

Proposal to Restructure Financing of the Federal Direct Student Loan Program Portfolio: Reducing the National Debt and Future Debt Obligations

Background: Following the passage of the Health Education Reconciliation Act of 2010, the Federal Direct Loan Program (FDLP) eliminated the FFEL Program, under which commercial student loan lenders received subsidies from the US Federal Government. In March 2010, the Congressional Budget Office estimated that the elimination of FFELP subsidies would result in \$68 billion of taxpayer savings from 2010 through 2020.¹ The elimination of the FFEL Program represents a fundamental change in funding sources and financing methodology for new student loan originations. The adoption of the FDLP, however, also directly and continuously increases national debt, given the reliance on the Department of Education (DOE) as lender and the US Treasury as funding source. **The purpose of this document is to propose a new funding option for the FDLP that, we believe, would act to significantly reduce the current national debt burden while providing a solid foundation for the FDLP into the future.**

Current Size of Debt Burden Relative to a \$550 Billion Debt Reduction: As of August 22, 2011, gross debt of the United States Government (the Government) totaled \$14.61 trillion dollars. Pursuant to the Budget Control Act of 2011, the Congressional Joint Select Committee is charged with drafting debt reduction legislation by November 23, 2011 to **cut at least \$1.5 trillion from the budget deficit** over the next 10 years.² **Reducing obligations of the Department of Education represents a unique opportunity to reduce the federal debt by as much as \$550 billion or more.** On June 17, 2009, The Honorable Arne Duncan, US Secretary of Education, announced that the DOE owns \$550 billion in student loans.³ Additionally, the DOE expects to disburse \$133.5 billion in Direct Loans in FY2011 and \$185.3 billion in FY2012 (per the DOE FY2012 budget).⁴ With the elimination of the FFEL Program, all student loan disbursements are funded by the Government within the FDLP. Shifting the financing of the Direct Loan Program to private funding sources **without government subsidies** would directly reduce federal debt by the size of the existing portfolio plus future originations. The mechanism to implement this proposal is to incorporate elements utilized by the proven and successful Government National Mortgage Association (GNMA) program.

We propose an alternative financing program aimed at:

- 1) Reducing Government debt currently and in the future;
- 2) Diversifying the FDLP's funding sources to achieve more efficient and stable access to funding;
- 3) Providing Treasury with an important risk management tool by locking in term financing for the loan portfolio, mitigating interest rate risk; and
- 4) Avoiding any changes to loan terms, disbursement or servicing of the loans from the student's perspective, preserving the benefits of the Direct Lending Program, and continuing to help Americans pay for school.

¹ Congressional Budget Office. Letter response drafted by CBO Director, Douglas W. Elmendorf to the Honorable Judd Gregg, dated March 15, 2010

² Budget Control Act of 2011

³ US Department of Education. Press Release, dated June 17, 2009

⁴ Budget of the United States Government, Fiscal Year 2012 – Department of Education

Funding Proposal:

Building on the Success of GNMA: In GNMA's 2010 report to Congress, the Honorable Shaun Donovan highlighted the nation's reliance on GNMA's stability during the financial crisis.⁵ Despite market turmoil, GNMA has remained profitable, protected US taxpayer dollars, and continued to offer global investors the safety and simplicity of the GNMA pass-through security, backed 100% by the full faith and credit guaranty of the United States Government. Since 1970, GNMA has guaranteed \$3.7 trillion of mortgage backed securities with \$413 billion issued in FY 2010 alone. The basic business model of a pass-through security includes five key elements: 1) Certified Lenders originate mortgages under federal guidelines; 2) Issuers pool together mortgages and create mortgage backed securities (MBS); 3) Issuers sell GNMA securities through a highly competitive auction process, minimizing costs to the Government; 4) For a fee, GNMA guarantees MBS investors for timely payment of principal and interest on securities; and 5) Investors in the MBS product receive the full asset coupon of the loan pools net of guarantee and servicing fees.

