

The Toughest Test: The Student Loan Liquidity Crisis of 2007-08 in Texas

A report to the 81st regular session of the
Texas Legislature

Prepared by TG Research and
Analytical Services

November 2008

About TG

TG, a nonprofit organization established in 1979 to administer federal higher education loan programs in Texas, is part of a public/private partnership committed to placing postsecondary education within reach of all citizens. This partnership, forged by the federal government, consists of private lenders, state designated guaranty agencies, student loan secondary markets, educational institutions, and student borrowers. Together, they operate the Federal Family Education Loan Program (FFELP), the largest source of student financial aid in the nation.

TG Research Reports

This report, *The Toughest Test: The Student Loan Liquidity Crisis of 2007-08 in Texas*, is a publication of TG's Research and Analytical Services subprocess and is designed to provide Texas legislators and other readers with information and insight about the demand for student aid in Texas. Other recent TG research publications, available on either TG's publications Web site (www.tgslc.org/publications/index.cfm) or on TG's research Web site (www.tgslc.org/research/index.cfm), include:

- *State of Student Aid and Higher Education in Texas (SOSA)*, July 2008;
- *Ready, willing, and unable: How financial barriers obstruct bachelor-degree attainment in Texas*, December 2006;
- *Legislative Fact Sheets*, 2006;
- *School Fact Sheets*, 2007;
- *Risk Factors for Dropping Out: Comparing the Southwest to the Nation*, 2006;
- *Risk Factors for Dropping Out: Comparing Texas to the Nation*, 2006;
- *Risk Factors for Dropping Out: Examining State and Regional Difficulties*, 2006;
- *Opening the Doors to Higher Education: Perspectives on the Higher Education Act 40 Years Later*, November 2005;
- *The Role of Work and Loans in Paying for an Undergraduate Education: Observations from the 2003-2004 National Postsecondary Student Aid Study (NPSAS)*, November 2005

Comments and requests for additional information regarding this report or any of TG's other research reports are welcome. Please direct any questions to:

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Prepared by TG Research and Analytical Services

November 2008

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TG[™]
The **Guarantor of Choice**[™]



November 2008

TO: Members and Staff, 81st Regular Session of the Texas Legislature
FROM: Sue McMillin, President and CEO
RE: The Toughest Test: The Student Loan Liquidity Crisis of 2007-2008 in Texas

The Texas Guaranteed Student Loan Corporation (TG) is pleased to submit its second Demand For Student Financial Aid report to the 81st Regular Session of the Texas Legislature in compliance with Section 57.21 (d), as added by the passage of House Bill 2274, 79th Legislature, Chapter 221, Section 9.

TG was established by the 66th Texas Legislature in 1979 as a public, nonprofit corporation with oversight by the state executive and legislative branches of government to administer the Federal Family Education Loan Program (FFELP), the largest source of student financial aid in Texas, for the State of Texas on behalf of the U.S. Department of Education.

We all have a common goal, expressed in the *Closing the Gaps* initiative, that must be achieved if we are to ensure the future economic and social well-being of Texas through a well-educated population. TG believes that providing the best information possible to the legislature is a necessary component to accomplish this goal.

For this second mandated report to the legislature, we have chosen to provide a summary and update of recent and ongoing financial liquidity issues impacting many lenders participating in the Federal Family Education Loan Program (FFELP) and the potential impact on continued access to the largest source of student financial aid for Texas postsecondary education students and families.

TG looks forward to discussing the findings and recommendations included in this report with Members and staff during the 81st Session of the Texas Legislature.

Sincerely,

Sue McMillin
President and CEO
TG

Acknowledgements

We would like to acknowledge George Torres, Sue McMillin, and Deanne Varner for their many contributions to this report.

The authors, of course, take full responsibility for any errors contained in this report.

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Student lenders have experienced this tightening of credit in varying degrees.



Introduction

The credit market in the United States currently suffers from a rare and serious disruption. Once flowing with liquidity, the creativity and vibrancy of these markets helped fuel an economy that had been the envy of the world. Poor repayment performance in the subprime mortgage market has now reduced the availability of funds needed for other consumer loans, including those for students. As these funds were drying up, Congress reduced subsidies to student lenders in the federally guaranteed student loan program, making student loans less profitable and less attractive to investors. Student lenders have experienced this tightening of credit in varying degrees, with some deciding to exit the market altogether, many continuing to loan to students, and others lending only to borrowers at schools with lower default rates and high average borrower indebtedness. These changes have created anxiety and uncertainty among students and their families as they plan their pathway to college.

This paper will outline the important factors of this student loan “credit crunch” with emphasis on its impact on Texas students. Section 1 focuses on the time period directly prior to the “credit crunch,” primarily the 2005-2006 time frame, and gives other general background information about student loans. Section 2 discusses the subprime mortgage crisis and how it affected student loans. Section 3 considers the government response to this crisis and how the crisis has affected Texas.

Section 1

Before the Crisis

Created as the Guaranteed Student Loan Program by the Higher Education Act of 1965, the (now) Federal Family Education Loan (FFEL) program was a response to the failure of the free market to provide educational loans. Although earning a college degree was known to improve one's lifetime earning power, lenders were reluctant to make loans to students with no credit history, no collateral assets, and no certainty of academic success. College-qualified students and their families struggled to obtain credit at affordable rates to allow them to pay the costs of their higher education investment over time. At that time, the U.S. economy was not reaching its potential because this market failure deprived the country of needed college-educated workers to boost productivity in an increasingly technological age. Policymakers and Congress believed that subsidies to lenders and a guarantee against student default would promote student lending and help remove financial barriers to postsecondary education. Although there have been periodic adjustments through subsequent legislation, this program has provided over \$650 billion dollars in the form of 187 million loans¹ to college students, helping to make college available for millions of students who may not otherwise have had the opportunity.

Texas relies heavily on the FFEL program. In Texas in Award Year (AY) 2005-2006, about 64 percent of all student aid, including grants and institutional aid, was in the form of FFEL loans.^{2,3} That figure was only 48 percent nationwide.^{4,5} Texas's state-designated guarantor, Texas Guaranteed Student Loan Corporation (TG), guaranteed \$2.9 billion in loans in AY 2005-2006 in Texas, helping almost 372,000 Texans attain higher education. Not surprisingly, Texas relies heavily on the federal government for higher education in general: 84 percent of all student aid in Texas in AY 2005-2006 was from the federal government, with the rest split about evenly between state and institutional aid. Nationally, 74 percent of all student aid comes from the federal government. Instability in the FFEL program touches Texas families more than those in other states.

Roles of FFELP Entities

To encourage student lending, the federal government provides financial incentives to lenders and guarantees loans against default. Through years of competition and cooperation, organizations have evolved to serve various functions within this system. Describing these roles will provide a background to understanding the current student loan environment.

The FFELP has provided over \$650 billion dollars in the form of 187 million loans to college students.

¹ U.S. Department of Education, Office of Postsecondary Education. *Federal Student Financial Assistance Programs – Loan Volume Updates* (2008). <http://www.ed.gov/finaid/prof/resources/data/opeloanvol.html>.

² Texas Higher Education Coordinating Board. *Bentson Report 2006* (2006). (unpublished data); Independent Colleges and Universities in Texas (ICUT). *Annual Statistical Report 2007* (2007). <http://www.icut.org/publications-1.html>.

³ U.S. Department of Education, Office of Postsecondary Education. *Federal Campus-Based Programs Data Book* (2006). <http://www.ed.gov/finaid/prof/resources/data/databook2006/databook2006.html>; U.S. Department of Education, Office of Postsecondary Education. *2005-2006 Federal Pell Grant Program End-of-Year Report* (2006). <http://www.ed.gov/finaid/prof/resources/data/pell-2005-06/pell-eoy-2005-06.html>; U.S. Department of Education, Office of Postsecondary Education. *2005-2006 FFELP and DL Volume* (2006). (unpublished data).

⁴ Ibid.

⁵ College Board, The. *Trends in Student Aid 2006* (2006). http://www.collegeboard.com/prod_downloads/press/cost06/trends_aid_06.pdf.

The **student** borrower in the FFEL program selects a school and lender. This selection can be done on the student's own or with the help of the school. Students can use any lender that participates in the FFEL program, even if their school has never worked with this lender before. Students must have earned a high school diploma or GED, be enrolled at an eligible institution at least half-time while making satisfactory academic progress, be a U.S. citizen (or eligible noncitizen), register for the military's selective service (if male), and sign a statement of educational intent verifying that the federal aid would be spent for educational purposes. Students must fill out a FAFSA⁶, be in good standing on any prior federal student loan, and not have been convicted of a drug-related crime while receiving any federal student aid.

Schools verify borrower's enrollment for lenders, guarantors, and the Department of Education. Schools in the FFEL program can provide some help for their students who are unsure of which lender to choose. Typically a list of all lenders that the school has worked with before, and/or a "preferred-lender list" that includes lenders that the school knows offer students good service and benefits, will be provided by the school. This may help students narrow down the field of lenders and choose one that is suited for their needs. Schools provide entrance and exit counseling for borrowers, so that they are aware of their responsibilities regarding their loans. Providing financial literacy information and other services aimed at helping students understand their rights and responsibilities in regard to their student loans has become common among schools.

Lenders work with schools to provide loan programs that are suitable for various borrower populations. Lenders provide the loan to the borrowers and may offer various benefits to students, such as interest rate reductions for auto-debit, combined billing for borrowers with multiple loans, and rate reductions or partial principal forgiveness after a series of on-time payments. Lenders can provide deferments and forbearances when needed to help borrowers in financial straits from falling into delinquency and/or default. If a borrower does become delinquent, the lender contacts the guarantor for help with the default aversion effort.

