turmoil has lead to investor demanded rate spreads that are too expensive to make newly originated loans profitable.

As mentioned previously the other sector of financing for student loans is the ARS market. ARSs are long-term bonds bearing interest rates that are set during an auction but can be held at intervals as short as one week. During the auction, those bondholders who wish to sell their bonds can do so if sufficient buyers bid. Generally speaking, the more market interest there is in purchasing an auction rate security, the lower the rate the issuer must pay bondholders. The less market interest, the higher the rate the issuer must pay. If there are insufficient buyers to purchase the auction rate securities that holders wish to sell, the bondholders must keep their bonds (turning a liquid investment into a less liquid one), and the issuer must pay a rate (the "failed auction rate") that is specified in the bond documents. The failed auction rate is typically much higher than the rates the market has traditionally accepted, which places financial pressure on the issuer. Historically, investment banks would step in to purchase any otherwise un-purchased auction rate securities. However, the liquidity crunch that has affected nearly all market participants has left them unable to support the volume of bonds that investors want to sell. Early this year over 700 auctions failed in a single week. In addition to being issued by student loan finance authorities, they are issued by municipalities, non-profit hospitals, and housing finance agencies.

The crisis in the ABS and ARS markets has been exacerbated, according to many players in the student loan market, by the College Cost Reduction and Access Act of 2007.

College Cost Reduction and Access Act of 2007.

Many lenders have pointed to other changes in the student lending market that have reduced the attractiveness of these loans for investors. The largest of those changes was the passage of the HR 2669 (Miller), the College Cost Reduction and Access Act of 2007 (CCRAA), which reduced both borrower interest rates and reduced the subsidy rates that the government would pay to lenders. Furthermore, the Congressional Budget Office estimated the total reduction in lender subsidies, resulting from CCRAA, would exceed $40 billion over 10 years , a reduction that some lenders have felt would make it virtually impossible to continue to offer loans in a such a market.

CCRAA cut the subsidy rates on loans in order to free up money for an increase in Pell Grants, starting with a $490 increase for the first two years, rising to $1,090 for the 2012-2012 school year and as a response to troubling developments involving lenders and student aid officers steering students into questionable loans. Key provisions relating to students loans are as follows:

- The bill gradually cuts interest rates on subsidized Stafford loans for undergraduate students in half, according to the following schedule:
    - 6.8 percent for loans first disbursed July 1, 2006 to July 1, 2008
    - 6 percent for loans first disbursed July 1, 2008 to July 1, 2009
    - 5.6 percent for loans first disbursed July 1, 2009 to July 1, 2010
    - 4.5 percent for loans first disbursed July 1, 2010 to July 1, 2011
    - 3.4 percent for loans first disbursed July 1, 2011 to July 1, 2012
- Loan payments will be limited to 15 percent of a borrower's discretionary income or 15 percent of the amount that a borrower's (and spouse's if applicable) adjusted gross income exceeds 150 percent of the poverty line, divided by 12. Unpaid interest and principal are capitalized and any outstanding loan balance is forgiven after 25 years of repayment.
- PLUS Loans made on behalf of a dependent student and Direct Consolidation Loans that contain PLUS loans are not eligible for the income-based repayment program.
- Holders of these loans must apply the borrower's payments first to interest, second to fees, and then toward the principal of the loan.
- Any interest due and not covered by the borrower shall be paid by the Secretary of Education for up to three years except for periods that a borrower is in deferment due to economic hardship.
- The lender shall also capitalize the interest due when the borrower stops participating in the income-based repayment program, or begins making payments larger than what is specified under income-based repayment.
- Principal due and not paid under income-base repayment shall be deferred.

- Borrowers may remain in income-based repayment more than 10 years.
- When borrowers leave the program the maximum payment required on the loan shall not exceed the monthly amount based on a 10-year repayment period when the borrower first joined income-based repayment. The time the borrower is permitted to repay the loan may exceed 10 years.
- The Department must repay or cancel any outstanding loan principal and interest for borrowers after 25 years of repayment.
- Borrowers currently repaying loans according to income-contingent repayment or income-sensitive repayment plans will have the choice to continue in their current plans or may participate in the program created by this bill.
- The USDE must establish procedures to annually determine borrowers' eligibility for the program, including verification of a borrower's income and the amount of their loans.
- Reductions to Lenders in the FFELP program.
    - Eliminate the "Exceptional Performer" status that allows lenders that meet certain requirements established by the Secretary of Education to receive higher insurance rates on defaulted loans
    - Reduce the insurance paid by the federal government to lenders on defaulted loans from 98 percent to 97 percent of unpaid principal balances through October 1, 2012 at which point the insurance will be reduced to 95 percent
    - Reduce the amount that guarantors may keep through collections on defaulted loans from 23 percent to 16 percent
    - Reduce the special allowance payments (SAP) from the Department to lenders based on their tax status. For-profit lenders would receive a 55 basis point SAP reduction and non-for-profit lenders would receive a 40 basis point SAP reduction. To ensure that only nonprofit lenders benefit from the increased subsidization, nonprofit lenders that are owned in-whole or in-part by a for-profit entity would not be eligible for the reduced subsidy reductions. Nonprofit lenders that are purchased by for-

profit entities would also lose their higher subsidization rates on the date of the sale.

