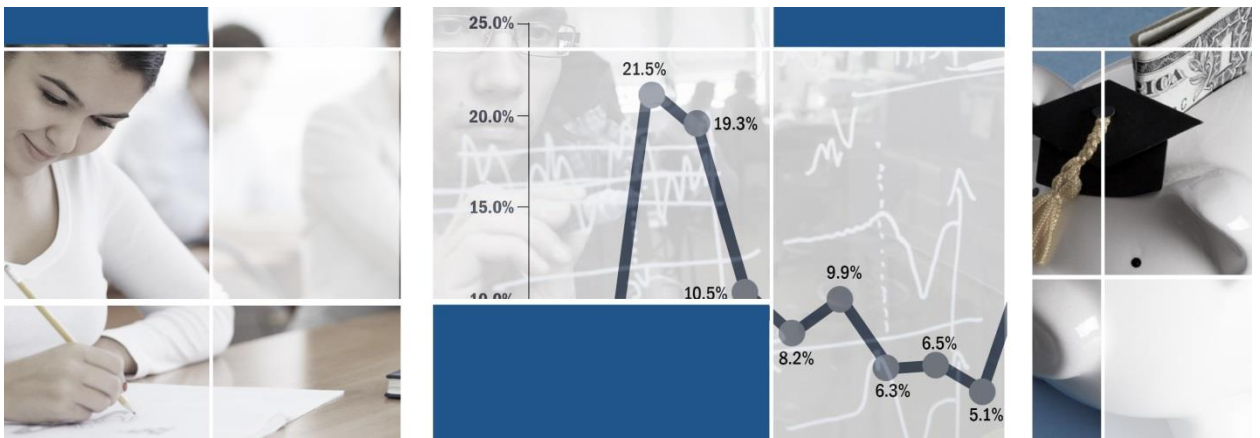


November 1, 2016



Policy Considerations for a Student-Loan Refinancing Authority

State Council of Higher Education for Virginia
Virginia Department of the Treasury
Virginia529 College Savings Plan

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Executive Summary

Access and affordability are the main themes of Goal 1 of The Virginia Plan for Higher Education. Progress toward these goals can be measured by a variety of means, but access and affordability serve as foundational guiding principles as the Commonwealth of Virginia crafts its annual and biennial higher-education budgets.

Student-loan debt is but one measure in determining if Virginia's system of higher education is maintaining affordability. This can be evaluated two ways: by the amount of debt accumulated, and by evaluating if debt levels are manageable by borrowers. This paper focuses on the latter.

As student-loan debt continues to escalate, a number of observers have expressed concerns about the ability of borrowers to manage their debt as well as about the potential negative impact of high debt on the economy. Specifically, there is evidence of borrowers whose debt level has increased years after graduation due to finance charges, collections fees and increased interest rates. During the 2016 session of the General Assembly, Senator Janet Howell and Delegate Marcus Simon asked that the Commonwealth consider the state's role in addressing student debt.

In response to legislative requests, SCHEV, Department of Treasury and the Virginia529 Savings Plan reviewed various means by which a state could be involved in student-loan refinancing. The review found a growing number of states with planned or existing student-loan refinance programs but no state with an agency whose sole responsibility is to refinance student loans. The review further found that these state refinancing programs focus on borrowers maintaining good credit scores and that refinancing the loans of higher-risk borrowers increases financial exposure to the state.

Other loan-refinancing models were reviewed and are presented within this paper. To determine which of these models best balances the role of state government and the needs of borrowers in addressing student-loan debt, the Commonwealth should decide 1) what blend of low- and high-risk applicants the program should target; 2) an acceptable level of financial exposure in the form of state debt and student-loan guarantees; 3) the amount of equity contribution available from general funds; 4) staffing levels; and 5) the governance structure of any proposed refinancing authority.

The committee also has identified a number of proactive strategies for addressing student-loan debt. Many of these strategies serve to minimize debt before a student becomes burdened with amounts that are unmanageable by post-college earnings. In addition to considering if there is a state role in loan refinance, the Commonwealth may wish to also explore, or in some cases continue to explore, one or more of these strategies.

Legislative Background

In the 2016 session of the Virginia General Assembly, companion bills were introduced to address the issue of escalating student loan debt. Two bills — HB 400, introduced by Delegate Marcus Simon, and SB 52, introduced by Senator Janet Howell — would establish the Virginia Student Loan Refinancing Authority, a state entity to provide loans to individuals for the purpose of refinancing all or part of their qualified education loans — that is, loans incurred while the individual was a Virginia student at an institution of higher education in the Commonwealth.

Related bills HB 401 (Simon) and SB 604 (Howell) would create an Office of the Student Loan Ombudsman to provide assistance to student-loan borrowers in the Commonwealth. The office would establish and maintain a student-loan borrower-education course that would cover key loan terms, documentation requirements, monthly payment obligations, income-based repayment options, loan forgiveness, and disclosure requirements. The bills would also prohibit any person or organization from acting as a student-loan servicer without first obtaining a license from the State Corporation Commission.

The House bills were referred to the Commerce and Labor Committee and the Senate bills were referred to the Education and Health committee. The chairs of each committee, Terry Kilgore and Stephen Newman respectively, agreed that the bills deserved further study and continued most of the bills to the 2017 session. Following the legislative session, Chairman Kilgore sent a letter to SCHEV, Virginia529 Savings Plan and the Department of Treasury to request that they collaborate on a study of the legislative proposals as introduced. Delegate Simon, Delegate Glenn Davis and Senator Howell followed up with a letter on April 22, 2016, emphasizing their continued interest in the study and in finding strategies to address the student-debt crisis.

The three state agencies formed a joint committee to respond to the legislative request. During its research, members of the committee consulted with former staff of the now-defunct Virginia Education Loan Authority, Virginia 21, Progress Virginia, representatives of the Virginia Bankers Association and others.

It is important to note that the committee's review determined that every other state that has established a refinancing program already had a larger student-loan authority in which to house their refinancing authorities. Virginia has not had such a student-loan authority since the Virginia Education Loan Authority was liquidated and sold to Sallie Mae in 1997.¹ As a result, unlike those other states, Virginia would have to establish a new authority if it chooses to implement a refinancing program.

¹ <http://dls.virginia.gov/GROUPS/nonprofitedu/meetings/062609/Authority.pdf>

Loan Background

According to data provided by the Federal Reserve System (<http://www.federalreserve.gov/releases/g19/current/>) student debt — including federal and private loans — likely will exceed \$1.4 trillion by the end of 2016. This represents an increase of more than 40% in less than five years (from \$961 billion at the end of 2011 to \$1.354 trillion through the first quarter of 2016). This dramatic growth has produced concerns about whether the student-loan system is creating lifelong financial barriers rather than helping students toward a more prosperous future. While responsible borrowing remains a good investment in higher education, negative consequences for many borrowers are in evidence. The committee researched a number of resources to understand the current state of student-loan debt and its more prevalent consequences.

