Implementing a Student Loan Program Using Qualified Scholarship Funding Bonds Feasibility Study

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Maryland Higher Education Commission

Office of Student Financial Assistance

As Requested by the

Report of the Chairmen of the

Senate Budget and Taxation Committee

And

House Appropriations Committee

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Introduction

Report on Qualified Scholarship Funding Bonds: The budget committees have requested the Maryland Higher Education Commission (MHEC), in conjunction with the Department of Budget and Management and the Attorney's General Office, to submit a report that provides information on the feasibility of implementing a student loan program operated by a private, nonprofit organization under the authorities of the United States Internal Revenue Code (IRC) § 150 (d). Funding of this student loan program would be accomplished through the use of Qualified Scholarship Funding Bonds, which represent one of many types of securities funded using private activity bonds.

Private Activity Bonds

Private activity bonds are securities issued by or on the behalf of a state or local government to provide debt financing for certain qualified projects used most often by a private user. Private activity bond financing normally results in reduced financing cost since interest on the bonds is not subject to federal income taxes under IRC 146. The state or local government does not generally pledge its credit for payment of the bonded debt. Debt service on qualified private activity bonds are normally payable solely from payments made by the private user of the property financed.

Financing with tax-exempt bonds requires strict compliance with a series of requirements and limitations established by the Internal Revenue Code. Additionally, recent changes to federal securities rules provide that in most instances the entity obligated to pay debt service on the bonds must annually provide operational and financial data to all national information repositories sanctioned by the S.E.C.

State laws governing the conduct of the issuers and pertaining to the issuance of bonds must also be satisfied.

Project Eligibility Using Private Activity Bonds

Projects to be financed on a tax-exempt basis with private activity bonds must comply with the Internal Revenue Code and various state statutes. The federal tax rules are usually more restrictive and complex than the applicable state laws. Under Federal law, only the private activity bonds used for the following purposes may bear tax exempt interest:

- Exempt facility bonds (that include airports, docks, water and sewage facilities, residential rental projects; hazardous waste facilities and certain environmental enhancements.)

- Qualified mortgage bonds

- Qualified veterans' mortgage bonds

- Qualified small issue bonds (for manufacturing facilities)

- Qualified student loan bonds (as defined in Internal Revenue Code 144)

- Qualified redevelopment bonds

- Qualified 501(c)(3) bonds

Private Activity Bond Volume Cap

Many types of projects that are eligible for tax-exempt financing are subject to the federally required annual volume cap, which restricts the amount of certain tax-exempt private activity bonds that can be sold in any one state. Each state is presently eligible to received $85.00 per capita and each state's volume cap is replenished each January 1st.

Private Activity Bond Use – Student Loans

There are several classifications under the Internal Revenue Code for private activity bond issuances for student loans:

<u>Qualified Scholarship Funding Bonds (QSFB) - IRC section 150(d) –Defined</u>

These bonds are defined by the Internal Revenue Code as bonds issued by a corporation that is a not-for-profit corporation established and operated *exclusively* for purposes of *acquiring* student loans incurred under the *Higher Education Act of 1965*, **and** is organized at the request of a state or a political subdivision of the state. A bond issued by a corporation described above is treated as a state or local bond and is exempt from federal income tax.

Such a corporation should be required by its organizational document or by state law to devote any income (after payment of expenses, debt service, and the creation of reserves) to the purchase of additional student loans or to pay over its income to the United States.

Issuance of Quality Scholarship Funding Bonds does not directly increase the pool of funds available for student loans; it does create a secondary market where a state may purchase loan portfolios from lenders or guarantee agencies so those organizations may expand their activities. For lenders, selling of student loan portfolios will increase their lending capacity but does not legally bind them to make additional student loans. They may choose to increase lending in a more profitable area.

Qualified Student Loan Bonds - IRC section 144(b) (1) - Defined

Any bond where 90% or more of the net proceeds of the issue are to be used directly or indirectly to make or finance student loans under the Guaranteed Student Loan program or Parent Loans for Undergraduate Students program under the *Higher Education Act of 1965*.

