New America Foundation

Issue Brief

Student Loan Purchase Programs Under the Ensuring Continued Access to Student Loans Act of 2008

Jason Delisle, Federal Education Budget Project, Education Policy Program

December 2009 Update

In May of 2008, Congress passed the Ensuring Continued Access to Student Loans Act (ECASLA) in response to concern that credit market conditions could disrupt federal student loan availability. The law gives the U.S. Department of Education temporary authority to purchase federally backed student loans made by private lenders, effectively providing a secondary market for the loans. Congress opted to leave the new purchase authority largely undefined in statute, giving the Department considerable discretion to design and administer it. The Department created four separate loan purchase arrangements under ECASLA: a put option; a short-term purchase program; a financing arrangement; and an asset-backed commercial paper support program. This issue brief provides a detailed description of these arrangements and updates earlier versions released in 2009.

Background

The Federal Family Education Loan (FFEL) program provides federal subsidies to private lenders that make loans to students enrolled in postsecondary education.[1] In 2007, FFEL lenders provided nearly 75 percent of federal student loans. Lenders must finance FFEL loans with funds raised in private capital markets. These markets were severely disrupted in 2008 and 2009, inhibiting private lenders' ability to raise sufficient and affordable capital. Federal policymakers and the wider financial aid industry confronted the possibility that FFEL lenders, absent any Congressional action, would not be able to make loans for the 2008-09 and 2009-10 academic years.

The Direct Loan program could theoretically have met loan demand not covered by FFEL. The program provides loans at nearly identical borrower terms as the FFEL program directly from the U.S. Treasury. As credit market problems unfolded in 2008, however, policymakers feared the Direct Loan program could not smoothly handle a rapid increase in loan volume.[2] At the same time, some policymakers favored the continued use of private entities via the FFEL program over an expansion of the Direct Loan program.[3] Consensus suggested that FFEL lenders needed assistance to ensure the availability of federal loans for all students. In response, Congress passed and the President signed into law the Ensuring Continued Access to Student Loans Act (ECASLA) in May of 2008.[4] It should be noted that since 2008 many colleges and universities have voluntarily switched to the Direct Loan program in response to political and financial uncertainties surrounding the FFEL program. Among other things, ECASLA grants the Department of Education the authority to purchase FFEL loans from lenders. This ensures lenders have adequate and affordable capital to make loans and can convert their loan assets into cash if necessary. Establishing the Department as a guaranteed loan buyer can give investors more confidence, thereby making it easier for lenders to raise capital. Additionally, lenders can use loan sale proceeds to issue new FFEL loans. The loan purchase authority was originally set to expire on July 1, 2009, but was extended for an additional year by legislation enacted in October 2008.[5] Some members of Congress support a further extension of the law and introduced legislation to that end in November 2009.[6]

The ECASLA loan purchase authority is largely undefined in law and establishes only a few broad implementation requirements. For example, it limits the purchase authority to loans originated between October 2003 and July 2010, and requires the Department of Education (in consultation with the Office of Management and Budget and the U.S.

U.S. Department of Education Student Loan Purchase Programs Under The Ensuring Continued Access to Student Loans Act of 2008

Loan Purchase Program	Effective Date	Eligible Loans (Academic Year Issued)*	Purchase Price Paid by Ed Dept	Requirements
Put Option	5/21/08 to 9/30/10	2008-09 and 2009-10	100 percent of unpaid principal and accrued interest, plus $75 fee; 1 percent lender origination fee reimbursed	Loan sale includes all individual borrower's loans
Short-Term Put Option	12/01/08 to 2/28/09	2007-08	97 percent of unpaid principal plus accrued interest	$3,000 minimum average loan balance within loan package sold; $500 million maximum aggregate weekly Ed Dept. Purchase
Financing	5/21/08 to 9/30/10	2008-09 and 2009-10	100 percent of principal	$50 million minimum lender-sponsored loan pools; Lender pays Ed Dept. 3-month commercial paper interest rate, plus 0.5 percentage points
Conduit	5/01/09 to 1/20/14**	2003-04 to 2009-10***	100 percent of principal and accrued interest for loans issued after 5/01/08; 97 percent of unpaid principal plus accrued interest for earlier loans	Conduit pays annual and monthly fees to Ed Dept.; Loans in conduit include all individual borrower's loans; Loans put to Ed Dept. from conduit selected by complex process

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

***Loans may not be put into the conduit after June 30, 2010, but the put option on loans in the conduit does not expire until 2014.*

****Loans made after July 1, 2009 and disbursed after September 30, 2009 are ineligible.*

Source: U.S. Department of Education; New America Foundation.

