

A Market-Speak Primer for Meeting with Your Lenders

by Jim Day
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A Plain-Talk Grounding in How We Got Into this Mess

The way in which the capital markets have innovated in segregating, bundling, and securitizing different types of debt obligations is well chronicled in the financial press, though little understood beyond that.

The capital for most mortgages and student loans is the result of securitizing these assets.

Securitization is the packaging of many different loans, or payment streams, into portfolios with varying risk and reward characteristics which are then sold as investments to, say—European pension funds or private investors for whom these investments are appropriate. The market for U.S. student-loan-backed securities is global because the time frame and risk/reward make them attractive to investors with a specific horizon and trajectory for cash flow in mind—for example, they can be tied actuarially to retirement projections.

David Laird of the Minnesota's Private Colleges estimates conservatively that two-thirds of student loans were funded through securitization over the past several years.

These financing techniques have resulted in more capital being made more available, more competitively, for a host of investment needs and interests—notably mortgage lending and student loans. Both are good examples of what used to be simple—if inflexible and more limited—industries in which banks simply lent for their own portfolios from their deposit base, in compliance with New Deal banking regulations.

Here's the problem today: The credit markets are frozen and little securitization is taking place

The burst of the market bubble was predictable, and so was the impact, at least to some savvy investors. The combination of the burst bubble (and home prices which underpin the value of any mortgage-related security falling) combined with the greed-driven misjudgments of investment banks and other investors in over-betting on these securities, two major questions arise in the capital markets:

- 1) What are these securities really worth? And:
- 2) How large is the exposure of individual institutions?

Holders of these instruments are required under Generally Accepted Accounting Principles to value investments and "mark to market" in their accounting.

There has been a 65% decrease in sales of student-loan-backed securities from the first quarter of 2007 to the same quarter this year. (Nelnet managed to sell \$500 million in such assets on the very last day of March, so the situation would be more dire if that hadn't happened.)

According to Bloomberg.com April 10 (emphasis mine), "After **20 years**, Wall Street firms that ran the bidding suddenly stopped using their own capital in February to buy auction-rate bonds that went unsold because of concern about the creditworthiness of insurers that guaranteed the debt. No municipal bonds backed by student loans, including auction-rate debt, were sold in the first quarter, the first time that happened in almost **40 years**, according to Thomson Financial." This is a situation of historic magnitude, not just a vagary.

If companies manage to sell student-loan-backed securities, they take a hit to the profit/loss statement. If they can't sell, eventually they'll have to take a hit to the equity on their balance sheets. In either case, if you're a publicly-traded company, your market capitalization fizzles.

Your ability to withstand and survive as, say—an investment bank—is thrown into question, which compounds the problem. Student loans *are* still good investments—lack of investor confidence is the real issue. All of this results in a largely frozen flow of capital. The result is that lenders become very reluctant to lend.

The Cold, Hard Truth

Colleges, not realizing the magnitude of the capital needed to replace securitization-based loans (an estimated \$60 billion for 2008-9) have assumed that traditional banks and nonprofit lenders will step in to make these loans, from their deposit base, for their own portfolios. At a time when Congress has stripped the FFELP program of any profit incentives for these banks, this is simply not likely.

Sure, some lenders will step in with an eye to increasing market share for some better, more rational future. That means they'll employ higher qualification standards on borrowers and focus their attention on colleges with the lowest default rates. What percent of your families have impeccable credit? What is your institution's default rate? The days of nontraditional students—and even some middle-class families—being qualified for loans as “EZ as 1, 2, 3” are g-o-n-e.

Should We Switch to Direct Lending?

The direct lending route is available, but there should be no illusion. This program is already underwater, and this program was never viewed as competitive from a service point of view. The direct program provided \$13 billion in loans in FY 2007. Margaret Spellings has said the direct-loan system could pick up about a third (\$31 billion) of all FFELLP participants. What about the other two-thirds (\$62 billion)?

Secretary Spellings is Lining Up the Guarantee Agencies to Help Out, Right?

Riiiiigghhtt. Secretary Spellings met with 25 of the 35-some guarantee agencies on Friday, April 11 to discuss Lender-of-Last-Resort provisions. The system has never been tried. It is not electronic (!), there is no firm set of rules or procedures, and it is not designed to serve large numbers of borrowers. The guarantors told Secretary Spellings they needed “...a detailed understanding of lender-of-last-resort guidelines by July 1”, according to the Chronicle of Higher Education. Yipes. The guarantors don't know what the rules are; I sure hope Secretary Spellings does.

