Student Aid Policy Recommendations

Solving the Student Loan Credit Crunch

Mark Kantrowitz
Publisher, FinAid.org

March 10, 2008
Revised March 23, 2008[1]
Last updated April 30, 2008

INTRODUCTION

The subprime mortgage credit crisis, when combined with the lender subsidy cuts from the College Cost Reduction and Access Act of 2007, has presented significant challenges to the nation's education lenders. These challenges have caused several prominent education lenders to suspend their participation in federal and/or private student loan programs, often with little or no advance notice. Most of the remaining lenders have cut borrower benefits[2] on federal education loans and many have increased interest rates and fees on private student loans especially to borrowers with bad or marginal credit. The lenders are also eliminating subprime exposure by establishing more stringent credit underwriting criteria for their private student loan products and by curtailing the marketing and origination of federal student loans at high default rate schools. PLUS loan denial rates are also likely to increase due to an increase in foreclosures and repossessions. There is also the potential for significant short-term disruptions to the federal and private education loan programs when lenders run out of the liquidity needed to make new loans. These challenges will reduce the availability of federal and private education loans somewhat, especially to subprime borrowers, and will increase the cost to all borrowers.

The purpose of this policy paper is to summarize the current problems faced by the student loan industry, evaluate the impact on borrowers and to suggest solutions. The solutions are focused on increasing federal education loan limits, injecting liquidity into the federal education loan system and eliminating the index rate mismatch.

---

[1] Data concerning lender cost of funds has been updated to include weighting by the weighted average life of the credit tranche in addition to the principal balance. The weighted average life is based on a 12% Constant Prepayment Rate (CPR) model. This increased the cost of funds by up to 13 basis points. The paper also includes additional detail and discussion and an improved presentation.

[2] Except for up-front fee waivers, these discounts usually have negligible impact on cost. See Mark Kantrowitz, *Evaluating Student Loan Discounts*, Student Aid Transcript 18(2):32-38, NASFAA, July 2007. The improvements to student aid enacted by the Higher Education Reconciliation Act of 2005 and the College Cost Reduction and Access Act of 2007 yield a greater financial benefit to students than the loss of loan discounts.

EXECUTIVE SUMMARY

The turmoil in the capital markets is leading to decreases in availability and increases in costs for both federal and private student loans. It is also generating a bit of turbulence as lenders have suspended their participation in federal and private student loan programs. The main actual and potential impacts involve borrower eligibility, lender availability and loan cost.

Borrower Eligibility

- An increase in PLUS loan denials for the 2008-09 student loan season because more borrowers will have an adverse credit history due to the increase in foreclosures. The additional unsubsidized Stafford loan eligibility for dependent undergraduate students whose parents were denied a Parent PLUS loan falls short of the average PLUS loan. Graduate and professional students do not have such a safety net when they are denied a Grad PLUS loan. Prospective borrowers with a foreclosure are also unlikely to qualify for private student loans or home equity lines of credit.

- More stringent credit underwriting criteria for private student loans will mean that subprime borrowers (FICO score under 650) and even some borrowers with FICO scores as high as 680 or 700 may find it more difficult to obtain a private student loan without a creditworthy cosigner. Lenders are looking at institutional default rates, graduation rates and job placement rates, especially at for-profit and community colleges, when deciding whether to provide private student loans to students at those schools.

- Approximately 1% to 2% of borrowers will be ineligible for the PLUS and private student loans as a result of the increase in foreclosures and tightening of credit underwriting criteria.

Lender Availability

- Some Federal Family Education Loan Program (FFELP) lenders are no longer making Stafford and PLUS loans at eligible colleges that have higher default rates. This may limit the availability of federal student loans at colleges that have cohort default rates of 10% or more. These colleges may have difficulty finding replacement lenders and may have to switch to the Direct Loan program.[3]

- Lenders representing 14% of Stafford and PLUS loan origination volume and 76% of Consolidation loan volume have suspended their participation in those loan programs.

[3] 59 colleges applied to join the Direct Loan program in January and February 2008. 45 of the applications were from for-profit colleges. The average number of schools joining the Direct Loan program from 2000-01 through 2005-06 was 44 per year.

- Many of the non-bank lenders and state loan agencies that continue to originate loans are working off of existing liquidity. Unless there is a thawing of the capital markets more lenders are likely to suspend federal and private loan program participation within the next year. However, several of the larger banks are using the withdrawal of non-bank lenders and state loan agencies as an opportunity to increase market share.

Loan Cost

- FFELP lenders do not have pricing power on federal education loans, as the maximum interest rates and fees are set by law. However, they can still increase costs to the extent that they were previously offering limited discounts ("borrower benefits") on those loans. Many have cut the value of discounts on Stafford and PLUS loans in half and eliminated discounts on consolidation loans.

- Lenders have increased the interest rates on private student loans by 0.25% to 3.0%, especially for loans that are pegged to the Prime Lending Rate. More of the increases in interest rates are falling on borrowers with bad or marginal credit. The average increase was 0.86% for borrowers with bad or marginal credit.

Possible Solutions

While the Direct Loan and lender-of-last-resort programs have been offered as a potential solution for lenders leaving FFELP, the ability of those programs to compensate for the changes in the student loan marketplace have never been sufficiently tested. There is the possibility of significant disruption for a few months during a transition to these programs.

The following solutions could be implemented at no cost (and possibly significant profit) to the federal government while simultaneously saving borrowers money.

- Increase annual and aggregate unsubsidized Stafford loan limits, either for all borrowers or just independent students and students subject to a PLUS loan denial. Since the unsubsidized Stafford loans (as opposed to the subsidized Stafford loan) have a negative subsidy rate, the government could earn up to an additional $500 million per year from increasing these loan limits, enough for a $125 increase in the maximum Pell Grant. This would also save borrowers money by shifting debt from higher cost private student loans to lower cost federal loans. It would also improve access since private student loans are unavailable to low and middle income families with bad credit.

- Establish an Undergrad PLUS loan similar to the Grad PLUS loan to allow undergraduate students to borrow from the PLUS loan program with or without parental involvement. This would save the federal government up to $1 billion a year (enough for a $250 increase in the maximum Pell Grant) due to the higher interest rates and fees on the PLUS loan program, but would still save most students money as compared with an average interest rate of 10% to 11% on private student loans. This also addresses concerns parents have about their inability to defer payments on the Parent PLUS loan while the student (as opposed to the parent) is in school[4] and about the student not being obligated to repay the Parent PLUS loan. Unfortunately this proposal would still be insufficient for borrowers with an adverse credit history.

- Offer a reverse loan auction in which the US Treasury would invest a limited amount of money in student loan securitizations, where the lenders who bid the highest cost of funds after adjusting for quality of the student loan paper would win the new investments. This will provide the lenders with additional liquidity to make new loans and some profit to the federal government because of the government's lower cost of funds. This could also jump start the securitization markets for federal student loans by serving as a vote of confidence in FFELP.

- Switch the special allowance payments from the Commercial Paper Rate to the LIBOR index in a cost-neutral fashion. This would eliminate the index mismatch between lender revenues and their cost of funds, providing them with more predictable spreads.

These proposed solutions are focused more on liquidity and the availability of student loans and less on costs. Making sure that students have access to cash flow assistance is more important than the cost of that financing in ensuring access to a higher education.

THE PROBLEMS

Non-bank lenders rely on credit warehousing facilities[5] and the capital markets[6] as a source of funds. Initially a lender uses the credit warehousing facility as a source of funds to make new loans. As soon as the lender has originated enough loan volume (usually at least $100 million, but $1 billion is more common these days) the lender transfers the loans to a trust and sell shares in the trust to investors at a premium through a process called securitization. The proceeds from the securitization are used to repay the credit warehousing facility. This not only provides the lender with a lower cost of capital than the credit warehousing facility, but also provides the lender with about half of its future profits up front. The rest of the lender's profits are earned over time from servicing and advisory fees. A key to lender profitability involves minimizing the use of the higher cost credit warehousing facility by originating as much loan volume as possible in as short a time as possible so that one can securitize as frequently as possible.

---

[4] If Congress does not establish an Undergrad PLUS loan it should consider amending Section 428B(d)(1) by inserting "or dependent undergraduate student on whose behalf the parent is borrowing" after "parent" to permit an in-school deferment when the student is in school.
[5] A credit warehousing facility is a large loan of $500 million to several billion dollars typically made by a large international bank.
[6] The capital markets used by education lenders include asset-backed securitizations and bond issues.