Treasury) to establish the price at which loans will be purchased. The price cannot result in new costs to the federal government and the agencies must publish a statement outlining the methodology and factors used to establish purchase prices.[7] The law also requires lenders participating in a purchase program to continue making new FFEL loans. The Department of Education has used its purchase authority under ECASLA to implement four different arrangements that apply to Stafford and PLUS loans, but not consolidation loans. Each arrangement is discussed below.

ECASLA Loan Volume By Year Originated ($ billions)

Program	2007-08	2008-09	2009-10*	Total	Lenders (actual)
Put Option	--	48.5	2.4	50.9	93
Financing	--	33.4	14.8	48.1	30
Short-Term Put Option	1.0	--	--	1.0	6

**As of December 9, 2009*

Source: U.S. Department of Education; New America Foundation

Purchase Commitment ("Put Option")

The Department announced in May 2008 that it would implement a purchase commitment program giving lenders the option to sell FFEL loans issued for the 2008-09 academic year. This option expired on September 30, 2009.[8] Lenders have until September 30, 2010 to sell loans made for the 2009-10 year. The arrangement is a "put option" because it allows, but does not require, lenders to "put" (sell) loans to the Department by a certain date at a predetermined price. For example, a lender that made a FFEL loan in August 2009 may sell it to the Department at any point until September 30, 2010. Alternatively, the lender may let the option expire on that date and continue to hold the loan. When selling 2008-09 or 2009-10 loans via the put option, a lender must sell all loans it holds for a particular borrower for those years.

Under the put option, the Department pays lenders the face value of the loan (unpaid principal and accrued, unpaid interest), plus a $75 fee to cover lenders' origination, servicing, and loan sale costs. Lenders are also reimbursed for the 1 percent origination fee paid to the Department when the loan was made. The Department used information from lenders and loan servicers to set the fee, determining that it costs small lenders $75, and large lenders $20 to $30, to originate a loan. They also estimated that selling a loan to the Department costs lenders an additional $20 to $50.[9]

The put option only applies to loans issued for the 2008-09 and 2009-10 academic years. This limitation may exist to guard against "cherry picking," whereby lenders sell the worst performing or lowest balance loans to the Department.[10] Similarly, the program requires lenders to sell all 2008-09 or 2009-10 loans for a particular borrower, further discouraging lenders from selling only poorly performing or small loans. Loans sold via the put option are serviced by private contractors hired by the Department.

Lenders began putting loans to the Department in September 2008, and by the September 30, 2009 deadline 93 lenders had sold $48.5 billion in 2008-09 academic year loans.[11] That figure accounts for about two-thirds of the $68.2 billion in FFEL loans made for the 2008-09 academic year.[12] Most of these loans were sold to the Department during the month before the put option expired.

Short-Term Purchase Program

The Department operated an additional loan purchase program from December 2008 through February 2009.[13] This short-term purchase program differed from the put option program because it applied only to academic year 2007-08 loans (instead of 2008-09 and 2009-10) and limited weekly loan sales to $500 million (the put option program has no limit). The Department also required that average loan value within any package of loans sold by a lender be at least $3,000. This provision prohibited lenders from selling only their smallest (and therefore, least profitable) loans.[14]

The Department paid lenders 97 percent of outstanding principal (including accrued but unpaid interest) for each sold loan. This figure matches the default guarantee rate the government already provides on FFEL loans. This price was less favorable than the 100 percent of outstanding principal and interest paid under the put option. Furthermore, the short-term purchase program did not include a $75 fee paid to lenders to cover origination and administrative costs. The program, however, applied to earlier issued loans, giving lenders the opportunity to raise cash from loans not eligible for the put option. According to the Department, the program was implemented to help lenders raise funds for 2008-09 academic year second semester loan disbursements. In total, six lenders sold $998 million in loans under the program. One lender, the SLM Education Finance Corp (Sallie Mae), accounted for $952 million of that amount.[15]

