

TESTIMONY BEFORE THE BANKS COMMITTEE AND  
THE HIGHER EDUCATION AND EMPLOYMENT  
ADVANCEMENT COMMITTEE FORUM

"The Effect of the Sub-Prime Mortgage Crisis on the Availability of  
Funds for Student Loans"

Peter Warren  
Executive Vice President  
Education Finance Council

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## INTRODUCTION

Good afternoon. Thank you for inviting me to be here with you today to discuss this very important topic. My name is Peter Warren, and I am Executive Vice President of the Education Finance Council (EFC), a trade group based in Washington, DC. EFC is the umbrella organization representing 34 state-based and nonprofit student loan providers around the Nation -- including the Connecticut Student Loan Foundation.

In the brief time I have here today, I will discuss why student loan providers have struggled this year to raise funds to lend to students.

By way of background, I'll just mention that I have been with EFC for more than four years. Prior to that, I served for a total of more than six years on the professional committee staff of two standing committees of the U.S. House of Representatives pertinent to the federal student loan program -- the Education and Workforce Committee, and the Budget Committee.

The nonprofit loan providers EFC represents collectively finance 20 to 25 percent of all FFELP loans. They raise funds to originate or purchase loans by selling investors a combination of taxable and tax-exempt debt. As nonprofits, any margin they earn on these loans is funneled back to students in the form of fee waivers, rate reductions and loan forgiveness programs. They also provide value-added services such as financial literacy and college planning programs. Nonprofit student lenders have collectively been recognized in recent years by national publications like *US News and World Report* and *Business Week* for offering borrowers great deals on student loans.

## STUDENT LOAN CAPITAL LIQUIDITY PROBLEM

Lenders -- both for-profit and non-profit -- lend to students using funds they raise in the private capital markets. Lenders must receive sufficient income on the loans to pay off their bond investors, and also to cover their operating costs, such as loan servicing.

With most consumer loans, when a lender's cost of funds rises, the lender responds by raising borrower interest rates. But the yield on federal student loans is essentially set in statute.

Today, student lenders are in a "squeeze play" in which their cost of funds has risen while their income on loans has fallen. Lender yields are down due to a law Congress enacted in September, 2007, the College Cost Reduction and Access Act. That legislation reduced the yield on FFELP loans by roughly 65 basis points for for-profit lenders and roughly 50-basis points for non-profit lenders.

Those reductions made student loans marginally profitable in the best of circumstances. In today's credit market environment, the cost of raising funds to make student loans is largely prohibitive. Nonprofit lenders, in particular, are willing to operate on very little margin; they can only run negative cash flow for so long, however, before risking insolvency.

The investor reluctance to buy student loan bonds is a puzzling situation, since the loans themselves are largely Government-guaranteed. Sub-prime mortgage bonds declined in value because it was discovered that the collateral quality was weak, and defaults and delinquencies were higher than expected. The decline in value of student loan bonds is not due to questions about the underwriting or the performance of the underlying loans. It is rather due to a ripple effect of the sub-prime mortgage market collapse that has drained liquidity from the capital markets. Student loans are packaged in a manner similar to housing loans. They are both structured finance assets, and this entire asset class has been largely shunned by investors in the current capital market environment.

Another key factor was the collapse in February of a \$330 billion auction rate securities market that included more than \$80 billion in student-loan backed securities. The way that market worked, the interest rate an issuer paid its bondholders was reset periodically through an auction process. But the broad capital market liquidity problems precipitated widespread auction failures, beginning in February. The auction market remains frozen today. Consequently, issuers of these bonds are paying "penalty rates" to bond holders.

This has sapped equity from nonprofit student lenders, depriving them of funds that could be used to finance new loans.

In sum, the capital markets have been largely closed off to student lenders this year. New bond issuance volume is a small fraction of prior year volume. The cost of funds on the new bond issues of the largest student lender, SLM Corp., has risen by more than 100-basis points. Only a handful of nonprofit lenders have been able to issue any new student loan bonds at all this year, and these at unattractively high rates. Unlike non-bank lenders, bank lenders have access to consumer deposits and ultimately to the Federal Reserve discount window. Many banks, however, have ceased student lending this year due to reduced loan margins and bank balance sheet concerns.