Reports have differed on the impact of student loans on the individual as well as on the economy. Following are examples of both a negative report on student loans as well as a positive report. An example of a perceived negative impact is that the rate of home ownership by the age of 30 may have declined post-recession due in part to student debt; however, other research suggests that, while student-loan debt can impact an individual's eligibility for a mortgage and the amount of mortgage debt available, home ownership has declined markedly for non-borrowers and borrowers alike. This suggests that student-loan debt cannot be the sole factor for slowing home ownership and that a reduced rate of home-ownership may be the result of an uncertain post-recession economy and higher unemployment rates for recent college graduates.

By contrast, some observers have suggested that the student-loan crisis is overstated. This argument points out that the percentage of income going toward monthly loan payments has stabilized for most of the 2000s and is well below levels found in the 1990s. However, this ignores the cumulative effect of an increasing proportion of the population devoting ever-larger portions of their disposable incomes to service student-loan payments rather than to other purchases that can drive a growing economy.

National Student Debt Overview

It is difficult to fully understand the magnitude and consequences of student-loan debt in the United States, as there is no single dynamic data source providing a regular status update of all federal, state and private student loans. Nevertheless, the Washington Center for Equitable Growth has attempted a one-time nationwide snapshot of student debt using data from Experian (debt data) and the American Community Survey (income numbers) to create the maps found on www.mappingstudentdebt.org. The data are not robust enough to provide a definitive description of student debt but do provide an interesting perspective.

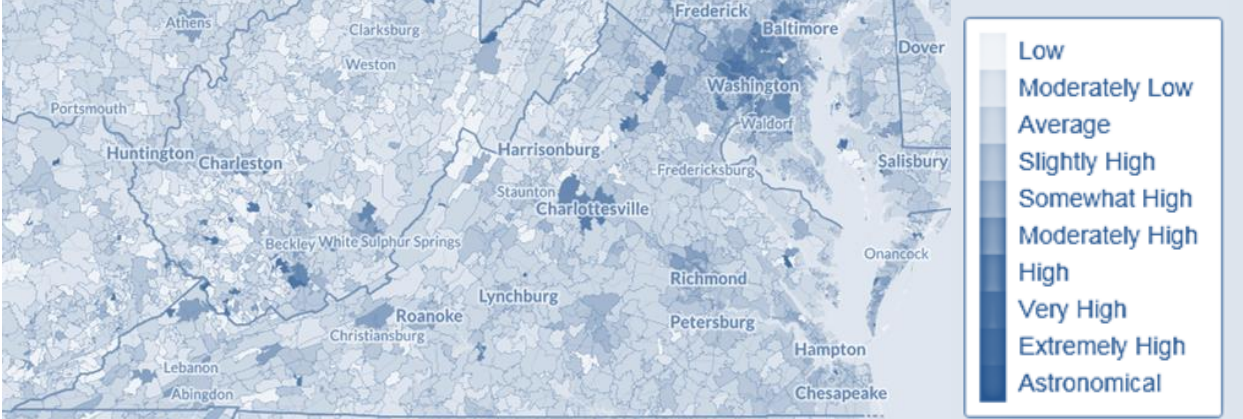
The color-coded maps below break down the United States by ZIP code, reflecting variations in levels of delinquency, debt and income. The map of Virginia reflects widespread high delinquency rates across the Commonwealth. These delinquency rates are concentrated

primarily in the Chesapeake Bay, Southside, Southwest and parts of Shenandoah. (For this study, a loan is considered delinquent if it is 90 days or more past due; the delinquency rate is a construct developed by the researchers based on number of delinquent loans compared to the number of outstanding loans within a given ZIP code. Reported student-loan debt is based on comparison to national averages.)

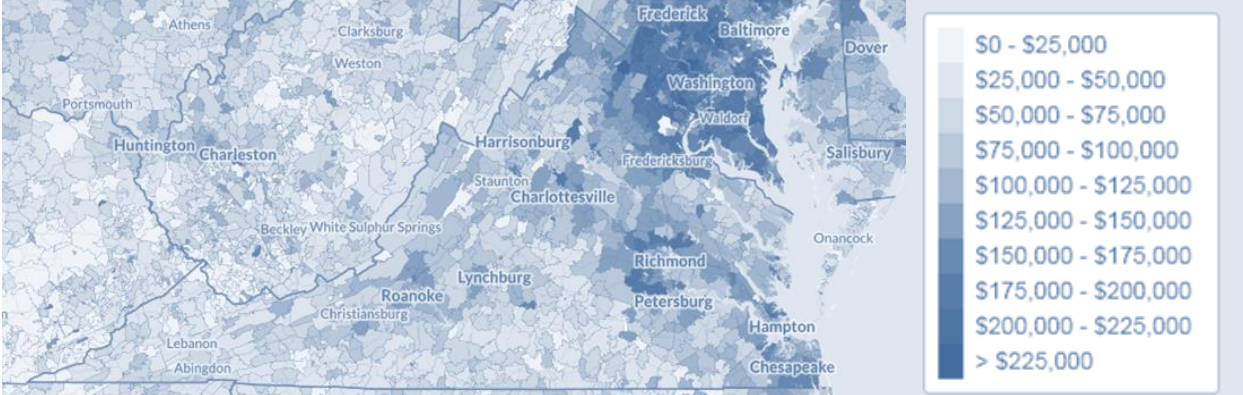
Student-Loan Delinquency Rates by ZIP code:



Student-Loan Debt Levels by ZIP code:



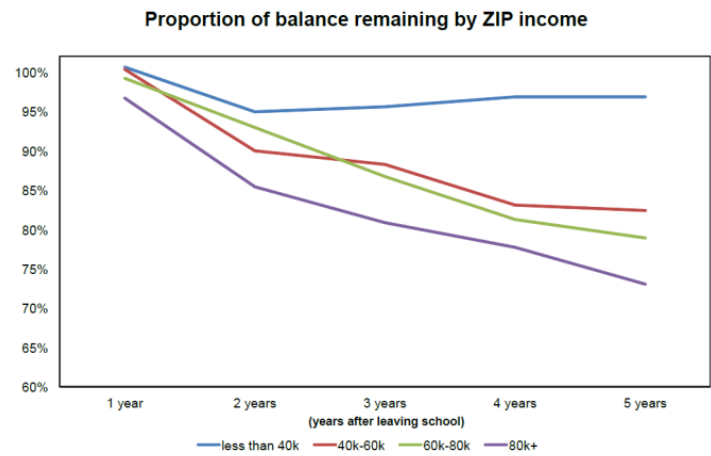
Average Income by ZIP code:



The data represented through these maps challenge the assumption that student-debt problems grow as the average debt increases. The data instead demonstrate that students with higher average debt levels generally manage their debts better than students with lower average debts. This suggests that the primary cause for delinquency is not the amount of indebtedness but the lack of sufficient income to support the debt. This lack of sufficient income could be due to a lack of sufficient employment in a borrower’s geographic area (as suggested by lower income numbers) or due to failure to complete a college degree that would open the doors to improved employment and earnings (as suggested by lower average debt levels).

