**TESTIMONY OF**

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**BEFORE THE**

**UNITED STATES SENATE**
**COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS**

**HEARING ON**

**TURMOIL IN U.S. CREDIT MARKETS:**
**IMPACT ON THE COST AND AVAILABILITY OF STUDENT LOANS**

**APRIL 15, 2008**

Mr. Chairman and members of the Committee:

My name is Tom Deutsch and I am the Deputy Executive Director of the American Securitization Forum ("ASF")[1]. I very much appreciate the opportunity to testify before this Committee today on behalf of the 370 member institutions of the ASF and the 650 member institutions of the Securities Industry and Financial Markets Association ("SIFMA")[2]. These members include not only firms who originate and securitize most

[1] ASF is a broad-based professional forum of over 370 member organizations that are active participants in the U.S. securitization market. Among other roles, ASF members include issuers, investors, financial intermediaries, professional advisers and rating agencies working on securitization transactions backed by all types of assets. ASF's mission includes building consensus, pursuing advocacy and delivering education on behalf of the securitization markets and its participants. Additional information about the ASF, its members and activities may be found at ASF's internet website: www.americansecuritization.com.

[2] SIFMA brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

of the student loans made in America, but also the institutional investors who purchase securities backed by these student loans. We are pleased to present our views on how the current turmoil in the U.S. credit markets might affect students in the coming lending season.

**FFELP and Private Student Loan Lending Programs**

Generally, students and their families have two private sector financing options specifically designed to fund higher education expenses—government guaranteed Federal Financial Education Loan Program ("FFELP") loans and private student loans. Both types of products are facing specific challenges in today's capital markets, which I discuss in greater detail below.

The FFELP, a highly successful public-private partnership, has leveraged federal guarantees and funding from the private global capital markets to make available almost $100 billion each year to students in need of financial resources to pay for the costs of higher education. Recently, these originations represent nearly 80 percent of all government subsidized loans with the other 20 percent originated through the Government Direct Lending Program. Since 1965, private sector FFELP lenders have helped more than 60 million Americans attend college by making efficient, low cost student loans. More than 80 percent of all post-secondary institutions have elected to participate in FFELP because they believe the program provides affordable loans and excellent service to borrowers. Due to the increased number of college-age students and rising higher educational expenses, the FFELP program has assumed an even more important role for the current generation of students.

The four pillars that have supported the overall success of FFELP lending over the last 40 years have been: 1) the low cost, efficient funding mechanism the capital markets have supplied to lenders of student loans; 2) appropriately sized incentives to lenders in the form of government principal and interest guarantees and special allowance payments; 3) robust market competition among student loan lenders that keep lender rates low and borrower benefits high; and 4) the universal availability of FFELP loans to all potential students.

Unfortunately, the reductions of federal guarantee rates and special allowance payments during the peak of the credit cycle in 2007 have made origination of student loans uneconomical to a large portion of the student lending market in today's credit constrained capital markets. The combined force of these events over the last six months now threatens each pillar of the FFELP lending program and these developments will ultimately leave some students without access to loans to help pay for their educational expenses. Students with access to education finance loans are finding their overall costs are increasing, as they are now incurring government mandated origination and default fees, in addition to reductions in borrower benefits, such as on-time payment discounts.

Beyond FFELP lending, private student loans bridge the educational financing gap between federal student loan limits and the ever-increasing cost of education in the United States. The College Board estimates that private loans have provided students with over $18 billion in the 2006-2007 academic year and $77 billion over the last seven years. However, like FFELP lenders, private student loan lenders have also felt a significant impact from the disruptions in the capital markets.

## Structure of Capital Market Funding for Student Loans

The securitization industry has been an integral part of the success of student loan lending in the United States, serving as an efficient and cost-effective funding mechanism for originators of consumer and business credit in nearly every sector of the economy including not only student loans, but also residential and commercial mortgages, automobile loans, credit cards, commercial loans and corporate bonds. In 2006 for example, U.S. securitization issuance across all asset types topped $3.1 trillion dollars.

