



# NEW AMERICA FOUNDATION FEDERAL EDUCATION BUDGET PROJECT

## STUDENT LOAN PURCHASE PROGRAMS UNDER THE ENSURING CONTINUED ACCESS TO STUDENT LOANS ACT

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In May of 2008, Congress passed the Ensuring Continued Access to Student Loans Act (ECASLA) in response to concern that credit market conditions could disrupt federal student loan availability. The law gives the U.S. Department of Education temporary authority to purchase federally backed student loans made by private lenders, effectively providing a secondary market for the loans. Congress opted to leave the new purchase authority largely undefined in statute, giving the Department considerable discretion to design and administer it. To date, the Department has created four separate loan purchase arrangements under ECASLA: a put option; a short-term purchase program; a financing arrangement; and an asset-backed commercial paper support program. This issue brief provides a detailed description of these arrangements and will be updated as new information becomes available.

### Background

The Federal Family Education Loan (FFEL) program provides federal subsidies to private lenders that make loans to students enrolled in postsecondary education.<sup>1</sup> In 2007, FFEL lenders provided nearly 75 percent of federal student loans. Lenders must finance FFEL loans with funds raised in private capital markets. These markets were severely disrupted in 2008, inhibiting private lenders' ability to raise sufficient and affordable capital. Federal policymakers and the wider financial aid industry confronted the possibility that FFEL lenders, absent any Congressional action, would not be able to make loans for the 2008-09 academic year.

The Direct Loan program could theoretically have met loan demand not covered by FFEL. The program provides loans at nearly identical borrower terms as the FFEL program directly from the U.S. Treasury. As credit market problems

unfolded in 2008, however, policymakers feared the Direct Loan program could not smoothly handle a rapid increase in loan volume.<sup>2</sup> At the same time, some policymakers favored the continued use of private entities via the FFEL program over an expansion of the Direct Loan program.<sup>3</sup> Consensus suggested that FFEL lenders needed assistance to ensure the availability of federal loans for all students. In response, Congress passed and the President signed into law the Ensuring Continued Access to Student Loans Act (ECASLA) in May of 2008.<sup>4</sup>

Among other things, ECASLA grants the Department of Education the authority to purchase FFEL loans from lenders. This ensures lenders have adequate and affordable capital to make loans and can convert their loan assets into cash if necessary. Establishing the Department as a guaranteed loan buyer can give investors more confidence, thereby making it easier for lenders to raise capital. Additionally, lenders can use loan sale proceeds to issue new FFEL loans. The loan purchase authority was originally set to expire on July 1, 2009, but was extended for an additional year by legislation enacted in October 2008.<sup>5</sup>

The new loan purchase authority is largely undefined in law, and establishes only a few broad implementation requirements. For example, it limits the purchase authority to loans originated between October 2003 and July 2010, and requires the Department of Education (in consultation with the Office of Management and Budget and the U.S. Treasury) to establish the price at which loans will be purchased. The price cannot result in new costs to the federal government and the agencies must publish a statement outlining the methodology and factors used to establish purchase prices.<sup>6</sup> The law also requires lenders

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# U.S. Department of Education Loan Purchase Programs

## The Ensuring Continued Access to Student Loans Act of 2008

Loan Purchase Program	Effective Dates	Eligible Loans (Academic Year Issued)*	Purchase Price Paid by ED Dept.	Requirements
Purchase Commitment (“Put Option”)	5/21/08 to 9/30/10	2008-09 and 2009-10	100 percent of unpaid principal and accrued interest, plus \$75 fee; 1 percent lender origination fee reimbursed	Loan sale includes all individual borrower’s loans
Short-Term Purchase Program	12/01/08 to 2/28/09 †	2007-08	97 percent of unpaid principal and accrued interest	\$3,000 minimum average loan balance within loan package sold; \$500 million maximum aggregate weekly ED Dept. purchase
Loan Financing - Participation Interest Program	5/21/08 to 9/30/10	2008-09 and 2009-10	100 percent of principal	\$50 million minimum lender-sponsored loan pools; Lender pays ED Dept. 3-month commercial paper interest rate, plus 0.5 percent
Asset-Backed Commercial Paper Conduit	2/28/09 to 9/30/10	2003-04 to 2010-11	Not yet determined	Not yet determined

\* Applies to Stafford, Grad and Parent PLUS loans; Consolidation loans are excluded from all programs

† Expires 2/28/09 or when commercial paper conduit is operational, whichever is sooner

*Source: Department of Education*

participating in a purchase program to continue making new FFEL loans. The Department of Education has used its purchase authority under ECASLA to implement four different arrangements that apply to Stafford and PLUS loans, not consolidation loans. Each arrangement is discussed below.