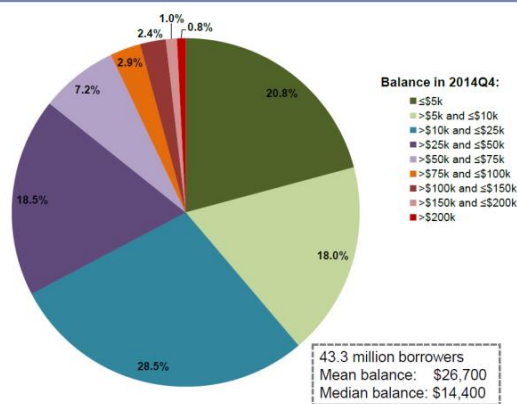
Further evidence that both low income and low debt levels are problematic can be found in a 2015 report by staff at the Federal Reserve Bank of New York. According to the report, borrowers earning less than \$40,000 still owed over 95% of their original balance after five years of making payments. This trend could be caused by a difficulty in making regular monthly payments — resulting in defaults that trigger increased interest and penalties — or by participation in income-based repayment plans which make monthly payments affordable but stretch repayment over many more years.

2009 cohort repayment rates by income



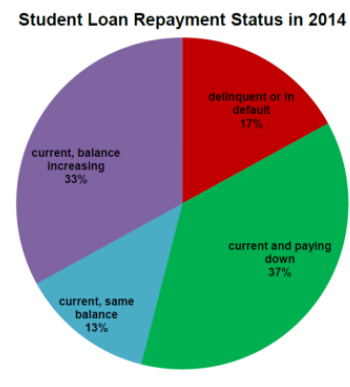
Source: FRBNY Consumer Credit Panel/Equifax

Distribution of borrowers by 2014Q4 balance



Source: FRBNY Consumer Credit Panel/Equifax

Student loan repayment behavior



Source: New York Fed Consumer Credit Panel / Equifax

Despite increasing average loan balances, as of the final quarter of 2014 (2014-15 award year), more than two-thirds of borrowers owed less than \$25,000, with more than 38% owing \$10,000 or less. Though the average borrowing was nearly \$26,700, the median balance was just \$14,400.

As of 2014, just 37% of borrowers were current in their payments and paying down their debts. Nearly the same percentage of borrowers were current in their payments but had an increasing balance. Increasing balances for non-defaulted loans are indicative of borrowers taking advantage of income-based repayment plans.

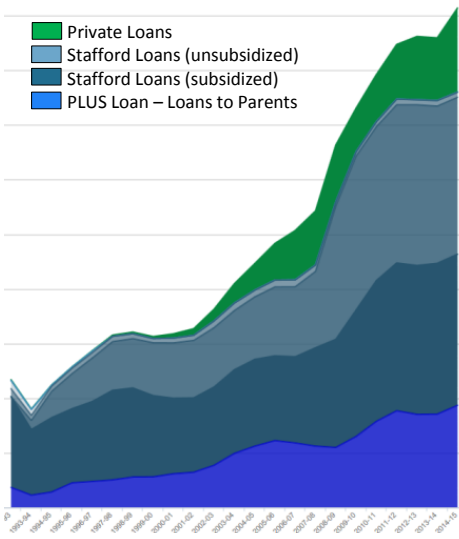
Student Debt in Virginia

The above data are based on national studies and national data sets with no corresponding data at the state level. The committee has reached out for additional data but as of this writing has not received information that can be included in this report.

From 1992-93 to 2014-15, annual student borrowing increased in Virginia from less than \$400,000 to just under \$1.8 billion (all reporting institutions). The majority of this increase has occurred since 2006-07. Though total volume and number of borrowers of federal Stafford loans has declined since 2012-13, total volume and number of borrowers has increased for private student loans over the same period to reflect steady increases in total annual borrowing.

2014-15 Undergraduate Students Who Borrowed Grand Total, All Reporting Institutions, Undergraduate Loan Dollars by Loan Category (SCHEV FA19A report)

Public Four-Year Institutions



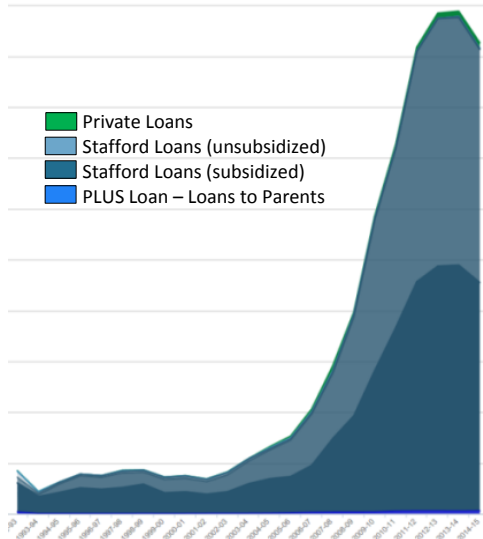
Private loans represented 17% of the total with average borrowing of \$13,007.

Federal unsubsidized Stafford loans represented 31% of total borrowing and an average debt of \$3,992.

Federal subsidized Stafford loans represented 30% of the total and an average debt of \$4,146.

Federal PLUS loans represented 20% of the total with average debt of \$14,027.

Public Two-Year Institutions



Private student loans represent less than 1% of total borrowing in 2014-15 and the average debt among private student-loan borrowers was \$5,108.

Federal unsubsidized Stafford loans were 49% of the total, with average borrowing at \$3,567.

Federal subsidized Stafford loans were 48% of the total, with average debt of \$3,053.

Section Summary

The student-debt issue can be summarized as follows:

- The number of students borrowing and the average debt are both increasing.
- The high average debt is primarily due to a small number of extremely high-debt students.
- High-debt borrowers generally are able to handle their loan/debt loads.
- The vast majority of borrowers owe less than \$25,000 — but many of these borrowers are having trouble managing monthly payments.
- Loan delinquency is primarily a function of low income; which would have a strong relationship with non-completion of a degree.
- Anecdotal evidence and examples of extreme debt upon completion of an associate's or bachelor's degree are certainly available; however, the evidence suggests that the majority of borrowers are borrowing with a reasonable degree of expectation of being able to manage the debt.
- Low-income borrowers are more likely to still owe the majority of their debt — or more — five years after leaving college. This is due to some borrowers facing higher fees and interest rates following a loan default but is also symptomatic of individuals taking advantage of income-based repayment plans.

