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January 29, 2020

Hon. Michael Marcotte, Chair
Hon Jean O'Sullivan, Vice Chair
Vermont House of Representatives Committee on
Commerce and Economic Development

Hon Michael Sirotkin, Chair
Hon Alison Clarkson, Vice Chair
Vermont Senate Committee on Economic Development, Housing
and General Affairs

Re: Report on Student Loan Refinancing Possibilities

Dear Representative Marcotte, Representative O'Sullivan, Senator Sirotkin and Senator Clarkson:

On June 12, 2019, you sent a letter to the undersigned in connection with your respective Committees' work on workforce development, asking us "to identify appropriate funding sources and one or more mechanisms for refinancing student loan debt at lower interest rates." We have been collaborating on research and analysis in order to present this report to you. As we note at the conclusion, we are prepared to come to your respective Committees and answer questions, and to explore the best policy option for Vermont.

In order to set the table for the refinancing options, it is necessary to discuss the basics of how VSAC issues debt (bonds) to raise capital for making student loans, and the important features of the student loans.

Overview of Student Loan Bonds and How VSAC Sets Student Loan Interest Rates

VSAC has been making student loans for nearly 40 years and has seen the interest rate structures and levels evolve over that time. The interest rates on the student loans VSAC currently makes are based on the type of loan (secured vs. unsecured) and the cost of the funds used to make the loan. Student loans, like other "personal loans", are not secured like mortgages and auto loans, which are backed by the value of the collateral. Secured loans have lower interest rates than unsecured loans, as a general rule.

The interest rates and fees on VSAC's loans are largely driven by VSAC's cost of funds and projected losses from borrower defaults. VSAC borrows money by issuing tax-exempt bonds and uses the proceeds from selling the bonds to make student loans. By

IRS regulation, unlike a for-profit lender, VSAC may retain no more than 2% to cover the cost of making and servicing the loans and support the administration and delivery of its other programs (grants, scholarships, outreach, etc.). Put another way, if a borrower's VSAC loan bears interest at 5.0%, VSAC can use only the revenue from 2% of the rate to pay for the costs of operating its loan originating and servicing programs – and its other mission-related programs. In this example, the revenue from the other 3% must be enough to cover the costs of making interest (also in certain instances principal payments) to bond owners, and other bond-related expenses (e.g., rating agency fees, costs of issuing the bonds (bond counsel, underwriter's counsel, securities registration fees)). The 3% revenue also must cover the losses associated with borrowers who default on repaying their loans – or this cost must come out of the revenue from the 2% (in this example). The cost of defaults, therefore, increases the interest rate on the student loans. All of these cost projections, including the minimum FICO credit scores for loan eligibility and projected borrower default rates, are subject to very close scrutiny by the bond rating agencies (Moody's, Standard & Poors, Fitch), who hold VSAC's bond issuances to very high standards in order to generate an investment grade bond rating (typically, an "A" rating).

All VSAC loans made to students since May 2009 have required a creditworthy co-signer. VSAC currently makes loans to students with a co-signer (both are obligated on the loan) and to parents (the student is not obligated). As discussed later in this report, these loans are certified by the schools that the borrowers attend that they are equal to or less than the cost of attendance minus financial aid.

The bond interest rate is set in a competitive market context and based upon the rates prevailing when VSAC sells its bonds, typically in May or June each year. If our loans perform better than projected by the rating agencies and the bonds earn more than 2%, (after payment of interest and principal to bond owners and the other bond-related costs) we provide the excess back to borrowers in the form of loan forgiveness or interest rate reductions. This past year we gave $2 million in rebates to borrowers and have cumulatively saved Vermont borrowers more than $180 million since 1995.

It is important to note that each VSAC bond issuance is established as a stand-alone financing in the form of a bond trust for the benefit of the bond owners, and that VSAC itself has no independent or general obligation to pay the principal and interest on the bonds. VSAC's obligation is to diligently make, service and collect the loans. The bond owners' recourse in the event of a bond default (which has never happened in the 36 years VSAC has been issuing bonds) is solely to the assets in and the revenues generated by the bond trust. Under this structure, the state of Vermont has no general obligation on the VSAC bonds. VSAC has the authority to issue bonds carrying the moral obligation of the state of Vermont for an amount not to exceed $50 million. VSAC currently has $3.6 million in outstanding debt that carries the state's moral obligation.