### Purchase Commitment (“Put Option”)

The Department announced in May 2008 that it would implement a purchase commitment program giving lenders the option to sell FFEL loans issued for the 2008-09 academic year. This option will expire on September 30, 2009.<sup>7</sup> (Under the extension of the law, lenders have until

September 30, 2010 to sell loans made for the 2009-10 year.) The arrangement is a “put option” because it allows, but does not require, lenders to “put” (sell) loans to the Department by a certain date at a predetermined price. For example, a lender that made a FFEL loan in August 2008 may sell it to the Department at any point until September 30, 2009. Alternatively, the lender may let the option expire on that date and continue to hold the loan. When selling 2008-09 or 2009-10 loans via the put option, a lender must sell all loans it holds for a particular borrower for those years.

Under the put option, the Department will pay lenders the face value of the loan (unpaid principal and accrued,

unpaid interest), plus a \$75 fee to cover lenders' origination, servicing, and loan sale costs. Lenders are also reimbursed for the 1 percent origination fee paid to the Department when the loan was made. The Department used information from lenders and loan servicers to set the fee, determining that it costs small lenders \$75, and large lenders \$20 to \$30, to originate a loan. They also estimated that selling a loan to the Department costs lenders an additional \$20 to \$50.<sup>8</sup>

The option to sell loans applies only to loans issued for the 2008-09 and 2009-10 academic years. This limitation may exist to guard against "cherry picking," whereby lenders sell the worst performing or lowest balance loans to the Department.<sup>9</sup> Similarly, the program requires lenders to sell all 2008-09 or 2009-10 loans for a particular borrower, further discouraging lenders from selling only poorly performing or small loans.

Loans sold via the put option will be serviced by private contractors hired by the Department. As of November 2008, two lenders had exercised the put option, selling \$62 million in loans (about 1 percent of 2008-09 issuance at the time).<sup>10</sup> The Department expects the volume of loans sold to increase once final 2008-2009 loan disbursements are made in January 2009.

### Short-Term Purchase Program

In November 2008, the Department announced an additional loan purchase program to begin December in 2008 and continue until February 28, 2009.<sup>11</sup> This short-term purchase program differs from the put option program because it applies to academic year 2007-08 loans (instead of 2008-09 and 2009-10) and limits weekly loan sales to \$500 million (the put option program has no limit). If lenders in aggregate attempt to sell more than \$500 million in loans in a given week, the Department will apportion its purchase of each lender's loans based on that lender's share of total 2007-08 academic year loan volume. Average loan value within any package of loans a lender wishes to sell must be at least \$3,000. This provision prohibits lenders from selling only their smallest (and therefore, least profitable) loans.<sup>12</sup>

The Department will pay lenders 97 percent of outstanding principal (including accrued but unpaid interest) for each sold loan. This figure matches the default guarantee rate the government already provides on FFEL loans. This

price is less favorable than the 100 percent of outstanding principal and interest paid under the put option program. Furthermore, the short-term purchase program does not include a \$75 fee to cover origination and administrative costs. The program, however, applies to earlier issued loans (2007-08), giving lenders the opportunity to raise cash from loans not eligible for the put option. According to the Department, the program helps lenders raise funds for 2008-09 academic year second semester loan disbursements. At this time, the Department has not published any information on the number of loans purchased or lenders participating in this program.

### Loan Financing Arrangement - Participation Interest Program

The participation interest program was announced in May 2008, in conjunction with the put option program. It allows lenders to secure temporary financing from the federal government for loans issued in academic years 2008-09 and 2009-10. Effectively, the Department lends federal money to FFEL lenders through a third-party custodian that agrees to hold the loans in trust while the program is in effect. First, lenders make FFEL loans to borrowers, which are then temporarily sold to a bank that has agreed to act as a custodian. The Department of Education then purchases a 100 percent ownership interest in the loan principal held by the custodian. The lenders continue to service the loans and can make new loans with the proceeds from the sale.