Federal Student-Debt Provisions

Federal Stafford student loans provide many advantages to borrowers:

- The federal government requires that borrowers received entrance and exit counseling providing comprehensive information on the borrower's rights and responsibilities.
- Borrowers are limited in the annual amount of Federal Stafford loans that may be borrowed: \$5,500–\$20,500 in combined subsidized and unsubsidized loans, depending upon grade level and dependency status.
- Interest is suspended on the “subsidized” portion of a loan during periods of enrollment.
- Interest rates generally are more generous than the private market: 4.29%–5.84%.
- Deferments and forbearances are available: while the student is enrolled; up to three years if the borrower is unable to find full-time employment; up to three years of economic hardship; and during active-duty service.
- Loan cancellation is available in limited circumstances including total and permanent disability, death, and if the student's school closes during enrollment.
- Loan forgiveness is granted for certain types of service such as teaching and public-service employment.

- There are eight separate repayment plans available depending upon the type of student loans.
- Student-loan consolidation is available for multiple types of federal student loans.

With these advantages, most students who default on a federal student loan should be encouraged to rehabilitate the loan — i.e., take steps to return a defaulted loan back to good standing — rather than attempt to refinance outside the federal system. However, the rising three-year federal default rates suggest that, despite the availability of information and multiple levels of counseling, many borrowers are not fully aware of the rights and the remedies available to them through the federal government (see three-year deferment options above).

Options for addressing private student loans are extremely limited, comprising only the terms of the promissory note, federal and state law, and the good will of the lender to help a borrower address debt that has become unmanageable. Also, to encourage lenders to make unsecured education loans on the promise of increased earnings, most student loans — federal and private — are protected against bankruptcy proceedings. Short of death or permanent disability, most forms of student loans stay with the borrower until the terms of the note are fulfilled.

Student Loan Ombudsman

In 1999, the federal government established a federal student loan ombudsman to handle student concerns that were unresolved after working through the lenders and guaranty agencies. The role of the ombudsman is to serve as a student advocate or mediator. In a 2014 report, the ombudsman's office reported in excess of 38,600 individual contacts. The contacts included verifying account balances, schools closing while a student is enrolled, collection practices, consolidation, credit reporting, loan defaults, deferment / forbearance, loan cancellation, repayment plans, service quality, tax refund offset, and wage garnishment. The office reported that 100% of all contacts were resolved or closed.

HB401 and SB604 proposed to add a state-level loan ombudsman to address the growing number of borrower complaints and difficulties. Despite the federal office's claim to have resolved all of the loan contacts, anecdotal evidence suggests that additional student resources would be helpful. Borrowers report that they are being sent to collections for loans they have repaid, the inability to verify who holds their student loans, concerns about institutions improperly managing student loans, and difficulties in resolving student loan defaults, among other complaints. Many of these borrowers are unaware of the availability of the federal loan ombudsman.

If Virginia were to consider establishing a student loan ombudsman, the parameters of the mission would need to be carefully outlined. A state-level office would have no authority over federal or private student loans. Many of the complaints would be more properly directed to the federal office while the state-level office would serve primarily as an information resource and mediator.

Licensing Student Loan Servicers

HB401 and SB604 propose to task the State Corporation Commission (SCC) with licensing student loan servicers. This function could assist in providing some “teeth” for the ombudsman’s office as well as serve a means to hold servicers accountable. The bills exempt banks and credit unions.

It is uncertain whether the licensing would also be applicable to colleges and universities offering monthly payment plans for outstanding debts. Of particular concern is how effective the licensing would be for servicers assigned by the federal government to service federal student loans, which comprise the vast majority of the student debt. The SCC would have suggestions on specific provisions necessary for effective administration of the licensing of servicers. Finally, Connecticut has signed into law a loan servicer licensing requirement and their experiences may be instructive.

A Primer on Student-Loan Refinancing

Just as a homeowner can lower interest-rate payments if she is able to refinance her mortgage, so too can a student borrower refinance educational debt. The mechanics of refinancing debt are almost always the same: New debt is issued to pay off old debt, with the new debt having a lower interest rate than the old. In other words, for a refinancing to make economic sense it must be cheaper to borrow new debt than to maintain the current debt. Students must also decide if they are willing to forfeit certain protections (such as loan forgiveness through public service) that are lost when a student refinances. Currently there is no federal program for student borrowers seeking to refinance their non-federal student loans.² Students must find either a private-sector lender or a public-sector program to refinance student debt.

As an example of what a refinancing looks like in a state-run program and what kind of savings students could expect, the Rhode Island Student Authority recently detailed one person’s experience:

² <http://www.usnews.com/education/blogs/student-loan-ranger/2015/04/29/4-things-to-think-about-when-refinancing-student-loans>

Figure 1: Real-life Example of a Student-Loan Refinancing

Pre-Refinancing	Post-Refinancing
A woman had 5 federal PLUS loans : 4 loans at 7.9% + 1 at 8.5% <hr/> \$52,000 total \$678 / month	A woman now has 1 loan : 1 loan at 5.39% <hr/> \$561 / month
<i>Over the life of her loan, the woman saves \$117 / month and \$5,549 in total interest cost.</i>	

Source: Analysis prepared by Bank of America Merrill Lynch for the Virginia Treasury Department

This individual was able to obtain a lower monthly payment (and a consolidation of her loans) because Rhode Island was able to offer a lower interest rate. Rhode Island was able to do this because it can issue debt at a much lower rate than this individual borrower could find if she had gone “out to the student-loan refinancing market” herself.

Student-loan refinancing in the private sector works much the same way as the above example but with private banks as the conduit lenders. A student obtains a new loan from a bank at a lower rate to pay off the old loan. The only significant difference between the two is that private-sector loans draw on an abundance of banks and other private lenders whose goals are generally to make a profit, whereas state programs tend to see their mission as helping students the private sector considers too risky in terms of credit.

The amount students can save through refinancing varies depending on a student’s overall debt load, the rate at which they originally borrowed, the length of the repayment period, and the rates offered by the refinancing authority. To provide a concrete example, below are the amounts a student would save if she began with a 10-year, 7.50%-interest-rate loan and reduced it either 100 or 200 basis points (bps) down to 6.50% and 5.50% respectively. As seen below, savings are relatively modest in terms of monthly amounts; over the life of the 10-year loan, however, total savings can be significant.

Figure 2. Example of Savings from a Hypothetical Student Loan Refinancing

Reducing a 7.50% interest rate loan by 100 or 200 bps provides the following monthly and total savings:

Savings - Monthly and Total						
Interest Rate Reduction	\$10,000 Loan		\$30,000 Loan		\$50,000 Loan	
	Monthly	Total	Monthly	Total	Monthly	Total
100 bps	\$5.15	\$618.00	\$15.47	\$1,855.00	\$25.77	\$3,092.00
200 bps	\$10.17	\$1,221.00	\$30.53	\$3,663.00	\$50.88	\$6,105.00

Source: Analysis prepared by Bank of America Merrill Lynch for the Virginia Treasury Department

How Other States Run Student-Loan Refinancing Programs

Other states have established student-loan refinancing programs like the one proposed in HB 400 and SB 52. As of the end of 2015, 18 states were issuing student loans through their own student-loan authorities.³ Of those, nine also had refinancing programs up and running as of September 2016.

