

# Student Loan ABS Update

21 February 2006

On February 8, the President signed the Budget Deficit Reduction Act, which reauthorized the Higher Education Act and made key changes to the federal student loan programs.<sup>1</sup> The changes should affect student loan ABS in the following ways:

- new deals backed by federally re-insured student loans should require greater credit enhancement (starting in July), but older deals should be unaffected,
- prepayments should increase through June and decline thereafter, and
- the volume of new federally re-insured loans should increase at the expense of private loans.

**Credit Enhancement:** Credit enhancement levels for new student loan ABS backed by federally re-insured loans should increase because the new law lowers the applicable re-insurance percentages. Starting on July 1, the re-insurance percentage for most new loans drops to 97% from 98%.<sup>2</sup> The re-insurance percentage for loans made by "exceptional performance" lenders drops to 99% from 100%.<sup>3</sup> The reduced levels of federal re-insurance apply only to loans for which the first disbursement of principal occurs on or after July 1. Older loans retain the previous (and higher) re-insurance percentages.

Therefore, deals backed by loans with the lower re-insurance percentages will be exposed to potentially larger uninsured losses than earlier deals. The rating agencies should require somewhat higher levels of credit enhancement to counterbalance the greater risk.

**Prepayments:** Prepayments should be affected by changes to the consolidation rules and by previously legislated changes to interest rates.

Most student loan prepayments are from loan consolidations. Changes to the interest rates for new loans will affect borrowers' incentive to consolidate, while changes to the consolidation rules will somewhat reduce the availability of consolidation.

**Interest Rate Changes:** Starting on July 1, new Stafford loans will have a fixed interest rate of 6.8%.<sup>4</sup> That represents a big change from the prior system of floating rate Stafford loans. For existing

<sup>1</sup> Higher Education Reconciliation Act of 2005, *included in* Deficit Reduction Act of 2005, Pub. L. No. 109-171, §§ 8001-8024 (8 Feb 2005) [hereinafter "DRA05"].

<sup>2</sup> DRA05 § 8014(a) (*amending* 20 U.S.C. § 1078(b)(1)(G)).

<sup>3</sup> DRA05 § 8014(j) (*amending* 20 U.S.C. § 1078-9(b)(1)). The Department of Education maintains a listing of lenders designated as exceptional performers at <<http://fp.ed.gov/PORTALSWebApp/fp/exceptional.jsp>>.

<sup>4</sup> 20 U.S.C. § 1077a(l)(1) (*adopted in* Pub. L. No. 107-139 § 1, 116 Stat. 8 (2002)).

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floating rate Stafford loans, consolidation provides a way for borrowers to lock-in attractive fixed rates. The consolidation formula specifies that the rate on a consolidation loan equals to the weighted-average rate on the loans consolidated, rounded to up the nearest one-eighth percentage point (and subject to a cap of 8.25%).<sup>5</sup> However, now that new Stafford loans will have fixed interest rates, much of the motivation for consolidation will fade away. A student entering college in the fall of 2006 will only be able to get fixed rate Stafford loans at 6.8%. If he consolidated his Stafford loans, he would get a single consolidation loan with a fixed rate of 6.875%. Thus, the next generation of borrowers is less likely to consolidate.

In the meantime, students who already have floating rate Stafford loans will continue to have an incentive to consolidate. However, that population will shrink as time goes by and the level of consolidation activity from that source should steadily decline.

**Consolidation Changes:** Starting on July 1, the new law (1) applies uniform restrictions to consolidations of Stafford loans and Federal Direct loans,<sup>6</sup> (2) eliminates in-school consolidations,<sup>7</sup> and (3) eliminates consolidations of loans among married couples.<sup>8</sup> The most important of the three changes is the elimination of in-school consolidations. Until July 1, students in school can take advantage of consolidation loans to lock in fixed rates. However, after then, only out-of-school borrowers will be able to consolidate their loans and, once having done so, they will not readily be able to do so again. Therefore, a wave of in-school consolidation activity is likely between now and July 1. By consolidating floating rate loans before July 1, an in-school borrower can lock-in the current low interest rates for the life of his loans; he can avoid the risk that the floating rates would adjust upward before he leaves school and could effect his final consolidation.