The subprime[7] mortgage credit crisis has lead to a significant decrease in investor interest in all securitizations, not just those involving subprime mortgages. This is clearly an irrational overreaction, since the quality of the student loan assets are still among the best available. For example, federal education loans are guaranteed against default by the federal government,[8] so investors should not care much about subprime exposure.[9] Private student loans, although not federally-guaranteed, usually have less than about 11% exposure to subprime borrowers[10] and then only to the best quality subprime borrowers (e.g., FICO scores of 620 to 650) and not the full spectrum. The risk associated with these assets is about half of the 20% risk weighting assumed for all Triple-A rated obligations. But the practical reality is all that really matters.

The decrease in investor interest has lead to a significant disruption of the capital markets. There have been no public securitizations of private student loans since First Marblehead's 2007-4 securitization of $1.4 billion on September 17, 2007. Roughly two-thirds of that securitization was auction rate, with only $550 million at the 1-month LIBOR plus a margin of 0.85%.[11] That was up from the weighted average rate of 1-month LIBOR plus 0.37% in the 2007-2 securitization.[12] The securitization of federal loans has also slowed, despite an increase in loan volume waiting for securitization. There have also been fewer classes in the securitizations. Also, none of the securitizations since October 1, 2007 have included any loans originated on or after that date.[13] There have also been no new state bond issues.

For example, consider the following chart of Sallie Mae's federal education loan securitizations. The average securitization through October 12, 2006 was roughly $2.5 billion. This increased to $3.7 billion through July 19, 2007 but plunged to $1.7 billion from October 2007 to the present. Total securitization volume in the first quarter is down 57% year over year.[14] Investor demand is so low that Sallie Mae was forced to decrease the size of its February 2008 offering and increase the average margin to 93 basis points.

---

[7] Subprime is generally defined as having a FICO score less than 650.

[8] Currently a 99% guarantee for exceptional performers and 97% for other lenders, both decreasing to a 95% guarantee starting on October 1, 2012.

[9] Besides the small amount of risk sharing, there is also a prepayment risk when a borrower defaults. While the government may repay most of the principal and accrued but unpaid interest, the investor will not obtain the interest he or she was expecting to receive over the lifetime of the loan. To the extent that the default rates exceeded expectations, the investor may have overpaid for the loan. However, the impact of this default risk on a federally-guaranteed loan is minimal, only a few basis points.

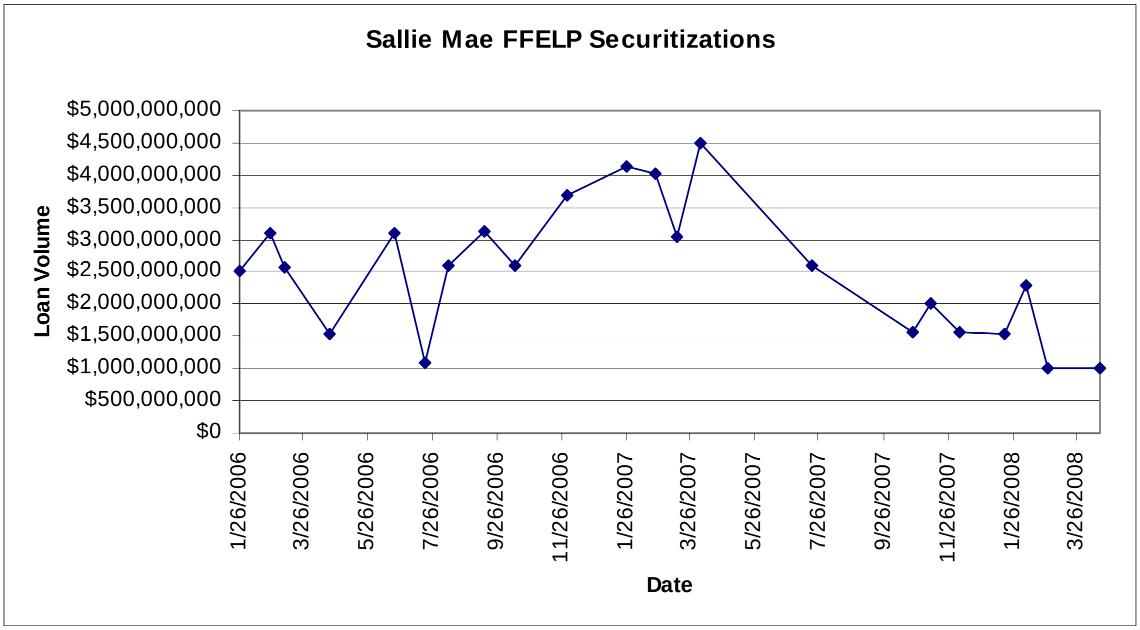
[10] 8.0%, 6.1%, 9.5%, 10.5%, 10.3%, 10.1%, 10.8% and 10.9% for First Marblehead's 2006-1, 2006-2, 2006-3, 2006-4, 2007-1, 2007-2, 2007-3 and 2007-4 securitizations, respectively (9.5% average), and 8.8%, 17.6%, 12.2% and 8.2% for Sallie Mae's 2006-A, 2006-B, 2006-C and 2007-A private student loan securitizations, respectively (11.7% average). The "Other" category was included in the Sallie Mae totals but not the First Marblehead totals.

[11] This securitization was forced to omit the Triple-B tranche, the lowest investment grade typically included in securitizations.

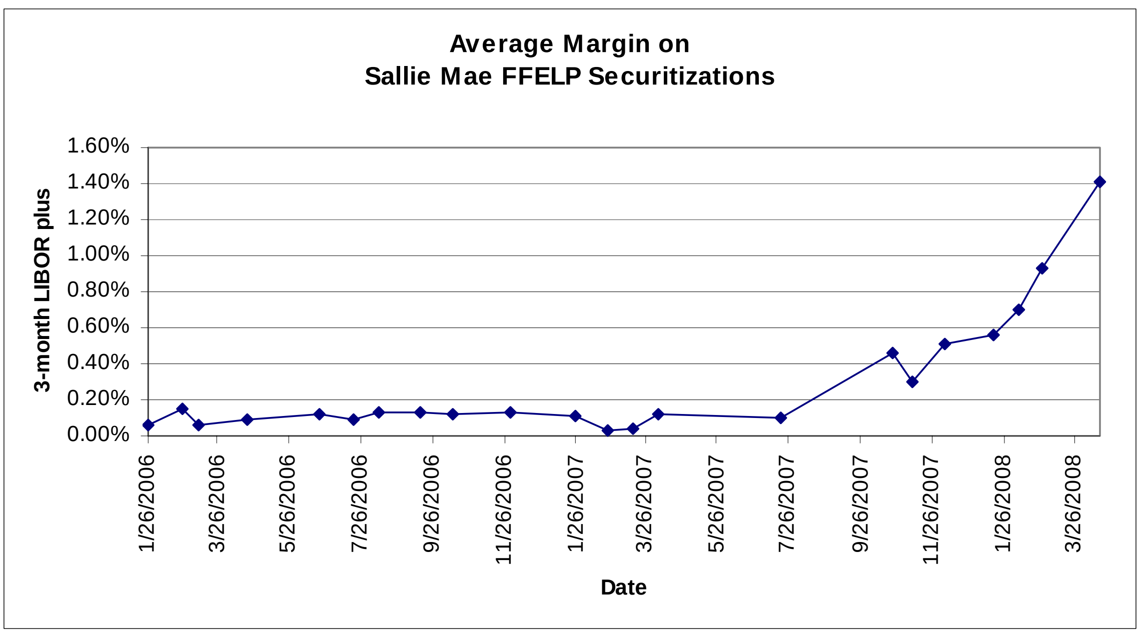
[12] Using a 10% CPR weighted average life in addition to the principal balance in the weighted average.

[13] The combination of the increased cost of capital from the credit crisis and the decreased special allowance payments from the College Cost Reduction and Access Act of 2007 has lead to such narrow margins that post-10/1/07 loans cannot be securitized in the current environment.

[14] Sallie Mae securitized $4.8 billion in Q1-2008 compared with $11.2 billion in Q1-2007.



The decrease in investor interest has forced lenders to pay more to get them to invest in the securitizations. Through July 19, 2007, the weighted average margin[15] paid relative to the LIBOR index was 10 basis points. It then jumped to 55 basis points and a recent peak of 93 basis points, an 83 basis point increase. The following chart shows how the weighted average margins (excluding a small amount of auction rate credit classes) on Sallie Mae's federal loan securitizations have changed since January 2006.