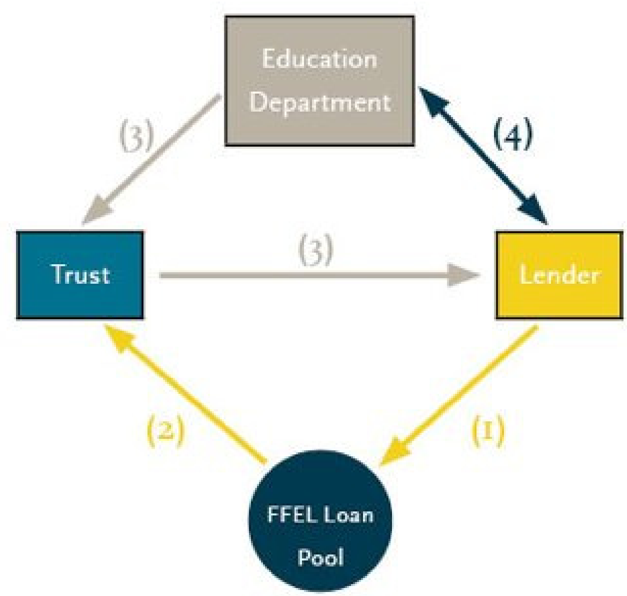
Loan Financing Arrangement - Participation Interest Program

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

The Department charges lenders a quarterly interest rate (3-month commercial paper, plus 0.50 percent) under the financing arrangement. The Department believes this interest rate is low enough to offer most lenders "sufficient opportunity" to continue making FFEL loans. Nevertheless, the agency recognizes that it is difficult to select one appropriate rate because smaller lenders are less efficient than larger ones and may not be able to profitably make loans at a higher financing rate.[16]

Loans financed through the participation interest program are still backed by the standard FFEL interest rate guarantee. Lenders receive a quarterly interest rate equal to 3-month commercial paper rates plus 1.19 percentage points. Therefore, lenders financing loans through the participation program effectively receive a guaranteed annualized interest rate equal to 0.69 percent (1.19 percent guaranteed rate - 0.50 percent financing cost).[17]

Loan Financing Arrangement - Participation Interest Program



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

Source: New America Foundation

The participation interest program provides lenders with a guaranteed source of funding at a preset price during a time when private capital may be scarce and costly. The program also allows lenders to hold the loans, rather than requiring them to permanently sell loans to the Department to generate proceeds. The Department began financing loans under the arrangement in August 2008 and provided $33.4 billion in financing to 24 lenders for 2008-09 academic year loans.[18] Therefore, about a third of all 2008-09 FFEL loans were made with financing through the participation interest program.[19]

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

Asset-Backed Commercial Paper Conduits

In November 2008, the Department of Education announced a fourth variation on its ECASLA loan purchase authority: support for asset-backed commercial paper conduits used to finance FFEL loans. The program was to begin by February 2009, but was delayed until May. The conduit program applies to loans issued between October 1, 2003 and July 1, 2009, making it the only purchase program for loans made before the 2007-08 academic year. The Department announced in November 2009 that the program would help lenders sell or refinance about $130 billion in older FFEL loans held on their books, freeing up funds to make new loans.[20]

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

An asset-backed commercial paper conduit must refinance funds it borrows from investors when the commercial paper matures and must be repaid (typically quarterly or every 180 days). When there is sufficient investor demand to issue new commercial paper to refinance maturing paper, this is a smooth, uninterrupted process. Credit market disruptions, however, have added uncertainty to this process, and investor demand for asset-backed commercial paper has been weak.

In an effort to bring greater certainty to the asset-backed commercial paper market for FFEL loans, the Department is acting as buyer-of-last-resort for loans financed through private conduits. The Department has committed to purchase the underlying FFEL loans in the event that a conduit cannot refinance maturing commercial paper. Commercial paper investors could then be repaid with proceeds from the loan sale.

Under the arrangement, the Department will purchase FFEL loans issued after May 1, 2008 for 100 percent of outstanding principal and accrued interest. Loans issued earlier will be paid out at 97 percent of unpaid principal plus accrued interest. The conduit must pay the Department two separate fees, an annual fee based on the value of outstanding commercial paper it issues to finance FFEL loans, and a monthly fee based on market interest rates.[21] The conduit is backed by the put option until January 20, 2014, but no loans may be placed into it after June 30, 2010.[22] In the event that loans must be put to the Department, a complicated selection process must be followed to determine which loans may be sold. This process prevents lenders from selectively selling only certain less desirable loans to the Department. Additionally, lenders placing loans into the conduit must place all of an individual borrower's loans into it.[23]

