"Increasing Student Aid through Loan Reform"

House Committee on Education & Labor

Testimony for the record

The Consumer Bankers Association

May 21, 2009

With Congress' action last month in approving the FY 2010 budget resolution, it is clear that major changes to the federal student loan programs will be made later this year. The Consumer Bankers Association (CBA) thanks Chairman Miller and the Education and Labor Committee for holding a hearing on student loans prior to considering legislation corresponding to the budget reconciliation instruction.

The legislation we expect you to consider holds the promise of justifying a new investment in Pell Grants but also includes the risk of disruption in the availability of loans for students and parents, higher costs and increased compliance risks for schools, and higher default rates for borrowers. CBA asks that the legislation you craft minimizes or avoids these risks.

Before discussing these risks, we feel obligated to express our concerns and questions with the estimates for budget savings associated with the President's proposal. We believe both the OMB and CBO estimates do not reflect the likely economic reality. Among the incorrect assumptions used in the budget estimates are an unrealistically low estimate of federal borrowing costs and an underestimate of the default rate on the expanded volume of Direct Loans, which will result from the proposed elimination of FFEL guarantors and the default avoidance services they currently perform on FFEL loans.

Although the future role of bank-based lenders in student loans will depend on your committee's actions, CBA asks this committee periodically to revisit or reassess whether the projected budget savings for the legislation you write actually occur.
Sound public policy and integrity would be well served if this review takes place.

CBA is deeply appreciative of the many statements made by members of both parties recognizing the value of FFEL loan providers as well as the inclusion of explicit language in the budget resolution itself referencing the role FFEL loan providers play in support of students, parents, and college opportunity and success.

Let us review some of the contributions of CBA members:

First, funding for loans. Having capital raised in the private sector—even with the support of programs like the successful ECASLA programs—both creates opportunities (especially in more favorable economic circumstances) for price and service competition, but also eliminates competition in the Treasury finance market for other Treasury borrowing. Lenders are proud of the role they have played in providing capital in the past and are hopeful that if financing markets recover, they might again be able to serve this role.

Second, program reliability built on a multiplicity of loan providers. Because reliability is enhanced by the participation of multiple entities, FFEL offers a degree of reliability that can never be equaled by a federally funded program even if supported by a group of qualified loan services. The vulnerability of the Direct Lending program to unanticipated demand has already been demonstrated once, in 1997 in the consolidation loan program. That incident necessitated emergency legislation. Until the recent overall economic crisis, no similar collapse had ever occurred in FFEL.

Third, technical innovation. Private financial institutions have made major contributions to the development and application of technology supporting financial services that have greatly improved the student loan experience for millions of borrowers. Among the innovations are the use of electronic signatures, data exchanges effectuated through ELM Resources and through standardized data sets, and 24/7 account access and transactional capability. In many cases, because the Department of Education's need to compete, the innovations that were implemented in FFEL were subsequently adopted in Direct Loans. CBA also notes that the competition between FFEL and Direct Loans has provided consumers and schools with the best products, services, and choices. We believe that competition will also help assure the quality of any student loan program going forward.

Fourth, customer service. FFEL loan providers offer personal customer service in support of both schools and borrowers that have helped the loan programs work effectively for the last 45 years. This customer service includes the assignment of specific customer service representatives to schools with service quality motivated by retail market competition. Can this type of customer service be duplicated in a program supported by outsourced contract servicers? We don't think so.

Let's turn now to how the risks we have outlined can be minimized in the legislation you will soon be considering. Here are our suggestions on how best to preserve some of the benefits of the FFEL program despite limiting the use of private capital in the program. We are hopeful that the principles and specific suggestions we offer here might be incorporated in the legislation this committee will draft in coming weeks.

Our suggestions are as follows:

1. Minimize the risks of a program breakdown. Because the administration's proposal envisions 4,000 schools currently in FFEL transitioning to Direct Loans by July 2010, a substantial risk of failure exists that could disrupt the educational plans of millions of students. As members of this committee know, if this committee's student loan legislation is signed into law in September, schools will have only five months to start the FFEL to Direct Loans conversion. This will create a bottleneck during the crucial months of May and June, 2010. During these two months, approximately 100 schools a day would need to complete the conversion.

