

Don't Direct FFELP to the History Books

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Don't Direct FFELP to the History Books

Eliminating FFELP, as proposed by the new Administration, would be a mistake. It has a proven track record of providing affordable student loans for over 40 years. And it's more cost-effective than the alternative

Soon after coming to office, President Obama announced that he intended to eliminate the Federal Family Education Loan Program (FFELP), the 40-year-old mainstay for extending loans to college students, and replace it with an extended direct government loan program. The President's intentions behind a switch to the Direct Loan Program are honorable — he plans to use any savings from such a change to increase college aid to low-income students. However, the savings that such a switch would ultimately yield are questionable.

The President's proposal should not come as a shock. It has been a goal long supported by key members of the Democratic Party and the current financial crisis has provided the opportunity to put an end to the FFELP program once and for all. After all, the Federal government has been providing emergency funding for the vast majority of all new FFELP student loans since the capital markets crisis began. It's hard to argue the merits of the FFELP program at a time when private funding — through asset-backed securities issuance — has come to a virtual standstill.

But eliminating FFELP would be a mistake. The program has efficiently and effectively provided support to millions of students for four decades. A better solution would be to keep the program in place while extending the liquidity and capital support that the government has been providing since the early days of the economic crisis. However, this support should not be a premise to end the FFELP program. The dislocation in the capital markets has made private funding for many assets uneconomical, but this is particularly true for FFELP loans, where the yield on the assets is set by legislation. FFELP lenders cannot increase the interest rate on loans and therefore have very limited financial flexibility. The government's support throughout these tough economic times is crucial.

This support will provide time for the financial markets to recover, for pricing to re-adjust and for the capital markets to make any necessary modifications so that private funding to the FFELP program can resume. That would allow FFELP to continue to serve the educational funding needs of America's university students for many decades to come.

What is the appeal of replacing FFELP with a government-run Direct Lending program? Democrats' chief argument is that the cost of the Direct Lending program is lower than the FFELP program.

For example, the Congressional Budget Office estimates that eliminating the FFELP program in favor of an expanded government-run Direct Loan program would save the government \$94 billion over 10 years. The Obama administration would use these savings to increase Pell Grants — federal aid granted to low-income students. While the intention of helping the neediest of students is an honorable one, the projected savings are not likely to materialize.

The estimated \$94 billion in cost savings has been much publicized. The means by which these cost savings will be accomplished has not. The reason for this is that the two programs are scored on a different basis, making an accurate comparable cost assessment between the two programs impossible. For example, under the Direct program, a loan is considered in default at 360 days past due compared with 270 days under FFELP. This creates a bias in favor of the Direct program when comparing default rates between the programs. Under the Direct program, Treasury guarantees 100% of defaulted loans, whereas under FFELP, Treasury guarantees 90% to 95% of a defaulted loan — the difference between federal guarantees and the minimum 97% guarantee on the loans is provided by private guarantee agencies under the FFELP program and not by the Treasury.

To complicate matters further, the \$94 billion in purported savings does not account for the administrative costs of the Direct program. These aren't officially tracked, but according to *Inside Higher Education* the current Direct program already costs US taxpayers almost two-and-a-half times as much as FFELP: every \$100 of FFELP loans originated during the 2008 academic year cost the government \$1.72, while every \$100 of Direct loans cost \$4.26.

FFELP has historically also offered a better deal to borrowers. Not-for-profit and state agencies can provide loans to students at a lower all-in cost than the Direct loan program when you factor in the many borrower benefits such as interest rate or principal reductions that lenders offer to reduce the amount that borrowers pay on their loans. FFELP borrowers have plenty of loan providers to choose from, meaning they can shop around for loans that provide the best loans and flexible repayment plans. The Direct lending plan would remove such choices, which would probably increase borrowing costs.

How We Got Here

The student loans market was one of the first to receive a bailout in the credit crisis. FFELP lenders were unable to access capital, causing some to exit the market and others to temporarily suspend new loan originations.

Fearing that students would not be able to obtain loans for the upcoming school year, lenders lobbied Congress for help. That resulted in the Ensuring Access to Student Loans Act (ECASLA) in May 2008 which created several programs to provide FFELP lenders with access to capital. These included the loan-participation program, which gave lenders affordable financing at 50 basis points over three-month double-A commercial paper rates, and the loan-purchase program, which allowed lenders to put the loans to the Department of Education (DoE) while making a gross profit of \$75 per loan.

While these measures provided FFELP lenders with a means to originate new loans, the programs have shortcomings. For a start, only loans originated on May 1, 2008 onward were eligible. Elsewhere, consolidation loans were not eligible, servicing had to be transferred to the DoE under the loan-purchase program and lenders had to come up with interim capital to originate and fund loans during the required holding periods.

To address some of these limitations, ECASLA was expanded to create the ABCP conduit program, making loans originated between October 2003 and June 2010 eligible for funding. Crucially, that gave lenders a means to refinance loans held in failed debt structures such as auction-rate and variable-rate demand obligations. In addition, servicing did not have to be transferred to the DoE, except under certain events. The main drawback of the Conduit is that lenders require up-front capital to access the program due to the Conduit's 97% advance rate as well as a requirement to fund a reserve account to obtain an underlying triple-A rating — estimated at 1% to 4% depending on the underlying collateral. Many not-for-profit and state agencies do not have the capital required to access the Conduit program, so although helpful, it is not a solution for all lenders.