Secondary markets purchase loans from lenders in order to provide the lenders with the liquidity to make more loans. Secondary markets use the proceeds from issuing bonds to purchase these loans. Often, secondary markets originate their own loans — for example, Sallie Mae is the nation's largest secondary market. There are also organizations set up to act entirely, or mostly, as secondary markets. The Texas Education Code provides for local governments to establish public, nonprofit corporations called Higher Education Authorities (HEA), which are currently assigned about \$200 million in student loan bonding authority and which allocate these funds through an annual lottery. The number of Texas HEAs has changed over time; currently, there are four main secondary markets in Texas: Brazos Higher Education

⁶ Free Application for Federal Student Aid.

Authority, North Texas Higher Education Authority, Panhandle-Plains Higher Education Authority, and the Council for South Texas Economic Progress (COSTEP). Brazos is the largest of the four Texas secondary markets: about half of the loans sold to Texas HEAs in FY 2006 were sold to Brazos HEA.⁷ These nonprofit organizations inject liquidity into the Texas student loan market and also provide outreach programs that provide prospective college students information about college and financial aid.

All loans, whether in the FFEL or Direct Lending program, are administered and maintained by a **servicer**. Sometimes lenders will service their own loans, but often the loans are serviced by an organization specifically dedicated to servicing loans. Lenders contract with these servicers, which compete for contracts based on cost and performance (e.g., keeping students out of default). Servicers contact borrowers after separation from school to give them information about loan repayment and provide borrowers with access to their loan accounts to make payments. Borrowers can apply for forbearances through their servicer. Servicers can also provide benefits to borrowers on behalf of the lenders, such as interest rate reduction for using auto-debit to pay their loan, grace period extension, and principal reduction for a certain number of consecutive on-time payments.

The primary **guarantor** role in the FFEL program is to financially guarantee the lender against loss in the case of borrower default. However, the guarantor also acts as an impartial supporter to the borrower, providing information and services to help borrowers stay in repayment or get out of delinquency or default. TG undertakes numerous efforts to prevent defaults, including

- calling and sending letters to delinquent borrowers,
- providing schools with default prevention training,
- providing a Web-based tool to help schools and lenders more effectively focus their default prevention resources, and
- participating in an industry advisory committee to develop best practices for default prevention and financial literacy.

Guarantors also provide information on financial aid awareness, financial literacy, and college planning. Additionally, guarantors provide training and resources to school and lender professionals and perform program reviews to ensure that regulations are being met. Guarantors may also provide other services or programs. For example, TG operates a financial aid hotline and administers a competitive Public Benefit Grant Program that has awarded nearly \$15 million since 2005 to organizations to help population groups that are traditionally underrepresented in higher education.



The guarantor also acts as an impartial supporter to the borrower, providing information and services to help borrowers stay in repayment



⁷ TG. Internal Database. Round Rock, Texas (2008). (unpublished data).

The robust market led to increased service levels and borrower benefits.

Direct Loan Program

In 1993, the William D. Ford Federal Direct Loan (DL) program was signed into law. In this program, the federal government loans directly to students through their school. The administration of the program, such as notices to students and bookkeeping, is contracted out via the federal government procurement process to a firm that services the loans. Having both the FFEL and DL programs provides competition and choice to students and schools. Additionally, because there are multiple lenders involved in the FFEL program, there is additional competition within the FFEL program itself. This competition motivates lenders and the federal government to provide better service, benefits, and products, and to simplify the process for students and schools. The competition also drives down prices and increases efficiency.

FFEL and DL Market Share in FY 2006

Data from Fiscal Year (FY) 2006 from the Department of Education (ED)⁸ show how the market looked prior to the credit crisis. Most schools in the U.S. participated in the FFEL program instead of the DL program. In FY 2006, about 18 percent of schools nationally that participated in the federal loan program participated in Direct Lending. Participation in the FFEL program had been increasing over the past several years. In FY 2002, 73 percent of federal loan volume was in the FFEL program, and by FY 2006 that had increased to 80 percent.

Figure 1: FFEL Percentage of National Market Loan Dollars

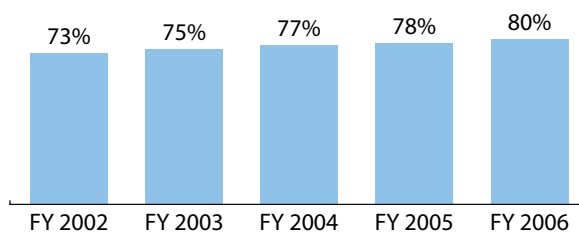
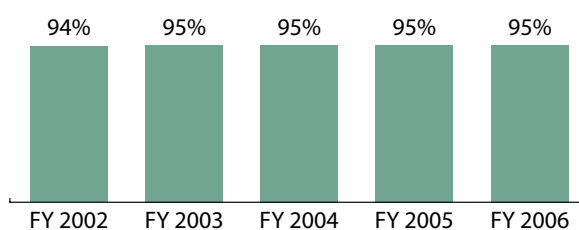


Figure 2: FFEL Percentage of Texas Market Loan Dollars



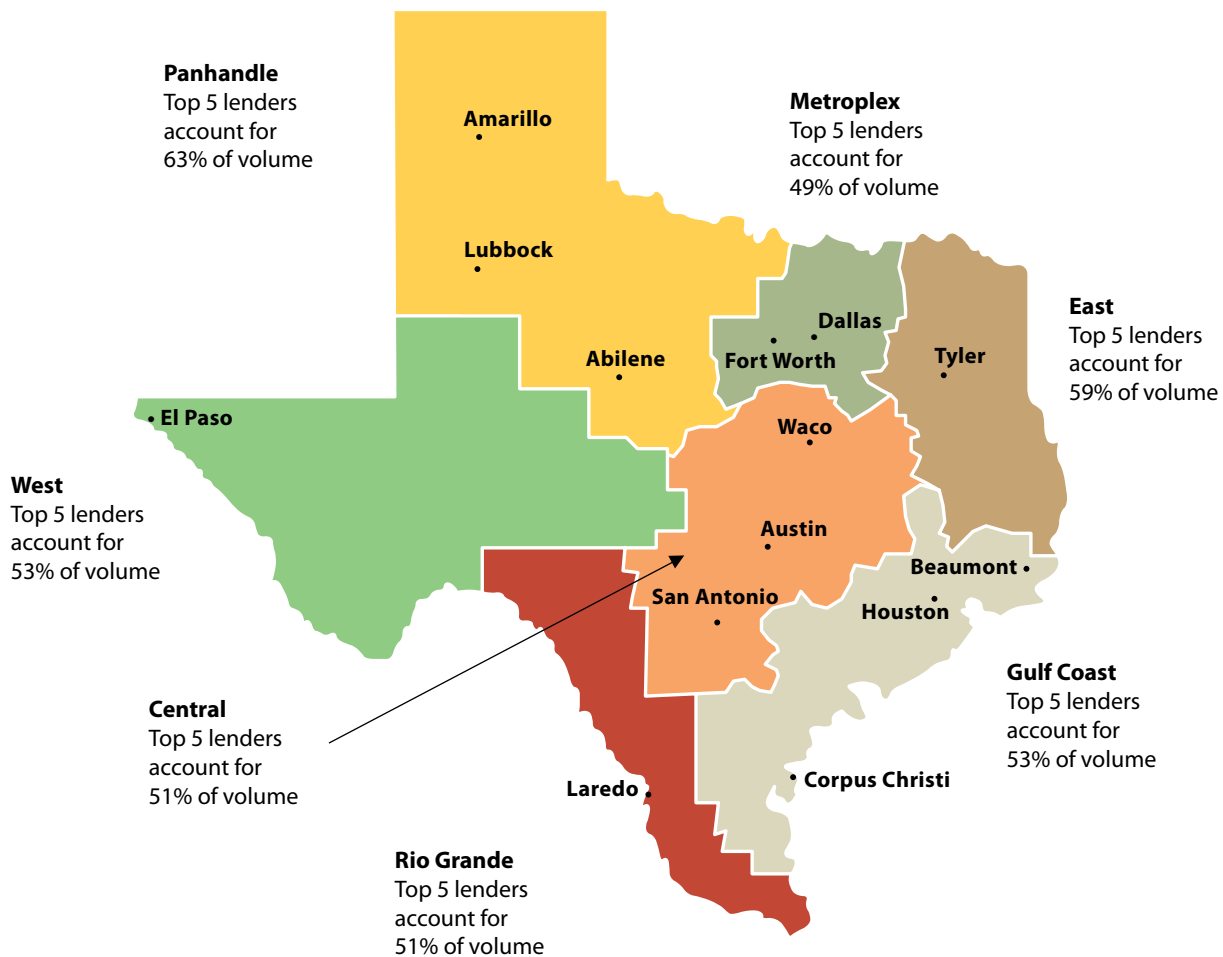
Schools in Texas traditionally prefer the FFEL program over Direct Lending, with only about 12 percent of schools that participate in the federal loan program participating in Direct Lending in FY 2006. The FFEL program market in Texas held fairly steady between FY 2002 and FY 2006 at around 95 percent.

Within the FFEL program in Texas, volume had become less concentrated among the largest lenders. The top 20 lenders in Texas represented 74 percent of the volume in the state in FY 2002, but by FY 2006 had declined to 69 percent. This suggests that entry into the market was open and competition allowed smaller lenders to gain market share. The robust market led to increased service levels and borrower benefits, such as waiving the origination fee for borrowers, rewarding good repayment with interest rate discounts, and providing financial incentives in the form of lump sum credits to borrowers for successfully completing their course of study.

⁸ U.S. Department of Education, Office of Postsecondary Education. *Market Share Data (2006)*. (unpublished data).

Not surprisingly, the major population centers of the Central, Gulf Coast, and Metroplex regions made up 81 percent of the FFEL and DL loan volume⁹ in Texas in FY 2006, with the other four regions making up the remaining 19 percent. These three regions had 75 percent of the schools in Texas. Lender choice varied quite a bit across regional lines. In FY 2006, only one lender, Wells Fargo EFS, was among the top five lenders in all seven regions.