Figure 3. States and Localities with Refinance Programs Running or Under Consideration

Legislation Pending	Working on Implementing Refinancing Programs	Active State-Based Programs (Years Programs Were Established)	
Wisconsin	New Jersey	North Dakota (2013)	Minnesota (2016)
Virginia	Montgomery County, Maryland	Rhode Island (2015)	Kentucky (2016)
		Massachusetts (2015)	New Hampshire (2016)
		Connecticut (2016)	Alaska (2016)
			Louisiana (2016)

Source: Analysis prepared by Bank of America Merrill Lynch for the Virginia Treasury Department

Each of these programs makes different policy decisions about how their refinancing programs are governed, which student borrowers are eligible to have their loans refinanced, and what kind of risks the program is able to take on. The following section looks at how other states structure their programs and what requirements they place on applicants.

Which Student Loans Can Be Refinanced and At What Rates?

In the private sector, nearly any private or federal loan can be refinanced as long as that student can find a participating bank or lender. Lenders such as SoFi and CommonBond will refinance variable and fixed loans, undergraduate or graduate loans and federally backed or private loans. The only practical limitations to a refinancing are the credit risk the applicant poses and

³ <http://www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2015/12/14/one-way-states-can-help-student-loan-borrowers>

whether the expected difference between the old loan and the new one makes economic sense for the bank. In the public sector, it's up to the respective states or localities to place restrictions on which loans can be refinanced.

The federal government puts restrictions on which student loans can be refinanced through public programs that seek to use tax-exempt bonds to fund their refinancings. The IRS recently released guidance saying states could use tax-exempt bonds for student loan refinancings:⁴

State and nonprofit organizations can have tax-exempt bond-financed student loan programs as long as they are approved by the state and the loan size doesn't exceed the student's cost of attendance, taking into account other financial assistance. Also there must be a nexus between the students and the loans. The student must be either, a resident of the state from which the volume cap for the student loan bonds was provided, or enrolled in an educational institution located in the state.

The IRS said in its notice that parents who are borrowing for the benefit of their children, as well as students, are eligible for tax-exempt bond financed student loans. It said that a student or parent borrower of an original student loan is also eligible for tax-exempt bond funded refinancings.

The notice said a refinancing meets the student nexus requirement either at the time of the original loan or at the time of the refinancing, with the latter covering situations in which the student may have moved. A refinancing meets the size requirements if the original loan met the loan size requirements and the stated amount of the refinancing does not exceed the sum of the refinanced loan's outstanding stated principal amount and any accrued but unpaid interest as of the date of the refinancing.

The IRS made clear that tax-exempt bonds can be used for refinancings of other types of original loans such as those that are federally guaranteed or private, as long as they meet the same requirements as for state loans.

States and localities often place restrictions on which borrowers are eligible to participate in their programs. On the following page is a chart outlining the requirement for student loan refinancings in other states.

⁴ <http://www.bondbuyer.com/news/washington-taxation/irs-issues-favorable-guidance-for-student-loan-bonds-1089477-1.html>

Figure 4. Comparison of other states’ loan and applicant requirements for student loan refinancings.

	Massachusetts	North Dakota	Rhode Island	Connecticut	Minnesota
Must be a resident of the state?	No.	Yes, or have a student loan that originated by the Bank of North Dakota.	No, can reside in any state.	Must be a resident of Connecticut or have a Connecticut-originated state student loan.	Yes.
Other eligibility requirements for borrower?	Must have at least a 670 FICO credit score, have no history of default, bankruptcy, or foreclosure. Minimum of \$10,000 borrowed.	Must meet credit score requirements.	Must meet credit score requirements, loans must be in repayment status. Borrower (and co-signer) must make at least \$40,000 a year.	Must meet credit score requirements and have monthly installment payments amounting to 43% or less of monthly gross income.	Must have earned certificate or degree. Must have 720 FICO credit score without co-signer or 650 with. Must have debt-to-income ratio of 45% or less.
Can loans be in a grace period, deferment, or forbearance?	No.	Loans can be in a grace period, but cannot be in deferment or forbearance.	No.	No.	No.
Types of Loans Eligible for State Refinancing	Federal education and private education loans.	Federal loans, loans originated by the Bank of North Dakota, private loans.	Federal education or private education loans.	Federal loans, loans originated by Connecticut, private loans. Only loans made to students who attended not-for-profit schools are eligible.	Federal education and qualified private education loans

Source: Analysis compiled by the Virginia Treasury Department from state websites and EMMA disclosures.

In most state-run programs, applicants generally fill out a form online and receive immediate initial notification of whether their credit scores are high enough to qualify. The applicants then can receive an initial approval, contingent upon submitting verification of income, loan details and other information. After approval, the applicant (if not prompted earlier in the process)

decides on a fixed or variable interest rate for their loan. Finally, the applicant electronically or physically signs the closing documents. After this, the refinancing authority officially takes on the obligation of the students’ debt and students make future interest payments to the authority.

In terms of interest rates charged to students, most programs offer a fixed or a variable interest rate, with the variable rate tied to the monthly LIBOR benchmark. Rates can fluctuate depending on applicants’ credit scores, the length of the repayment terms and a host of other factors. The chart below summarizes what some other states offer in terms of interest rates.

Figure 5. Comparison interest rates, fees, and payments terms offered by other states

	Massachusetts	North Dakota	Rhode Island	Connecticut	Minnesota
Interest Rates on Refinancing Loans	4.95% to 6.85% fixed interest rate, 3.28% variable rate to 6.18% variable interest rate.	4.33% fixed interest rate, 2.15% variable interest rate.	4.49% to 7.24% fixed interest rate, depending on repayment loan schedule and whether with a co-signer.	4.50% to 7.00% fixed interest rate, depending on creditworthiness.	4.50% to 6.95% fixed interest rate depending repayment timeframe, 3.20% to 4.55% variable interest rate.
Fees	No fees.	3.75% fee for consolidation loans. No fees otherwise.	Loan servicing fees may be applied.	No fees.	Fees only on late payments and returned payments.
Repayment times offered	5, 10, and 15 year.	5, 10 and 15 year.	5, 10 and 15 year.	5, 10 and 15 year.	5, 10 and 15 year.
Credit Ratings on Refinancing Bonds	S&P: AA(sf)* Fitch: Asf	N/A: loans refinanced by Bank of North Dakota.	S&P: AA(sf) Fitch: AAsf	Moody’s: Aa3 Fitch: A+	N/A: program has yet to issue bonds.