   To minimize this risk, CBA suggests that modified versions of the highly successful ECASLA programs be enacted. Changes would include allowing qualifying lenders to continue to service loans they originate and sell to the Department. This would eliminate the need for complicated servicing transfers and encourage lenders to compete for business on the basis of the quality of their loan servicing. Extending ECASLA with this modification would also encourage continued competition and innovation in loan origination technology and services to the benefit of families, students and schools.

Importantly, any extension of ECASLA must be crafted to provide lenders with an economic return on student loans. Without assuring an economic return, an extension of ECASLA will not succeed in keeping private sector capital available for student loans.

2. Maintain default aversion services currently provided in FFEL. Continue to support the provision of default avoidance activities by guarantors, lenders, and other student loan participants on both Direct Loans and on FFEL loans before and after such loans are sold to the Department of Education. These services should be offered on a competitive basis similar to the current FFEL program to encourage fair competition based on the quality of service. CBA believes that awarding franchises that would require the use of specified state agencies or non-profit organizations, regardless of how such entities were designated, would be a mistake that would disadvantage borrowers.

Mr. Chairman, our recommendations are intended to capitalize on the strengths of the infrastructure of the FFEL program that has served borrowers well for more than 40 years. By preserving substantial parts of this infrastructure, a future restoration of the use of private sector capital in student loans will be easier than if all lenders, all guaranty agencies, and virtually all servicers are eliminated from the program.

Amendment Needed Relating to Calculation of Lender Return:

In addition to addressing the major changes to the student loan programs you are currently considering, CBA wishes to briefly raise an issue on which we recently wrote members of this committee: Lender return on outstanding FFEL loans.

As members of this committee know, provisions setting lender return in the Higher Education Act reflect the assumption that the 3-month commercial paper (financial) rates published by the Federal Reserve are reflective of market rates. Unfortunately, since the third quarter of 2008, that market has not functioned normally. That market collapsed and necessitated the creation of the Commercial Paper Funding Facility (CPFF).

The publication of this alternative 90 day commercial paper rate was used by the Department of Education in January to support a modified calculation of lender return for the fourth quarter of 2008. Specifically, on any given day when no traditional 3-month financial commercial paper rate was published by the Federal Reserve, the Department used the published commercial paper 3-month financial CPFF rates on those days to index the lender return.

By all accounts, this modified methodology was both permitted under the statute and also provided lenders with a return that better reflected the historic returns on FFEL loans.

Unfortunately, when the Department published rates for the first quarter of 2009, it reverted to a methodology that had been used for quarters prior to the fourth quarter of

2008. Under this methodology, on days when no commercial paper (financial) transactions were reported by the Federal Reserve, the rate published on the most recent date where a rate was published was used. This approach resulted in an unusually low rate.

The 90 day commercial paper (financial) rate published for the first quarter of 2009 was 0.74 percent. This rate produced a reduction in anticipated lender return of 50-70 basis points, resulting in decreased revenues to lenders of millions of dollars. Because investors had anticipated that the Department would continue to adjust the rate to correspond to market disruption, the announcement of the first quarter 2009 rates shook investor confidence and, unfortunately, set back efforts to restore a healthy student loan financing marketplace.

CBA suggests that this committee consider an amendment to the Higher Education Act to base lender return on outstanding loans on LIBOR. Such an amendment would remove the uncertainty undermining the current program and would encourage continued lender participation in FFEL. Our specific recommendation is that a rate based on LIBOR minus 13 basis points be adopted.

We have attached a copy of an industry letter recently sent to this committee to our testimony today. We would be further pleased to meet with you and/or your staff to provide additional information on this important issue.

In closing, thank you for the opportunity to submit testimony for the record. We hope that as you proceed with the legislation you will consider the broadest array of alternatives and will both critically examine savings claims made in support of the administration's proposal as well as remember the fact that the FFEL program has been highly reliable and supportive of students throughout its history.