VSAC education loans have certain consumer protections that are not available to other types of loans (including vehicle loans and home mortgages or loans from many for-profit lenders), VSAC loans provide qualified borrowers with up to two full years of reduced or no-pay forbearances if the economic circumstances of the borrower and coborrower temporarily prevent making payments (i.e. unemployment or reduced salary). In addition, VSAC education loans are cancelled if the borrower becomes totally and permanently disabled (or passes away). We also provide borrowers with three repayment options allowing the opportunity to begin making payments immediately (lowest rate), make interest payments while the student is in school (middle rate) or defer all payments one to six years until after graduation (highest rate). These are very important features to us from a mission perspective but because these loans are not backed by collateral, in order for us to finance these loans in the bond market, the cost of special benefits, deferred payments, delinquencies and defaults must be reflected in the interest rate.

While the VSAC loan program lets borrowers choose their interest rate based on the repayment option they choose (immediate payment plans have the lowest rates and deferred payment plans have higher rates), the origination fees are set based upon a borrower's credit score (the co-signer's credit score on the student loans, the parent's score on the parent loans). The fees are structured to address VSAC's risk that a loan will become delinquent or go into default and possibly become uncollectable. The fee structure is part of the overall credit profile of the VSAC bonds, and that profile is carefully and conservatively evaluated by the bond rating agencies. Without a sound fee structure and strong credit underwriting, the interest rates on the VSAC loans would be higher – and some loan applicants would not get loans at all.

Every year VSAC works to find ways to strike the right balance among interest rates, origination fees and borrower benefits, with the overall goal of having students and parents "know more and borrow less," at an affordable cost. We do realize that the cost of postsecondary education itself is a very challenging factor in the affordability calculation.

The Prospect of a Student Loan Refinancing Program

Refinancing a student loan involves replacing one or more student loans with a new loan. Both private and federal student loans can be refinanced. The purpose of refinancing is to get a lower interest rate and/or a more desirable loan term and thereby reduce the monthly payments and life-of-loan costs. Many private lenders, including banks, online lenders, and credit unions offer student loan refinance loans. People with federal student loans may also be eligible to consolidate—rather than refinance—their federal loans. Debt consolidation involves combining multiple federal loans into a single federal loan with one monthly payment.

Whereas federal and many private student loan lenders look only at a borrower's (or, in private loans, the co-borrower's) credit score, refinance loan products look also at the applicant's income and debt-to-income ratio. Some refinancing loan products also look at employment status. Thus, the underwriting standards for refinancing loan products tend to be distinctly more rigorous than for regular student loans. Some refinancing loan products are focused only on applicants with the highest credit scores and surplus monthly income. A loan product's underwriting standards factor into the lender's own cost of funds when raising capital (usually debt) to make the refinancing loans (see earlier discussion).

VSAC has never offered a refinancing loan. We have looked at some of the leading refinancing loan products, reflected on what VSAC does well, and have drafted the following as a starting point for more in-depth discussions with your Committees on what such a loan product might look like.

Refinance Loan Structuring Options and Issues

Student loans have become one of the primary means by which students and their families pay the cost of higher education. The average undergraduate student debt incurred by students attending Vermont colleges and universities (excluding parent debt), is $30,651. Roughly 60% of students use student loans to obtain their undergraduate degree. In addition, the fastest growing segment of student loan debt is incurred by graduate and professional students—a group highly sought after by states seeking to meet workforce needs and spur economic development.

Vermont is 2nd in the nation in the per capita importation of college students. Each year, more than 20,000 non-Vermont students flock to our institutions of higher education. These students are attracted to Vermont, its values and its natural beauty to pursue their studies. They represent an unmatched opportunity to grow Vermont's knowledge workforce and economy.

Mounting evidence suggests that increased student loan debt, exacerbated by poor counseling in the federal student loan programs, is impacting the economic decisions of college graduates, particularly in rural areas. As a result, states, municipalities and employers are exploring and, in some cases, launching loan refinance, loan repayment, and loan forgiveness programs to attract and retain college graduates.

A model loan refinance product designed to attract and retain college graduates would address the following considerations. The following represent one possible set of underwriting criteria. A final set of criteria can be devised after all of the goals of the program are defined.

