February 17, 2011

The Honorable Mary L. Schapiro
Chairman Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Implementation of the risk retention provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 related to nonprofit and state-based student loans providers

The Education Finance Council (EFC), the association representing the nation's nonprofit and state-based student loan providers, submits the following information to assist the Securities and Exchange Commission (SEC) in the development of a credit risk retention regulation. Section 941 of the Dodd-Frank Consumer Protection and Wall Street Reform Act of 2010 ("Dodd-Frank")[1] directs the SEC, in its upcoming credit risk retention rulemaking, to grant "a total or partial exemption"[2] for municipal and nonprofit student lenders authorized to use tax-exempt financing under section 150(d) of the Internal Revenue Code. This submission provides support for a total exemption from the risk retention rulemaking for all nonprofit student loan issuers.

Background

Nonprofit and state-based student loan providers are public purpose organizations dedicated to making college more affordable and accessible. These student loan providers operate as secondary markets, loan servicers as well as loan originators and provide a wide array of college outreach and planning information. Historically, these providers have expanded access to higher education by ensuring the availability of funding for student loans and by making it easier and less expensive to pay for college. Specifically, nonprofit and state-based student loan providers have provided the liquidity required to meet the country's growing college financing needs by raising money through the sale of bonds to investors, and using that money to make student loans directly or to acquire them from banks, savings and loans, and credit unions. Of equal importance, nonprofit student loan providers have used earnings from student loan originations to become leaders in innovation to reduce the cost of a college education. Currently over two-thirds of states have nonprofit or state-based student loan providers.

Nonprofit and state-based student loan providers fall into two categories. The first category includes entities that are state agencies. These entities are instrumentalities of a state formed either by an act of the legislature or state executive. The second category is nonprofit entities that are designated by a particular state to originate student loans. Some of these entities are, pursuant to Internal Revenue Code section 150(d), eligible to utilize tax-exempt financing to acquire student loans made under the Higher Education Act of 1965.

[1] Pub.L. 111-203, H.R. 4173.
[2] See Sec 941(b), creating a the new section 15g(c)(1)(G)(ii) and (iii). See also, the new 15(c)(1)(G)(i) which directs the SEC to provide a total or partial exemption for any securitization as may be appropriate in the public interest and for the protection of investors.

Securitizations in the Student Lending Context

Since the 1960's, state-based and nonprofit student loan providers have issued fixed and floating rate bonds to finance the origination or purchase of student loans. Following the adoption in 1992, of Rule 3(a)-7 of the Investment Company Act of 1940, state-based and nonprofit student loan providers have issued asset backed securities (ABS) as the primary vehicle to finance student loan originations or secondary market purchases. Historically, these securities were issued directly by state-based and nonprofit loan providers as nonrecourse revenue bonds. Student loans can generate attractive financing spreads because of low expected losses and long maturities, which make them prime candidates for securitizations. The traditional student loan ABS structure is a nonprofit or state agency owner trust that issues one or more classes of sequential-pay, triple-A rated notes and a single class of single-A rated certificates.[3] Currently, the market for subordinate ABS has nearly evaporated. This means that credit enhancement for the Senior AAA rated securities, of which there is some market for, comes primarily from over-collateralization in the form of an equity contribution by the issuer – a topic discussed in detail below. Securitizations issued by state agencies and nonprofit student lenders are exempt from the Securities and Exchange Act of 1933 (the Act).[4] Student loan ABS are backed by student loans originated under the Federal Family Education Loan Program (FFELP) or by non-federally guaranteed student loans ("supplemental loans"). FFELP ABS are comprised of FFELP loans which are student loans guaranteed by an eligible guarantor to at least 97% of principal and accrued interest, depending on loan origination date. The loans are also reinsured by the U.S. Department of Education up to the same amount.[5] The maximum loan amount is set by statute.[6] Supplemental student loan ABS are comprised of non-federally guaranteed student loans which are usually sized to cover the cost of college in excess of FFELP loan limits. There are some student loan ABS structures that contain both FFELP and supplemental loans.

In addition to financing new student loan originations, securitizations are used to refinance existing student loan ABS structures. For several years, state-based and nonprofit student loan issuers utilized auction rate securities (ARS) as the primary type of financing structure. In 2008, the ARS market completely collapsed and remains frozen with virtually no probability of recovery. This was particularly problematic for nonprofit and state-based student lenders because the financial crisis decimated the retained earnings that formed the principle form of capital used for loan origination.

[3] Source, Student Loan ABS Primer, Solomon Smith Barney, September 2002. Note, however, that current markets are not open to buying Single A rate securities at economics that work for student loan providers.
[4] With respect to exempt securities, section 3(a)(2) of the Act states in relevant part, "Any security issued or guaranteed by the United States or any Territory thereof, or by the District of Columbia, or by any State of the United States […] or by any public instrumentality of one or more States or Territories." Further, section 3(a)(4) exempts securities issued by "a person organized and operated exclusively for … educational… purposes and not for pecuniary profit."
[5] The Health Care and Education Reconciliation Act of 2010 (HCERA, P.L. 111-152) terminated new FFELP originations as of July 1, 2010.
[6] For example, for a dependent student, the loan combined (subsidized and unsubsidized) FFELP loan limits are as follows: First-Year Undergraduate (Freshman) $5,500, Second-Year Undergraduate (Sophomore) $6,500 and Third-Year and Beyond Undergraduate (Junior, Senior) $7,500. This information was taken from a table prepared by FinAid and can be accessed at the following URL: http://www.finaid.org/loans/studentloan.phtml.