Through the various ECASLA initiatives, the government is essentially providing FFELP lenders with access to capital. It should continue to do so, as the current economic environment offers little in alternative capital sources. The dislocation in the capital markets has made private funding for many assets uneconomical, but is particularly true for FFELP loans, where the yield on the assets is set by legislation. FFELP lenders cannot increase the interest rate on loans and therefore have very limited financial flexibility. However, this support should not be a premise to end the FFELP program.

New infrastructure

An expanded Direct-lending program would also need adequate infrastructure. The FFELP program already provides state-of-the-art customer service and loan servicing. It also offers a variety of services to borrowers, including financial literacy, default prevention and debt management, loan counseling, outreach activities and need-based scholarships. All of this support results in lower default rates than under the Direct program — which saves the government money.

The Department of Education (DoE) states on its website that the Direct loan program has the capacity to assume a higher loan volume and will have the capacity required to originate 100% of all student loans by the end of 2009. However, this would require the DoE to quadruple its annual origination volume from approximately \$20 billion to \$80 billion in less than a year. To even attempt to do this would require a tremendous amount of federal investment in people and systems, which would add to the program's size and cost. In the process, it would also eliminate over 35,000 FFELP-related jobs throughout the U.S.

The DoE must have realized that it did not have the ability to successfully originate 100% of all student loans because the new plan calls for the DoE to contract with third-party lenders, through a bidding process, to service and administer the loans and to provide other services such as debt avoidance and outreach. Therefore, instead of providing all student loans, the DoE is now looking at a hybrid program. This is not necessarily a bad idea, but the savings being touted are still about 80% to 90% of the original \$94 billion estimate, which seems highly unlikely. But one of the obvious problems with this third-party contractor proposition is that it inherently favors the large-scale lenders. Sallie Mae is carving out its new role in the industry as the provider of choice for the DoE and in full support of the administration's plan. Most of the not-for-profit and state agencies do not have the scale to compete with Sallie Mae. As a result, borrower choice would still be much reduced.

Other than the three largest for-profit entities — Sallie Mae, Nelnet, and Citibank — the industry is mostly comprised of not-for-profits and state agencies which operate on thin margins and maintain a public purpose mission that helps their borrowers, their states and the schools with which they do business. These are the entities that will be the casualties in this war. Ironically, it will be the large for-profit entities that stay in business long after FFELP is gone.

Lower-cost alternative

Under the President's proposal, every dollar lent under the Direct program is borrowed by the Treasury. This translates to approximately \$500 billion of new government debt over the next five years. The government's Direct loan portfolios are expected to account for more than 10% of the projected \$14 trillion debt expected to be on the books in 2019. Many observers, including Moody's Investors Service, have warned that the U.S. could lose its triple-A rating if it does not put its finances in order. Considering the extraordinary increase we have seen in federal borrowings to address various problems across our economy, is taking on 100% of all student loans the best use of our limited resources when there is a lower-cost alternative program already in place?

Why are FFELP lenders not fighting back against the Federal government's proposals? After all, it's in their direct interest. A recent series of scandals about conflicts of interest and public outrage against the profits generated by private student loan lenders over the prior several years, primarily towards the large for-profit lenders, may be at least partly to blame. The industry's tarnished image was the driving force

behind Congress cutting profit margins for FFELP loans in half in September 2007. This action made issuing student loan-backed bonds only marginally profitable even prior to the credit crisis. However, the stigma associated with FFELP lenders remains to this day, despite the fact that only a very limited number of lenders — 14 out of several hundred — were found to have acted inappropriately. There has also been substantial media coverage on the increasing amount of student loan debt that graduates carry. The blame seems unjustifiably directed towards the lenders. However, FFELP lenders do not determine tuition fees nor do they set the interest rates on student loans. The latter are set by Congress — just as they are under the Direct loan program. Since legislation was passed in September 2007, FFELP lenders are required to return money to the federal government to the extent the loan yield exceeds the borrower interest rate. With current low interest rates, the government has actually earned money from the FFELP program just as it has under the ECASLA programs (see box). The real problem behind the growing level of student loan debt would be better addressed by looking at the rise in tuition costs, which have consistently and materially outpaced inflation. Providing financial literacy to high school students and their families would also help them make responsible decisions when the time comes to choose a college. At some point, individuals have to be held accountable and responsible for the choices they make. But that is a topic for a different story.

No united front

Due to this negative publicity and the current state of the capital markets, it is challenging for these decentralized lenders to fight for the FFELP program. Instead of speaking with one voice, FFELP lenders are scrambling to fight their own battles in their own states or for their own interests. The lack of a united front is the biggest weakness that FFELP lenders face and is a big reason why their fight has been unsuccessful thus far. I have read many letters written by individual state agencies, not-for-profits or their representatives stating all that they have accomplished and the benefits they provide to students in their states.

However, FFELP lenders have not put up a united front to showcase the millions of students they helped, or the savings they have passed through to students in the form of borrower benefits, scholarships, and outreach services. Moreover, the FFELP community has not provided a unified argument to the administration's data on cost savings by switching to the Direct program. Unfortunately this lowers the chances that the industry's story will be heard.

The proposal to eliminate FFELP in favor of Direct lending needs to be considered in a well thought-out process which should involve all constituents. The FFELP program has a long history of success, now serving over 12 million students a year at 4,400 institutions, and it has been the provider of choice for over 75% of all loan originations. The program has the infrastructure and the local presence to provide a high level of customer service. It can continue to operate, albeit with federal support during these extraordinarily challenging times. President Obama wants to provide access to higher education for students with the greatest financial need. That is a worthwhile pursuit. Eliminating FFELP is not the way to accomplish that goal.