To date, one conduit has been approved by the Department of Education: Straight-A Funding, LLC, which was set up by Citibank and Morgan Stanley and is run by Bank of New York Mellon. In addition to the put option provisions provided by the Department of Education, the federal government will provide a five-year, $60 billion line of credit to the conduit through the Federal Financing Bank (FFB) for an annual fee of 0.25 percent of the value of the commercial paper issued by the conduit. The FFB is an existing government corporation within the U.S. Treasury Department that centralizes federally-assisted borrowing. The line of credit will provide short-term (90 day), market-based interest rate loans to the conduit if it experiences difficulty refinancing maturing commercial paper.[24] Thus, the Straight-A Funding conduit has two federal liquidity supports: the FFB line of credit and the Department of Education put option on the underlying FFEL loans. The liquidity supports should, in theory, allow the conduit to borrow at lower interest rates than would otherwise be demanded by commercial paper investors.

In May 2009, four large lenders announced the first placement of FFEL loans into the conduit or approval from the Department to begin placing loans into it.[25] Twelve individual lenders had FFEL loans totaling $30.6 billion in the conduit as of November 27, 2009.[26]

Notes

[1] The subsidies include a guarantee against 97 percent of default losses and a guaranteed interest rate. Lenders receive an interest payments equal to short-term interest rates (three-month commercial paper), plus 1.79 percentage points (1.19 percent while the borrower is in school). Borrowers make loan payments to lenders at a fixed interest rate set in law. If the borrower interest payments do not cover the lender's guaranteed interest rate in a given financial quarter, the federal government pays the lender a subsidy to make up the difference. Conversely, if the borrower interest rate payments exceed the lender's guaranteed interest rate, then the lender remits the excess portion of the borrower payment to the government.

[2] In the past few years, Direct Loan volume accounted for about 25 percent of federal student loan issuance, with the FFEL program accounting for the balance. In a May 2008 letter, the Secretary of Education reported that the agency had the capacity to double Direct Loan issuance with an additional $15 billion in loans compared to the prior year. Expected FFEL loan volume, however, was $59 billion (for Stafford and PLUS loans).

[3] Private entities also play a large role in administering the Direct Loan program but are paid under contracts instead of a subsidy arrangement, as is the case under the FFEL program.

[4] Ensuring Continued Access to Student Loans Act of 2008. Pub. L. no. 110-227 (May 7, 2008).
http://federalstudentaid.ed.gov/ffelp/library/HR5715PL110-227FINAL.pdf

[5] An act to extend the authority of the Secretary of Education to purchase guaranteed student loans for an additional year. Pub. L. no. 110-350 (October 7, 2008).
http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_bills&docid=f:h6889rds.txt.pdf

[6] H.R. 4103, and press release http://republicans.edlabor.house.gov/PRArticle.aspx?NewsID=1362

[7] Department of Education, Department of the Treasury, and Office of Management and Budget. Notice of terms and conditions of purchase of loans under the Ensuring Continued Access to Student Loans Act of 2008. 73 Federal Register 37422 (July 1, 2008). http://federalstudentaid.ed.gov/ffelp/library/OfficialFedRegister_070108.pdf

[8] Spellings, Margaret. Dear Colleague Letter from U.S. Secretary of Education, May 21, 2008.
http://www.ifap.ed.gov/eannouncements/attachments/052108FFELPMonitoring.pdf

[9] Department of Education, Department of the Treasury, and Office of Management and Budget. Notice of terms and conditions of purchase of loans under the Ensuring Continued Access to Student Loans Act of 2008. 73 Federal Register 37422 (July 1, 2008). http://federalstudentaid.ed.gov/ffelp/library/OfficialFedRegister_070108.pdf

[10] Older loans have several years of repayment history from which lenders can assess future performance and profitability. Lenders can use this information to selectively sell less profitable loans to the Department. New loans, on the other hand, do not have a repayment history from which to make such assessments. Loans with low balances are less profitable for lenders because administrative costs are generally the same across all loans, regardless of size, but interest and subsidy payments are calculated as a percentage of loan principal.

[11] U.S. Department of Education, Federal Student Aid Loan Purchase Program Activity Reports. http://federalstudentaid.ed.gov/ffelp/reports.html

[12] U.S. Department of Education Federal Student Aid Data Center, Programmatic Volume Reports. http://federalstudentaid.ed.gov/datacenter/programmatic.html

[13] Spellings, Margaret. "Continued Implementation of the Ensuring Continued Access to Student Loans Act of 2008." Dear Colleague Letter from U.S. Secretary of Education, November 20, 2008. http://ifap.ed.gov/eannouncements/attachments/EDImplementAccessLoanAct2008.pdf

[14] Department of Education, Department of the Treasury, and Office of Management and Budget. Notice of terms and conditions of additional purchase of loans under the Ensuring Continued Access to Student Loans Act of 2008. 73 Federal Register 73263 (December 2, 2008).