Source: Analysis compiled by the Virginia Treasury Department from state websites and EMMA disclosures. Rates are current as of 9/1/2016.

*“sf” stands for “structured finance.”

How Refinancing Bonds Are Marketed, Packaged and Sold

In a state-run refinancing authority, individual student loans normally are refinanced by that state authority issuing new debt to pay off the students’ old debt. This process involves (whether by the state directly or outsourced to another organization) collecting together the

loans into a single package. The refinancing authority works with bond counsel, financial advisers and underwriters to sell a package of bonds at amounts sufficient to cover the cost of taking on the combined obligations of the students' loans, as well as any costs of issuance. Together, they gauge whether the best returns will come from a negotiated sale or a competitive bidding process.

Typically, authorities issue amounts ranging from tens of millions to hundreds of millions of dollars for a student loan refinancing. For issuances in which there is not yet enough capital in the form of reserves from previous loans (such as an authority doing its first refinancing) an equity contribution usually is required to make the financing work. An equity contribution essentially is a down payment that acts as collateral and provides security for potential bond buyers. In future issuances, the equity-contribution aspect of the bonds should be able to be paid for with proceeds from previous bond issuances.

Compliance, Monitoring and Customer Service

Like nearly all bond issuers, refinancing authorities must make mandatory disclosures and abide by tax rules and guidance. As mentioned earlier, in 2015 the IRS issued guidance allowing student-loan authorities to use tax-exempt bonds when performing refinancings through bond issuances.⁵ Student-loan authorities have to provide annual reports as well as audited financials, and post this information to the Electronic Municipal Market Access (EMMA) website.

Bond issuances for refinancing authorities most differ from typical offerings in that there are hundreds or even thousands of potential loan participants. To handle questions or problems students might have, refinancing authorities typically set up (normally within their student loan authorities) customer service departments. For example, in Rhode Island,⁶

RISLA provides a locally operated call center for students and schools; locally operated loan disbursement center; default prevention programs for students and schools; financial literacy counseling; and online entrance and exit sessions. By establishing our local presence, our loan origination staff is available to meet with students and their families to explain the various loan programs, assist in completion of loan applications and help to clear credit issues.

Again, the fact that many states simply add a refinancing program onto their already existing student loan authorities means that much of this customer service infrastructure is simply used again for refinancings. Because Virginia has no pre-existing student loan authority, any customer-service operations would have to be created from scratch.

⁵ <http://www.bondbuyer.com/news/washington-taxation/irs-issues-favorable-guidance-for-studentloan-bonds-1089477-1.html>

⁶ 2015 RISLA Annual Report: https://cdn2.hubspot.net/hubfs/18027/docs/RISLA_2015_AnnualReport.pdf?t=1469802543343

Policy Considerations for Establishing a Student-Loan Refinancing Authority

The committee could find no example of another state implementing a stand-alone student loan refinance authority as proposed and believes policymakers should decide how much further study is required before A) authoring new legislation that embraces a new model for a student-loan refinancing authority, B) proceeding with HB 400 and SB52 as is or altering it only slightly, or C) deciding that the costs of a student-loan refinancing authority outweigh the benefits and should not be implemented.

Although most up-and-running refinancing programs resemble one another, several underlying policy differences differentiate them. These most often relate to the scope and size of the program. Refinancing programs must decide how creditworthy applicants must be to qualify, how much risk the authority and the state want to take on, and how to structure the governance side of the authority. These decisions either must be made in the statute establishing the refinancing authority or power must be given to the authority to set its own parameters.

Qualification Criteria: How Creditworthy Do Applicants Need to Be?

Perhaps most importantly, policymakers must decide how creditworthy successful applicants need to be, and what “blend” of low- and high-risk applicants they are willing to accept. In the private sector, banks often choose to refinance the loans of students who took out large amounts but are obtaining high-paying degrees. For example, medical and law students already are well-served by these private-sector providers because they are excellent long-term credit risks. The entire point of a public refinancing authority is to provide an option for students that the private sector considers too risky.

However, there are limits to what a public refinancing authority can do, unless it is repeatedly subsidized by the state government for every issuance. The riskier the portfolio of student loans, the higher the yield bondholders will demand to carry that risk. For example, the Massachusetts Educational Financing Authority in its 2015 issuance for refinancing student loans required a FICO credit score of at least 670, with loans fully deferred to repayment requiring a score of at least 710.⁷

In an analysis prepared for the Virginia Treasury by Bank of America Merrill Lynch, the working models for such a refinancing authority required 50% of borrowers to have FICO scores of at least 740 and 50% of borrowers of at least 670.

To put this into perspective, the average 19-to-34-year-old had a FICO score of 625.⁸ Basing loans on these scores is compounded by the fact that having outstanding student loans hurts a borrower’s credit score. As a result, there is always a tension between “helping those most in

⁷ Page 55, 2015B MEFA Issuance

⁸ <http://www.cbsnews.com/news/what-is-the-average-credit-score-for-millennials/>

need” of a refinancing and the demand that the creditworthiness of the underlying loans meets market conditions. To address this tension, market conditions could be examined to determine if a proposed loan-refinance portfolio might allow for a limited number of lower credit scores.

Debt Capacity: How Much Risk Should the Commonwealth Take On?

Policymakers must decide not only how much risk should be taken in terms of individual refinancings but also how much total debt the authority and the Commonwealth should take on. The Commonwealth maintains a debt-capacity model that recommends to the Governor and General Assembly the maximum amount of tax-supported debt that the Commonwealth can authorize and issue over the next two years.⁹

Depending on how a refinancing authority is structured, the debt incurred by the authority may or may not add to the Commonwealth’s debt capacity. If policymakers structure the authority to largely be a “conduit” issuer (meaning that only revenues from student borrowers could be used to finance the program) and the Commonwealth ultimately is not liable for any losses, then the debt would not be added onto the Commonwealth’s debt capacity model. However, if policymakers decided to guarantee the loans or somehow take on full responsibility for the ultimate payment of the loans (which would likely result in getting a better interest rate for students), then that debt would have to be added to the Commonwealth’s debt capacity model.

In other words, policymakers must decide whether to expand the amount of debt that can be issued (which would likely require commensurate cuts elsewhere in the debt capacity portfolio), or decide that the Commonwealth ultimately will not back the debt the authority issues.

Equity Contribution: How Big a Down Payment?

As mentioned earlier, any student loan authority issuing debt requires a start-up appropriation in the form of an equity contribution. In addition to the funds needed to pay for the costs of issuance (such as staff, bond counsel and financial advisers, which become part of the cost of issuing the debt), bondholders normally will require the authority to make an equity payment, which is essentially collateral in the form of a down payment.

In an analysis prepared by Bank of America Merrill Lynch, equity contributions required to finance \$100 million in bond proceeds ranged from \$5 million to \$15 million. The size of the equity contribution depended on the parameters of the bond deal: The better the credit scores of the loan pool, for example, the smaller the equity contribution needs to be.