The Department charges lenders a quarterly interest rate (3-month commercial paper, plus 0.50 percent) under the financing arrangement. The Department believes this interest rate is low enough to offer most lenders "sufficient opportunity" to continue making FFEL loans. Nevertheless, the agency recognizes that it is difficult to select one appropriate rate because smaller lenders are less efficient than larger ones and may not be able to profitably make loans at a high rate.<sup>13</sup>

Loans financed through the participation interest program are still backed by the standard FFEL interest rate guarantee. Lenders receive a quarterly interest rate equal to 3-month commercial paper plus 1.19 percent. Therefore, lenders financing loans through the participation program effectively receive a guaranteed interest rate equal to 0.69 percent (1.19 percent guaranteed rate - 0.50 percent financing cost).

The participation interest program provides lenders with a guaranteed source of funding at a preset price during a time when private capital is scarce and costly. The program also allows lenders to hold loans over time, rather than requiring them to permanently sell loans to the Department to generate proceeds. As of November 2008, the Department provided \$8.7 billion in financing to 12 lenders, representing about half of all 2008-09 FFEL disbursements at the time.<sup>4</sup>

The participation interest program expires on September 30, 2009 for 2008-09 year loans and on September 30, 2010 for 2009-10 year loans. Upon expiration, lenders must either purchase their loans back from the Department (through the trust administered by the third-party custodian) or exercise the put option and sell the loans to the Department permanently. Lenders utilizing the participation interest program must sell at least \$50 million in loans into a custodial trust, though multiple lenders may pool loans together to meet this requirement.

## Asset-Backed Commercial Paper Conduits

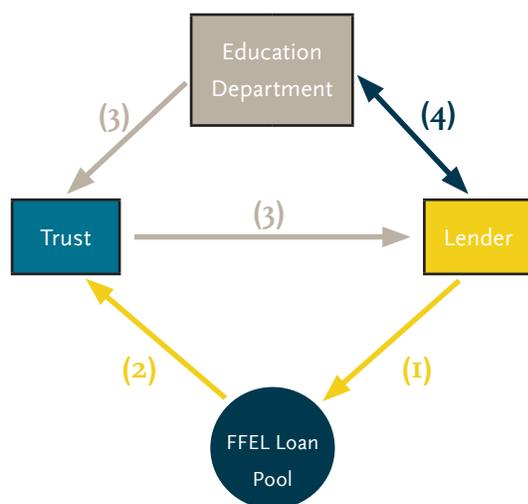
In November 2008, the Department of Education announced a fourth variation on its ECASLA loan purchase authority: support for asset-backed commercial paper conduits used to purchase FFEL loans. The program is set to begin by February 2009, and applies to loans issued between October 1, 2003 and July 1, 2009. It is the only purchase program that applies to loans made before the 2007-08 academic year. According to the Department, the program will help lenders sell or refinance about \$130 billion in older FFEL loans that they hold on their books, freeing up funds to make new FFEL loans.<sup>5</sup>

Asset-backed commercial paper conduits are used in private capital markets to finance assets and receivables such as mortgages, credit card payments, and loans. The conduit borrows funds by issuing commercial paper (a type of short-term bond). Investors buy the commercial paper and collect interest, and the conduit uses the borrowed funds to buy a pool of assets. Income from these assets is used to pay interest to investors holding the commercial paper.

An asset-backed commercial paper conduit must refinance funds it borrows from investors when the commercial paper matures and must be repaid (typically quarterly or every 180 days). When there is sufficient investor demand to issue enough new commercial paper to refinance maturing paper, this is a smooth, uninterrupted process. Credit market disruptions, however, have added considerable uncertainty to this process, resulting in little or no investor demand for asset-backed commercial paper. As such, FFEL lenders have had difficulty accessing this form of private financing.

In an effort to bring greater certainty to the asset-backed commercial paper market for FFEL loans, the Department will act as a buyer-of-last-resort for loans financed through private conduits. The Department will commit to purchase the underlying FFEL loans in the event that a conduit cannot refinance maturing commercial paper. A commercial paper investor would then be repaid with the proceeds from the sale of the loans to the Department. The Department has not yet published the price at which it will acquire the loans. The program expires on September 30, 2010, at which point conduits will no longer be backed by the purchase commitment. ■

### Loan Financing Arrangement - Participation Interest Program



- (1) Lender makes FFEL loans to students, then pools the loans.
- (2) Pooled loans are sold into a trust.
- (3) Department of Education buys a 100 percent stake in the trust, which then pays lender for the loans.
- (4) Each quarter, lender makes interest payments to and receives subsidies from the Department.

