

U.S. Structured Finance Newsletter

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HIDDEN RISKS IN THE “FFELP VERSUS DIRECT” DEBATE

Currently in Washington, there is a debate raging over whether to eliminate the Federal Family Education Loan Program (FFELP) and steer all federally supported post-secondary student lending to the William D. Ford Federal Direct Loan Program (Direct Lending). This decision not only affects future student lending, but potentially also the stability of millions of existing FFELP student loans because many of these loans are serviced by the same entities that rely on FFELP lending to fund a significant part of their business platforms.

The fundamental difference between the FFELP and Direct Lending is the source of the funds for the student loans: under the FFELP, funds for student loans are provided by private lenders, primarily banks, while under Direct Lending, funds come directly from the U.S. Treasury. Below the surface of this issue is the root of the debate. In the FFELP, private lenders are provided an incentive to participate in the program in the form of interest subsidies to ensure positive economics exist in their lending activities. These incentives come primarily in the form of the special allowance payment (SAP). This subsidy represents the quarterly interest income benchmark for loan holders. In the event the borrower interest paid on a FFELP student loan is *below* the SAP rate, or “market rate” set by the federal government, the loan holder receives the difference in the form of an interest subsidy. In the event the borrower interest rate *exceeds* the SAP rate, the loan holder must rebate the difference to the federal government.

Traditionally, lenders, especially not-for-profit entities, used significant portions of any excess interest subsidies to fund borrower benefits in the form of interest rate reductions and principal rebates. The *Ensuring Continued Access to Student Loans Act of 2008* (ECASLA) introduced many changes designed to reduce the cost of the FFELP to the federal government, including reducing the SAP rate. This had the effect of stripping away much of the excess interest subsidy available to loan holders. The result was that the FFELP lending business became marginally profitable for lenders and they were forced to eliminate most borrower benefits, which had helped students reduce their debt burden and improve loan performance.

Even following the passing of ECASLA and the meltdown of the capital markets, which have combined to drive many lenders out of the student lending business or at least significantly curb their lending activities, there is still a push from the Obama administration and primarily the left in Congress to eliminate the FFELP. The risk in eliminating the FFELP goes beyond the argument surrounding simply the raw cost of private lending versus Direct Lending. The issues include a variety of topics, including borrower choice, school choice, customer service and the future viability and survivability of the lenders who provide a much broader service to students and schools beyond just arranging FFELP student loans. Many of these entities currently service a sizable portion of FFELP loans.

Outside of the loans held by the three largest for-profit entities in the FFELP student lending industry, Sallie Mae, Nelnet and Citibank’s Student Loan Corporation, a large volume of FFELP loans are serviced by individual state agencies and state-affiliated not-for-profits. These entities operate on relatively thin margins and maintain not-for-profit missions that often include other non-revenue-producing services for their borrowers, their states, the schools they do business with and their local communities. One of the few fee-based services these entities often provide is the servicing and collecting on their portfolios of FFELP loans. Several of these entities also service their own private loan programs.

In the event any of these entities are driven out of business by the elimination of the FFELP program or forced to reduce their workforces to the point where they have virtually shut down, two significant consequences – both tied to the servicing of the loan portfolios – could occur that pose a risk to the loan portfolios. First, borrowers could be left without vital information, guidance and education on debt management and loan repayment, which could lead to performance deterioration. Second, the loan portfolios these companies currently service would have to be transferred to another servicer, which could cause a disruption in cash flows or reporting. Although FFELP loan servicing involves a highly commoditized process and is performed by a variety of companies in the industry, there remains risk in servicing transfers.

Investors in asset-backed securities supported by FFELP loans or private loans that are self-serviced by certain state agencies or state-affiliated not-for profits need be aware of this risk. DBRS believes that some FFELP servicing transfers can be accomplished with minimal disruption, but cautions against the assumption that all transfers would be without incident.

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