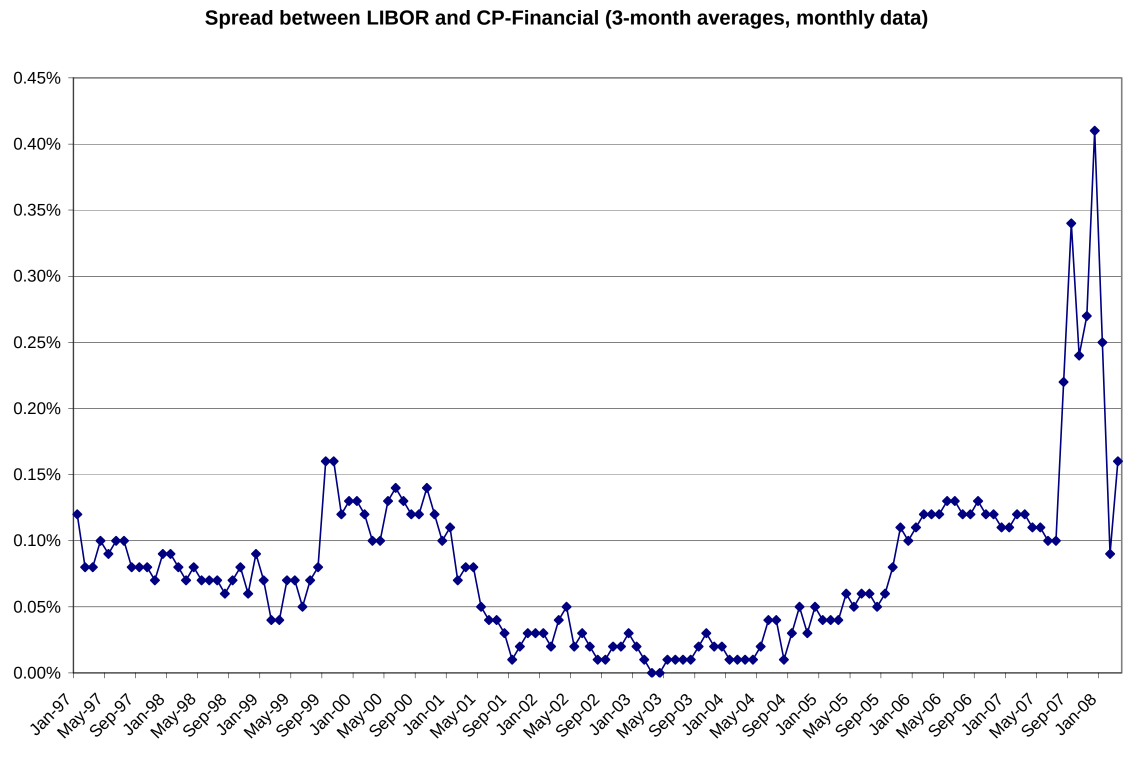


[15] Weighting based on loan principal volume and weighted average life assuming a 12% CPR Model.

When education lenders are not able to securitize their loan portfolios, they are forced to keep them on the credit warehousing facilities, which are more expensive. So either way the lender's cost of funds has increased significantly.

Index mismatches have been another important cause of margin compression for education lenders. An index mismatch occurs when the lender's income is pegged to a different index (base rate) than the lender's cost of funds. Both credit warehousing facilities and securitizations are usually pegged to the LIBOR index (either the 1-month or 3-month average). The special allowance payment on federal education loans, however, is pegged to the 3-month Commercial Paper Rate. While about half of all private student loans are pegged to the LIBOR index, and so have no index mismatch, two-fifths are pegged to the Prime Lending Rate.

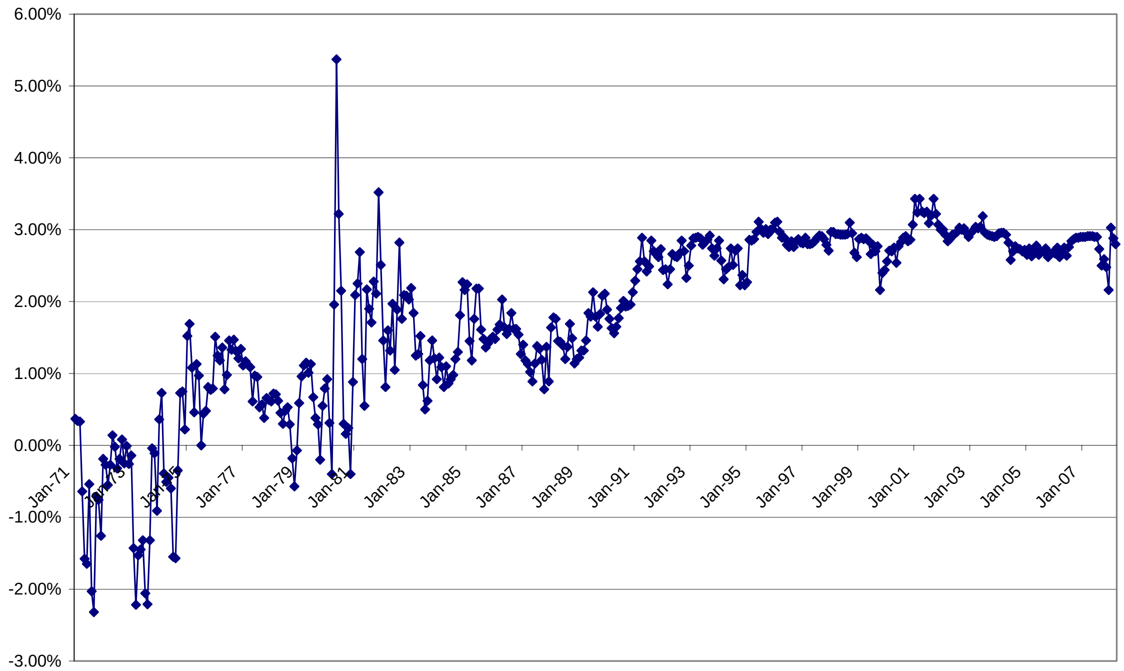
When there is an index mismatch, changes in the spread between the two indexes can affect the lender's profitability. The following chart shows how the spread between the Commercial Paper Rate and LIBOR index increased from 3 basis points in 2001-2005 to 12 basis points in 2006 and the first half of 2007 and then jumped to an average of 26 basis points and a peak of 41 basis points.[16] (The peak spread was 48 basis points in weekly data for December 7, 2007.)



The following chart shows that the spread between the Prime Lending Rate and the 3-month LIBOR index has been growing over time.

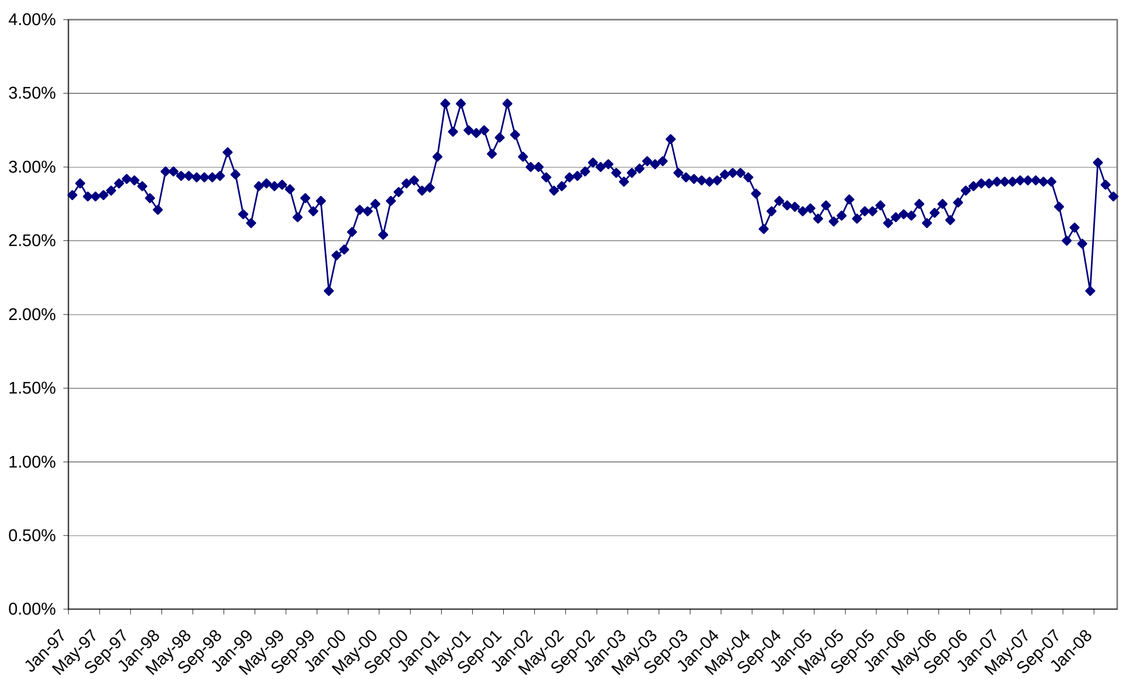
[16] The spread dropped to 16 basis points in March 2008 but was 35 basis points the week of April 4, 2008.

Spread PRIME over 3 Month LIBOR



However, the spread has been relatively stable over the past decade, as can be seen in the following enhanced detail on the data since January 1997.