**Federally Re-insured vs. Private Loan Production:** Several new changes to the Higher Education Act should boost originations of federally re-insured student loans at the expense of private loan origination. The most important change in this area is the expansion of the PLUS program to provide for loans directly to graduate and professional students.<sup>9</sup> Before the change, the PLUS program allowed only for loans to parents of undergraduate students (PLUS = Parental Loans to Undergraduate Students). After the change, the "PLUS" name becomes somewhat misleading because the program's scope will now cover loans that are neither to parents nor to finance undergraduate education. Starting on July 1, graduate and professional students will be able to get PLUS loans directly. The graduate and professional students, rather than their parents, will be the borrowers. This change means that some graduate and professional students who would have used private student loans instead will use PLUS loans.

However, some graduate and professional students will not be drawn to the PLUS program. Along with expanding the scope of the PLUS program, the new law raises the interest rate for new PLUS loans to 8.5%.<sup>10</sup> Some graduate and professional students may be able to get private loans with lower interest rates. Therefore, although the change to the PLUS program will draw borrowers away from the private loan sector, the effect should be greatest on the riskiest borrowers. The average credit quality of private loan borrowers should improve.

Another change that should boost the origination volume of federally re-insured student loans is an increase of loan limits. Starting on July 1, college freshmen will be able to borrow up to \$3,500

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<sup>5</sup> 20 U.S.C. § 1077a(k)(4); 1077a(l)(3).

<sup>6</sup> DRA05 § 8009(a) (amending 20 U.S.C. § 1078-3(a)(3)(B)(i) to refer to Federal Direct Consolidation Loans under 20 U.S.C. § 1087e(g)).

<sup>7</sup> DRA05 § 8009(b) (amending 20 U.S.C. §§ 1078(b)(7)(A), 1078-3(a)(3)(A)(ii)(I)).

<sup>8</sup> DRA05 § 8009(c) (amending 20 U.S.C. § 1078-3(a)(3)(C)).

<sup>9</sup> DRA05 § 8005(c) (amending 20 U.S.C. § 1078-2).

<sup>10</sup> DRA05 § 8006(a) (amending 20 U.S.C. § 1077a(l)(2)). As with Stafford loans, legislation from 2002 already provided that PLUS loans originated after 1 July 2006 would have fixed interest rates. The original 2002 legislation specified a rate of 7.9% but the new law raises the rate to 8.5%. See Pub. L. No. 107-139 § 1, 116 Stat. 8 (2002).

through Stafford loans, up from \$2,625 under current law. Similarly, sophomores will be able to borrow up to \$4,500, compared to \$3,500 now.<sup>11</sup> Those increases in the federally re-insured loan limits may allow some students to borrow less than they otherwise would have through private loans.

**Other Changes:** The new law makes additional changes to the Higher Education Act but those changes should have little or no effect on student loan ABS. For example, the new laws provide that interest payments by a borrower that exceed the lender's "special allowance support level" must be paid to the government.<sup>12</sup> In the past, lenders were allowed to retain the "excess" interest. Likewise, the new law reduces special allowance payments on the controversial "9.5% loans."<sup>13</sup> Those and many other changes in the law may be important to student loan borrowers or to lenders, but they should have little direct affect on student loan ABS.

**Conclusion:** The recent changes to the consolidation rules should increase prepayments through June, after which they will likely decline. In addition, the new changes to the re-insurance percentages should produce somewhat higher credit enhancement levels on deals backed by federally re-insured loans, starting after July 1. Finally, changes to interest rate terms and to maximum loan amounts should boost the production of federally re-insured loans at the expense of private loans.

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<sup>11</sup> DRA05 § 8005(a)-(b) (*amending* 20 U.S.C. §§ 1075(a)(1)(A), 1078(b)(1)(A)). Today's \$5,500 annual limit for juniors and seniors remains in effect.

<sup>12</sup> DRA05 § 8006(b).

<sup>13</sup> DRA05 § 8013(b). So-called "9.5% loans" became the subject of controversy after the government released a report finding that the loans were unjustly enriching student loan lenders at the taxpayers' expense. See, U.S. Government Accountability Office, *Federal Family Education Loan Program, Statutory and Regulatory Changes Could Avert Billions in Unnecessary Federal Subsidy Payments*, GAO Rep. No. 04-1070 (Sep 2004) <<http://www.gao.gov/new.items/d041070.pdf>> and <<http://www.gao.gov/docsearch/abstract.php?rptno=GAO-04-1070>>.

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