Target Customer: We presume that the target customers are former students and parents who are Vermont residents who have existing private and/or federal loans (federal Direct Loans likely would be excluded, with an exception for those who certify their desire to forgo the distinct benefits attached to those loans—i.e., income based repayment or loan forgiveness). The refinance loan market pursuing very high credit individuals is quite robust already – meeting the needs of higher income borrowers, so this report is focused on a refinance loan that is competitive for the next lower credit tier customers.

Some threshold choices quickly present themselves.

- Should the loans be available to Vermont residents only or to both residents and non-residents?
- Should all eligible loans be in repayment and not be still "deferred while in-school?"
- Should you separate cost-minus-aid loan amounts from "unknown" to enable use of tax-exempt funding[1]?
- Should there be a maximum loan amount (i.e., $250,000) and how much should it be?
- Should there be a minimum loan amount (i.e., $7,500)?

Underwriting: The following represent one possible set of underwriting criteria. As before, a final set of criteria can be devised after all of the goals of the program are defined.

- Cosigners
    - optional if individual borrowers meet the credit criteria on their own. Mandatory if they do not.

- Individual borrower or cosigner could be required to meet the following:
    - Minimum FICO = 680
    - Absence of negative credit
    - At least two active trade lines (activity within the last 60 days)
    - Debt-to-income ratio of 36% for all debts relative to gross pre-tax income
    - Minimum income of $40,000
    - Free cash flow[2]
- School completion: Should eligible borrowers be restricted to graduates, or available to any student regardless of whether they graduated?
- School type: Should loans be available to refinance loans made to attend proprietary and for-profit schools?

Loan Pricing

- Origination fees: should there be origination fees? Should origination fees be tied to the customer's credit?
- Should interest rates be tied to creditworthiness/risk targeting? For example, a loan could be structured using 5 credit tiers and fixed interest rates.
    - 800 – 850 = best rate
    - 770 – 799 = best plus 50bps
    - 740 – 769 = best plus 125 bps
    - 710 – 739 = best plus 225bps
    - 680 – 709 = best plus 325bps

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[1] Tax exempt financing may only be used to fund student loans equal to the cost of higher education minus any non-loan aid that was provided. U.S. Treasury regulations do not yet clearly allow use of tax-exempt bonds to finance the refinancing of student loans.

[2] SOFI and other lenders increasingly look to free cash flow as a criterion for reducing the risk of default.

Repayment Term, discounts, and forgiveness

- Repayment terms. What repayment terms should be offered?
    - 5, 10, 15, 20-year repayment term (shorter term could receive lower interest rate, longer term would receive higher rate)
- Forbearance. Should there be a forbearance period to allow for no or reduced payment during periods of economic hardship? If so, how many months (VSAC student and parent loans currently offer 24 months)?
- Discounts. Should a rate reduction be offered for auto payment and/or a purely electronic relationship?
- Prepayment penalties. VSAC does not currently have any prepayment penalties/
- Late fees. VSAC does not currently charge late fees.
- Total and Permanent Disability. VSAC currently forgives debt and releases cosigner from obligation if the borrower becomes totally and permanently disabled.
- Defaults. Loans will be considered in default if any payment is 180 days or more past due.

Capital Source Collateral

All student loan financing structures require initial collateral in excess of the dollar amount of the bonds being issued ("over-collateralization") in order for the structures to achieve an investment-grade rating from the rating agencies.

Over-collateralization requirements range from 15% to 30% depending on the underwriting and expected performance of the loans. To put this in context, a $10 million bond deal will require $1.5 million to $3 million in upfront collateral to pass the rating agency stress tests.

These collateralization requirements can be reduced or increased depending on the interest rate that is charged on the student loans. Higher collateral contributions can reduce rates. Lower collateral contributions require higher rates. Finding the right mix depends upon available collateral and cashflow assumptions.

Sources of Capital

As will be discussed in greater detail in the next section, there are three main sources of funding for student loans: Tax-exempt financing using private activity bonds, taxable bonds, and general obligation bonds (taxable or tax exempt).

1. Private-Activity Bonds. One of the most common ways of financing student loans, and the one that VSAC currently uses, is to issue tax-exempt

"private activity"[3] bonds. Tax exempt bonds are generally lower-cost, allowing for lower student loan rates. These bonds carry restrictions with regard to nexus (a connection between the borrower and Vermont), interest rate spread, and the loans that can be financed.