Since the collapse of the ARS market, nonprofit student loan providers have attempted to refinance out of ARS structures and into alternatives such as floating rate note (FRN) transactions. Additional FFELP refinancing needs also arise from the need to terminate temporary funding sources such as warehouse lines or bank letters of credit backed transactions. It should also be noted that securitization volume for student loans will also come from lenders attempting to refinance loans put into an Asset Backed Commercial Paper conduit (known as the "Straight A conduit").[7] State-based and nonprofit lenders utilized Straight A because they didn't have the equity at that time to finance loans in the capital markets.

While the number of new issuances in the student loan ABS market has diminished over the past four years, securitizations still exist under the current market dynamics. In 2006 more than $70 billion in student loan securitizations were issued. Since then, the number has continued to decrease, and in 2010 there was about $15 billion in issuance. That figure demonstrates that securitization of student loan ABS is active despite the termination of new FFELP originations after July 1, 2010.[8] One estimate of the size of the overall student loan ABS market stands at approximately $250 billion in FFELP ABS and approximately $49 billion of supplemental student loan-backed ABS; of which approximately $62 billion is failed ARS that needs to be refinanced.

Characteristics of Student Loan ABS

The credit quality of student loans is, on the whole, superior to most other asset classes. Historically, the FFELP student loans underlying FFELP ABS have had a low default rate. This is due, in part, to borrowers having flexible repayment options including deferment, forbearance, and consolidation. For supplemental loans, default rates are reasonably low for unsecured "signature debt" because of tighter underwriting standards, including the requirement of co-signers. Default rates for supplemental loans issued by state-based and nonprofit student loan providers have been lower than similar loans issued by for-profit lenders in the important respect that the state-based and nonprofit lenders historically utilized the school channel rather than a direct-to-consumer model. FFELP loans and supplemental student loans also carry legal constructs designed to ensure repayments. Of course, increased repayment rates on the loans underlying student loan bonds translate into reduced risk to investors of those bonds.

Unlike many other forms of ABS, student loan ABS issued by nonprofit and state-based student loan providers do not utilize bankruptcy-remote, special purpose vehicles (SPV). The simple explanation for this is the fact that nonprofit and state-based student lenders are not "monied businesses" as the phrase is used in the Bankruptcy Code which means the structures they use are exempt from involuntary bankruptcy under the Code. The practical effect of not using SPVs is that the ABS structures remain "on the books" of nonprofit and state-based issuers. Further distinguishing the student loan asset class is the fact that the financing structure for nonprofit and state agency student loan transactions is more similar to traditional "revenue bonds" issued by conventional municipal

[7] Straight A was created under the authority of the Ensuring Continued Access to Student Loans Act (ECASLA).
[8] See, the Health Care and Education Reconciliation Act of 2010 (Pub.L. 111-152, 124 Stat. 1029).

issuers than the securitization structures used in the mortgage, auto or commercial leases.[9] The definition of "securitization" used in Dodd-Frank is quite broad and unnecessarily captures "limited obligation" securities issued directly by nonprofit and state based student lenders.[10]

Many nonprofit and state-based student loan securitization deals that have come to market over the past year have been highly over-collateralized to provide the credit enhancement necessary to attract investors. Before the financial crisis, many state-based and nonprofit student loan transactions had starting parity rates under par. Today, the level of over-collateralization for a typical FFELP FRN transaction is between four percent and eight percent. For supplemental loan transactions, the rate of over-collateralization is much higher (variables include type of issuer and the portfolio's performance history or lack thereof). Importantly, the funds that are used to meet over-collateralization requirements for new financings come from the issuer's very limited net assets, or equity, and is therefore analogous to first-loss "skin in the game." Moreover, the high rate of over-collateralization shows that the marketplace is requiring a significant amount of retained risk for these transactions. In the case of refinancing, over-collateralization takes the form of haircuts from existing bondholders and investors. Therefore, an additional risk retention requirement will deepen those haircuts which in turn will result in fewer refinancing opportunities for nonprofit and state-based student loan providers.

Another important feature of nonprofit and state-based student loan ABS is an alignment of investor and issuer interests. In recent years, nonprofit and state-based issuers typically hold the first lost piece of securitizations in the form of a residual that is not payable to an issuer until the bondholders are paid off.

Further demonstrating an alignment of investor and issuer interests, nonprofit and state-based issuers are actively engaged over the life of their transactions as primary servicers and administrators. The income that nonprofits earn to operate their businesses is derived from administrative fees and servicing fees earned over the life of their transaction with respect to their active management and servicing roles. If a deal is not successful in the corporate world, the sponsor still realizes all the benefits. If a deal is not successful in the nonprofit world, the issuer loses all of its benefits because its operating revenue and servicing revenue goes away. Finally, in some instances, state agency student loan providers' issuances have been fixed rate transactions with some type of state backing (e.g., moral obligation). These transactions make the student loan transaction akin to other municipal transactions.