Application to Student Loan Funding: Unlike the GNMA program, we still envision the Department of Education, not third parties as the lender. However, the basic mechanics of a guarantee fee, servicing fee, and net pass-through of loan cash flow to security investors would remain the same as the GNMA model. Investors would buy securities that pass-through the underlying student loan principal and interest payments less servicing and guarantee costs.

Establishing a 100% guarantee for student loan securities would require legislation, and would be critical to obtaining the desired funding benefits and favorable investor demand. The explicit Government guarantee allows GNMA securities to generate investor demand at substantially lower interest rates than would otherwise be possible, especially in the current turbulent economic environment. An explicit guarantee of student loan securities would allow the Government to obtain similarly efficient financing. **Moreover, as the Government currently owns this portfolio and the associated default risk, the Government guarantee should result in no additional default risk to the taxpayer.**

The historical market size of the GNMA model (\$413 billion in FY 2010 alone) suggests that, over time, capital markets could directly provide financing for a portion or the entirety of the student loan portfolio at attractive interest rates. Lastly, we see value in designing a program that, once established, allows for a competitive bid process to obtain the best execution for the taxpayer.

The details of the security and of the associated legislation would need to carefully optimize market appetite and the Government's economic, funding, risk management and debt reduction objectives.

Next steps. If this program is attractive, implementation could be relatively straightforward. Most, if not all of the concepts required have been tested and proven over several decades. This funding structure would have a direct impact on reducing the US debt and positively impact US deficit reduction.

A syndicate of underwriters, selected through a request for proposal process, would collectively manage the pacing of securitization to fulfill the entire funding need of the current FDLF portfolio, in addition to future annual originations. The initial underwriter syndicate process could migrate to a competitive bidding framework to facilitate market efficiency and best execution for the Government.

Important issues that one should evaluate in detail include determining the cost relative to funding with Treasury securities, quantifying the value of funding diversification and interest rate risk management, and identifying the legal requirements and accounting implications of different transaction structures.

⁵ Ginnie Mae Report to Congress. Fiscal Year 2010

More detailed information on key economic and operational considerations are offered below as an appendix.

APPENDIX

Economics. The Government funds the outstanding FDLP portfolio with Treasury securities at interest costs that are at historical lows. Issuances into the securitization markets would be expected to price at somewhat higher interest rate levels compared to the US Treasury securities. This is also the case with GNMA securities, but the added cost could be offset by three powerful benefits evident in the GNMA program:

- 1) **Reduction of Government debt currently and in the future:** GNMA allows the Government to help support American home ownership without expanding Government debt. The FDLP currently requires ongoing expansion of Government debt by large amounts, which in certain environments can prove economically unattractive or difficult. Independent funding with a GNMA-like guarantee solves this problem. Over the next decade, there could be a potential \$1.3 trillion debt reduction, assuming implementation of this proposal as an alternative funding source for \$125 billion of loan origination volume per year for the next ten years.
- 2) **Diversifying Funding Sources:** Currently, the market provides cheap funding for Treasury securities. This may not be the case in future economic environments, and funding FDLP with Treasury securities may not always be an attractive option for a variety of other strategic and tactical reasons. In our view, Treasury could benefit by developing an alternative funding program today that provides for flexibility and stability in the future, ensuring long-term FDLP viability.
- 3) **Interest rate risk management:** The issuance of debt that locks in interest rates today and directly matches the term of the underlying loan pools would allow the Government to mitigate interest rate risk. It is a common corporate treasury best practice to match the term structure of one's assets to one's liabilities to manage any interest rate risk associated with refinancing. This proposal could provide the Government with a powerful tool to manage, or even eliminate this interest rate risk. Note, that in certain market environments, the Government could choose to retain some of this interest rate risk by issuing floating rate debt or debt with a guaranteed maturity if doing so provides for more attractive financing costs. Again, the aim here is not to necessarily prescribe a one-size-fits-all solution, but to provide the Government with a useful new financing tool that could be advantageous in many circumstances.

Given the success of GNMA, a similar student loan-based security would generate strong investor interest for a program that passes through fixed rate student loan coupons to a fixed rate bond coupon. Student loan borrowers currently pay a fixed interest rate ranging from 3.4% to 7.9% depending on loan type.⁶ In the current low interest rate environment, the relatively high underlying loan coupon should allow the Government to charge a robust guarantee fee and still achieve financing of the FDLP portfolio at or above the par amount of the loans.