About the Consumer Bankers Association:

The Consumer Bankers Association is the recognized voice on retail banking issues in the nation's capital. Member institutions are the leaders in consumer financial services, including auto finance, home equity lending, card products, education loans, small business services, community development, investments, deposits and delivery.

CBA was founded in 1919 and provides leadership, education, research and federal representation on retail banking issues such as privacy, fair lending, and consumer protection legislation/regulation. CBA members include most of the nation's largest bank holding companies as well as regional and super community banks that collectively hold two-thirds of the industry's total assets.

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May 13, 2009

Dear Members of Congress:

For over 40 years, the public-private partnership known as the Federal Family Education Loan Program (FFELP) has provided an uninterrupted supply of education capital to 60 million Americans. We are extremely proud to have played a role in that legacy and are writing to express our great concern that recent interventions by the government to address the ongoing dislocation in the credit markets have had serious but unintended consequences for providers of student loans. Specifically, the complete disruption of the commercial paper market has had a severe impact on federal student loans and investors in student loan-backed securities. Swift legislative action is necessary to avoid negative consequences to the securities--owned by retirement accounts, 401(k) accounts and pension funds--that have financed the vast majority of these loans.

As you know, the FFELP is structured to encourage private lenders to invest in the education of young people across our nation, regardless of circumstance or creditworthiness. The Higher Education Act (HEA) established the return for lenders based on a special allowance formula with the intent of ensuring an equitable return on loans, thereby ensuring the availability of loans to all eligible students. Section 438(a) of the HEA states that the purpose of special allowance payments are to ensure:

> ...that the limitation on interest payments or other conditions (or both) on loans made or insured under this part, do not impede the carrying out of the purposes of this part or do not cause the return to holders of loans to be less than equitable...and that appropriate consideration of ...money market conditions is made in setting the quarterly rates of such payments.

In exchange for a guarantee from the federal government that defaulting loans will be reimbursed at 97%, FFELP lenders accept a low fixed annual return, now 1.19%-1.79%, on each loan. This return is paid as a spread over a key corporate financial rate and is calculated by the Department of Education.

Under the HEA, the Department of Education is required to determine "the average of the bond equivalent rates of the quotes of the 3-month commercial paper (financial) rates <u>in effect for each of the days in such quarter as reported by the Federal Reserve in Publication H-15</u> for such 3-month period." Historically, the Publication H-15 rate has been stable and reliable. Until recently, the 3-month commercial paper financial rate ("the H-15 CP Rate"), reported by the Federal Reserve, reflected the daily average cost of issuance in one of the most liquid daily funding markets in the world. But in the chaos of last fall's credit crisis, this market (like many others) fell apart.

In response, the Federal Reserve took emergency action, creating the Commercial Paper Funding Facility (CPFF), which offered an outlet to commercial paper issuers who could no longer access the dysfunctional credit markets. While this action was necessary and effective, an unintended side-effect was the severe distortion of the H-15 CP Rate upon which the FFELP lender yield is based. To save many large U.S. companies from imminent default on their short-term debt obligations, the Federal Reserve broke the H-15 index, and quite clearly acknowledges it on its website: "[T]he rates published after September 19, 2008, likely reflect the direct or indirect effects of the new temporary programs and, accordingly, likely are not comparable for some purposes to rates published prior to that period." In other words, the traditional H-15 CP Rate is no longer a market-based rate.

On many days between September of 2008 and March of 2009, there was no issuance in the conventional CP market which created a quandary on which rate to accrue subsidies for the Department of Education. On occasions when issuance did occur, only a select few of the highest quality corporate financial CP issuers that did not require government assistance placed securities. As a result, the rates published by the Federal Reserve since the end of the 3rd quarter 2008 have been artificially low and not representative of a real market. Meanwhile, tens of billions in securities have since been issued in the CPFF program.