To quote Sue McMillan, President and CEO of Texas Guaranteed Student Loan Corp., from the March 2008 Greentree Gazette: “[Guarantors] don't actually serve as a lender. We locate or designate a lender who is willing to loan to a borrower when one or two others will not....If a guarantor cannot find such a lender, the guarantor can become the lender of last resort. That guarantor may use its own capital, and if unable, there are never-before-used provisions to receive money from the U.S. Treasury.”

Oh, and The Education Resources Institute—the oldest and largest guarantor in the country—filed for Chapter 11 bankruptcy protection on April 7.

But, Congress is Moving Fast...

It is. Congress contributed to this mess in a misguided effort to exploit the misbehavior of a few aid officers and lenders to benefit direct lending. Now the House has passed, and both President Bush and Ted Kennedy are pushing the Senate to approve, legislation for which NASFAA is patting itself on the back. It would:

- allow the DOE to buy loans from lenders (the idea is to inject liquidity into the market);
- clarifies that the DOE has the authority to advance federal funds to guarantee agencies;
- okays designating emergency lender of last resort status for colleges rather than on student by student basis;
- give parents the option to defer repayment on LUS loans until up to six months after their children leave school; and
- increase the **annual** loan limits on federal unsubsidized student loans by \$2,000 for all students, and increase the aggregate loan limits to \$31,000 for dependent undergraduates and to \$57,500 for independent undergraduates.

This legislation is moving at light speed for Congress (It's an election year, after all), but it's not clear yet whether it will be enacted in time to benefit students for this fall, and, classically, it doesn't seem to address the underlying problems. The head of America's Student Loan Providers, a trade group, has expressed doubt that enabling lenders to basically see loans at a loss to the DOE will solve anything.

On the longer-term political front, Barak Obama says he'll eliminate FFEL. McCain has no stated position on FFEL. Clinton says she'll tighten federal oversight of the program, create a fast-track for colleges that want to switch from FFELP to Direct Lending, and remove the automatic exclusion from PLUS for applicants who have defaulted on mortgages.

So What's the Final, Final, Last Resort?

That's a good question. The Federal Reserve and other entities are being pressured to restore liquidity to (bail out) student loan markets as they have with the mortgage lenders. In fact, Fed Chair Ben Bernanke has already rejected a request by Rep. Paul E. Kanjorski (D, PA) that student-loan companies be allowed to borrow from the reserve, saying the reserve "rarely extends credit to nondepository institutions."

The White House and Treasury Department have also nixed the possibility, suggested by Congress, of tapping the Federal Financing Bank, which is designed to help out other federal agencies, not private lenders.

Two small but sad stories lost in all of this are:

- A report just released by the Institute for Higher Education Policy found that in 2005/06, the average Pell Grant recipient had more than \$4,500 in need remaining after the Pell, all other aid, and the EFC. That extra \$400-some boost to Pell from Congress last fall will barely make a dent in that.
- An estimated 50,000 of the poorest students will be unable to get Perkins Loans next fall, and these loans will be smaller for students who are able to secure them. It's a small number of students and the Perkins situation has nothing to do with the credit crunch, but this neediest group of students is least likely to be able to qualify for other types of loans.

There are no generic solutions, so our advice is this:

- 1) Your CFO and financial aid officer should be having serious conversations with the major traditional banks in your region about their willingness and capacity to meet the loan needs of students from your school specifically.
- 2) These talks should involve a bank officer at a higher level than the student loan marketing personnel. Where beneficial, these talks should be trustee assisted, especially if the trustee is someone steeped in capital markets.
- 3) Consider lenders who have stated they will expand their loan programs, such as Wells Fargo, Citi Bank, JP Morgan Chase, and US Bank. As with regional banks, you must conduct due diligence to ensure that what these lenders say next week will be true next month.
- 3a) Get everything in writing. A day after I wrote #3, Chase announced it will no longer serve colleges with high-risk borrowers and that it's eliminated front-end benefits for those with good credit.
- 4) Consider other borrowing sources for your students such as campus-based loan funds, leveraging your institution's relationships with local corporations, and even alumni and lead donors.
- 5) Counsel families to act now and get their applications filed. You might refer them to this two-minute Wall Street Journal video: <http://link.brightcove.com/services/link/bcpid452319854/bctid1468257003>