In other words, policymakers should anticipate the need to make an appropriation to start up any refinancing program beyond any appropriation to cover operational costs. The size of that equity contribution will depend on policymakers’ decisions about what kind of risk policymakers are willing to take on and which student borrowers they want the program to target.

⁹<https://www.trsvirginia.gov/Documents/Debt/DCAC/2015%20DCAC%20Package%20for%20Governor%20and%20GA.pdf>

Staffing

One important policy consideration is how the refinancing program will be staffed. Most crucially, policymakers need to decide whether to directly staff their program with government employees or to largely outsource the staffing needs. As mentioned earlier, staff will be needed not only to package and issue the debt on behalf of the Commonwealth but also to handle customer service, application intake and receipt of loan payments from individual students.

For Virginia, this is an especially important decision because the Commonwealth has no student-loan authority currently established. Most states that have active refinancing programs simply house them in their student-loan authorities. Since Virginia has not had such an authority since 1997, policymakers will have to decide where to house any potential refinancing program.

Governance Structure of a Refinancing Authority

Finally, policymakers need to decide who will run the refinancing authority and what powers these individuals will have. For example, HB 400 and SB 52 essentially would allow the members of the authority's governing board to decide what kind of student debt can be refinanced and how much debt the program can take on. Specifically, the legislation says that the only criteria the authority must use to evaluate eligibility shall be "similar to the criteria used by private lenders in the Commonwealth." It places no ceilings or floors in terms of interest rates, fees that could be charged to students, what the penalties for nonpayment would be, the size or characteristics of the student loans to be refinanced and so on. The authority would have broad powers to set these parameters.

Policymakers also have the option of more narrowly tailoring the powers of the governing board. For example, policymakers could decide to set a ceiling on how much debt could be issued, what kind of fees the authority can charge, or what "blend" of high-risk to low-risk student borrowers the authority can take on for any one issuance.

In other words, policymakers need to decide in advance what program parameters they want to establish and which they want to leave up to the authority.

Optional Policy Proposals

Below are five models that policymakers may find helpful in trying to decide how to approach the issue of student debt and a potential refinancing authority. These models are meant to be illustrative of the various costs and benefits with which policymakers must contend in approaching the creation of a student-loan refinancing authority.

No. 1: Maintain the Status Quo

Policymakers always should consider the current system as a viable policy option. Maintaining the status quo acknowledges that establishing a refinancing authority requires significant public

investment, potentially forces the Commonwealth to take on more debt, and provides minimal help to students who have the lowest credit scores and highest barriers to accessing refinancing through private lenders. This option results in no student-loan refinancing authority being established.

No. 2: Best Practices Model: Lower Cost, Lower Impact

Another option for policymakers is to simply borrow the prevailing model employed by other refinancing programs and tailor it for Virginia's current organization. This option entails housing the refinancing authority in a governmental unit and having that unit issue the bonds to finance the authority. Under this model, customer service, payment intake and all duties not directly tied to bond issuances would be outsourced to a third party.

Under this proposal, the Commonwealth puts up only a small equity payment, with the result that the pool of students who qualify would skew towards better credit risks. For the sake of this policy option, 50% of borrowers who can qualify for refinancing for any issuance must have FICO credit scores under 740, and the other 50% of student borrowers must have a FICO score under 670.

This is the inherent trade-off made by other states' refinancing programs — the smaller the investment the state provides initially, the smaller the scope of the program and the more the pool of loans must lean towards refinancing borrowers who have better credit scores. This can be seen as the largely unsubsidized version of what other states do and ensures that costs are minimal relative to other states and their refinancing authorities.

No. 3: Best Practices Model: Higher Cost, Higher Impact

Proposal No. 3 is the same as No. 2 except it consists of a higher equity contribution and a pool of student borrowers that skews towards higher credit risks. In this proposal, only 25% of borrowers would need to have FICO credit scores under 740, while the pool could have 75% with scores under 670.

Most other states have taken the approach of providing sizeable equity payments in order to take on more higher-risk student borrowers, and this proposed model is keeping with the goal of reaching borrowers who most need the help. However, this model involves much more "subsidization" of student borrowers; if policymakers want to have the highest impact they may need the Commonwealth to formally take on the students' debt to obtain the best possible interest rates. Again, this model involves reaching more student borrowers in need but at a potentially higher cost to the Commonwealth.

No. 4: HB 400 and SB 52's Approach: Let the Authority Decide

Another option available to policymakers is the one articulated in Delegate Simon's and Senator Howell's bills. As discussed earlier, the bills set up the governance rules for the authority but leave it up to the authority to decide the size, scope and structure of how it will refinance

student loans. It also instructs the authority to follow practices comparable to the private sector in terms of financing and structuring the debt.

This model represents the simplest model in terms of legislation. It largely hands the reins to the authority and lets it decide how best to fulfill the mission of refinancing student debt. The trade-offs here are apparent: The Commonwealth would be trusting members of the authority's board to design and implement a system that meets the public's need without much guidance or restriction. Fewer governing rules may allow the authority to more quickly and efficiently create and structure a student loan authority; however, fewer rules may also allow such an authority to "stray" from the goals policymakers may have wanted the authority to pursue.

No. 5: The Gap-Financing Model

Another option available to policymakers would be to use state resources not to perform the refinancings through the authority itself, but to allow on-the-margin student borrowers to access loans directly from banks and private lenders. Essentially, the refinancing authority under this model would not issue bonds but would guarantee (or partly guarantee) the loan or provide additional collateral to the lender in order to secure the loan.

This "gap-financing" model was suggested by the Virginia Bankers Association and is modeled after the Virginia Small Business Financing Authority (VSBFA). The banking association expressed concerns about a student-loan refinancing authority competing with the private sector and taking away parts of its business. This model would allow a refinancing authority to help on-the-margin borrowers without competing directly with private lenders.

As with many other policy options, this model would require the Commonwealth to make an up-front appropriation (and likely continuing appropriations until loans generate enough revenue to support the program) to pay for staff and financial guarantees. It is probably the most complex policy model presented here, as it requires each individual refinancing to be examined and negotiated between the authority and the private lender. To illustrate, the VSBFA performs just over 150 such loans annually, whereas student loan authorities can refinance thousands of borrowers several times a year.¹⁰ Again, this model has been employed with success for small businesses that need additional collateral to secure loans, but the model is largely untested for student-loan refinancing programs discussed here.

Proactive Strategies for Addressing Student Debt

The Commonwealth could consider proactive steps to help students make more informed decisions, reduce debt and make debt more manageable. Many of these strategies, or a combination of them, could serve to reduce the number of borrowers struggling with debt in the future.