Spread PRIME over 3 Month LIBOR (January 1997 to March 2008)



The credit crisis has caused the spread between the 3-month LIBOR index and the Prime Lending Rate to drop from the usual 2.91% to as low as 2.16%, a difference of 75 basis points.[17]

Several lenders have reacted by increasing the interest rates on their private student loans by 25 to 300 basis points, with an average increase of 0.86% in the rates charged to borrowers with bad or marginal credit and an average increase of 0.79% in the rates charged to borrowers with excellent credit. More of the increases have occurred on private student loans that are pegged to the Prime Lending Rate, and mostly on the interest rates offered to the prospective borrowers with the worst credit scores.[18] Banks are less likely to increase interest rates than non-bank lenders.

Finally, the College Cost Reduction and Access Act of 2007 cut for-profit lender subsidies[19] by 65 to 72 basis points and not-for-profit lender subsidies by 50 to 57 basis points.[20] (These cuts were used to pay for increases in the maximum Pell Grant, cuts to the interest rates on subsidized Stafford loans for undergraduate students, increases in the amount of money students can earn before it affects aid eligibility, the addition of a new grant program for students interested in teaching in national need areas, and the introduction of the income-based repayment plan and public service loan forgiveness.) In particular, the special allowance payments on Stafford loans were cut by 55 basis points and on PLUS loans by 85 basis points, yielding a special allowance payment of the 3-month Commercial Paper Rate plus 1.79% for both. The special allowance payments on consolidation loans were also cut by 55 basis points, yielding a net payment of the 3-month Commercial Paper Rate plus 1.04%. Consolidation loans have a 75 basis point tighter spread than Stafford and PLUS loans.

In effect, the education lenders have experienced margin compression at the top (cuts to the lender subsidies), bottom (increases in cost of funds) and middle (index mismatch). This makes it much more difficult for them to earn a profit. The following is a worst-case spread analysis for Stafford and PLUS loans originated after October 1, 2007 by a for-profit lender:

Gross Income:	3-month CP + 1.79%
Risk Sharing:	-0.05%
Lender-Paid Origination Fees:	-0.10%
<u>CP-LIBOR Mismatch:</u>	<u>LIBOR – 3-month CP - 0.40%</u>
Net Income:	LIBOR + 1.24%
<u>Cost of Funds:</u>	<u>LIBOR + 0.93%</u>
Spread:	0.51%

[17] The spread seems to have recovered recently, returning to 2.88% in February 2008.
[18] Less than 10% of borrowers get the best advertised rate on private student loans and more than 2/3 get the worst rates, so a lender can improve its average spread by increasing the worst interest rates while seeming to still offer a good deal by leaving the best rates unchanged.
[19] These consist primarily of cuts in the special allowance payments, increases in risk-sharing (decreases in the insurance percentage) and increases in lender-paid origination fees.
[20] See www.finaid.org/educators/2007subsidycuts.txt

From this 51 basis point spread the lenders must pay approximately 70 basis points of origination and servicing costs,[21] as well as "borrower benefits".[22] Not counting servicing costs, which are offset by servicing fees paid by the student loan trust, the net spread after deducting the other costs is approximately 16 basis points. While this is a worst-case and hopefully temporary scenario, it seems clear that Stafford and PLUS loans are now only marginally profitable for the for-profit lenders due to the combined impact of the credit crisis and the cuts in the lender subsidies.[23] Moreover, since margins on consolidation loans are 75 basis points tighter, it seems clear that consolidation loans are no longer profitable. (With further deterioration in lender cost of funds from 93 basis points in February 2008 to 144 basis points in March 2008, a 51 basis point increase, even new Stafford and PLUS loan originations are no longer profitable for lenders that depend on the capital markets as a source of funds.[24]) This has forced lenders to cut costs and discounts. For example, there have been more than 3,000 layoffs industry-wide and many lenders have cut the value of Stafford and PLUS loan discounts in half and eliminated consolidation loan discounts entirely. Some lenders have eliminated all discounts. Others are switching to more profitable private student loan programs. It is also potentially significant that there have been no securitizations of loans originated since October 1, 2007 as the margins in the current environment are too thin.[25]

The spread analysis example given above was for a for-profit lender. Not-for-profit lenders have an additional 15 basis points of spread. Yet even they are still experiencing problems, as discussed below. This underscores that the current crisis is first and foremost a liquidity crisis. Cost of capital and liquidity are intertwined. When a lender is unable to securitize its loan portfolio, it has to rely on higher cost credit warehousing facilities.[26] But the bottom line is that without liquidity a lender cannot make new loans regardless of the margins.

---

[21] The securitization prospectuses for Sallie Mae provide for a servicing fee of up to 50 basis points in the 2006-1 through 2007-8 securitizations and a servicing fee of up to 90 basis points in the 2008-1 through 2008-3 securitizations. The servicing fee switched in 2008 from a percentage of the outstanding principal to a unit basis of \$1.50 per month per borrower in the in-school period, \$2.75 per month per borrower in the grace period and \$3.25 per month per borrower in all other statuses (repayment, deferment, forbearance, etc.), with a monthly cap of 1/12th of 0.90% of the outstanding principal balance. Since servicing costs are approximately 35 basis points, it would appear that Sallie Mae's revenues have shifted somewhat from the spread to the servicing fees.

[22] The 70 basis point figure was provided to the Congressional Research Service by Sallie Mae.

[23] The cost of funds has been getting progressively worse. Sallie Mae's 2008-3 securitization at an average weighted margin of 93 basis points over LIBOR was in February 2008. Citibank's 2008-1securitization and Nelnet's 2008-2 securitization, both in March 2008, were at weighted average margins of 144 and 143 basis points over LIBOR, respectively.

[24] Some lenders can still obtain some net revenue from servicing the loans.

[25] The rating agencies require lenders to have some extra margin beyond the amounts paid to investors. This "credit enhancement" ensures that the lender will be able to continue making the interest payments on the securitizations and bonds even if market conditions change. Other credit enhancements besides excess interest include a third party guarantee against default by the underlying student loans and a reserve account. The securitizations may also be wrapped with a note guarantee insurance policy to ensure the timely payment of interest (i.e., guarantee against default by the issuing lender).

[26] There is a bit of a chicken-and-egg or maybe Gordian knot. Higher cost of capital yields thin margins that prevent securitizations which could have yielded a lower cost of capital. Unless there is a dramatic change the present situation is likely to be self-sustaining.

In addition to the previously described problems plaguing the student loan industry, there has also been an unprecedented complete collapse of the auction-rate securitization markets. With auction-rate securitization the interest rate is reset periodically (typically every 35 days) through investors buying and selling the existing securitizations. This makes a long-term obligation, such as a student loan or mortgage, act more like a short-term debt. This is attractive to businesses that are looking for a place to park their excess cash on a short-term basis. Unfortunately, a crisis of confidence in this particular type of instrument has caused almost all such auction-rate securitizations to fail recently. It is, in effect, a self-fulfilling prophecy: investors aren't investing in them because investors aren't investing in them, so there's no liquidity. Investors are universally trying to reduce their exposure to this form of investment. Moreover, when investors are unable to sell these securities, the interest rates switch to a default rate specified in the securitization prospectus, significantly increasing the cost to the lender (e.g., one lender saw its rates increase from 5% to 18%, resulting in hundreds of thousands of dollars of unanticipated costs). This has caused many lenders to try to refinance the debt to reduce costs, putting more pressure on already stressed capital markets. There is, after all, no guarantee that the problem won't persist at the next rate reset. In fact, it seems clear that the auction-rate securitization market is dead unless the government does something to jump-start it (highly unlikely).

The increased costs have lead to several of the nonprofit state loan agencies suspending loan programs or other benefits in order to conserve cash. There have been almost no new state student loan bond issues, so the states are spending down existing liquidity to make new loans. Several of the states have suspended their private student loan programs (e.g., Michigan's MI-LOAN and New Hampshire's LEAF) or loan discounts (e.g., Northstar Guarantee's T.H.E. Bonus) or consolidation loan program (e.g., Missouri, Indiana and Colorado) in order to conserve capital for the Stafford and PLUS loan programs. Five state loan agencies (Pennsylvania, Texas, Minnesota, Michigan and Massachusetts) have suspended their student loan programs entirely.

