Government law changes the face of the student loan market

A briefing on the history of the government programs

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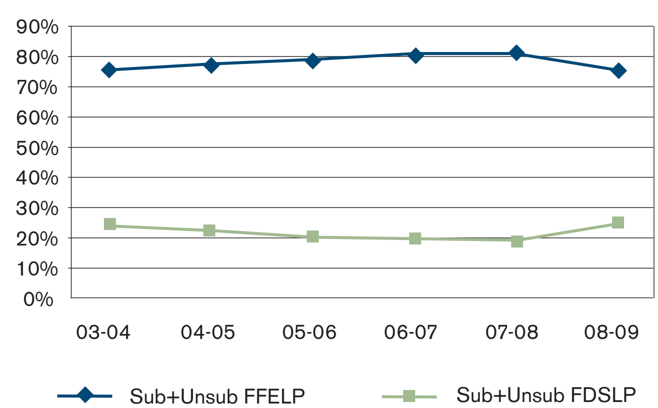
By now, it is clear that the recent economic downturn has affected much more than just big-name financial institutions. The credit crunch has trickled down to most families, but families especially affected are those looking for college funding. As the amount of available credit remains limited and the cost of college increases, many families are finding it increasingly difficult to come up with the funding necessary for a college education. To stabilize the student loan market, the federal government has stepped in and taken control of all new federally guaranteed loans with the hopes of creating reassurance among borrowers regardless of economic condition.

On March 30, 2010, President Obama signed the Health Care and Education Reconciliation Act, setting in motion widespread reform in student lending. The education component of the law includes the Student Aid and Fiscal Responsibility Act, which calls for the elimination of the Federal Family Education Loan Program (FFELP) and transfers all federally funded loans to the William D. Ford Federal Direct Student Loan Program (FDSLP). Cooperation from students and colleges across the United States will be needed to make this transition possible, given that the percentage of FFELP loans issued over the last five years, as shown in Figure 1, has never fallen under 75%. Such a dramatic shift in student loans will obviously bring change, but just how widespread the impact will be is yet to be determined.

FIGURE 1: PERCENTAGE OF FFELP VS. FDSLP LOANS OVER TIME



SOURCE: College Board

The idea of creating a nationwide federally backed student loan program began in 1965, when the Higher Education Act was passed. Later renamed the Federal Family Education Loan Program, this loan plan was based on the concept of private capital and government guarantee. FFELP differed from prior loan programs in a few ways: It did not rely on federal capital, and it gave opportunity to both low-income and high-income borrowers alike, offering interest rate subsidies to the lower-income borrowers. Over the past 45 years, FFELP has evolved into a program that has provided more than $750 billion in loans to millions of college students and their families.

In the early 1990s, amidst credit reform legislation and FFELP challenges, a lending alternative funded by the federal Treasury emerged. New accounting guidelines with the credit reform created an opportunity to issue loans directly from the government, saving $4.3 billion over five years. These factors contributed to the beginning of the William D. Ford Federal Direct Student Loan Program in 1994. Since 1994, FDSLP has provided aid to more than 5 million college students.

The most obvious difference between FFELP and FDLSP lies in the capital provider for the loan. FFELP is funded by banks and other financial institutions, while FDSLP is funded "directly" by the government. Other differences between the programs are less apparent. Borrowers are more likely to be approved for loans under FDSLP, because colleges are the responsible parties for running credit checks. This contrasts with FFELP, where lenders are the responsible parties. This credit check by lenders yields a lower percentage of loan approvals because of higher underwriting standards. Though both programs offer Stafford and Plus loans, the interest rates for Plus loans vary by program; Plus loan interest rates are slightly higher through FFELP (8.5% compared to 7.9% through FDSLP). Other changes associated with FDSLP include the omission of the 1% FFELP default rate fee added by the lender, the inability to sell loans, and the option to consolidate.

Under FFELP, banks and other institutions—the middle men—were paid three different types of subsidies to encourage involvement in student loans. The government ensured that banks made a benchmark interest rate, guaranteed almost all principal and interest on the loan, and paid for a variety of administrative services. The elimination of these subsidies is projected to save an estimated $68 billion in the federal budget, including $42 billion that will be invested back into education and $10 billion that will be given to the Treasury to reduce entitlement spending. In total, the number of Pell grants will increase by 820,000 by 2020, and the maximum amount given by each grant is estimated to be increased from $5,550 to $5,975 by 2017. All of these budgetary savings are claimed to be possible by, as many politicians have put it, "cutting out the middle man."