Figure 3: Top 5 Lenders Percentage of Total Regional Volume, FY 2006¹⁰



⁹ Excluding consolidation loans.

¹⁰ TG. Internal Database. Round Rock, Texas (2008). (unpublished data).

Figure 4: Top 5 Lenders by Region in Texas in FY 2006¹¹

Panhandle	Metroplex
1. PlainsCapital Bank	1. Wells Fargo EFS
2. Wells Fargo EFS	2. Bank of America, N.A.
3. First Financial Bank of Abilene	3. Bank One
4. Bank of America, N.A.	4. Sallie Mae Education Trust
5. Amarillo National Bank	5. Citibank

West	East	Central
1. Wells Fargo EFS	1. Commercial Bank of Texas, N.A.	1. Wells Fargo EFS
2. Bank of America, N.A.	2. Bank of America, N.A.	3. Bank of America, N.A.
3. State National Bank	3. Wells Fargo EFS	3. University Federal Credit Union
4. San Angelo National Bank	4. Bank One	4. Sallie Mae Education Trust
5. Citibank	5. JP Morgan Chase Bank	5. Frost National Bank

Rio Grande	Gulf Coast
1. International Bank of Commerce	1. Wells Fargo EFS
2. COSTEP	2. Bank of America, N.A.
3. Texas State Bank	3. JP Morgan Chase Bank
4. Wells Fargo EFS	4. Sallie Mae Education Trust
5. JP Morgan Chase Bank	5. Citibank

Loan Types, Limits, and Interest Rates

The two largest federal student loan programs — FFEL and DL — offer an array of loan types, while the level of borrowing that may occur is statutorily limited based on academic grade level and dependency status. As college costs rise, so too does the demand for student loans. Understanding the available types of loans, the borrowing limits, and the interest rates charged will provide context to the student loan climate and the perspective of college students seeking aid.

There are four basic types of loans borrowers can receive from either the FFEL or DL program: Stafford subsidized, Stafford unsubsidized, Parent PLUS, and Grad PLUS. Interest does not accrue on Stafford subsidized loans while the student is in school at least half-time or in their six-month grace period following separation from school. Interest does accrue on Stafford unsubsidized loans from the time of disbursement, but students do not have to start making payments on the loan until after the six-month grace period following separation from school. Both Parent PLUS and Grad PLUS loans require a modest credit check,¹² and require that a borrower have applied for the maximum amount of Stafford subsidized and unsubsidized loans prior to

¹¹ Ibid.

¹² Borrower credit is checked to determine whether the borrower has an adverse credit history, defined as being 90 days or more delinquent on any debt or having a default, discharge, foreclosure, repossession, tax lien, wage garnishment, or write-off of Title IV debt in the previous five years.

applying for a PLUS loan. After the borrower leaves school, he or she can combine any of these loans into one loan, called a consolidation loan.

In FY 2006, both dependent and independent¹³ students had the same maximum subsidized loan limit each year of school, but independent students could borrow additional unsubsidized loans because they had higher overall annual limits than dependent students. The aggregate undergraduate limit for dependent students was \$23,000, and independent students had double that limit.¹⁴

Figure 5: 2006 Stafford Subsidized and Unsubsidized Loan Limits

		Freshman Year	Sophomore Year	Junior Year	Senior Year	Aggregate Undergrad Limit
Dependent Students whose parents were not denied a PLUS loan	Total Amount of Subsidized and Unsubsidized Loans	\$2,625	\$3,500	\$5,500	\$5,500	\$23,000
	Maximum Amount of Subsidized Loans	\$2,625	\$3,500	\$5,500	\$5,500	\$23,000
Independent Students and Dependents whose parents were denied a PLUS loan	Total Amount of Subsidized and Unsubsidized Loans	\$6,625	\$7,500	\$10,500	\$10,500	\$46,000
	Maximum Amount of Subsidized Loans	\$2,625	\$3,500	\$5,500	\$5,500	\$23,000

In FY 2006, graduate students could borrow up to \$18,500 per year, with a maximum of \$8,500 in subsidized loans. They could borrow an aggregate total of \$138,500, with a maximum of \$65,500 in subsidized loans, including their undergraduate education loans. PLUS loans do not have any specific dollar limit. PLUS loans may amount to the cost of attendance minus all aid received. From 1994 until 2007, student loan limits remained stagnant at the above limits for all loan types.

Loans originated between July 1, 1998 and June 30, 2006 had variable interest rates that were reset every year on July 1 according to a specific formula. Loans originated between July 1, 2006 and June 30, 2008 had a fixed interest rate of 6.8 percent. Then, every year for the next four years the interest rate will decrease until it reaches the lowest rate of 3.4 percent starting July 1, 2011. However, the law that lowered the interest rate only specified the new rates through June 30, 2012. Therefore, starting July 1, 2012, barring a new law or extension of the current law, the interest rate will revert back to 6.8 percent.¹⁵

¹³ The U.S. Department of Education defines an independent student as age 24 or older, married, with dependents to support, a veteran, orphan, or ward of the court, or graduate student. Students who do not meet these criteria, but who receive no financial support from their parents, may also be considered independent.

¹⁴ FinAid.org. *Historical Loan Limits*. <http://www.finaid.org/loans/historicallimits.phtml>.

¹⁵ FinAid.org. *Student Loans*. <http://www.finaid.org/loans/studentloan.phtml>.

Figure 6: Interest Rate Changes by Loan Type

Loan Originated	Interest Rate			
	Stafford Subsidized Loans	Stafford Unsubsidized Loans	Parent PLUS Loans ¹⁶	Grad PLUS Loans ¹⁷
July 1, 1998 – June 30, 2006	Variable ¹⁸	6.8%	Variable ¹⁹	n/a
July 1, 2006 – June 30, 2008	6.8%	6.8%	8.5%	8.5%
July 1, 2008 – June 30, 2009	6.0%	6.8%	8.5%	8.5%
July 1, 2009 – June 30, 2010	5.6%	6.8%	8.5%	8.5%
July 1, 2010 – June 30, 2011	4.5%	6.8%	8.5%	8.5%
July 1, 2011 – June 30, 2012	3.4%	6.8%	8.5%	8.5%

As noted in the table above, loans originated prior to July 1, 2006 had variable interest rates that were reset every year on July 1. The interest rates rose almost two percent on July 1, 2006 for loans that had been borrowed prior to that date²⁰ (loans borrowed starting July 1, 2006 have the above fixed interest rates). In anticipation of this considerable rate increase, consolidation loans increased dramatically as borrowers hurried to lock in low fixed rates on all of their loans.

In the FFEL program, consolidation loans increased just 3 percent from FY 2003 to FY 2004, then increased 50 percent from FY 2004 to FY 2005 and 33 percent from FY 2005 to FY 2006. The consolidation volume in FY 2007 fell 34 percent from its peak in FY 2006.²¹

A much smaller program than either FFEL or DL, the Federal Perkins Loan Program provides low-interest loans to undergraduate and graduate students who have financial need. These loans are similar to subsidized Stafford loans, but Perkins loans have a 5 percent interest rate and a nine-month grace period following separation from school before repayment begins. There are also no fees charged to take out the loan. Undergraduates can borrow up to \$4,000 per year with a maximum of \$20,000 for undergraduate study, and graduate students can borrow up to \$6,000 per year with a maximum of \$40,000 for graduate study. In AY 2005-2006, 727,600 students received \$1.6 billion in Perkins loans in the U.S. Nearly 20,000 Texas students received \$52.1 million of this total.²²

If a borrower falls into default, he or she can participate in the rehabilitation loan program.²³ For FFEL and DL loans, the borrower must make nine voluntary²⁴ on-time payments over a 10-month period. For Perkins loans, the borrower must make 12

¹⁶ The 8.5% interest rate is for the FFEL program. The interest rate in the DL program is 7.9%.

¹⁷ Ibid.

¹⁸ Reset every year on July 1.

¹⁹ Ibid.

²⁰ Hobson, Melody. "Student Loan Consolidation: For Graduates Paying Back Student Loans, Consolidation is a Must." *ABC News Online* (June 16, 2006). <http://abcnews.go.com/GMA/MelodyHobson/story?id=2082309>.

²¹ U.S. Department of Education, Office of Postsecondary Education. *Federal Student Financial Assistance Programs – Loan Volume Updates* (2008). <http://www.ed.gov/finaid/prof/resources/data/opeloanvol.html>.

²² U.S. Department of Education, Office of Postsecondary Education. *Distribution of Campus-Based Awards, Award Year 2005-06, by School* (2006). (unpublished data).

²³ U.S. Department of Education, Federal Student Aid. *Loan Rehabilitation* (2008).

²⁴ Payments made through wage garnishment or other litigation do not count toward these nine rehabilitation payments.

voluntary on-time payments. Completing this program successfully will get the loan out of default status, delete the guarantor's defaulted loan status from the borrower's credit report, and halt wage garnishment and tax refund withholding upon sale to a new holder.

College Costs and Private Loans

While federal loan programs have offered substantial amounts of credit to students, college costs still have driven up the demand for loans beyond the federal program limits. In Texas, the cost of attendance at private 4-year schools increased 36 percent from AY 2000-2001 to AY 2005-2006, compared to 29 percent nationwide. In Texas between AY 2000-2001 and AY 2005-2006, public 4-year costs increased 33 percent, public 2-year costs increased 28 percent, and proprietary school costs increased 47 percent. Similar increases also occurred nationally.²⁵

Tuition deregulation in Texas, passed by the Texas legislature in 2003, decentralized tuition setting authority from the state Legislature to the local campuses. According to the Texas Higher Education Coordinating Board, tuition at 4-year public schools in Texas increased 58 percent from fall 2003 to fall 2007.²⁶

Colleges have raised tuition and fees to keep pace with rising expenses. Unlike other types of enterprises, higher education depends heavily on higher-educated — actually, the most highly educated — workers. These workers tend to have many options inside and outside of academia. Colleges, eager to maintain their academic stature, bid up salaries for these workers. Health care benefits are another major expense for labor-intensive organizations. With these costs on the rise, moderating overall costs becomes especially challenging. Few states have been able to maintain their historical levels of support for higher education.