Effect of Additional Risk Retention Requirement

The legislative intent of Dodd-Frank section 941 suggests that a risk retention requirement is not applicable to student loan ABS. When the legislative history is reviewed, it is clear that student

[9] In fact, most student loan transactions have been historically referred to as "student loan revenue bonds".
[10] For consistency with terminology used in Dodd-Frank, references are made throughout this paper to "student loan ABS." However, financing structures used by nonprofit and state-based student lenders are more properly classified as student loan bonds and direct nonrecourse debt.

loan securitizations are not the policy issue that risk retention was seeking to solve. In the Senate Banking Committee Report, the underlying policy goal of section 941 is clear: "When securitizers retain a material amount of risk, they have 'skin in the game,' aligning their economic interests with those of investors in asset-backed securities. Securitizers who retain risk have a strong incentive to monitor the quality of the assets they purchase from originators, package into securities, and sell."[11] Moreover, a July 2010 Senate Banking Committee Summary of the Conference Report summarizes the goal of risk retention as: "[requiring] companies that sell products like *mortgage-backed securities* (emphasis added) to retain at least 5% of the credit risk, unless the underlying loans meet standards that reduce riskiness. That way if the investment doesn't pan out, the company that packaged and sold the investment would lose out right along with the people they sold it to."[12] Given the characteristics of student loan ABS structures used by nonprofit and state-based student loan providers coupled with the nature of these issuers, it's logical to conclude this asset class, and the structure of the securitizations used to finance it, lies outside the intent of section 941.

Most nonprofit student loan providers would not be able to absorb the additional cost of capital that would result from a risk retention requirement that exceeds what is already being imposed by the requirements of the capital markets as described above, and would be forced to pass this cost on to borrowers or schools. In all likelihood this circumstance will significantly disadvantage nonprofit and state-based student loan providers who, unlike for-profit institutions do not have ready access to the needed equity to pour into retained risk. The necessity of charging borrowers or – more likely – schools to offset the cost of an additional risk retention requirement is based on the fact that in many instances it cannot be offset by increasing interest rates on the loans. This is particularly true in the FFELP context where the interest rate and yield is set by the federal government. Another impact of additional risk retention is a further reduction in college access and outreach programs. Nonprofit and state-based student loan providers, while historically thinly capitalized, used a portion of that capital to fund public purpose programs focused on increasing access to and completion of higher education. An increase in risk retention would further drain capital and result in the inability to continue these programs. Thus, additional risk retention will have the duel effect of unfairly advantaging for-profit lenders while frustrating the public purpose of providing reasonable financial access to higher education.

Additional costs generated by a new layer of credit risk retention could unnecessarily preclude securitizations. If nonprofit lenders are forced to retain an additional percentage of the credit risk, the increased cost of financing and subsequent reduction in margin will likely lead many nonprofit issuers to abandon securitizations. Moreover, a student loan securitization with increased retained risk does not offer investors a more attractive – or necessarily safer – return. This would mean that ARS deals that could be refinanced - to the benefit of investors - would remain frozen. For those state-based and nonprofit student loan providers that only originated FFELP loans, this problem is compounded by the

[11] Senate Report 111-176, p. 129.
[12] Senate Banking Committee Conference Report Summary, July 2010. http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf

fact that they cannot issue new loans and thus have no way to generate additional capital to refinance existing transactions.

The FRN market has come back to life to some degree, but it is still very weak, lacking the number of volume buyers that would drive spreads down to more acceptable levels for issuers. Of the more than $80 billion of failed ARS that existed when that market collapsed in February 2008, some $62 billion remains outstanding and in need of refinancing. Currently, only the FRN market has the capacity to absorb a significant portion of that overhang. The FRN buyers are well aware of that situation and are dictating wide spreads. In addition, the rating agencies are imposing cash flow stresses that require significant levels of over-collateralization. Even under these current circumstances, there are a number of state agency and not-for-profit issuers that cannot come up with enough equity to meet the demands of buyers and the stresses of the rating agencies. Thus, it is a certainty that if an additional risk retention requirement is imposed in addition to what the market is already requiring, the number of nonprofit student loan issuers that will be in a position to refinance frozen ARS will shrink to almost nothing.

Recommendation

The clear focus of the Dodd-Frank legislation is on securitizations that carry a far greater risk to investors than student loan securitizations, which already have retained risk in excess of the five percent requirement imposed by Dodd-Frank. Additional risk retention would limit the ability to originate new loans, thereby negatively impacting students and families. The SEC should use its discretion to grant a total exemption for state agencies, 150(d) and other nonprofit student lenders from its risk retention regulation.

EFC appreciates the opportunity to provide the perspective of its members' in connection with the Commission's rulemaking process on risk retention. Should you have any questions issues raised in this letter, please do not hesitate to contact me.

Sincerely,

Sampson

Vince Sampson
President