2. Taxable Bonds. VSAC has used taxable bonds in the past when loan volume exceeded available private activity bond cap. This is currently the most common way to finance student loan refinance programs. These bonds do not carry the restrictions regarding residency, nexus, spread, or the loans that can be financed. Taxable bonds are generally higher cost than tax exempt bonds.

3. General Obligation Bonds. As described earlier, VSAC's financings do not carry the full faith and credit of the State of Vermont. As a result, the bonds that VSAC issues must have a rate structure and sufficient collateral to meet the stress cases assigned by the rating agencies to achieve a rating attractive to investors. At least one state (Texas) has elected to fund a portion of its student loan program using general obligation bonds that avail themselves of the strength of the state's credit rating. Because these bonds have the full faith and credit of the state, they typically have the lowest cost of funds and have lower collateral requirements.

Financing Options

A. Warehouse

One strategy for raising capital for refinancing student loans is to make student loans with other available, typically short-term, funds, and hold the loans in a "warehouse" financing structure until enough student loan volume is accumulated to efficiently securitize these loans in the bond market or through other longer-term structures. Under this strategy, one or more warehouse capital providers will agree to a capital limit (e.g., $50 million). VSAC would draw against that limit to initially fund refinance loans. The loan assets would be the property of the warehouse until they are permanently funded by either debt notes or securitized using taxable or tax-exempt bonds.

The warehouse capital providers are paid interest for their capital with the expectation that the warehouse will be repaid through debt notes or securitization within a specified time limit and generally invoke interest penalties if these time limits are not met. The potential benefit of this strategy is that it can lead to more efficient securitization. There is, however, also the risk that fluctuations in the bond market (i.e., interest changes, lack of investors, changes in rating risk assessments) make it difficult or expensive to move loans from the warehouse into a long-term financing structure. Nonetheless, this is a strategy regularly used to finance student loans.

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[3] "Private activity bonds" are bonds used to the benefit of private, not public, uses. A student loans is one type of private activity bond. The U.S. Treasury regulates this type of bond, and each state is annually allocated a "cap" on the amount of private activity bonds that may be issued in the state.

B. Pre-fund with Taxable or Tax-exempt Funds

A second strategy for raising capital for refinancing student loans is to "pre-fund" them using proceeds from taxable bonds (VSAC currently uses tax-exempt bonds) to raise the needed loan capital. As indicated earlier in this report, IRS regulations currently prohibits using tax-exempt bonds to fund or refinance student loans that were made in amounts greater than the students' cost of attending college minus financial aid (i.e., tax-exempt financing cannot be used to refinance loans that included non-education expenses). There are simple and well-established methods for complying with this requirement for in-school loans (those made to current students). Strategies for complying with this requirement for refinance loan products are being explored but are not established. The U.S. Department of Treasury has indicated that this provision is scheduled for regulatory review as part of its forthcoming review cycle. We hope that it will provide the clarity needed to permit use of tax-exempt financing.

Student loans made by the federal government and student loans made by VSAC and many non-profits and state agencies are all subject to the cost-minus aid limitation. As a result, it may be possible to use tax-exempt bonds to finance a refinance loan product that limits itself to refinancing federal student loans and non-federal loans made by VSAC or other agencies subject to the same limitations. This would exclude loans made by banks, for-profit lenders and others whose loans may not have been subject to the limitation. In the interim, it would be possible to pre-fund refinance loans by issuing taxable bonds.

Because taxable bonds are not subject to the same limitations as tax-exempt bonds, this creates the possibility of different pricing and financing strategies.

Taxable bonds are not subject to nexus restrictions that require that a borrower be a Vermont resident or attending a Vermont school. As a result, it would be legally possible to offer a refinance loan to any otherwise eligible customer without regard to residency.

Taxable debt costs are higher than the debt costs for tax-exempt financing, however spread can exceed the 2% limitation imposed on tax exempt bonds. As a result, it is possible to adjust the interest rates to reduce the capital required to collateralize the bonds. This can increase the cost of the loan to borrowers but reduce the capital required to collateralize the loans.

As with tax exempt loans, the loan performance assumptions would be dictated by the rating agencies. The rating agencies currently require VSAC to provide more than 15% overcollateralization on its existing student loan bonds.

There are several ways that this overcollateralization need could be met or reduced. First, the state itself could provide funds to meet this collateral requirement. In addition, the spread between loan rates and financing costs could be widened in order to decrease the amount of collateral required to meet the rating agency stress case assumptions.