Relying on credit warehousing facilities is not a long-term solution, as these facilities are intended to provide short-term liquidity and the lenders providing the facilities will generally not increase the amount of available credit by much. Credit warehousing facilities need to be refinanced periodically. For example, Sallie Mae's recently closed $35 billion in credit warehousing facilities is a 364-day refinancing of their previous $30 billion in interim credit warehousing facilities from JPMorgan Chase and Bank of America. As such it does not provide much new lending liquidity.[27] The cost of the credit warehousing facilities is also high enough to preclude profitability if the non-bank lenders rely on them for too long.[28] The credit warehousing facilities are mainly a method

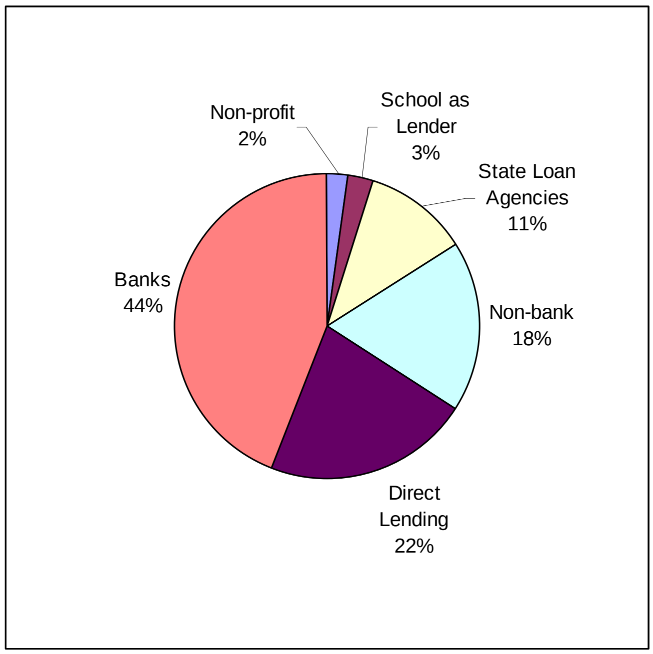
[27] Sallie Mae 8-K SEC filing dated 2/29/08. $23.4 billion of FFELP ABCP, $5.9 billion of private ABCP, $2.0 billion of secured FFELP, plus an additional $3.5 billion for ABCP and the potential of an additional $2.6 billion in FFELP ABCP and $100 million in private ABCP.

[28] The cost of funds under the new Sallie Mae facilities for FFELP loans is LIBOR + 0.68% and for private loans is LIBOR + 1.55%. When all fees are factored in the overall cost of funds will likely be about LIBOR + 2.00%.

of weathering the storm until the lenders are again able to tap into the asset-backed securitization market for a lower cost of capital.

If the situation continues without remedy for more than a year it could lead to a mass exit of all non-bank lenders and nonprofit state loan agencies from the federal education loan programs, without much forewarning. The private student loan programs offered by these lenders are also at risk. When these lenders run out of liquidity, they cannot make new loans.

Already, 65 lenders have suspended some or all of their federal education loan programs. These lenders previously originated 14% of FFELP Stafford and PLUS loan volume[29] and 76% of consolidation loan volume.[30] Nine of the top ten largest loan consolidators have suspended their participation in the consolidation loan program. In addition, 22 lenders have suspended their private student loan programs.



Non-bank lenders originate 17.9% of all federal education loans (excluding consolidation loans), state loan agencies originate 11.3% and other nonprofit lenders 2.3%.[31] Sallie Mae controls about two-thirds of non-bank loan origination volume and about ten percent of overall federal loan volume. If the non-bank lenders and state loan agencies are unable to originate new loans, there are other lenders available to replace them. Banks, in particular, are not as affected by the turmoil in the asset-backed securitization markets because they depend on customer deposits as a source of funds, not securitizations or credit warehousing facilities.[32] Banks originate 44.1% of all federal education loans. The Direct Loan

[29] These figures include lenders that are not in the Top 100 list for FY2006 and loan marketers that were not directly Title IV participants. The figures include more than $6.9 billion of Stafford and PLUS originations to more than 800,000 borrowers and more than $55.0 billion of consolidation loan volume to more than 1.6 million borrowers. So far 33 of the top 100 consolidators and 22 of the top 100 Stafford and PLUS originators have suspended participation in the loan programs.

[30] Borrowers who are unable to find a FFELP lender willing to consolidate their federal education loans can consolidate them with the Direct Loan program, loanconsolidation.ed.gov, even if their alma mater did not participate in the Direct Loan program.

[31] These figures are derived from a spreadsheet from the US Department of Education listing the Top 100 originating lenders for FY2006. These lenders originate 90.8% of all FFELP loans.

[32] Banks such as JPMorgan Chase and Bank of America are often the source of the credit warehousing facilities relied upon by the non-bank lenders. However, smaller banks rely on secondary markets as a source of liquidity instead of holding the loans until maturity. When the secondary markets have limited or eliminated their loan purchases and decreased the premiums they pay to acquire loans, this has had a

program is another potential source of funds, as it originates 21.8% of all federal education loans. School-as-Lender schools originate 2.6%.[33] Lenders that are most likely to be affected by the turmoil in the ABS and bond markets represent about a third (31.5%) of the federal student loan marketplace. These lenders tend to dominate the private student loan marketplace, which represents 20% of overall education loan volume. So at most half of all new education loan origination volume is potentially at risk of disruption.[34]

The banks see the withdrawal of non-bank lenders and state loan agencies as an opportunity to gain market share. However, there is a limit to their capacity and willingness to absorb loan volume on both a short-term and long-term basis.[35] (Some banks do not hold the loans until maturity and instead sell the loans to a secondary market shortly after origination. The shutdown of the secondary market has forced several medium and large-sized banks to leave the federal student loan program.) The Direct Loan program can also increase its loan volume to compensate when education lenders exit FFELP. Borrowers who are unable to consolidate their loans with a FFELP lender can obtain a Federal Direct Consolidation Loan from the Direct Loan program.[36] With more than two-thirds of consolidators no longer making consolidation loans, the Federal Direct Consolidation Loan program is likely to see a four-fold increase in loan volume as compared with last year, more than double the peak loan volume. To obtain a Stafford or PLUS loan from the Direct Loan program, however, the borrower's college must participate in the Direct Loan program. It is unclear whether the Direct Loan program can handle a five-fold increase in the number of Direct Loan schools and a six-fold increase in the number of borrowers, as the capacity limits have never been tested.[37] This has the

---

cascading impact on such lenders. For example, HSBC, TCF Bank and M&T Bank have all suspended their FFELP loan originations.

[33] School-as-Lender is in the process of being phased out and is not a practical source of liquidity, as the lenders are restricted to originating Stafford loans to graduate students only, and only at their schools. Most school-as-lender schools flip the loans shortly after full disbursement. The lender partners for 46 school-as-lender schools have suspended their purchases of these loans, forcing the schools to seek new partners.

[34] Many banks do not hold student loans to maturity but instead sell the loans on the secondary market. With the secondary market slashing premiums paid for student loans, 24 banks have suspended their participation in the federally-guaranteed education loan program. So potentially more than half of all education loan volume is at risk.

[35] The banks are likely to focus on the most profitable highest credit quality paper and not pursue loans from subprime borrowers or with thin margins. Like the non-bank lenders and state loan agencies, they are also likely to minimize lending at colleges with low graduation rates and high default rates. They already have significant exposure to student loan paper through the credit warehousing facilities they provide to non-bank lenders. They will not make new loans indiscriminately.

[36] See loanconsolidation.ed.gov

[37] The increase is unlikely to be that extreme, unless the leading Democratic presidential candidates are successful in eliminating the FFELP program, as even in a worst-case scenario there are likely to be 15 or more large lenders still participating. But it is not unreasonable to expect that total Direct Loan volume will increase by a factor of 2 to 3. With lenders representing three-quarters of FY06 FFELP consolidation loan volume suspending their participation in the consolidation loan program, the Direct Loan program is likely to see a four-fold increase in consolidation loan volume as compared with last year and more than double the previous peak.

potential to lead to a bit of turbulence should the Direct Loan program need to ramp up capacity.[38]

The lender-of-last resort program is another existing option for addressing liquidity issues. Sections 428(j) and 428(c)(1)(E) of the Higher Education Act allows guarantee agencies (or the lenders they designate) to make loans with a 100% guarantee with funds provided by the US Department of Education. The Department can also substitute different special allowance payments. While the Higher Education Act limits the lender-of-last-resort program to borrowers eligible for the subsidized Stafford loan, the regulations at 34 CFR 682.401(c)(2) expand this authority to include borrowers of unsubsidized Stafford and PLUS loans, without regard to whether the borrower qualifies for a subsidized Stafford loan. The lender-of-last-resort program, however, has never been tested and so there may be a bit of turbulence should the Department need to launch the program, especially if it has to implement it on short notice.[39]

But there are actually more serious problems that represent a clear and present danger to students and institutions of higher education. These involve increases in PLUS loan denial rates, lenders refusing to lend at some eligible institutions, and more stringent credit underwriting standards for private student loan programs.