[15] U.S. Department of Education. FFEL Program Loans Sold to the Department of Education through the 2007 - 2008 Loan Purchase Program. http://federalstudentaid.ed.gov/ffelp/library/0809Purchases.pdf

[16] Department of Education, Department of the Treasury, and Office of Management and Budget. Notice of terms and conditions of purchase of loans under the Ensuring Continued Access to Student Loans Act of 2008. 73 Federal Register 37422 (July 1, 2008). http://federalstudentaid.ed.gov/ffelp/library/fedreg120208.pdf

[17] The commercial paper rate charged by the Department under the participation interest program and the commercial paper rate that the lender is guaranteed on FFEL loans cover different financial quarters. The former is based on the prior financial quarter and the later is based on the current financial quarter. Therefore, as interest rates on commercial paper have declined, the rate charged to lenders has been higher than the commercial paper interest rate guaranteed to lenders.

[18] U.S. Department of Education, Federal Student Aid Loan Purchase Program Activity Reports.

[19] U.S. Department of Education Federal Student Aid Data Center, Programmatic Volume Reports.

[20] Spellings, Margaret. "Extension of Authority to Purchase FFEL Program Loans." Dear Colleague Letter from U.S. Secretary of Education, November 10, 2008. http://ifap.ed.gov/eannouncements/attachments/111008DCLHR6889Final.pdf

[21] The Department of Education charges the conduit an annual fixed fee equal to 0.05 percent of the average daily outstanding balance of the commercial paper issued by the conduit in calendar years 2009 and 2010. The fee increases to 0.15 percent for 2011 and to 0.25 percent for years 2012 through 2014. A variable rate fee is also charged. It is a monthly fee equal to 80 percent of the spread between 1-month LIBOR interest rates and the interest rate paid on the commercial paper issued by the conduit (when LIBOR is greater), multiplied by the outstanding value of the commercial paper. This fee effectively charges the conduit for the difference between market interest rates and the lower interest rate at which it may borrow because of the put option.

[22] Department of Education, Department of the Treasury, and Office of Management and Budget. Notice of terms and conditions of additional purchase of loans under the Ensuring Continued Access to Student Loans Act of 2008. 74 Federal Register 2518 (January 15, 2009).

[23] U.S. Department of Education, Straight A Funding LLC as Conduit, and Bank of New York Mellon as Conduit Administrator and Eligible Lender Trustee. Amended and Restated Put Agreement. (May 8, 2009).
http://federalstudentaid.ed.gov/ffelp/library/ExecutedAmendedandRestatedPutAgreement.pdf

[24] Rebecca Christie. "U.S. Said to Give $60 Billion Student-Loan Backing". Bloomberg News, January 29, 2009; Steve Levitan "Straight A Funding - An Overview of the First Student Loan Conduit Supported by the U.S. Department of Education" [PowerPoint Slides].

[25] These lenders include Nelnet, Sallie Mae, Citibank, and Access Group.
Nelnet, "Nelnet Completes Initial Placement Through Straight-A Funding," [Press Release], May 27, 2009
http://news.prnewswire.com/DisplayRelease%20Content.aspx?ACCT=104&STORY=/www/story/05-27-2009/0005033530&EDATE=;
Chris Chapman, Testimony before the House Education and Labor Committee, May 21, 2009.
http://edlabor.house.gov/documents/111/pdf/testimony/%2020090521ChrisChapmanTestimony.pdf;
Sallie Mae, "Sallie Mae completes initial placement under U.S. Department of Education-sponsored conduit" [Press Release] May 11, 2009; http://www.salliemae.com/about/news_info/%20newsreleases/051109.htm;
Securities and Exchange Commission The Student Loan Corporation form 8k May 14, 2009
http://www.sec.gov/Archives/edgar/data/%20893955/000120100909000025/form8k0%201409.htm

[26] U.S. Department of Education, spreadsheet available from author.

Main Office
1899 L Street, NW
Suite 400
Washington, DC 20036
Phone 202 986 2700
Fax 202 986 3696

California Office
921 11th Street
Suite 901
Sacramento, CA 95814
Phone 916 448 5189

New America Foundation
WWW.NEWAMERICA.NET