As an alternative, the state, through VSAC, could issue taxable State general obligation bonds to raise the needed loan capital. Revenue from the payment of student loans would be pledged to pay the obligations. The general obligation of the state could be used as a rating "wrap" to lower the cost of financing, the collateral requirements, and the student loan rates. Under this model, the loan performance assumptions would be dictated by the state and the total amount of bond issued would be subject to and limited by the authorization cap set by the Capital Debt Affordability Committee. The impact, if any, of this approach and structure on the state's bond rating would have to be explored.

C. Private Placement

Pledging (securitizing) pools of newly originated refinance loans to debt notes, similar to securitized bonds, may offer another efficient and cost-effective solution. Operational realities will require flexibility for up-front loan funding and accumulation of those funded loans into sufficient amounts for cost efficient permanent placement. The structure will have at least three primary components:

A) A forward purchase or placement agreement for the debt notes that will guarantee a price, rate, and note amount. We would need certainty that if we were to fund $2 million in refinance loans, those loans would ultimately be placed in a permanent financing debt note. The capital from that debt note transaction would then be used to fund additional refinance loans. This agreement would be open to one or more participants who ultimately want to invest in the debt notes backed by the refinance loans.

B) Temporary capital: This would be a type of "warehouse" financing to initially fund the refinance loans. The warehouse capital provider(s) would agree to a capital limit (e.g., $5 million). VSAC would draw against that limit to initially fund refinance loans. The loan assets would be the property of the warehouse until permanently funded by debt notes. Under this model, one would accumulate $1 - $5 million in refinance loans, then transfer those loans as pledged collateral to debt notes. The capital from the debt notes exchanged for the loan assets would replenish the financing capacity of the warehouse. The warehouse capital provided would earn a market return on the amount drawn from the warehouse using the repayments from the refinance loans as a source of payment. The warehouse provider could be the State or other short-term investors.

C) Privately placed debt notes of $1 – 5 million in size. As VSAC accumulated newly funded refinance loans, under this structure we would bundle those loans as pledged collateral for debt notes. The Rhode Island agency places their notes with a commercial bank. If this structure were explored further, we would envision reaching out to several possible investment entities including the State, VTCF, and commercial banks. The return demands from the debt note investors would dictate the refinance loan pricing and interest rate the state could offer.

- Supporting debt note legal document templates would be developed and pre-negotiated allowing repeatable placements with the investor pool making the forward purchase commitment.
- Debt note interest to investors would be pre-negotiated allowing for predictable funding cost to use in refinance loan pricing.
- Loan loss reserve, credit enhancement, etc., would all be pre-negotiated with investors.
- Depending on the loan characteristics (repayment term, interest rate, etc.), we can customize the debt notes to some degree. For example, if we have refinance loans that utilize a 5 year repayment term, the final maturity date for the debt note would be fairly short. Refinance loans utilizing a 10- or 15-year repayment term would result in much longer final maturity dates for the debt notes. Mixing refinance loans of different repayment terms could further tailor the maturity date of the debt notes to investor preference.
- A trustee would be utilized for refinance loan collection payments, payments to investors, paying a loan servicer (VSAC), etc. This role exists today for all VSAC bonds sold in the public markets.

Additional Strategies for Reducing the Cost of Student Debt

Our charge was to exploring refinancing as a tool for reducing the impact of student loan debt. This strategy could be complemented and leveraged by offering an income tax credit or deduction on some portion or all the payments made to repay a refinance loan made under this program. This would have the effect of further reducing the cost of these loans to working Vermonters.

In addition, other states are exploring ways they can use tax incentives and repayment benefits to encourage employers to offer student loan repayment benefits. An economic development strategy that combined student loan refinance opportunities with targeted benefits to reduce the cost of borrowing and encourage employer benefit programs could signal strong state commitment to attracting and retaining a young, educated workforce.

We are pleased to be able to deliver this report to you and appreciate the opportunity to explore ways to develop a student loan refinance program that would be consistent with Vermont's goals for economic and workforce development.

We are prepared to respond to questions and would be pleased to meet with you and your Committees to discuss these issues in greater detail.

Very truly yours,

Beth Pearce

Elizabeth A. Pearce
State Treasurer

Scott A. Giles
President/CEO