Student loan asset-backed securities ("ABS"), secured by either private lender FFELP loans or private student loans, as well as tax-exempt and taxable repackagings of municipal, state agency and not-for-profit FFELP loans have been the primary financing sources for lenders to raise funds in the global capital markets. For example, 85% of FFELP loans have historically been financed through student loan asset-backed securities or bank facilities, in which originating banks sell participations in pools of loans that they originate. Approximately 75% of holders of student loans are non-depository institutions, which almost exclusively rely on the capital markets for funding. But even depository holders have securitized a majority of their student loan holders as well. As such, over $80 billion in student loan ABS was issued in 2006 with that issuance number declining to slightly above $60 billion in 2007.

Given the stable and predictable returns of the cash flow payments on student loan ABS and repackagings, institutional investors, such as pension funds, mutual funds and insurance companies, have employed the capital from their investment funds to purchase these securities. This fresh capital is then deployed by lenders to make additional low cost FFELP loans to other students.

## Increasing Capital Market Funding Costs and Originator Withdrawals

Over the past six months, turmoil in the debt capital markets, including significant repricing of credit risk generally, deleveraging of balance sheets and failures in the auction rate securities market, has eliminated economical access to this financing market for many lenders. No student loan originated after September 30, 2007 has been funded through the capital markets. For the first time in 40 years, no state agency or non-profit has been able to access the capital markets in the first quarter of 2008 to finance student lending. And originators of private student loans have not been able to access the traditional securitization markets since September, 2007.

Further, The Education Resources Institute Inc. (TERI), the largest not-for-profit guarantor of private loans, filed for Chapter 11 bankruptcy protection just last week, further drying up credit protection for this part of the market. Issuers of private student loan asset-backed securities contracted with TERI to obtain 'insurance' on a portion of the credit risk of the securities. Without TERI operating effectively in the market, a critical contributor to facilitating liquidity for private student loan asset-backed securities will be lost.

For those who have been able to access capital market funding, they are experiencing significantly higher costs that they cannot make back. Spreads on triple-A rated student loan ABS, backed by FFELP Stafford and PLUS loans that are already at least 97% government guaranteed, have widened by 150 basis points, or roughly 15 times the levels seen just last summer. Unlike most other forms of consumer credit, the interest rates charged to students on FFELP loans are set by law, so lenders are not able to recoup these additional costs in the FFELP loans they originate. As a result, only $8.4 billion of student loan ABS was issued in the first quarter of 2008, as compared to $21.7 billion issued in the first quarter of 2007. Put simply, originating new FFELP student loans has largely become a money losing proposition.

As a result of the unprofitability of these loans or the inability to secure any funding at all, 43 lenders have already either exited the FFELP program altogether or suspended lending. Of those 43 lenders, three of the top eight student loan holders (Brazos Group, the Pennsylvania Higher Education Assistance Agency (PHEAA), and the College Loan Corporation) have exited the program. Altogether, the withdrawal of these lenders alone, irrespective of continuing lenders' reduced capacity, represents nearly $7 billion or approximately 15% of overall 2007 originations. But still looming over the next month or two are the decisions as to whether other lenders will continue originating under FFELP and, if so, what origination reductions they will be forced to implement if they do continue their participation in the program.

In sum, the combined effect of last year's significant incentive reductions with the current high cost of credit in the capital markets has increased substantially the potential for severe disruption in the availability of student loans through the FFELP.

## Effects of Originator Withdrawals/Reductions on Students

Although we are not aware that any eligible student has been denied a FFELP loan to date, new loan applications are currently at their seasonal low given the structure of the academic funding calendar. In the coming months, approximately 6.7 million students and parents are expected to apply for a FFELP loan, as three-quarters of all student loan volume is originated between April and September. As demonstrated over the last few months by the announcements of lender withdrawals, most originators of student loans have made, or will be making shortly, their capital availability decisions for the 2008-2009 academic year, which highlights the urgency of the need for relief.

Unlike FFELP loans, we believe that some students in search of private student loans have not had access to them already in the current credit-constrained environment. The current turmoil in the credit markets has eliminated many of the smaller firms that had been active in this market sector, and many others will likely be forced out of business as a result of a lack of liquidity and uneconomical costs of operation.

In addition, unlike the mortgage market, there are no government sponsored enterprises to provide funding or temporary liquidity to student loan lenders. Entities such as Fannie Mae and Freddie Mac provide confidence to lenders that conforming mortgage loans can be financed even in distressed market conditions. No such program exists for the student loan market.