The PLUS loan program involves a modest credit check that looks for the existence of an adverse credit history. One of the components of an adverse credit history is a foreclosure in the last five years. To the extent that the subprime mortgage credit crisis was precipitated by an increase in foreclosure rates, it is reasonable to expect an increase in PLUS loan denial rates for the 2008-09 education loan season.[40] [41] The regulations at 34 CFR 682.201(c)(2)(iii) allow lenders to establish "more restrictive credit standards" for the PLUS loan program. While it is unclear whether lenders have already implemented stricter credit underwriting for the PLUS loan program, such as FICO score thresholds, it is apparent that many lenders are no longer exercising their authority under 34 CFR 682.201(c)(2)(ii) to approve a PLUS loan despite an adverse credit history when extenuating circumstances exist.

When the parent of a dependent undergraduate student is denied a Parent PLUS loan, the student becomes eligible for increased unsubsidized Stafford loan limits. The additional

---

[38] There were problems in the early days of the Direct Loan program. However, the Direct Loan program handled the doubling of consolidation loan volume in 2005, when borrowers could lock in rates as low as 2.88%, without significant problems. Yet the potential increase in direct loan volume is much greater now.

[39] While both the Direct Loan program and lender-of-last-resort provide viable albeit untested emergency solutions, both are reactive solutions that would require waiting until a failure had already occurred. A better approach is to proactively inject liquidity into the FFELP loan programs.

[40] Since borrowers typically obtain their PLUS loan approvals at or before the start of the academic year, and those approvals are good through the end of the academic year, one would not expect to see an increase in PLUS loan denials until the start of the 2008-09 academic year.

[41] PLUS loans are obtained by approximately 10% of federal education loan borrowers, not including consolidation loans, and represent 17% of federal education loan volume, not including consolidation loans. Assuming a 50% increase in PLUS loan denials (not unreasonable based on RealtyTrac foreclosure and repossession rate data) and a current 20% PLUS loan denial rate would yield a 30% PLUS loan denial rate. Combined this suggests that approximately 1% of federal education loan borrowers will be affected.

loan eligibility includes an additional $4,000 per year during the freshman and sophomore years and an additional $5,000 per year during the junior and senior years. This falls short of the average $11,000 PLUS loan.[42] Graduate and professional students who borrow from the Grad PLUS loan do not have this safety net if they are denied a PLUS loan. Since PLUS loan borrowers represent approximately 10% of federal loan borrowers and most will still be approved, only a few percent of borrowers – 80,000 to 100,000 students – are likely to be affected by an increase in PLUS loan denials. Prospective borrowers with a foreclosure, however, are unlikely to be able to obtain a private student loan or a home equity line of credit and so may be forced to rely on credit cards or drop out of college.

Some lenders have decided to stop making federal and private education loans at certain types of institutions, such as for-profit and community colleges. Others have adopted limits on cohort default rates that are tighter than those established by Congress. For example, while the Higher Education Act specifies that colleges become ineligible for federal education loans when their cohort default rate exceeds 40% in a single year or 25% for three years in a row, at least one lender has adopted a lower 10% threshold. While other lenders will likely take over for the withdrawal of this lender, there is the potential that students at an eligible institution will be denied access to federal student loans.

Such actions are not precluded under the current anti-discrimination rules as encoded in the Higher Education Act in sections 421(a)(2), 428C(b), 438(c), 439(e) and 440A and the regulations at 34 CFR 682.404(h) and 34 CFR 682.800.[43] Specifically, prohibitions on discriminating based on the borrower's income, attendance at a particular eligible institution or length of the borrower's educational program only apply to Sallie Mae, the guarantee agencies, and 9.5% floor income lenders. In addition there is a ban on discrimination for consolidation loans based on the "type or category of institution of higher education that the borrower attended". There is no language in the statute or regulations that precludes other lenders from discriminating against students at eligible schools based on income, default rates, graduation rates or credit scores, for example. Likewise there is nothing to preclude any lender, including Sallie Mae, from discriminating in its marketing practices (e.g., by asking a school to not include the lender in its preferred lender list).

Lenders have also been tightening their credit underwriting criteria for private student loans. Because they are unlikely to be able to securitize loans made to subprime borrowers in the future, many lenders have been eliminating all of their subprime exposure. For example, on January 18, 2008, Sallie Mae sent a letter to several for-profit colleges, including Corinthian, Career Education, ITT Educational Services, DeVry, Education Management Corporation and Lincoln Educational Services, informing them that it would be ending its recourse loan programs effective March 1, 2008. While some

[42] According to the President's FY2009 budget baseline spreadsheets the average PLUS loan in 2008-09 will be $11,118 (DL and FFEL) and $11,309 (FFEL only). Aggregate PLUS loan borrowing is about double annual PLUS loan borrowing, as is discussed below.
[43] See www.finaid.org/loans/discrimination.phtml

of these colleges announced that other lenders would be replacing Sallie Mae, loan approval rates have apparently decreased significantly. It also appears that other lenders have increased their credit score thresholds to 650 or even 680 or 700 while not publicly announcing this change to their credit underwriting criteria. At least 10% of private student loan borrowers will be affected by the more stringent credit underwriting criteria.[44] Not all of them will be able to find creditworthy cosigners, so it is likely that a percent or two of borrowers – hundreds of thousands of students – will not be able to obtain a private student loan.

The reduced availability of private student loans is not going to be limited to for-profit colleges. According to the 2003-04 National Postsecondary Student Aid Study (NPSAS), for-profit colleges account for 20% of undergraduate[45] private student loan borrowers, while 2-year colleges account for 15%, 4-year public for 32% and 4-year private non-profit for 32%. The NPSAS data does not include credit scores, so it is not possible to assess how many subprime borrowers attend each type of institution. However, a reasonable proxy is to limit the data to low income families, since credit scores tend to correlate with income. When the NPSAS data is limited to families with adjusted gross income (AGI) less than $50,000, for-profit colleges account for 29% of private student loan volume, 2-year colleges for 18%, 4-year public colleges for 26% and 4-year private non-profit colleges for 27%. So the impact of tighter credit underwriting standards will likely be well distributed among all types of colleges, albeit a little more concentrated at for-profit colleges and other colleges that serve low and moderate income students.

Unfortunately, cutbacks in private student loan eligibility represent an access problem. The fast growth of private student loan volume, now 20% of overall education loan volume, has been driven by several limitations and flaws in the federal education loan programs:

- Aggregate Stafford loan limits have remained unchanged since 1992. Congress is unwilling to increase these limits because of the high cost of the subsidized Stafford loan program. Some public policy advocates have argued that increasing federal student aid leads to increased college costs. However, college costs have increased despite the stagnant loan limits and despite four years of no increases in the maximum Pell Grant. When the federal government abdicates its vitally important role in ensuring access to higher education, it makes it more difficult for students to pay for college.

- More students are reaching the maximum annual and aggregate Stafford loan limits[46] and are unwilling[47] or unable to use the PLUS loan program.[48]

[44] This 10% to 11% figure assumes that lenders raise the FICO score thresholds from 620 to 650. If they raise the threshold to 680, then 24% to 29% of private student loan borrowers will be affected. If they increase the threshold to 700, then 41% to 46% of private student loan borrowers will be affected.
[45] Considering the data for graduate students is not likely to be meaningful because the Grad PLUS loan was introduced on July 1, 2006, shifting most private student loan volume by graduate and professional students to the federal education loan programs.
[46] The cost of attendance at many colleges exceeds the sum of the maximum Pell Grant and the maximum Stafford loan available to dependent and independent students. Based on the 2003-2004 NPSAS, 62.2% of

- Approximately 20% of PLUS loan applicants have an adverse credit history and so are ineligible. This denial rate will increase in 2008-09.
- Independent students are not eligible for the PLUS loan program.
- The Parent PLUS loan program does not provide an in-school deferment when the student is in school, only when the parent is enrolled in college. Although some lenders have used administrative forbearances to provide the equivalent of an in-school deferment, this option is not available to most borrowers.
- The Parent PLUS loan is a parent obligation, not a student obligation. Even if they must cosign a private student loan, at least the student is also obligated to repay the debt.

- Students who are not making Satisfactory Academic Program (e.g., a 2.0 or better GPA) are ineligible for federal student aid and must rely on private student loans while they try to improve their grades.

The shift from federal to private loans makes it more difficult for low and middle income families to pay for college because private student loans are focused on profitability, not access. Low and middle income families are more likely to have bad credit or no credit. While some people may not think of financing as a form of student aid because it has to be repaid (and is not as effective as the Pell Grant program), it nevertheless provides critical cash-flow assistance. Few parents can afford to write a check for the full amount of their out-of-pocket college costs.