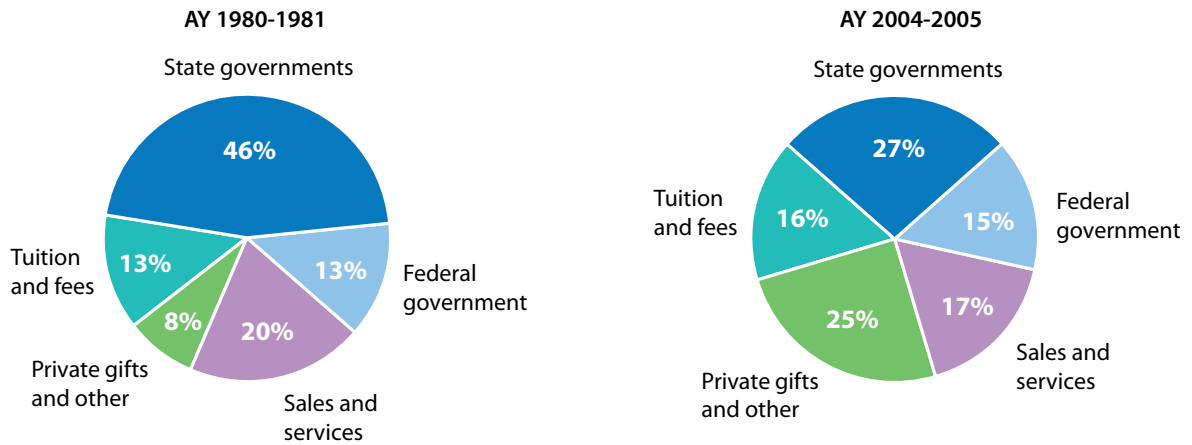
Although state dollar appropriations for higher education increased 16 percent between FY 2001 and FY 2006, the appropriations were inconsistent: they increased 14 percent from FY 2001 to FY 2002, decreased 6 percent the next year, increased 2 percent the following year, decreased 3 percent the next year, then increased 9 percent between FY 2005 and FY 2006. State tax appropriations for higher education per \$1,000 in personal income in Texas decreased 7 percent between FY 2001 and FY 2006, as it did in 38 other states in the U.S. The Center for the Study of Education Policy at Illinois State University, which compiles state tax higher education appropriation data through its *Grapevine* project, wrote that this decrease in appropriations per \$1,000 in personal income suggests “that most states are devoting a smaller proportion of their total wealth to tax support for higher education than they did five years ago.”²⁷

²⁵ U.S. Department of Education, National Center for Education Statistics. *IPEDS Peer Analysis System Dataset Cutting Tool* (2008). <http://nces.ed.gov/ipeds/>.

²⁶ Texas Higher Education Coordinating Board. *Tuition and Fees Data, Fall 2002 to Fall 2007* (page 27). <http://www.thehb.state.tx.us/Reports/pdf/1498.pdf>.

²⁷ Illinois State University, Center for the Study of Education Policy. *Grapevine Project*. <http://www.grapevine.ilstu.edu/index.shtml>.

Figure 7: Revenue at U.S. Public Degree-Granting Institutions by Source



State governments have accounted for a decreasing percentage of public college revenue over the past few decades in the U.S. In AY 1981, state-government funding accounted for 46 percent of public degree-granting institution revenue, before falling to 27 percent in AY 2005. Revenues from the federal government, sales and services, and tuition and fees shifted by only a few percentage points in this time frame. Private gifts and other aid made up the ground lost by state governments by increasing from 8 percent to 25 percent of revenues.²⁸ Much of the increased costs have been passed off to students in the form of higher tuition and fees.

With these increases in college costs and no concurrent increases in the federally guaranteed student loan limits, students often turned to private loans. Student lenders pursued this market aggressively. The College Board notes that in AY 2006 private student loans, which are not federally subsidized, totaled \$17.3 billion in the U.S., and that they had “grown at an average annual rate of about 27 percent between 2000-2001 and 2005-2006, after adjusting for inflation.”²⁹ In Texas, about 4 percent of undergraduates borrowed an average of nearly \$5,600 in the 2003-2004 school year. The highest borrowing took place at private 4-year institutions, with 14 percent of students borrowing an average of \$7,722. The lowest borrowing took place at public 2-year institutions, with only 1 percent of students borrowing an average of just over \$3,500. Five percent of students at public 4-year institutions borrowed an average of \$4,749 in private loans in the 2003-2004 school year in Texas.³⁰

Private student loans initially were targeted to creditworthy students attending high-cost colleges and graduate/professional degree programs as “gap” loans to fill unmet financial need after eligibility for federal, state, and institutional aid had been exhausted. As more students faced difficulties paying for college, private loans

Private student loans initially were targeted to creditworthy students.

²⁸ U.S. Department of Education, National Center for Education Statistics. *Digest of Education Statistics 2007* (2007) (pages 487, 488, and 489). <http://nces.ed.gov/pubs2008/2008022.pdf>.

²⁹ College Board, *The Trends in Student Aid 2006* (2006).

³⁰ U.S. Department of Education, National Center for Education Statistics, *National Postsecondary Student Aid Study (NPSAS) 2004* (2004). <http://nces.ed.gov/surveys/npsas/>.

became a more popular option at lower cost public universities and at for-profit career schools. Marketing broadened to include students with poorer credit scores with accompanying higher interest rates — the student loan equivalent of subprime mortgages.

Many lenders were active in both the private student loan and FFEL markets, competing with each other to be on the preferred-lender lists of schools. These lists allow schools to suggest lenders to students based on past performance, customer service, borrower benefits, etc., as a way to narrow choices to a manageable level and to protect students — many of whom had never borrowed — from less-respectable lenders. Because these lists are the primary source used for identification of student-loan lenders, it is highly beneficial to lenders to be placed on one. Preferred-lender lists augment brand visibility, especially in the case of lists at large financial aid offices.

In 2007, the Attorney General of New York, Andrew Cuomo, argued that many of the preferred-lender practices limited student choice too much, creating potential conflicts of interest that undermined the trusted advocate role of financial aid offices. In particular, Cuomo shed light on many overly aggressive lender marketing practices, which appeared to many to have been improper inducements. These revelations garnered significant press coverage and weakened public support for lender-based student loans. While most of the abuses uncovered by the New York Attorney General involved private student loan providers, many of these lenders also participated in the FFEL program, highlighting the need to police this program. To restore public trust, Congress enacted the Higher Education Opportunity Act (HEOA) in August 2008 to better regulate schools' relations with lenders, secondary markets, and guarantors.

The HEOA lists a number of prohibited inducements, outlines the technical and reporting responsibilities of lending institutions, and specifically requires that lenders disclose information relevant to a student's decision-making regarding the loans they borrow. The HEOA mandates lenders and servicers holding student loans to disclose fully the terms and responsibilities associated with deferments and forbearances. Before, and after, the HEOA was passed, the preferred-lender scandal has led many schools to change the ways they select the lenders on their preferred lists (if they choose to have one).

For instance, some schools now request that potential lenders fill out detailed standardized forms that require a great deal of information about the lenders' business operations — for example, the proportion of borrowers who default on student loans originated by the lender. Initially, responding to these requests for information was a high priority for some lenders, in that the requests had a role in determining which lenders a school might designate as "preferred." Most importantly, they provided comparative information across considered lenders, which could be used to justify



To restore public trust, Congress enacted the Higher Education Opportunity Act (HEOA) in August 2008.



a school's decisions when developing preferred-lender lists. Thus, the FY 2007 controversy had a significant potential for influencing lenders' competitive business strategies, at least those related to student loans. However, the liquidity issue has created a possible friction for some lenders, which may find themselves either fighting to retain schools with which they have a business partnership or competing with other lenders to gain volume with schools while also struggling to find financial backing for originating loans.

Section 2

Student Loan Profitability
During the Credit Crisis

A public company's first responsibility is to generate profit for distribution to shareholders. With changes to the legislative landscape and an icy consumer credit market, student lenders have had to re-evaluate how they do business. For some, it has meant leaving the business altogether, but most have worked to adjust to the changing environment. Lenders of student loans do not have the authority to increase interest rates on federally backed loans beyond a mandated maximum set by Congress. Furthermore, the interest rate on student loans is fixed while the lender's cost of capital varies with the market rates.³¹ Thus, FFELP lenders are subject to limited profitability even without hindrances from the financial markets or changes in legislation.

Economists at the Federal Reserve Bank of Cleveland suggest that six factors affect the profitability of student loans:³²

- 1) the fixed rate paid by the student borrowers,
- 2) the federal insurance against default,
- 3) the Special Allowance Payment subsidy paid to lenders by the federal government,
- 4) the LIBOR (London Interbank Offered Rate),
- 5) the commercial paper rate, and
- 6) the auction rate securities market.

Fluctuation in any one of these factors could make student-loan issuance uneconomical for lenders. The combination of lender subsidy cuts and the subprime mortgage credit crisis have caused changes in all of the factors impacting profit margin, seemingly forcing the student loan industry into a crisis of its own. According to Andrew Ackerman, writing in *The Bond Buyer* in May,

One reason FFEL lending has plummeted is because a new law that went into effect last fall halved the interest rates on certain FFEL program loans. Another reason is related to the ongoing credit crunch, which has elevated borrowing costs for lenders. The combination of lower yields that FFEL lenders receive with the sharply higher borrowing costs has squeezed many issuers out of the market.³³

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³¹ The federal government pays FFELP lenders a subsidy to compensate for the funding costs that may not be fully covered by the maximum student loan interest rate mandated by Congress, i.e. when the borrower's interest rate does not meet a statutorily specified level of return to the lender. The subsidy is referred to as a Special Allowance Payment (SAP) and is pegged to the commercial paper rate plus a legislatively determined premium.