CHANGE FOR FFELP MEMBERS

How exactly will FFELP-dependent institutions adjust to an FDSLP-monopolized world? While there are many possibilities, most companies appear to be leaning towards one of two options: layoffs or restructuring.

The removal of FFELP may save billions every year, but it also jeopardizes at least 40,000 jobs associated with FFELP. To adjust, some companies have been forced to eliminate jobs. Sallie Mae, for example, has cited the new student loan law as the primary reason for shutting down servicing centers in Texas and Florida, eliminating 1,200 jobs. By the end of 2011, Sallie Mae expects to have to cut 8,000 jobs total. This trend is likely to continue for banks and financial institutions that previously originated FFELP loans.

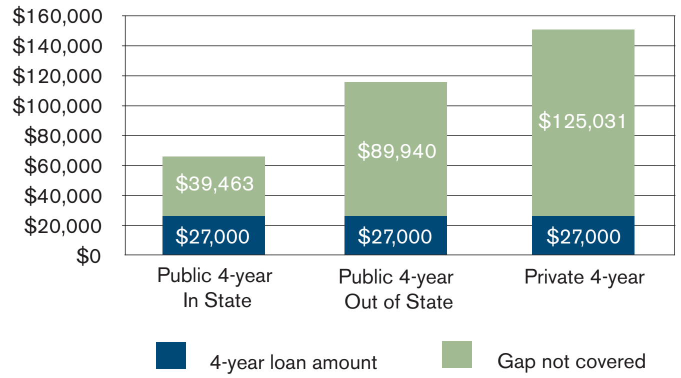
In order to avoid future job losses, most companies are looking to evolve and adapt to the new student loan environment through restructuring their existing business practices. One option that employers at participating institutions are facing is the restructuring of employees' responsibilities and duties. Namely, banks and financial institutions that previously originated FFELP loans are looking to transition to loan servicing. This form of restructuring has already been backed by the U.S. Department of Education (DOE), which has created a $50 million fund to help aid FFELP employees in the transition from loan origination responsibilities to loan servicing responsibilities. These servicing contracts will be especially crucial to the survival of nonprofit organizations that previously specialized in FFELP loan originating.

National Education Loan Network, or NelNet Inc., is one such company that has been awarded a servicing contract by the DOE. The company's loan portfolio, which consists of $26 billion in student loans, is mostly composed of FFELP-originated loans. The ability to switch from originating FFELP loans to servicing them will keep NelNet Inc. from laying off workers.

While some companies appear to be restructuring job responsibilities, others are hoping to capitalize on what looks to be an expanding private loan market. As long as tuition and fees continue to rise faster than the government loan limits, private loans will continue to grow faster than federal loans, as illustrated in Figure 2. The most recent data shows that private loans are growing at a rate of 25% per year versus 8% per year for federal loans.

Currently, a student attending a four-year in-state college has the ability to receive $27,000 in federal loans. However, according to the College Board, the average price tag for four years of education is around

FIGURE 2: 4-YEAR LOAN LIMITS VS. 4-YEAR TUITION COSTS



Source: College Board and Stafford Loan Information

$65,000. The average college student will need to take out almost $40,000 in additional private student loans just to go to school if he or she cannot rely on college savings. For out-of-state and private schools, the gaps are even greater. With these figures in mind, many of the big former FFELP lenders have turned to private student lending as a way to avoid layoffs and expand business. However, these new private loans are subject to default risk, in stark contrast to what these lenders were accustomed to under FFELP, which makes them much riskier. Sallie Mae, the nation's leading provider of student loans, has developed a loan that could have industry-wide ramifications; it will now require students to make monthly interest payments while still in school. The hope is that this new approach will reduce the overall loan interest. The new design also includes shortening the maximum loan repayment term from 30 to 15 years, which will further reduce interest payments. However, qualifying for a loan of this nature may be more difficult for many students.

Another large student lender, Wells Fargo, has launched a plan to help parents pay for their children's college education. Dubbed the "student loan for parents," this loan is designed to cover all college expenses with no fees for early repayment, disbursement, or origination. As with the Sallie Mae loan, parents can stretch payments out to 15 years. In addition, parents will have the ability, but not the obligation, to repay interest while their children are still in college.

It is evident that there is no single answer for how FFELP-originating companies will evolve to adapt to the changing world of student loans. While some must resort to layoffs, others are aiming to capitalize on a newly growing loan-servicing market; others yet are aiming to plunge into the private loan market. No matter how these strategies shake out, change is evident in the student loan market.

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