THE SOLUTIONS

There are several possible solutions to the student loan credit crunch which may be employed individually or in combination:

4-year undergraduate Stafford borrowers are borrowing the maximum amount of Stafford loan eligibility available to them (68.9% among borrowers who did not receive the Pell Grant). This is a 6.1% increase compared with the 56.1% figure from the 1999-2000 NPSAS. These percentages include the additional unsubsidized Stafford loan limits available to independent students and to dependent students whose parents were denied a PLUS loan. The figures vary by year in school, with 73.0% of freshmen, 69.3% of sophomores, 58.0% of juniors and 52.1% of seniors borrowing to the limit. (The corresponding 1999-2000 figures are 71.3%, 63.9%, 51.3% and 43.4%.) It is reasonable to assume that more than two-thirds of 4-year undergraduate Stafford borrowers are currently borrowing to the limit, and more than three-quarters of 4-year undergraduate Stafford borrowers who do not qualify for the Pell Grant.

[47] Additional reasons why some families prefer private loans over the PLUS loan can be seen at www.finaid.org/loans/loantradeoffs.phtml.

[48] Based on the 2003-04 NPSAS, 91.1% of undergraduate student private loan borrowers do not borrow from the PLUS loan program and 22.7% do not borrow from the Stafford loan program. Of undergraduate private loan borrowers who do not borrow from the Stafford loan program, 5.6% are international students, 10% have a GPA less than 2.0, 10.5% are using credit cards to pay tuition, 37.8% are independent, 16% are getting no help from their parents and 12.0% have parents who are divorced or separated. Of undergraduate private loan borrowers who do not borrow from the PLUS loan program, 1.4% are international students, 8.1% have a GPA less than 2.0, 8.2% are using credit cards to pay tuition, 36.7% are independent, 16.6% are getting no help from their parents and 13.1% have parents who are divorced or separated. These categories may overlap and do not total to 100%.

- Increase annual and aggregate unsubsidized Stafford loan limits.
- Establish an Undergrad PLUS loan similar to the Grad PLUS loan which would allow undergraduate students to borrow from the PLUS loan program with or without parental involvement.
- Offer a reverse loan auction in which the US Treasury would invest in student loan securitizations, providing education lenders with sufficient liquidity to make new loans.
- Switch the special allowance payments from the Commercial Paper Rate to the LIBOR index (in a cost-neutral fashion) to eliminate the index mismatch.
- Improve the US Department of Education's monitoring of the viability of FFELP.

These are all proactive solutions that are intended to avert a potential student loan credit crisis. In contrast, the existing tools – increasing Direct Loan origination volume and initiating the Lender-of-Last-Resort program – are both reactive solutions which will be implemented only after a crisis has already occurred and is apparent and so may involve a delay. As a result, reactive solutions will necessarily entail tolerating some disruption.

Increase Unsubsidized Stafford Loan Limits

As noted previously, Congress has been reluctant to increase Stafford loan limits because of the high cost of the subsidized Stafford loan program. Increasing the annual and aggregate loan limits for just the unsubsidized Stafford loan program could be accomplished under PAYGO rules at no cost to the government.[49] In fact, it would yield additional revenue to the federal government, as much as an additional $500 million a year. That would be enough for a $125 increase in the maximum Pell Grant, reducing student debt slightly. It would also save students money by shifting their borrowing from high cost private student loans to the lower cost federal student loans. (Federal student loans also have more flexible repayment options than private student loans and better protections for borrowers who encounter unfortunate events such as death, disability or school closures.) This proposal would also increase access to higher education since the government loans have less stringent eligibility requirements than private student loans, since private student loans are focused more on profit than the public good.

The following table is based on the subsidy costs for the federal education loans as published on page 364 of the Department of Education Appendix to the President's FY2009 budget:

Subsidy Rate	FFELP	Direct Loans	Weighted Average
Subsidized Stafford	16.67%	10.80%	15.46%
Unsubsidized Stafford	-3.07%	-9.97%	-4.34%
PLUS	-5.94%	-11.75%	-7.24%

[49] This could be accomplished by increasing the additional unsubsidized Stafford loan limits for independent students and undergraduate students whose parents were denied a PLUS loan. Alternately, Congress could increase the unsubsidized Stafford loan limits for all students.

A positive subsidy rate costs the government money. For example, the 16.67% subsidy rate for the subsidized Stafford loan in the FFEL program means that for every dollar the lent by a FFELP lender as a subsidized Stafford loan, it costs the government almost 17 cents. On the other hand, the table demonstrates that there is a negative subsidy rate in both the FFEL and Direct Loan programs for unsubsidized Stafford loans and PLUS loans. This means that increasing loan limits in these programs would probably save the government money. The increased loan limits would not yield increased default rates,[50] as it would mainly be shifting borrowing from private student loans and credit cards to federal education loans and not increasing aggregate debt or over-borrowing.[51]

The increases in the additional unsubsidized Stafford loan limits should be set at a level sufficient to replace most PLUS loan borrowing, either cost of attendance minus other aid received or a fixed set of annual and aggregate loan limits.

Based on the 2003-04 NPSAS, average annual PLUS loan borrowing was $9,019[52] and the average aggregate for graduating seniors was $16,217. Annual borrowing at the 90th percentile was $17,000 ($11,690 at the 75th percentile) and aggregate borrowing for graduating seniors at the 90th percentile was $36,359 ($19,750 at the 75th percentile). PLUS loan borrowing has increased 25% in the past four years, so current totals are likely much higher. While the average aggregate PLUS loan for graduating seniors falls within the $23,000 limit on additional unsubsidized Stafford loan eligibility for independent students and dependent students whose parents were denied a Parent PLUS loan, the need in any given year may exceed the current annual limits. Moreover, the PLUS loan totals given above are averages; it is likely that more than a quarter of borrowers need to borrow more than the $23,000 limit on additional unsubsidized Stafford loans. These figures also predate the introduction of the Grad PLUS loan on July 1, 2007 and so do not reflect the experience of graduate and professional students who do not receive increased Stafford loan limits if denied a PLUS loan.

[50] According to the President's FY2007 budget, FY2005 PLUS loan default rates were 5.41% in FFEL and 5.50% in DL. According to the President's FY2008 budget, FY2006 PLUS loan default rates were 5.20% and 5.49%, respectively. According to the President's FY2009 budget, FY2007 PLUS loan default rates were 4.51% and 5.59%, respectively. Therefore the introduction of the Grad PLUS loan program on July 1, 2006 does not appear to have significantly affected the projected life-of-loan default rates for the PLUS loan program.

[51] The opportunity for over-borrowing could be limited by expanding the authority of college financial aid administrators to limit borrowing by their students.

[52] The average is slightly higher at $9,319 for undergraduate students at 4-year colleges. The average PLUS loan broken down by year in school was similar, with $9,640 for freshmen, $9,488 for sophomores, $9,366 for juniors, $8,234 for seniors, and $7,763 for fifth year undergraduate students. However, the percentage borrowing showed a monotonic decrease with increasing year in school, with percentages of 9.4%, 6.5%, 4.8%, 3.3% and 2.4%, respectively. This is likely due in part to the front-loading of grants and lower Stafford loan limits for freshmen and sophomores.

Establish an Undergrad PLUS Loan

This is the same as the proposal Leo Kornfeld and Mark Kantrowitz published in the Chronicle of Higher Education in early 2007.[53] That proposal would allow undergraduate students to borrow from the PLUS loan program on their own without parental involvement by inserting "undergraduate student or" before every mention of "parent of an undergraduate student" in the sections of the Higher Education Act that involve the PLUS loan program.

The main flaw with this proposal is that the undergraduate student borrowers would still be subject to the adverse credit history restriction. This would disqualify many from the PLUS loan, leaving them with the same need for additional financing. It also doesn't address the lack of a safety net for graduate and professional students who are denied a Grad PLUS loan. For these reasons the proposal to increase unsubsidized Stafford loan limits would be more effective.[54] However, allowing undergraduate students to borrow from the PLUS loan program would likely save the government up to $1 billion a year, enough for a $250 increase in the maximum Pell Grant.[55]

The shift in student borrowing from private loans to federal loans may negatively impact for-profit colleges by making it more difficult for them to satisfy the requirements of the 90-10 rule.[56] On the other hand, the 90-10 rule will prevent for-profit institutions from raising tuition to match the new loan limits.[57]

Reverse Student Loan Auction and Other Approaches to Injecting Liquidity

Increasing unsubsidized Stafford loan limits and establishing an Undergrad PLUS loan would shift borrowing from private loans to federal loans without addressing the underlying lack of liquidity. For this reason it is important that this proposal be coupled with a proposal for injecting liquidity into FFELP.

The following proposal for a reverse loan auction would not only save the government money, but also address the liquidity issues associated with the turmoil in the asset-backed securitization market. It is based on a proposal posted by Mark Kantrowitz to the FINAID-L mailing list on January 22, 2008.