³² Ergungor, O. Emre and Ian Hathaway. "Trouble Ahead for Student Loans?" *Economic Commentary, Federal Reserve Bank of Cleveland* (May 15, 2008). <http://www.clevelandfed.org/research/commentary/2008/0508.cfm>.

³³ Ackerman, Andrew. "Student Loans: Education Department Meets on FFEL Program" *The Bond Buyer*, vol. 364, no. 32885, May 21, 2008.)

Lender Subsidy Cuts

Lenders issuing federally backed student loans saw a sharp decrease in their profit margins when The College Cost Reduction and Access Act of 2007 went into effect on October 1, 2007. This legislation reduced the subsidies paid by the federal government that had been in place to entice lenders to issue loans to college students. The subsidy cuts impacted lenders in three key ways:

- **Reduction in Special Allowance Payments (SAP):** Special Allowance Payments are intended to provide lenders with a rate of return on student loans similar to other types of loans issued by financial institutions. SAPs are pegged to the Commercial Paper Rate plus a margin.³⁴ The College Cost Reduction and Access Act cut the margin on Stafford and Consolidation loans by 55 basis points and on PLUS loans by 85 basis points for for-profit lenders; the cuts were 40 basis points and 70 basis points, respectively, for not-for-profit lenders. For example, Stafford loan SAPs were reduced from 1.74 percent to 1.19 percent for for-profit lenders. This reduction equates to a \$27.50 loss in interest income per year on a \$5,000 Stafford loan.³⁵
- **Increase in Origination Fees:** Lender origination fees paid to the federal government doubled from 0.5 percent to 1 percent of total loan value effective on all new loans made after October 1, 2007. This occurred simultaneously to the decrease in origination fees that borrowers pay to lenders; there will be no origination fee for borrowers as of July 1, 2010. Lenders previously paid the federal government an origination fee of \$25 on a \$5,000 Stafford loan, but now the origination fee associated with the same loan is \$50.
- **Increase in Default Costs:** Effective on all loans originated after October 1, 2012, the federal government will insure defaulted loans at 95 percent rather than the previous 97 percent insurance rate. Additionally, the “exceptional performer” status (held by approximately 80 percent of all education lenders³⁶) that designated a 99 percent guarantee against default was eliminated as of October 1, 2007. “Exceptional performer” lenders were formerly guaranteed repayment of \$4,950 on a \$5,000 Stafford loan. With the “exceptional performer” status no longer in existence, all lenders are currently guaranteed repayment of \$4,850 on a \$5,000 Stafford loan. After October 1, 2012 guaranteed repayment on a \$5,000 Stafford loan will further decline to \$4,750.

³⁴ While Special Allowance Payments are pegged to the Commercial Paper Rate, a lender’s cost of capital is pegged to the LIBOR index. This mismatch affects a lender’s profitability when there is a change in spread between the two indexes. Mark Kantrowitz, publisher of *FinAid.org*, reported the spread to be 12 basis points in 2006 and the first half of 2007; it then peaked at 48 basis points in December 2007 and was 35 basis points in April 2008.

³⁵ Special Allowance Payments occur on a quarterly basis. Therefore, lenders suffer a \$6.88 loss in interest income (per quarter) on a \$5,000 Stafford loan.

³⁶ *FinAid.org. Impact of the Subprime Mortgage Credit Crisis on Student Loan Cost and Availability.* <http://www.finaid.org/loans/creditchris.phtml>.

The Congressional Budget Office estimated the cost to lenders from The College Cost Reduction and Access Act of 2007 to be \$17.8 billion over the 2007–2012 period and \$41.5 billion over the 2007–2017 period.³⁷ Decreased profitability attributable to subsidy cuts triggered many lenders to scale back their participation in FFELP. Furthermore, some lenders completely terminated the service of consolidating existing student loans because consolidation loans already had the tightest profit margin.

Just as in any industry, student lenders operate on economies of scale. Thus, large lenders with lower administrative and overhead costs have felt less of an impact while several smaller lenders have been pushed out of the market. For example, national giants such as Bank of America, Citibank, and Wells Fargo are still actively issuing FFELP loans while smaller, regional entities including Bank of Texas, FirstBank Southwest, and San Antonio Federal Credit Union have suspended participation in the FFELP. The size of a loan (often associated with the length of time a student is enrolled in postsecondary education) matters in terms of profitability to lenders. Total loan amounts at community colleges and proprietary schools are significantly less than cumulative loan amounts at both public and private 4-year institutions while the costs to administer these loans are relatively the same at all types of institutions. Because it has become uneconomical to offer small scale loans, some lenders are no longer providing loans to students at 2-year institutions, especially those with high default rates.

Not only are students impacted by the decline in lender availability, but lenders are also discontinuing borrower benefits that were typically included with student loans.³⁸ Lenders that are maintaining borrower benefits as part of their student loan services have made it harder for borrowers to qualify for these discounts. The decrease in or total elimination of interest rate reductions for on-time or direct debit payments and the reinstatement of origination and default fees will ultimately raise the student's cost of paying for postsecondary education.

Subprime Mortgage Crisis

The subprime mortgage credit crisis spurred a collapse in all financial markets as investors became wary of purchasing even the most secure financial assets. Decreased liquidity and the increase in the cost of capital were the primary issues challenging the student loan industry. Many lenders of student loans do not keep these assets in house. Instead, they package together a group of loans, transfer them to a trust,

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The subprime mortgage credit crisis spurred a collapse in all financial markets as investors became wary of purchasing even the most secure financial assets.

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³⁷ Kalcevic, Deborah and Justin Humphrey. "H.R. 2669 College Cost Reduction and Access Act." *Congressional Budget Office Cost Estimate* (September 19, 2007). <http://www.nchelp.org/elibrary/BudgetReconciliation&HEAReauthorization/2007HEALegislation/StatutoryMaterials/CBOCostHR2669.pdf>.

³⁸ Borrower benefits are typically discounts that lenders offer for competitive purposes. The most common discounts include a 0.25% interest rate reduction for using direct debit methods to make monthly loan payments, waiver of borrower loan origination fees, waiver of default fees, and interest rate reduction for consecutive on-time payments.

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No student loan originated since October 1, 2007 has been used as an asset-backed security, unless significant credit and yield enhancements were a part of the offering.

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and sell securities in the trust; this is termed “securitization.” Securitizations backed by student loans as revenue-producing assets are referred to as Student Loan Asset Backed Securities (SLABS). The American Securitization Forum reports that 85% of FFELP loans are securitized.³⁹ Securitization allows lenders to quickly recover cash, which can then be used to create additional loans.

The problems in the subprime mortgage market began affecting the Asset Backed Security (ABS) markets in the late summer of 2007. Initially investors avoided only mortgage-backed securities, but concern with all asset categories quickly spread throughout the rest of the ABS markets as investors became anxious about all forms of securitization. Even the more secure forms of ABSs, those containing student loans guaranteed against default by the U.S. Government, fell victim to the credit crisis as investors scrambled for liquidity. No student loan originated since October 1, 2007 has been used as an asset-backed security, unless significant credit and yield enhancements were a part of the offering.⁴⁰

The interest rates on SLABS are usually pegged to the LIBOR index plus a margin; this type of securitization is referred to as LIBOR-based or floating-rate funding. Market disturbances have forced lenders to pay more in order to attract investors. In early summer 2007 lenders were financing at LIBOR + 10 basis points, but by April 2008 transactions in the ABS market were done at LIBOR + 140.⁴¹ Stated simply, these rates indicate that, on average, lenders’ cost of capital increased by 1.3 percent during that time period. The high cost of capital has made it less profitable for lenders to make loans to students at low, fixed rates.

While two-thirds of student loan securitization is floating-rate structured, one-third of lenders’ liquidity needs are funded through the auction rate securities market.⁴² To increase profitability, many lenders seek to find the lowest cost of capital by selling existing loans as Auction Rate Securities. Auction Rate Securities essentially allow lenders to borrow for the long term at short-term rates. The interest rate on these securities is determined at the time of the auction through a competitive bidding process; auctions are typically held every 7, 28, or 35 days. A failed auction results if there are not enough orders to purchase all outstanding shares. Auctions for student loan securities began failing in November 2007 when investors demanded higher returns than the maximum rate (determined based on the interest income and fees

³⁹ U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs. “Turmoil in U.S. Credit Markets: Impact on the Cost and Availability of Student Loans.” Testimony by Tom Deutsch, Deputy Executive Director, American Securitization Forum (April 15, 2008). <http://banking.senate.gov/public/index.cfm?Fuseaction=Hearings.Detail&HearingID=08955ff1-d3cc-434c-b32a-60972599a048>.

⁴⁰ Kantrowitz, Mark. “Solving the Student Loan Credit Crunch.” *FinAid.org* (April 30, 2008). <http://www.finaid.org/educators/2008-03-10studentloancreditchrisis.pdf>.

⁴¹ U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs. “Turmoil in U.S. Credit Markets: Impact on the Cost and Availability of Student Loans.” Testimony by John F. (Jack) Remondi, Vice Chairman and Chief Financial Officer, Sallie Mae (April 15, 2008). <http://banking.senate.gov/public/index.cfm?Fuseaction=Hearings.Detail&HearingID=08955ff1-d3cc-434c-b32a-60972599a048>.

