

Economic Brief

DECEMBER 2008, EB08-03

Turmoil in the Student Loan Market

By John R. Walter and Samuel Henly

Recent credit market problems have diminished the availability of some types of student loans. Nevertheless, new sources of funding have become available, changing the structure of the market while helping to meet the demand for student loans.

Earlier this year, a number of large financial firms curtailed the number of loans they issued to students because they were unable to cover the costs of those loans. The largest student lender, Sallie Mae, announced in April that it could make student loans only at an economic loss. Other lenders failed.

The broad financial system turmoil that began in the subprime mortgage market spread to the student loan market, raising funding costs for lenders. Recent changes to federal student loan programs appeared to exacerbate the problem. The government has since taken steps to ensure adequate funding for those seeking a college education, but the financial infrastructure behind the student loan market remains unsteady. This *Economic Brief* will outline the forces that have shaped the market this year.

SIZE OF THE MARKET AND THE GOVERNMENT'S ROLE

College students collectively borrow huge sums of money to pay for school. Over the 2007-2008 academic year, for example, about \$100 billion in student loans were issued. About two-thirds of students in four-year colleges graduated with debt, and the average debt-carrying graduate owed about \$19,000.

The size of the student loan market accounts for some of the press coverage and congressional interest in recent developments. But an additional factor is the significant role played by the government in the allocation and pricing of student loans (see figure).

The student loan market is heavily subsidized by the federal government through the Department of Education. The government issues some loans itself through the Federal Direct Loan Program (FDLP). In addition, it supports the private organizations – hereafter called “loan originators” or “lenders” – that issue most student loans through a public-private partnership called the Federal Family Education Loan Program (FFELP).

These organizations, a mixture of banks and specialized student loan originators, receive two forms of support through the FFELP. First, the government can guarantee a loan, promising a minimum rate of return to lenders and to cover most of the bill if a student defaults. This guarantee results in a lower interest rate for borrowers. Second, the government

A SNAPSHOT OF THE STUDENT LOAN MARKET

Loan	Originations in 2006 (\$Billions)		
	FDLP	FFELP	TOTAL
Stafford	5.8	23.0	28.8
Unsubsidized Stafford	5.1	23.7	28.8
PLUS	2.2	7.0	9.2
Consolidation	19.2	72.1	91.3
Perkins	—	—	1.6
Total from Government Programs			159.7
Total from Private Sector			17.0

SOURCES: Student Marketmeasure Inc.; FY 2007 Federal Student Aid Annual Report; Internal Federal Reserve System

can subsidize a loan by making interest payments on the student's behalf until six months after graduation.

THE COST OF LENDING

Before issuing a loan to a student, a lender must have funds of its own. One common mechanism for raising funds – capital – is through the sale of student loan-backed securities, a type of asset-backed debt. Student loan originators borrow money at a low interest rate from investors by using future income from loan payments as collateral.

Before 2008, this arrangement between lenders, investors, and the government did a good job of providing students with funding for college. Lenders made loans to students, the government backed the loans to keep them inexpensive for students, and lenders used guaranteed student debt as collateral to borrow at low rates from investors.

Unfortunately, this system has encountered problems over the last year. One straightforward reason is that the demand for student loan-backed securities, like that for all asset-backed debt, has contracted significantly since mid-2007.

Federal legislation also has contributed to the breakdown. As credit markets tightened in 2007, investors demanded higher interest rates for their capital. In other loan markets, a lender might be able to respond to pricier capital by raising the interest rate charged to customers. However, for a major portion of the student loan market, specifically for subsidized Stafford loans, lenders' proceeds are capped, and the cap was lowered by legislation passed in September 2007. As a result, rising funding costs bumped up against and even surpassed the cap. Many lenders indicated that they were losing money on every loan they made. By April 2008, lenders accounting for 15 percent of FFELP loans had left the market.

UNCLE SAM STEPS IN

In response to burgeoning problems in the student loan market, government agencies took a number of actions to increase originators' access to affordable capital. In the spring of 2008, the Federal Reserve allowed financial institutions to begin using student loan-backed securities as collateral to borrow from some of its lending facilities, increasing the desirability of the securities. In May, Congress passed legislation enabling the Department of Education to buy FFELP loans from lenders, effectively acting as an investor. The Department of Education also permitted its direct loan program to expand, and a flood of educational institutions applied to participate in the FDLP.

Students seem to have been able to obtain adequate funding this academic year despite the recent turmoil, but structural shifts in the student loan market have become apparent. By early September, FDLP loan origination volume, in dollar value, had expanded by 50 percent over the previous year while FFELP loan issuance contracted by 4 percent. Despite renewed government support, more than 100 lenders ceased offering FFELP loans. Many of the remaining companies have curtailed their lending to students attending schools with high default rates.

Credit markets remain tight and lenders continue to rely on the Department of Education loan buying program for capital. Private loans have become scarce, although dominant lender Sallie Mae announced a program to issue \$10 billion in new private loans to creditworthy borrowers.

Most students borrow to cover college expenses. Recent credit market turmoil and federal legislation lowering lender revenues have diminished the availability of some types of student loans. Nevertheless, new sources of funding have become available, changing the structure of the market while helping to meet the demand for student loans. ■

John R. Walter is a senior economist and research advisor in the Research Department at the Federal Reserve Bank of Richmond. Samuel Henly is a research associate in the Research Department.



THE FEDERAL RESERVE BANK OF RICHMOND
RICHMOND ■ BALTIMORE ■ CHARLOTTE