---

[53] Leo Kornfeld and Mark Kantrowitz, A New 'Independence Day' for Student Financial Aid, Chronicle of Higher Education, 53(23):B11, February 9, 2007.
http://chronicle.com/weekly/v53/i23/23b01101.htm

[54] One could pair the two proposals together, providing an Undergrad PLUS and increased unsubsidized Stafford loan limits for students who are denied a PLUS loan.

[55] One possibility would be to establish an Undergrad PLUS loan open to all eligible students, but restrict the increased unsubsidized Stafford loan limits to just those students denied access to the PLUS loan program.

[56] The 90-10 rule requires proprietary institutions to obtain at least 10 percent of their revenue from sources other than federal student aid. See section 102(b)(1)(F) of the Higher Education Act.

[57] Congress could address this also by choosing to limit the availability of the increased loan limits at for-profit colleges to just those colleges that limit tuition increases to less than the average tuition increase (both amount and rate of increase) at non-profit colleges.

Instead of cutting costs by reducing lender spread at the top end by accepting bids for a lower special allowance payment, as has been proposed for the Parent PLUS loan rights auction, the federal government should conduct a reverse auction for US Treasury investment in the securitizations of federally-guaranteed student loans. Lenders would bid on the highest cost of capital they would be willing to accept in exchange for the liquidity they need. Since the US Treasury would be providing a limited amount of liquidity (e.g., $20 billion), the lenders would have an incentive to bid higher in order to ensure that they obtained the capital they needed. The US Treasury investment would be allocated in descending order of the cost of capital bids. The premium to be paid would be set in advance by a formula weighted according to the proportion of each credit tranche in the securitization.[58] The lenders would bid the interest rates they would be willing to pay for each tranche, subject to certain minimum bids. The federal government would earn the spread between US treasuries and LIBOR plus the bid margin, helping to defray the cost of the FFELP program and further narrowing the differential between the FFEL and Direct Loan subsidy rates.[59] In the event of a default by the lender, the federal government's investment would be secured by the student loan assets, and the servicing of those loans could be transferred to the Direct Loan program. This proposal would not only directly inject liquidity into the student loan market, but also provide a vote of confidence in FFELP securitizations that might jump start the student loan ABS market by increasing demand to match supply.

This proposal is similar to proposals to allow education lenders to borrow from the Federal Home Loan Bank or the Federal Financing Bank or to use student loans as collateral for US Treasuries borrowed from the federal government, since in all of these proposals the government would be investing in securities or bonds backed by student loan assets. However, the reverse auction proposal is superior because it would allow the federal government to receive a higher return on investment. It likewise provides a superior return on investment than the lender-of-last-resort program. The reverse loan auction proposal provides liquidity that the lenders would have to earn, not a handout. It would also be a temporary fix and not a permanent change.[60]

Other possible ideas for providing liquidity to the federal loan programs include:

- Allowing the Direct Loan program to act as a secondary market, buying loans from FFELP lenders at a premium somewhere between the subsidy costs of the

[58] Alternately, the reverse loan auction could be limited to highly rated student loan securities.
[59] If Congress were to switch the index on special allowance payments from the Commercial Paper Rate to LIBOR in a cost-neutral fashion, the government's savings from this proposal would be more predictable, since securitizations are pegged to LIBOR.
[60] If education lenders had access to an unlimited supply of low cost capital through the Federal Home Loan Bank or Federal Financing Bank, they would abandon securitization and bond issues as a source of low cost capital. Such a proposal would have to involve either a time limit or set a cost of capital high enough that lenders would eventually switch back to the capital markets when the cost of funds returned to levels close to those in effect before the onset of the subprime credit crisis. Allowing non-bank lenders and nonprofit state loan agencies to borrow from the Federal Home Loan Bank or Federal Financing Bank would require legislative changes that would likely be opposed by banks.

FFELP and Direct Loan programs.

- Establishing a program of federal government insurance of municipal bonds, similar to the way in which the FDIC insures bank deposits.[61] This would benefit some state loan agencies by allowing their bond issues to proceed despite the downgrades of their bond insurers.

- Entering into standby loan purchase agreements in which the government would agree to buy the loans (as opposed to the securitizations) if investors were unable to refund the loans. Such letters of credit would be particularly helpful to lenders who are trying to refinance auction rate securitizations into variable rate demand obligations. Such agreements are unlikely to ever be executed, so this could potentially be implemented at no cost to the government, but would provide investors with additional confidence in these financial instruments.

The Direct Loan and Lender-of-Last-Resort Programs

Other approaches to ensuring that federal education loans remain available to students include:

- Retooling the Direct Loan program to permit it to make loans directly to students without requiring the college to formally join the Direct Loan program. This could be implemented through the use of an "alternative originator" as specified in the regulations at 34 CFR 685.102(b) and in sections 451(a), 452(a)(2), 453(a) and 456(b) of the Higher Education Act.

- Streamlining the application process for a school to join the Direct Loan program if the school previously participated in the FFEL program.

- Conducting a quarterly end-to-end realistic test of the lender-of-last-resort program to prevent any teething problems.

Eliminate the Index Rate Mismatch

This proposal would switch the special allowance payments from the Commercial Paper Rate to the LIBOR index in a cost neutral fashion.[62] Historically, the Commercial Paper Rate and LIBOR index have been in sync, only a few basis points apart. It is only recently that the two indexes have diverged. Switching the index for the special allowance payments to the LIBOR index would yield a more predictable spread for lenders who rely on securitization, bond issues and credit warehousing facilities as a

---

[61] The insurance would insure the payment of interest on the bonds against default by the issuer, not the student loan assets against default by the borrower. The federal government already insures federal student loans against borrower default.
[62] The average spread between the 3-month LIBOR index and the 3-month Commercial Paper Rate from January 1997 to July 2007 was 7 basis points. So instead of paying lenders the Commercial Paper Rate plus 1.79%, this proposal would pay LIBOR + 1.72%.

source of funds. Eliminating the risk associated with an index rate mismatch would make these loans more attractive to investors.

Monitor FFELP Viability[63]

The US Department of Education does not currently have any tools it can use to monitor the health of the FFEL program. For example, the Department learns about lenders leaving FFELP the same way the general public does, by reading about it in the newspaper. Congress should consider establishing a requirement that education lenders notify the US Department of Education and affected colleges in advance of the lender's unilateral reduction, suspension or termination of secondary market activities or of origination or disbursement activities involving one or more FFELP loan programs at one or more colleges. Ideally the lender should provide at least one month's notice, to give the colleges time to transition their students to other lenders, but this might not always be possible.

In the meantime, the US Department of Education could use the National Student Loan Data System (NSLDS) to monitor the number of active participants in the FFEL program. For example, it should be possible to calculate the number of lenders originating more than $1 million in Stafford and PLUS loan volume for each month in the last 5 years. One could then calculate year-over-year increases and decreases in the counts to adjust for seasonality. The US Department of Education could also use NSLDS data to identify which lenders are increasing their holdings from lenders that routinely sell their loan portfolios to secondary markets.

Advice for Prospective Borrowers

In the meantime here are a few suggestions for families who are concerned about their ability to obtain financing to pay for a college education.

1. Minimize debt. If you will be borrowing more than your expected starting salary, consider choosing a less expensive college. Live like a student while you are in school so you don't have to live like a student after you graduate.
2. Borrow federal first. Federal education loans are less expensive, more available, and have better terms. The unsubsidized Stafford loan and the PLUS loan are not based on financial need.
3. If you are having trouble finding a lender to consolidate your federal student loans, use the Federal Direct Consolidation Loan Program at loanconsolidation.ed.gov.
4. Wait until July 1, 2008 to consolidate variable rate Stafford and PLUS loans, as the interest rates will drop by about 3% then.
5. If your parents are denied a PLUS loan, talk to your school's financial aid office about getting increased unsubsidized Stafford loan limits.

[63] Added 3/23/2008.

6. When applying for a private student loan, apply with a creditworthy consigner. Not only does this increase the chances you'll be approved for the loan, but it also decreases the cost of the loan.
7. Focus on private loans that are pegged to the LIBOR index. Loans that are pegged to the Prime Lending Rate will be more expensive in the long term, all else being equal, as the spread between PRIME and LIBOR will grow wider over time.
8. Pay at least the interest that accrues during the in-school period. This will reduce the cost of the loan by avoiding the capitalization of interest. Some lenders offer lower fees for borrowers who pay the interest instead of deferring it.
9. Remember, the unsubsidized Stafford and PLUS loans are available to all students, even those who do not have financial need.
10. Banks are more likely to provide better discounts and lower interest rates and fees than non-bank lenders.
11. Talk to your school’s financial aid administrator if you have any concerns.
12. Submit the Free Application for Federal Student Aid (FAFSA) at www.fafsa.ed.gov and search for scholarships for free at www.fastweb.com.