Earlier this year, several large nonprofit student lenders announced they were suspending student loan programs. Among these were the Pennsylvania Higher Education Assistance Agency and the Michigan Higher Education Student Loan Authority. As other lenders departed by the dozens, it became unclear how many would remain, and the case for federal intervention to prevent a loan access problem grew.

## REMEDIAL ACTIONS

The U.S. Department of Education projected a demand for \$57.7 billion in FFELP loans from students and parents for the 2008-09 academic year. Increasingly concerned there would be unmet need, federal lawmakers in May passed emergency legislation – the Ensuring Continued Access to Student Loans Act. This law authorized the Federal Government to purchase federal student loans.

Two loan purchase programs have been set up. In one program, the Department of Education will purchase from lenders – essentially at par – any FFELP loan issued for the 2008-09 academic year. In the other program, the Department will purchase “participation interests” in such loans. These can be re-purchased by lenders before September 2009, if they are able to refinance them in the private capital markets.

The Department a few weeks ago began funding participation interest program requests. *The American Banker* reported a few days ago that as of Sept. 2<sup>nd</sup>, the Department had received a cumulative \$2.1 billion in funding requests from lenders, and it had issued a total of \$1.97 billion of funding to five different student loan providers. I expect those numbers will climb significantly during the month of September, if the program runs smoothly.

Unfortunately, many non-bank lenders are having difficulty accessing this facility, because the Department's plan requires student lenders to first make a loan before the Department will reimburse the funds. This has proven to be a Catch-22 for many lenders. They cannot get the short-term "bridge loans" necessary to make the loans to sell to the Government.

A bright spot in this difficult environment has been the willingness of a number of States to step in to assist either state agencies or nonprofit lenders, enabling those entities to lend to meet the needs of students in their state.

A recent example is the state of Kentucky, where, in order to prevent a loan capital shortage in the state, the Governor's office purchased a \$50 million private placement bond from the Kentucky Higher Education Student Loan Corporation, a state student lending agency. The bond proceeds will provide the short-term bridge necessary to access the Department's loan participation purchase facility. The Kentucky loan agency will use the bridge funds to originate student loans, sell interests in those loans to the Department, and then turn around and recycle those funds back into more student loans.

In a statement released by the office of Kentucky Governor Steve Beshear on August 21<sup>st</sup>, the state's Secretary of Finance, Jonathan Miller, said, "In exchange for purchasing the bond, the Commonwealth has not only received a high quality investment security, but one that will pay a very competitive rate of interest. This is not only an important investment in Kentucky's children, but with an interest rate that will be over one-percent higher than a comparable U.S. Treasury security, it is also a win for the taxpayers of the Commonwealth."

Kentucky is not an isolated case. Other states have taken similar actions. For instance:

- The New Mexico state treasurer also recently purchased a \$50 million private placement bond from its state-based non-profit lender, the New Mexico Educational Assistance Foundation, so that it could keep lending to New Mexico students and schools.
- In the spring, the state of Arkansas extended an \$80 million line of credit to the Arkansas Student Loan Authority to enable that state agency to continue lending to Arkansas students and schools.
- This summer, the state of South Carolina purchased a \$50 million portion of a bond sold by the South Carolina Student Loan Corporation, to help it continue lending.

It appears these efforts in recent months of the federal government, the states, private lenders, and colleges and universities are indeed paying off. At this point in time, the Department of Education has not reported a shortage in federal student loan availability. We hope this remains the case for the duration of the academic year.

The future, however, remains a question mark.

The Department's emergency legislation expires after this academic year. Absent a sudden and total reversal of the capital market collapse, the FFELP will not be a viable program next academic year, which begins July 1, 2009. This is a situation that needs to be addressed to ensure the continued availability of federal student loans.