Source: New America Foundation

## Endnotes

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- 1 The subsidies include a guarantee against 97 percent of default losses and a guaranteed interest rate. Lenders receive an interest payments equal to short-term interest rates (three-month commercial paper), plus 1.79 percentage points (1.19 percent while the borrower is in school). Borrowers make loan payments to lenders at a fixed interest rate set in law. If the borrower interest payments do not cover the lender's guaranteed interest rate in a given financial quarter, the federal government pays the lender a subsidy to make up the difference. Conversely, if the borrower interest rate payments exceed the lender's guaranteed interest rate, then the lender remits the excess portion of the borrower payment to the government.
- 2 In the past few years, Direct Loan volume accounted for about 25 percent of federal student loan issuance, with the FFEL program accounting for the balance. In a May 2008 letter, the Secretary of Education reported that the agency had the capacity to double Direct Loan issuance with an additional \$15 billion in loans compared to the prior year. Expected FFEL loan volume, however, was \$59 billion (for Stafford and PLUS loans).
- 3 Private entities also play a large role in administering the Direct Loan program but are paid under contracts instead of a subsidy arrangement, as is the case under the FFEL program.
- 4 *Ensuring Continued Access to Student Loans Act of 2008*. Pub. L. no. 110-227 (May 7, 2008). <http://federalstudentaid.ed.gov/ffelp/library/HR5715PL110-227FINAL.pdf>
- 5 *An act to extend the authority of the Secretary of Education to purchase guaranteed student loans for an additional year*. Pub. L. no. 110-350 (October 7, 2008). [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110\\_cong\\_bills&docid=f:h6889rds.txt.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_bills&docid=f:h6889rds.txt.pdf)
- 6 Department of Education, Department of the Treasury, and Office of Management and Budget. *Notice of terms and conditions of purchase of loans under the Ensuring Continued Access to Student Loans Act of 2008*. 73 *Federal Register* 37422 (July 1, 2008). [http://federalstudentaid.ed.gov/ffelp/library/OfficialFedRegister\\_070108.pdf](http://federalstudentaid.ed.gov/ffelp/library/OfficialFedRegister_070108.pdf)
- 7 Spellings, Margaret. Dear Colleague Letter from U.S. Secretary of Education, May 21, 2008. <http://www.ifap.ed.gov/eannouncements/attachments/052108FFELPMonitoring.pdf>
- 8 Department of Education, Department of the Treasury, and Office of Management and Budget. *Notice of terms and conditions of purchase of loans under the Ensuring Continued Access to Student Loans Act of 2008*. 73 *Federal Register* 37422 (July 1, 2008). [http://federalstudentaid.ed.gov/ffelp/library/OfficialFedRegister\\_070108.pdf](http://federalstudentaid.ed.gov/ffelp/library/OfficialFedRegister_070108.pdf)
- 9 Older loans have several years of repayment history from which lenders can assess future performance and profitability. Lenders can use this information to selectively sell less profitable loans to the Department. New loans, on the other hand, do not have a repayment history from which to make such assessments. Loans with low balances are less profitable for lenders because administrative costs are generally the same across all loans, regardless of size, but interest and subsidy payments are calculated as a percentage of loan principal.
- 10 U.S. Department of Education. "Ensuring Student Access to Federal Loans." Fact Sheet, November 20, 2008. <http://www.ed.gov/students/college/aid/ecasla-facts.html>
- 11 Spellings, Margaret. "Continued Implementation of the Ensuring Continued Access to Student Loans Act of 2008." Dear Colleague Letter from U.S. Secretary of Education, November 20, 2008. <http://ifap.ed.gov/eannouncements/attachments/EDImplementAccessLoanAct2008.pdf>
- 12 Department of Education, Department of the Treasury, and Office of Management and Budget. *Notice of terms and conditions of additional purchase of loans under the Ensuring Continued Access to Student Loans Act of 2008*. 73 *Federal Register* 73263 (December 2, 2008).
- 13 Department of Education, Department of the Treasury, and Office of Management and Budget. *Notice of terms and conditions of purchase of loans under the Ensuring Continued Access to Student Loans Act of 2008*. 73 *Federal Register* 37422 (July 1, 2008). <http://federalstudentaid.ed.gov/ffelp/library/fedreg120208.pdf>
- 14 U.S. Department of Education. "Ensuring Student Access to Federal Loans." Fact Sheet, November 20, 2008. <http://www.ed.gov/students/college/aid/ecasla-facts.html>
- 15 Spellings, Margaret. "Extension of Authority to Purchase FFEL Program Loans." Dear Colleague Letter from U.S. Secretary of Education, November 10, 2008. <http://ifap.ed.gov/eannouncements/attachments/11008DCLHR6889Final.pdf>



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