- Increase the loan fee paid to the Department by lenders - that cannot be passed on to borrowers - from 0.5 percent to 1 percent of the principal amount of each newly originated loan made on or after October 1, 2007
- Decrease the account maintenance fees paid by the Department to guarantors from .10 percent to .06 percent on newly originated loans
- The definition of economic hardship is also changed under from 100 percent of the poverty line for a family of 2 to 150 percent of the poverty line applicable to the family size.

Recent Developments:

The *lender-of-last-resort* (LLR) is a proposed solution to the current crisis, but this program directly involves guaranty agencies, not institutions of higher education.

Specifically, current law requires guaranty agencies to develop policies and operating procedures to ensure that a borrower in the geographic area serviced by that guaranty agency is able to obtain a loan. The agency can make the loan or direct the borrower to a designated lender. The Secretary of USDE is authorized to advance loan capital to the guaranty agency if it is needed in order to enable the agency to make loans under these provisions.

The federal guarantee on these loans is 100 percent, which is three percent higher than what lenders would receive if they made a loan under FFELP. Otherwise, the terms and conditions on these loans are the same as loans made under current law. The USDE issued guidance to guaranty agencies on LLR services in the FFEL program. The original intent of the LLR provisions was to deal with situations when individual students were not able to get loans, rather than to serve as a large-scale lending platform.

On Wednesday, May 21, 2008, the USDE released the implementation details of H.R. 5715, the Ensuring Continued Access to Student Loans Act of 2008, which was signed into law by President Bush on May 7, 2008. In a

Dear Colleague letter, the Department discuses the following four steps of its plan to ensure access to student loans:

1. As authorized by HR 5715, the Department will purchase loans from the FFEL program lenders for the 2008-2009 academic year and offer lenders access to short-term liquidity;

2. The Department pledges to continue working with the FFEL program community in the short-term to explore programs that might re-engage the capital markets;

3. The Department will make available, if needed, an enhanced lender-of-last resort program; and

4. The Department has the capability of doubling the capacity of the Direct Loan program, should it be needed.

Sallie Mae, the nation's largest originator of federally-guaranteed student loans, announced that they will continue to originate loans following previous reports that the student loan organization might withdraw from the federal program.

This federal response is fluid and is changing moment by moment, even at the time of this writing. Time will tell if efforts to boost market liquidity will have an impact.

California's Nexus with Federal Loan Programs:

The state's guarantor of FFELP student loans is the California Student Aid Commission (CSAC) established in 1955. CSAC guarantees principle and interest on federal student loans. EdFund was created on January 1997 as a non-profit corporation to act as an auxiliary for CSAC. Today, CSAC may be best known for administering the $800 million Cal Grant Program.

As the second largest provider of guarantee services in the nation, EdFund processed over $9 billion in loan guarantees in fiscal year 2006-07, and has the capacity to scale its operations to process LLR loan volume, as needed. CSAC and EdFund operate a single line of business as guarantors of loans as they do not engage in direct lending.

On May 30, 2008, the Assembly Budget Subcommittee #2 approved language to ensure that CSAC is able to exercise all options as a lender of

last resort and that EdFund must follow directives of CSAC in utilizing its authority to provide greater market liquidity for student loans.

On May 16, 2008, CSAC filed a detailed report with the USDE regarding their proposed participation in the LLR program as required by 34 CFR 682.401(c)

Conclusion:

All participants in the student loan market are hopeful that the latest plans to inject liquidity in the marketplace will ensure that student loans are available as needed. However, the changes that have occurred over the last year have raised many questions about the future of the student lending market. Due to liquidity concerns, the lending environment is beginning to change direction to a focus that may require increased role for state guarantor agencies. Furthermore, as the facts on the ground change moment to moment it is unclear whether the LLR program will become the predominant standard method of issuing student loans and not the exception as in the past.

Further, questions remain as to whether this the rapid change in student loans resulted from the credit crisis or the subsidy cuts contained in CCRAA. The National Association of Student Financial Aid Administrators released a white paper, *The Student Loan Credit Crunch,* on April 29, 2008 to that discussed the impacts of the credit crunch on student loans. In addressing the issue of originations of this crisis they wrote the following:

> "*Some lenders attribute their current troubles to subsidy cuts made by the College Cost Reduction and Access Act (CCRAA) signed into law on September 27, 2007. However, NASFAA agrees with the opinions expressed by a number of lenders in their testimony during several congressional hearings: While the subsidy cuts in the CCRAA may have exacerbated the problems in the capital market, this alone has not created the current credit crunch.*"