Strong investor demand would in part be driven by bank investors seeking assets with extremely low regulatory capital charges in light of Basel III rules. An explicit Government guarantee would presumably lead to the lowest possible regulatory capital charge. This regulatory benefit to banks, in addition to the strong demand from a broad range of other investors for secure investments, contributes to a market that has appetite for additional Government guaranteed securities.

It should be noted that the explicit guarantee of bond principal and interest by the Government would drastically improve pricing when compared to legacy FFELP student loan securitizations. The indirect and incomplete

⁶ College Cost Reduction and Access Act of 2007. The interest rates on FDSL and Subsidized Stafford loans will be reduced annually, on new originations through July 2012 from 6.8% to 3.4%

nature of the Government guarantee and the complex interest subsidy on legacy FFELP securitizations unfortunately leads to higher funding costs given the current market's aversion to risk and complexity.

Logistical and Marketing Considerations. The GNMA program benefits from a highly competitive standardized auction process that achieves efficient financing while greatly reducing legal, accounting and underwriting costs. Student loan financing should seek to benefit from a similar approach, however the first few deals would likely require a small, coordinated underwriting syndicate that can carefully construct an issuance program and educate investors on the loan program and the underlying payment behavior to lay the foundation for future success.

Unlike mortgages, student loans are generally originated twice a year coinciding with the academic calendar. The origination pattern of student loans could pose operational issues with a "GNMA - equivalent" funding structure for two reasons: 1) lumpiness of originations and 2) partially disbursed loans. The operational issues could be mitigated by temporarily funding on the DOE's balance sheet (with Treasuries) on an interim basis. The securitization program can be executed on a programmatic basis in an effort to develop an orderly and efficient capital markets financing program schedule.

Another feature unique to student loans is the "non repayment" periods when the borrower does not make payment and the interest on the loans is accrued and capitalized upon moving into repayment status. The "non repayment" periods occur when the borrower is still in school; it can also occur when the borrower has graduated and has either gone back to graduate school or is experiencing a temporary economic hardship. When the borrowers are not making payments it will not be possible to pay interest on the securities that fund these loans. As a result, there may be a need to utilize a mechanism to provide short-term liquidity to the structure via a line of credit or a cash deposit into the funding vehicle in order to maximize investor demand. That said, similar liquidity considerations were actually not necessary in GNMA's HMBS Program which provides financing for reverse mortgages.⁷ The market was willing to simply absorb the "non repayment" risk in that product.

Servicing. Servicing the student loans will be an important aspect of this "GNMA-equivalent" funding structure. The funding structure will allow for payment of servicing fees to the DOE for servicing the student loans. The DOE could still maintain the existing servicing program, i.e., the Title IV Additional Servicers (TIVAS), under this funding proposal. In its press release on June 17, 2009, the DOE announced that four companies were awarded contracts to service a portion of its outstanding federal student loan portfolio of \$550 billion.⁸ Under this funding structure, the DOE could act as the Master Servicer and will be paid a minimum fee based on the outstanding loan balance for servicing the student loans and administering the securities backing the loans. The DOE can in turn utilize the fees earned to pay the TIVAS that have the contract to service the loans. Over time, the DOE could have the flexibility to change the servicing structure and align the incentives of the TIVAS to increase efficiencies and focus on default aversion. The amount of servicing fees would be set to cover the DOE's cost of servicing contracts.

Defaults. Initially, default management could be maintained as currently structured. As currently done in the GNMA program, defaulted loans could continue to be rehabilitated/restored and re-securitized in the capital markets. Currently, the FFEL Program allows for the guarantee agencies to rehabilitate loans and the capital markets have accepted financings backed solely by rehabilitated loans.

⁷ HMBS Overview. Ginne Mae's Program to Securitize Government Insured Home Equity Conversion Mortgages

⁸ US Department of Education. Press Release, dated June 17, 2009