To compensate for this disruption, and in order to publish true market financial CP rates, the Federal Reserve announced and included in the H-15 publication the new CPFF Rates. The H-15 publication now lists three alternative 3-month financial CP rates: CP 3-month financial, CP 3-month financial posted by CPFF without surcharge, and CP 3-month financial posted by CPFF with surcharge.

In the fourth quarter of 2008 on any given day, when no traditional 3-month financial CP rate was published by the Federal Reserve, the Department of Education used the published CP 3-month financial CPFF rates on those days to index the lender return. This policy made sense: existing federal law requires the Department use the published 3-month CP rates in effect for each of the days in such quarter. While imperfect, it was a good faith effort to achieve some semblance of a market-based index at a time when few markets seemed to be functioning. As much sense as the blended approach made, the Department of Education unexpectedly dropped it for Q1 2009. The Department of Education cited "changing market conditions" as cause for reversing course, a statement that baffles commercial paper market participants and does not find support in the rates published by the Federal Reserve. The new policy by the Department is to ignore the rates published daily in the H-15, and instead to use the last published 3-month financial CP rate on days when it is not published. By undertaking this policy, it appears that the Department has acted in a manner inconsistent with the HEA, as a financial CPFF rate was in fact printed in the H-15 publication on each day of the first quarter of 2009.

The vast majority of these loans have been sold to investors in the asset-backed securities markets. The Department's change in methodologies will likely lead to ratings actions including downgrades on hundreds of billions of dollars of securities currently funded in retirement accounts, 401(k)s, and pension funds. Such ratings actions will have severe negative effects on the price of the bonds and may lead to material losses to the very holders the government is working to support. Moreover, the unpredictability of the interest rates, coupled with inconsistent interpretation of those rates by the Department of

Education, has frustrated ABS investors and undermined simultaneous government efforts (such as TALF) to spur non-bank lending.

As much as we believe the Department of Education's decision for the first quarter should be reversed, it starkly demonstrates the change that has taken place to the reported CP rates. Despite the CPFF and other Federal Reserve efforts, the 90-day AA financial commercial paper market is irrevocably altered and will not represent a market rate for a very long time. Issuance is now limited to a very small number of issuers, which distorts the market. We do not see this changing in the near or medium term.

Therefore, we strongly urge you to pass legislation that permanently bases the special allowance rate on the 3-month London InterBank Offer Rate (LIBOR), the global financing standard. As we are proposing to substitute the equivalent LIBOR-based rates for the now-unreliable CP rates, we suggest that the new LIBOR-based rates set in the statute could be adjusted to reflect the long-term differences between LIBOR and 3-month CP. For example, we understand that the CBO last fall found that LIBOR minus .13 percent was the equivalent of 3-month financial CP.

In just the first quarter of 2009, the decision to not use the published H.15 CP Rate cost FFELP loan holders and investors more than $200 million. This came at a time when the Federal Reserve is engaging in quantitative easing to avoid deflation and revive lending.

We are hopeful that our industry will be able to work with you to quickly resolve this issue. We fully understand that Congress is examining proposals that will fundamentally alter the delivery system for federal loans moving forward and may want to provide a permanent solution in that legislation. However, this rate calculation affects a majority of loans issued since 2000 and requires a swift, even if only temporary, solution.

Sincerely,

Consumer Bankers Association
Education Finance Council
National Council of Higher Education Loan Programs
Access Group
All Student Loan
Bank of America
Brazos Higher Education Services Corporation, Inc.
Citizens Bank
College Loan Corporation
Edamerica
EdSouth
Georgia Student Finance Commission
Kentucky Higher Education Student Loan Corporation
Key Bank NA
Missouri Higher Education Loan Authority

Nelnet
North Carolina State Education Assistance Authority
New Mexico Educational Assistance Foundation
Pennsylvania Higher Education Assistance Agency
PNC Bank
Sallie Mae
SunTrust Banks, Inc.
The Student Loan Corporation
US Bank
Utah Higher Education Assistance Authority
Wells Fargo Bank, N.A.
Wyoming Student Loan Corporation