⁴² Ergungor, O. Emre and Ian Hathaway. “Trouble Ahead for Student Loans?” *Economic Commentary, Federal Reserve Bank of Cleveland* (May 15, 2008). <http://www.clevelandfed.org/research/commentary/2008/0508.cfm>.

from the loans) specified in the bond's official statement.⁴³ If an auction fails, the interest rate is set at the maximum that was defined in the securitization contract, typically well above prevailing short-term commercial paper rates. Unable to securitize existing student loans at a reasonable rate, lenders must use other methods to access the capital required to issue new loans to college students or suspend participation in or permanently exit the FFEL program. Additionally, lenders that specialized in student loans were more likely to suspend participation or permanently exit the FFEL program than those that have additional revenue streams to keep them afloat, such as bank account fees. A recent publication from Moody's assessed the scope of student loans in bond auctions: "Of the estimated \$325 billion to \$360 billion in bonds that are offered in the auction rate market, about \$80 billion to \$90 billion are backed by FFELP student loan collateral."⁴⁴

Brazos Higher Education Service Corporation

Especially relevant to Texas was the announcement that as of March 21, 2008 Brazos Higher Education Service Corporation suspended its participation in FFELP. Brazos is the largest of the four Texas-based HEAs, third largest among all secondary markets active in Texas, and is the nation's largest nonprofit holder of federally guaranteed student loans. Murray Watson, Jr., President and CEO of Brazos, cited the following rationale for suspending participation in FFELP in a press release:

This action is necessary due to the ongoing credit crisis in the capital markets. In the past, these lenders have funded student loans from lines of credit arranged from credit providers and later securitized in the asset backed securities market. As the credit markets have tightened, access to both the credit lines and securitization market has ceased.⁴⁵

Brazos is headquartered in Waco, Texas and has an office in Austin. With \$15.4 billion in federally guaranteed student loans outstanding, Brazos is the fourth largest holder of FFELP student loans in the United States.⁴⁶ With nearly 50 percent of its total student loan backed debt in Auction Rate Securities (\$8.1 billion of \$16.4 billion in student loan backed debt) as of December 31, 2007,⁴⁷ Brazos is the largest municipal borrower in the Auction Rate Securities market.⁴⁸

Lenders that specialized in student loans were more likely to suspend participation or permanently exit the FFEL program than those that have additional revenue streams.

⁴³ In his March 24, 2008 article titled "Brazos Education Quits Student Loans Amid Auction Market Woes" on *Bloomberg.com*, Michael McDonald reports the average rate for auction bonds was 6.56% as of March 19, 2008 after reaching a record 6.89% on Feb. 20, 2008. The rate averaged 3.81% during the previous 12 months.

⁴⁴ "Moody's Evaluates Impact of Higher Interest Rates on Student Loan-Backed Securitizations," *Moody's Investor Service Press Release*, February 4, 2008.

⁴⁵ Watson, Murray Jr. "Brazos Suspends Lending." *Press Release, Brazos Higher Education Service Corporation* (March 21, 2008). <http://www.nasfaa.org/PDFs/2008/Brazos.pdf>.

⁴⁶ *FinAid.org. Largest Education Lenders.* <http://www.finaid.org/loans/biglenders.phtml>.

⁴⁷ Brazos Higher Education Authority, Inc. "Brazos Group Presentation." *Brazos Group Web Site: Investor Reporting* (February 2008). <http://www.brazosgroup.com/OMs%20Financials%20&%20Continuing%20Disclosures/Presentation%202-2008.pdf>.

⁴⁸ "Top Issuers: Auction-Rate Issues." *The Bond Buyer*, vol. 363, no. 32818 (February 14, 2008).

Because of the illiquid state of the Auction Rate Securities market, the costs associated with servicing Brazos' debt have increased by \$11 million a month.⁴⁹ Brazos began financing through the Auction Rate Securities market to increase profit margins in the 1990s, when the spread between its interest revenues and borrowing costs for traditional variable-rate and fixed-rate bonds declined. However, Auction Rate Securities are no longer cost saving; the recent increase in yields on Auction Rate Securities has put Brazos in the position where expenses exceed revenues. In a June 2 *Bloomberg* article, a credit-rating executive reported that Brazos was paying 5 percent on Auction Rate Bonds (up from 2 percent the previous year) while receiving only 4 percent on the loans backing the bonds.⁵⁰

The Ensuring Continued Access to Student Loans Act (ECASLA) that was signed into law on May 7, 2008 allowed the Department of Education to act as a secondary market on a temporary basis to provide capital to education lenders in a time of market distress. A stipulation of the legislation requires that the liquidity provided by the Department of Education be used to fund new student loans. Believing this legislation would end its liquidity problems, Brazos announced it would re-enter the FFELP on June 17, 2008. However, Brazos' statute prohibits it from originating federally backed student loans. To issue FFELP loans, it may use a trustee bank to essentially funnel its bond money, with that bank then using the money to originate FFELP loans. Legal limitations on student loan originations and time constraints before funding have made it difficult for Brazos to meet certain of the specified requirement of issuing new loans, and Brazos again suspended its participation in the FFELP on July 28, 2008. Ellis Tredway, executive vice president of planning and government affairs at Brazos, stated that his organization simply "ran out of time to get everything in place" to issue new student loans for the fall.⁵¹ *InsideHigherEd.com* reports that "Brazos is currently working with other entities to find liquidity in hopes of being able to make federal loans next spring or fall."⁵²

⁴⁹ Preston, Darrell. "Brazos Auction-Rate Yields Exceed Loan Interest Rates." *Bloomberg.com* (June 2, 2008). <http://www.bloomberg.com/apps/news?pid=20601103&sid=albPFQhzERPo&refer=us>.

⁵⁰ *Ibid.*

⁵¹ Lederman, Doug. "More Uncertainty in Student Loan Programs." *InsideHigherEd.com* (July 29, 2008). <http://www.insidehighered.com/news/2008/07/29/loans>.

⁵² *Ibid.*

Section 3

Government Response
and Effect in Texas

The College Board became the first lender to leave the FFELP due to the credit crisis when it exited in August 2007. During the fall of that year lenders began announcing layoffs. Student loan giant Nelnet was among the first to reduce their workforce, but they were soon followed by Sallie Mae, College Loan Corporation, and Student Loan Xpress. Lenders scaled back their operations by ceasing new consolidation loans, reducing borrower benefits, and suspending FFELP and/or private loans. By March of 2008 almost daily press releases announced the latest program suspensions. On April 14, 2008, JP Morgan Chase notified their school customers that they would determine the schools where they would continue to maintain a market presence by applying profitability standards. Many other student lenders followed suit, causing access worries at short-term programs such as proprietary schools and community colleges, especially if these schools had high default rates. School-as-lender discount agreements were also terminated, causing many schools to consider shifting to the Direct Loan program despite their previous reservations.⁵³

Government Response

In response to these destabilizing events, members of the U.S. Senate and House of Representatives quickly drafted legislation in April 2008 to address the growing crisis. Members of the congressional committees with oversight responsibilities over banking introduced legislation to allow federal bank entities (i.e. Federal Home Loan Banks and Federal Financing Bank) to buy packages of securitized student loans. Senator John Kerry and Representative Paul Kanjorski hoped that these purchases would restore liquidity in the student loan market until the credit market rebounded. The respective Chairmen of the Education Committees — Senator Edward Kennedy and Representative George Miller — took a different approach, one that would involve the Department of Education (ED) buying FFELP loans from lenders and carrying these as loans serviced by the ED government contractor. These loans accordingly will not receive the default prevention and counseling assistance of guarantors. Movement on the Kerry and Kanjorski bills stalled as the Education Committee legislation received swift bipartisan action culminating in the passage of ECASLA. President George W. Bush signed this bill into law on May 7, 2008. The key provisions of this act were:

Raise the FFELP Loan Limits: On April 7, 2008, the Boston-based guarantor of non-FFELP private loans — The Education Resource Institute (TERI) — filed for bankruptcy.⁵⁴ With the financial collapse of the largest guarantor of private loans, many lenders became wary of making private loans without the assurance of a guarantee and tightened their lending criteria or left the private loan market. ECASLA raised the FFELP loan limits significantly to fill the void left by the suspension of many private student lenders by allowing borrowers to get the additional money they need through the federal student loan programs. The old and new loan limits are shown in Figure 8.

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Members of the U.S. Senate and House of Representatives quickly drafted legislation in April 2008 to address the growing crisis.

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⁵³ FinAid.org. *Lender Layoffs and Loan Program Suspensions* (as of October 17, 2008). www.finaid.org/loans/lenderlayoffs.phtml.

⁵⁴ Ibid.

Figure 8: 2008 Stafford Subsidized and Unsubsidized Loan Limits

		Freshman Year	Sophomore Year	Junior Year	Senior Year	Aggregate Undergrad Limit
Dependent Students whose parents were not denied a PLUS loan	Total Amount of Subsidized and Unsubsidized Loans	\$5,500 (up from \$2,625)	\$6,500 (up from \$3,500)	\$7,500 (up from \$5,500)	\$7,500 (up from \$5,500)	\$31,000 (up from \$23,000)
	Maximum Amount of Subsidized Loans	\$3,500 (up from \$2,625)	\$4,500 (up from \$3,500)	\$5,500 (same as previous)	\$5,500 (same as previous)	\$23,000 (same as previous)
Independent Students and Dependents whose parents were denied a PLUS loan	Total Amount of Subsidized and Unsubsidized Loans	\$9,500 (up from \$2,625)	\$10,500 (up from \$7,500)	\$12,500 (up from \$10,500)	\$12,500 (up from \$10,500)	\$57,500 (up from \$46,000)
	Maximum Amount of Subsidized Loans	\$3,500 (up from \$2,625)	\$4,500 (up from \$3,500)	\$5,500 (same as previous)	\$5,500 (same as previous)	\$23,000 (same as previous)

Lender-of-Last-Resort Program: Within the existing Higher Education Act, guarantors had been required to serve as the lender-of-last-resort, i.e. to make loans directly to borrowers in circumstances where no FFELP lenders were willing to lend to a qualified borrower at an eligible school. Rarely used, the lender-of-last-resort program had been confined to a small number of students at a few schools. Each borrower had to demonstrate inability to secure a FFELP lender. The ECASLA loosened this requirement by allowing guarantors to implement the function on a school-wide basis in certain instances. This authority would allow guarantors to streamline the process and would address the larger scale of the problem were this emergency measure ever needed.