Under the Higher Education Act, the Department of Education can turn to guarantors that act as lenders of last resort (LLR), advancing federal capital to loan guarantors when there is not sufficient private capital to meet student demand. However, the Secretary of Education testified before the House Education and Workforce Committee on March 14, 2007 that the LLR program, if required, would be more expensive to taxpayers than loans under the current system. The continued weakening of the debt capital markets and the expected withdrawal of additional lenders from the FFELP will likely result in substantial reliance on the more costly LLR alternative. The LLR program was not designed to address this extremely large withdrawal of lenders from the market, so the infrastructure and operations of the LLR program have never been tested on a magnitude that may be required to meet student demands this fall.

While there have been suggestions of depository institutions stepping in to make FFELP loans where non-bank specialty finance companies have suspended lending, we believe that, due to the impaired economics of the FFELP program and broader liquidity constraints throughout the market, neither our bank nor large non-bank lenders will be in a position to meet increased demand.

Ultimately, if no relief is found, the total supply of loans available through all the various programs will likely not meet student demand efficiently and effectively this fall. As such, some borrowers may not have access to needed government subsidized loans and/or to private student loans to bridge the funding gap. And for those students who have or will have access, borrower benefits such as on-time payment discounts are disappearing and borrower services are declining.

## Short-Term Solutions

### 1. Federal Financing Bank

Given the urgent need for liquidity for student loan originators, the most comprehensive and elegant short-term solution to this developing crisis would be for the Federal Financing Bank ("FFB") to provide additional liquidity to lenders to originate new FFELP loans as well as to the asset-backed market indirectly. The FFB was established in 1973 for the primary purpose of assisting federal government agencies in financing marketable agency-issued and agency-guaranteed obligations. Over the years, the FFB has purchased various kinds of obligations issued or guaranteed by a wide variety of federal agencies. We believe the FFB currently has the statutory authority to purchase participation interests in pools of newly originated government guaranteed FFELP loans as well as senior, triple-A rated securities backed by FFELP loans.

The primary benefit of this solution would be to provide the necessary liquidity for FFELP originators to meet student demand in the coming lending season, and in a method similar to existing market structure and practices. This method would avoid significant risks of disruption and provide for maximum efficiency in meeting student needs this year. Importantly, the FFB would be purchasing interests in or senior securities backed by government guaranteed student loans so the American taxpayer would not be subject to any additional credit risks. We believe that this approach would be a more effective and efficient solution than other alternatives currently being contemplated and could also provide stimulus to the asset-backed market.

**2. Term Securities Lending Facility (TSLF)**

Another option that would provide some additional liquidity to the market would be to extend the definition of program-eligible collateral of the newly created Term Securities Lending Facility (TSLF) to include triple-A rated student loan ABS, which would allow these securities to be pledged as collateral to borrow from the newly created TSLF or a similar facility. Given the very limited credit risk inherent in triple-A rated government guaranteed and private student loan asset-backed securities (SLABS), we believe this proposal would also appropriately balances managing federal government risk exposure with meeting the urgent need for additional sources of liquidity to help fund student loan originations.

**Conclusion**

The costs of higher education have escalated substantially over the last decade as colleges and universities have raised tuitions well beyond the pace of inflation. We know that students will continue to need the federal government's assistance in meeting these costs. FFELP has been an extremely successful program, providing hundreds of billions of dollars of financing at a remarkably low cost and high service to 80% of American student loan borrowers.

Unfortunately, reductions in the government guarantee rates and special allowance payments as well as the current high cost of credit in the capital markets have come at a time when demand for education funds has never been greater.

We encourage the federal government to act expeditiously to implement a targeted and near-term set of solutions such as allowing the FFB or the TSLF to provide liquidity in the current credit constrained environment. We believe these actions would help avert a much greater, and potentially more costly, federal intervention later.

I thank you for the opportunity to testify on this important and timely issue today. The ASF and SIFMA look forward to working with you, Mr. Chairman, the Committee, Congress and the Administration to ensure student loans are available to all eligible borrowers who seek financing for their educational expenses.