¹⁰ Conversation with Scott Parsons, Executive Director of the VSBFA, 7/26/16

- 1. Increase the graduation rate of borrowers.** Evidence indicates that an important factor in avoiding loan defaults is having sufficient income to manage the debt. A number of students accumulated debt but did not graduate and consequently were not able to obtain the employment anticipated when they signed for the loans. Student success programs, and other initiatives, that increase graduation rates would enable more borrowers to secure the employment necessary to successfully manage their debt.
- 2. Improve employment opportunities that can support repayment requirements.** The data demonstrate that the highest rate of student-loan default occurs in areas having lower employment and lower wages. Many borrowers — including college graduates — living in these regions are unemployed or under-employed. Local economic development could assist these borrowers in securing the wages needed to meet their loan obligations.
- 3. Inform families of the advantages of making monthly payments in the form of education savings accounts rather than in the form of post-education monthly student-loan payments.** Many families have no concerns about making monthly payments post-graduation in order to pay for higher education, but balk at the idea of making similar monthly payments before enrollment. The cost of money works against students in the form of interest rates when borrowing but works significantly in their favor in the form of interest earnings when those monthly “payments” are made to savings accounts. Helping families learn the advantages of saving, including tax advantages of education savings accounts, could help some avoid the high cost of borrowing.
- 4. Improve our understanding of the costs borne by older students and those pursuing multiple degrees, then determining appropriate policy and cost implications.** Research indicates that many borrowers with high debt are either older students or those who have pursued advanced degrees. Increasingly, many career fields — such as education — require either a graduate degree or that older adults return to college. While there are programs available to make undergraduate studies affordable, there is very little financial assistance available for advanced degrees. Understanding the needs of these students may help the Commonwealth better target financial assistance.
- 5. Minimize the need for borrowing through direct state support and an efficient system of higher education.** Aligning state appropriations, financial aid and tuition and fees serves to enhance access and affordability. To this end, a comprehensive and balanced funding approach mitigates the rising cost of education for all students. Funding financial aid is a far more efficient tool for reducing the net price for low income students but too much attention on financial aid over tuition and fees places the burden of increased costs on higher

income students and results in more middle income students demonstrating financial need. A balanced approach benefits all students. Also, higher education is extremely competitive on a national scale and students are becoming more cost-sensitive. To remain competitive into the future, Virginia's institutions should continue to focus on efficiency while providing high quality education.

6. **Provide accurate, timely information to students to assist them in making rational decisions on pathways to a college degree and for borrowing as well as in knowing the provisions available to them post-college.** Student loans have been part of financing higher education for more than 50 years and there are multiple safeguards to educate students about their responsibilities, but there still are students unaware of how much they owe until after they graduate. Many students view promissory notes as an indication that they *can* go to college but too few question how much they *should* borrow. Data now are available to help determine how much debt is reasonable for the expected earnings within their career field. In addition, the availability of financial-literacy programs has expanded over the past few years; the programs should be reviewed to determine if there is sufficient coverage of student loans and responsibilities. Finally, the federal government has several student-loan provisions available that enable students to tailor their student loans to their current earnings or to secure forbearance or default for up to three years. With these provisions in place, student loan defaults within three years of leaving college should be rare. Determining the best timing and delivery of loan information could help students make better-informed decisions and avoid loan defaults.
7. **Study the federal student-loan process to determine areas in need of reform.** The current federal student-loan system can involve the student, the institution, a lender, a guaranty agency and the federal government. If a student attends multiple institutions, the number of entities involved in the process can multiply. This makes it extremely difficult for a borrower to determine whom to contact about a loan issue. Despite the movement to all-direct loans, the current system remains far more complicated than seems necessary. The Commonwealth could determine whether it has a role in lobbying for federal student loan reform.
8. **Consider an alternative to private loans such as a state loan system.** As students near the federal aggregate and annual limits, many turn to private loans to fill in the gaps. Some of these loans can provide favorable borrower benefits but they typically carry higher interest rates, fines and collection penalties. The Commonwealth may be able to provide better lending terms than those available from private lenders due to its favorable financial ratings and lack of a need to generate a profit. These loans should be structured to replace higher-cost private student loans rather than merely to increase a student's borrowing capacity.

9. **Assist students in rehabilitating delinquent federal student loans as opposed to refinancing them.** If a federal student loan is refinanced by the state, the original federal student loan is paid off and replaced by a state loan, which means that the federal benefits and protections also are no longer available. It would be difficult for the Commonwealth to replicate all the borrower benefits made available by the federal government. Even in extreme cases, most borrowers are far better off rehabilitating a federal student loan and returning to good standing than having that loan refinanced by a state or private entity. A state loan ombudsman may have a role in assisting borrowers in navigating the process to return a federal loan to good standing.

10. **Create a tax-based incentive for employers to repay student loans as an employee benefit.** The federal government and some states provide tax advantages for education savings accounts as a means to encourage saving for higher education. In addition, many forms of employee benefits such as health savings accounts are tax advantaged. Similar support could be provided to incentivize employers to pay off employee student loans as an employment benefit. This would be one means of encouraging the private employment sector to contribute to financing the higher education from which their companies have benefited.

Resources

Review Committee Members:

- Lee Andes: State Council of Higher Education for Virginia
- Beverly Covington: State Council of Higher Education for Virginia
- David Jonas: Virginia Department of Treasury
- Janet Aylor: Virginia Department of Treasury
- Mary Morris: Virginia College Savings Plan

Interviewees:

- Christopher Cronk: Bank of America Merrill Lynch
- Anna Scholl and Morgan Jameson: ProgressVA
- Claire Wyatt: New Virginia Majority
- Jared Calfee: Virginia21
- Matthew Bruning: Virginia Banker's Association
- Gene Cattie: former president (retired) of Virginia Education Loan Authority

Web Resources:

- <http://www.federalreserve.gov/releases/g19/current/>
- <http://libertystreeteconomics.newyorkfed.org/2013/04/young-student-loan-borrowers-retreat-from-housing-and-auto-markets.html#.V6Dctf4UX7Q>
- <http://www.forbes.com/sites/johntharvey/2014/04/28/student-loan-debt-crisis/#75cbb20c614d>
- <http://libertystreeteconomics.newyorkfed.org/2013/04/young-student-loan-borrowers-retreat-from-housing-and-auto-markets.html#.V6Dctf4UX7Q>
- <https://www.brookings.edu/research/is-a-student-loan-crisis-on-the-horizon/>
- http://jchs.harvard.edu/sites/jchs.harvard.edu/files/lew_research_brief_student_loan_11_2015.pdf
- www.mappingstudentdebt.org
- <https://www.debt.org/students/>
- <http://www.finaid.org/loans/studentloandebtclock.phtml>
- <https://www.newyorkfed.org/microeconomics/hhdc.html>
- <https://www.newyorkfed.org/medialibrary/media/newsevents/mediaadvisory/2015/Student-Loan-Press-Briefing-Presentation.pdf>
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- <http://www2.ed.gov/about/reports/annual/2014report/fsa-report.pdf>