U.S. Department of Education (ED) as Secondary Market: Perhaps the biggest departure from current statute was the empowering of ED to serve as a temporary emergency secondary market for lenders unable to sell their loans to FFELP secondary markets or realize asset liquidity through the sale of securitizations. While these purchase agreements were prohibited from adding cost to the federal government, the specific terms were left to the discretion of the Secretary of Education. The Secretary's challenge was to set the terms so that the program would augment, and not replace, the current system of financing FFELP loans.

Less than two weeks after the enactment of ECASLA, Secretary of Education Margaret Spellings announced the details of ED's plan to implement this new law. The plan provided student lenders with two options for funding new loans, reinvigorated the lender-of-last-resort program, reaffirmed ED's commitment to a strong FFELP, and

readied the Direct Loan program for dramatically increased loan volume. The lender funding mechanisms were central to the plan:

- (1) **Loan Purchase Commitment:** FFELP lenders would have until July 1, 2009 to enter into a loan purchase agreement with ED, with sales under the agreement to be completed by September 30, 2009. The price of these loans would be set at a level to allow lenders to recover their costs, but at no additional cost to the federal government.
- (2) **Access to Short-term Liquidity:** For loans made for the 2008-09 academic year, ED would buy “participation interests” from lenders. The participation interests would be pegged at the short-term commercial rate plus 50 basis points.⁵⁵

In response to ED’s plan, Sallie Mae, Nelnet, NorthStar Guarantee, and many state agencies agreed to continue making FFELP loans.⁵⁶ Congress has extended these provisions until July 1, 2010.

While this legislation and the Secretary’s quick action temporarily kept FFELP lenders making student loans for the 2008-09 academic year, the overall credit markets have deteriorated. By late September 2008, the subprime mortgage crisis had endangered the world economy, prompting Congress and the President to collaborate on the largest financial bailout in U.S. history. The Emergency Economic Stabilization Act granted the Secretary of the Treasury broad powers to promote liquidity and buy distressed assets. While focused on nonperforming mortgage loans, section 3(9) (B) of this act empowered the Secretary of the Treasury to consider other types of loans, including FFELP and private student loans, as “troubled assets.” However, on October 10, 2008, the secretaries of Treasury and Education issued a joint statement implying that the extension of the Ensuring Continued Access to Student Loan Act for an additional year (which was signed into law on October 7, 2008) provides the Administration with the tools it needs to maintain funding for federal student loans.⁵⁷ Policymakers and student loan industry participants will monitor the FFEL program and the credit markets throughout the school year to determine if additional action is needed.

⁵⁵ U.S. Department of Education. *Protecting Student Access and Affordability in Higher Education: The Secretary’s Plan for Ensuring Access to Federal Student Loans for the 2008-09 School Year* (May 21, 2008). <http://www.ed.gov/students/college/aid/loans.html>.

⁵⁶ FinAid.org. *Lender Layoffs and Loan Program Suspensions* (as of October 17, 2008). www.finaid.org/loans/lenderlayoffs.phtml.

⁵⁷ U.S. Department of Education. *Joint Statement by Treasury Secretary Henry M. Paulson, Jr. and Department of Education Secretary Margaret Spellings* (October 10, 2008). <http://www.ed.gov/news/pressreleases/2008/10/10102008.html>.



In good economic times, competition within the FFELP spurs innovation, promotes customer service, and keeps costs low for borrowers.

Despite many fears, no student was denied a FFELP loan in Texas.



Student Access to Educational Loans in Texas

In good economic times, competition within the FFELP spurs innovation, promotes customer service, and keeps costs low for borrowers. The FFELP — with the help of some timely intervention by Congress and ED — showed resilience in the face of the most challenging of financial circumstances. Despite many fears, no student was denied a FFELP loan in Texas. TG mobilized its computer systems and implemented a comprehensive communication strategy to alert schools and students of their right to obtain loans through the lender-of-last-resort program. *Yet no student had the need to seek this emergency measure, as lenders were found to make FFELP loans to students attending school in Texas.* More common was for lenders to voluntarily drop off schools' preferred lender lists. As some financially strapped lenders left certain markets — or dropped out of the program completely — other lenders stepped in to provide the credit that students needed to stay in college. Nevertheless, the disruptions caused anxiety and administrative burdens for schools and borrowers accustomed to a more dependable source of loans.

Most borrowers saw no change in their lender. Some borrowers experienced more difficulty in securing student loans, but were ultimately able to do so. Borrowers whose lenders left the programs or that only made loans available of certain types or at certain schools were required to find new lenders. Even if these borrowers had little difficulty locating a new lender, they will now have to keep track of “split loans” following college. Split loans occur when a borrower has loans with more than one lender. Having split loans makes it more difficult to coordinate payment schedules, deferments, forbearances, and the consolidation of loans. Schools worked hard behind the scenes to maintain as much continuity as possible for borrowers. For example, late in the processing cycle for fall enrollment, one lender announced that it would not be able to disburse loans that had already been guaranteed and on which borrowers expected to receive funding. This caused schools to scramble to notify borrowers and to help find lenders for their students. Conversely, some lenders that limited their market kept making loans to students who had previously borrowed from them, even if the lenders no longer loaned to new borrowers at that school. The next section will review the extent of this situation in Texas.

FFELP Lender Suspensions in Texas

A number of lenders left the FFELP within the last year.⁵⁸ While many of these lenders have a relatively small share of the student loan market, some lenders that have discontinued or limited their involvement in the program have had a large presence in the industry historically. The institutions that have exited the FFELP, either by choice or out of necessity, are not limited to banks. Rather, suspension of the program has crossed all categories of lenders — banks, credit unions, nonprofit secondary markets, publicly traded secondary markets, and schools that serve as student loan lenders.

⁵⁸ All calculations in this section exclude consolidation loans.

As of October 27, 2008, 168 lenders out of 3,168 nationally had halted their participation in at least one type of FFELP loan program.⁵⁹ The majority of these lenders have stopped providing all FFELP loan types — Stafford, PLUS, Grad PLUS, consolidation loans, and rehabilitation loans. Even though FY 2008 saw a record increase in the dollar amount in FFELP loans made, the number of lenders from which either students or students' parents could borrow has decreased. Some of the 168 lenders continued to make Stafford, PLUS, and Grad PLUS loans, but stopped offering consolidation loans (which have become the least profitable type of FFELP loan). Both small and large participants in the FFELP have suspended their lending. For example, Happy State Bank, a relatively low-volume, Texas-based lender, exited the program this past summer. Among the earliest of lenders to suspend their student loan operations was the College Loan Corporation (CLC). In FY 2007, CLC was the seventh largest originator of non-consolidation loans and the ninth largest consolidator in the nation. The CLC originated \$29,428,393 in loans in Texas between June 1st and September 30th of FY 2007, but only \$3,500 during the same months of FY 2008.

Information from TG's database suggests that there are indeed fewer lenders originating student loans in Texas. Between June 1, 2007 and September 30, 2007 TG guaranteed loans for 253 originating lenders for Texas higher education students. During the same period in 2008, TG guaranteed loans for 199 lenders. Seven of TG's 20 largest volume lenders from June 1, 2007 to September 30, 2007 dropped below the top 20 in ranking. Even more significantly, all seven lenders had a volume decrease of 80 percent or over. However, as a group the 199 lenders of 2008 originated a higher dollar amount in loans than did the 253 lenders in 2007. As demonstrated in Figure 9, several of the top 20 volume lenders of the period of June 1, 2007 to September 30, 2007 had significant increases in volume for the same months of the subsequent year.

An important question is whether there were any particular Texas regions in which students borrowed a lower dollar amount in FFELP loans in 2008 than they had in 2007. Figure 10 uses TG data to show the difference in lender volume by region during the periods from June 1, 2007 to September 30, 2007 versus June 1, 2008 to September 30, 2008.

**Figure 9: Lender Ranking Changes —
Loans at Texas Schools (June – September)⁶⁰**

Lender's Rank in 2007	Lender's Rank in 2008	% Change in Volume (\$) from 2007
1	1	21%
2	2	9%
3	4	-9%
4	3	78%
5	6	19%
6	5	39%
7	0	-100%
8	7	74%
9	9	24%
10	8	37%
11	10	43%
12	63	-97%
13	0	-100%
14	12	-8%
15	194	-99%
16	17	-13%
17	25	-45%
18	44	-84%
19	50	-89%
20	196	-99%

⁵⁹ FinAid.org. *Lender Layoffs and Loan Program Suspensions* (as of October 17, 2008). www.finaid.org/loans/lenderlayoffs.phtml.

⁶⁰ Based on TG data only.

Five of the regions in Figure 10 saw an increase in volume, with the lowest in the Central Texas region (10 percent) and the highest in the Gulf (19 percent). The East Texas and Rio Grande Valley regions had a decrease in volume across the two periods and, at -27 percent, the drop in the Rio Grande Valley was considerable.

Figure 10: Lender Volume Change by Texas Region — Regions' Top 10 FFELP Lenders (June – September)

Region	% Change from 2007
Central Texas	10%
East Texas	-3%
Gulf Coast	19%
Metroplex	16%
Panhandle	18%
Rio Grande Valley	-27%
West Texas	16%

Figure 11 indicates that several of the Rio Grande Valley's top 10 volume lenders during the period of June 1, 2007 and September 30, 2007 underwent a dramatic decrease in dollar amount of financial aid loans made to Rio Grande Valley students. Two of the region's highest volume lenders were among the FFELP lenders that left the program completely during FY 2008. As such, the departure of these lenders had the potential to significantly affect the ability of the region's students to access federal student loans. Fortunately, the negative impact to students was mitigated, partly because one of the region's lenders nearly tripled its volume from the period between June 1, 2007 and September 30, 2007 to the period between June 1, 2008 and September 30, 2008.

Figure 11: Lender Volume Change, Rio Grande Region — Top 10 FFELP Lenders (June – September)

Lender's Rank in 2007	Lender's Rank in 2008	% Change from 2007
1	11	-94%
2	2	29%
3	4	-23%
4	8	-57%
5	3	5%
6	12	-93%
7	0	-100%
8	7	9%
9	1	284%
10	0	-100%

Figure 12 shows at least some volume decreases within particular regions in all but the proprietary school sector. These decreases were not distributed evenly across regions. Once again, the loss of FFEL volume was shouldered mostly by the Rio Grande Valley. Two of the larger schools in the Rio Grande Valley, the University of Texas–Pan American (a four-year public school) and Texas State Technical College–Harlingen (a 2-year public school), transitioned from the FFEL program to Direct Lending during this period, resulting in a combined decrease of over \$27 million dollars in FFELP volume from the period between June 1, 2007 and September 30, 2007 to the period between June 1, 2008 and September 30, 2008. Uncertain of access to FFELP lenders, these schools chose to leave the program of their choice in order to assure their students access to federal loans. In seeking to minimize uncertainty, schools appeared willing to forgo the advantages their students had enjoyed in the FFEL program, such as borrower benefits.⁶¹

Figure 12: Lender Volume Change by Region and Sector (June – September)

Region	2-Year	4-Year Private	4-Year Public	Proprietary
Central	-3%	26%	-5%	10%
East Texas	34%	-10%	15%	N/A
Gulf Coast	58%	33%	5%	12%
Metroplex	45%	1%	10%	22%
Panhandle	13%	12%	20%	23%
Rio Grande Valley	-89%	N/A	-27%	39%
West Texas	-8%	N/A	4%	24%

Serving as one test of whether Texas higher education students were impacted by lenders exiting the FFEL program, Figure 13 examines volume change for TG’s top 20 largest volume schools (from June 1, 2007 through September 30, 2007 versus June 1, 2008 through September 30, 2008). The data indicate that most of these large schools saw an increase rather than a decrease in volume across the two periods. Assuming that the schools did not undergo a substantial increase in either students or cost of attendance, it appears that the students from these schools were able to find FFELP loans, although their choice of lenders may have been narrowed.

However, the exceptions below are notable ones. For example, the top 5 volume lenders for Stephen F. Austin State University originated 40 percent less volume from June 1, 2008 through September 30, 2008 than they did from June 1, 2007 through September 30, 2007. This is partially a result of Commercial Bank of Texas’s exiting the FFEL program effective May 21, 2008. Nevertheless, Stephen F. Austin State University actually saw an overall increase of 19 percent of volume from June 1, 2007 through September 30, 2007. It appears that other lenders were able to fill the gap left by the lender’s exit from the FFEL program.

⁶¹ National Association of Independent Colleges and Universities. *NAICU Follow-up Survey on the Impact of the Credit Crunch on Student Loans at Independent Colleges and Universities* (September 2008), p. 4. http://www.naicu.edu/news_room/naicu-follow-up-survey-on-the-impact-of-the-credit-crunch-on-student-loans-at-independent-colleges-and-universities.

The school with the largest drop in volume from June 1, 2007 through September 30, 2007 versus June 1, 2008 through September 30, 2008 was the University of Houston–Clear Lake. This decrease is almost entirely attributable to the fact that the school moved to the Direct Lending program this year.

Figure 14 focuses on changes in volume for TG’s top 20 2-year public and proprietary schools. Changes in lender availability might be particularly disruptive to borrowers from these institutions, as some lenders have recently stopped providing loans to schools where borrower balances tend to be low. TG data indicate that half of the schools in Figure 14 demonstrated a drop in loan volume between June 1, 2007 and September 30, 2007. For several of the schools (e.g., Collin County Community College), volume decreased by almost 100 percent. However, in almost all instances, volume loss is mainly accounted for by school guarantor changes. While the two branches of Texas State Technical College moved to Direct Lending in FY 2008, the federal loans for other institutions, such as Collin County Community College, are now guaranteed by agencies other than TG. Because TG does not have access to lender information from other guarantors, it is unknown whether or not there have been

Figure 13: Volume Change of Top 5 Lenders at Top 20 Schools in Texas (June – September)⁶²

Rank	School	% Change in Volume from 2007 to 2008
1	University of Texas at Austin	25%
2	University of North Texas	17%
3	Texas A&M University	24%
4	University of Texas at San Antonio	-19%
5	University of Houston	32%
6	Texas Tech University	7%
7	Southern Methodist University	1%
8	Texas Southern University	11%
9	Baylor University	53%
10	University of Texas at Arlington	-12%
11	University of Texas at El Paso	17%
12	Sam Houston State University	8%
13	Stephen F. Austin State University	-39%
14	University of Texas at Dallas	5%
15	Texas Woman’s University	4%
16	Texas A&M University – Corpus Christi	<1%
17	Texas Christian University	-18%
18	University of Houston – Clear Lake	-95%
19	University of Houston Health Science Center–Clear Lake	15%
20	Tarleton State University	19%

⁶² Based on TG data only.

lender disruptions for the schools that no longer use TG as their primary guarantor. Data for the schools that saw an increase in TG volume from June 1, 2007 through September 30, 2007 to June 1, 2008 through September 30, 2008 suggest that there were no significant effects of lender FFELP suspensions on TG's FY 2007 highest volume short-term schools.

Private, Non-Federal Lender Suspensions

FFELP loans are not the only aid that traditional lending institutions have suspended. Even though the rapid increase in college costs over the past five years has required more students and their families to take out private loans for the purpose of higher education, a number of lenders have ceased offering this supplemental funding this year. This number may be even larger than currently known, as it is likely that many lenders that have stopped providing private student loans have not made this announcement to a broad public audience.⁶³ It appears that some institutions that continue to lend private student loans are significantly raising the FICO score (also known as the credit score) requirements for lending to students and their families.

Figure 14: Volume Change of Top 5 Lenders at Top 20 Short-Term Schools in Texas (June – September)

Rank 2007	School	% Change from 2007
1	Austin Community College	14%
2	Blinn College	17%
3	McLennan Community College	12%
4	Texas State Technical College–Waco	-96%
5	Tyler Junior College	33%
6	Navarro College	-8%
7	South Plains College	-54%
8	Temple College	7%
9	Amarillo College	5%
10	San Jacinto Community College District	-1%
11	Collin County Community College	-93%
12	St. Phillip's College	23%
13	ATI Career Training Center	-99%
14	Texas State Technical College–Harlingen	-98%
15	Concorde Career Institute	-45%
16	Trinity Valley Community College	5%
17	San Antonio College	-14%
18	El Paso County Community College	7%
19	Houston Community College	302%
20	ATI Technical Training Center	-99%

⁶³ In general, it has been difficult to measure precisely how many lenders offer private loans and how much money is borrowed for meeting college costs. Although lenders are required to report the amount of money they distribute to students through the FFELP, there is no centralized point for reporting who borrows private educational loans or how much is borrowed.



The increase in the FFELP annual and aggregate loan limits have moderated the demand for private loans somewhat.



The increase in the FFELP annual and aggregate loan limits have moderated the demand for private loans somewhat, although students attending high-cost colleges and more affluent families seeking to extend higher education expenses over time still rely on private loans to pay for college. Borrowers seeking private student loans faced more difficulties finding private lenders at an affordable price this year.

The Direct Lending Option

In light of the uncertainty of lender participation in the FFELP, many Texas schools completed the required paperwork to become eligible for Direct Lending (DL). Many took these steps as a safeguard in case FFEL lenders could not be found. A few schools that were heavily reliant upon lenders that suspended or narrowed their market decided to switch their processing of loans to DL. Some technical colleges that used lenders allied with Brazos Higher Education Authority left FFELP for DL. In the Rio Grande Valley, University of Texas–Pan American and Texas State Technical College–Harlingen decided to use DL in order to have a more certain source of federal loans. The largest DL school in Texas, Texas State at San Marcos, decided to process all of their loans through DL. Previously, they had allowed students who had prior FFELP loans to remain in that program in order to avoid students having loans in separate programs.

Summary and Conclusion

Over the last 12 months, the student-lending industry has experienced its most volatile period since its inception. The crisis in the U.S. financial sector and world markets has made it more difficult for student lenders to finance their student loan acquisitions. At the same time, changes in national policy priorities resulted in reductions in federal subsidies, which lowered lender profit margins. What had been an aggressive market with new and traditional lenders competing to gain access on school preferred-lender lists has suddenly stalled and proven vulnerable. With quick action from Congress and ED, student lending through the FFELP delivered record amounts of education loans to students seeking access to college. However, disruptions along the way have added an additional administrative burden to schools and caused anxiety among students. While some Texas schools have sought refuge in DL, most stayed in the FFELP and found lenders for their student loan needs.

There remains work to be done to ensure access to FFELP loans in the future. Much of the legislation and regulation designed to address the current credit crunch in the FFELP are temporary and may expire. Lenders continue to monitor their options under the Secretary's purchase plan; lender decisions in the next 12 months will test the viability of the FFELP for Texas students. Given the value and assistance that the FFELP has brought to Texas students over the years, the stakes remain high.



With quick action from Congress and ED, student lending through the FFELP delivered record amounts of education loans to students seeking access to college.



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