OR

Ninety-five percent or more of the net proceeds of the issue of which are to be used directly or indirectly to make or finance student loans under a program of general application approved by the state, as long as the loan does not exceed the difference between the total cost of attendance and other forms of student assistance for which the student may be eligible. Bonds issued under this section are exempt from federal income tax. A student receiving a loan from such an issuance must be a resident of the state from which the allocation was derived or enrolled at an institution located in that state. These types of bonds are issued strictly for the financing or making of new student loans.

Maryland Private Activity Bonds

Maryland private activity bonds are under the authority of and allocated by the Maryland Department of Business and Economic Development (Financial Institutions Article, §§13-801 et seq.). For 2008, Maryland had the authority to create and sell $477,559,240 in private activity bonds under the IRC code.

Allocation and use of Maryland Private Activity Bonds

Under State statute, Maryland reserves 50% ($238,779,620) of its bond allocation to the counties and Baltimore City; 25% ($119,389,810) to the Maryland Department of Housing and Community Development, and 2.5 % ($11,938,981) to municipalities for varied purposes. The remaining 22.5 % ($107,450,829) stays with the Department of Business and Economic Development and is allocated to the Secretary’s reserve. At present, there is approximately $175,000,000 in the reserve. The Secretary may at any time make any allocation of a portion of the Secretary’s reserve to any State issuer or local issuer in any amount and in any order that the Secretary, in the Secretary’s sole discretion, may determine and will advance one of more of the statutory goals described as follows:

- Increasing the supply, quality, and geographic distribution of housing for low-income persons;
- Expanding opportunities for homeownership;
- Creating significant job opportunities;
- Location job-creating facilities in enterprise zones or areas of high unemployment, urban redevelopment, or planned unit development;

- Reducing, recycling, or treating solid or hazardous wastes;
- Assisting in the expansion or modernization or existing Maryland industry and the attraction of new and diverse firms to Maryland;
- Promoting the health, safety, education, or welfare of the citizens of Maryland;
- Providing opportunities for minority business enterprise as borrower, lessee, or contractor or subcontractor for construction, services, or supplies.

There are no explicit goals for Qualified Scholarship Funding Bonds or Qualified Student Loan Bonds, and State law may need to be amended to permit allocations for such purposes.

The IRC does not allow carry forward from year to year except for solid waste treatment projects and manufacturing. Any private activity bonds that are not used as specified above by the end of year are retained by DBED and used for other purposes. The counties rarely use all of their non-housing allocation to issue bonds.

DBED uses the Maryland Industrial Development Financing Authority to assist agencies/localities with bond issuances.

Feasibility Issues

Internal Revenue Code Restrictions

Because Qualified Scholarship Funding Bonds (**IRC section 150(d))** are issued for the exclusive purpose of acquiring previously-issued student loans incurred under the *Higher Education Act of 1965,* the only method that will clearly increase the amount of funds available for new loans is to utilize Qualified Student Loan Bonds as defined in **IRC section 144(b)(1)(B).**

To ensure proceeds from bond sales are used for student loans, a non-profit corporation needs to be established and organized at the request of a state or political subdivision of the State and operated exclusively for the purpose of funding and making student loans as described above under Qualified Student Loan Bonds **– IRC section 144(b)(1).** The State of Maryland previously had a similar organization, The Higher Education Supplemental Loan Authority, created in 1982 based on findings at that time that "*there existed a serious problem in the State regarding the ability of students to obtain financing for the cost of education beyond the high school level"*. The Authority was created and used the proceeds from bond sales to loan directly to institutions funds that could then be loaned to students. The Authority issued one series of revenue bonds in 1984 and proceeds were used to fund student loans and redeem part of the bonds. The interest collected on the loans partially paid the expenses associated with administering the program and paying the interest on the bonds.

The Tax Reform Act of 1986 resulted in such onerous restrictions on tax exempt student loan revenue bonds that the Authority was unable to issue any additional bonds and as the outstanding principal amount issue decreased, the program became uneconomical to maintain and administer. In 1992, the Maryland Higher Education Supplemental Loan Authority sold all of the outstanding bonds in its portfolio and applied the monies received to the redemption of the outstanding bonds. A State lending entity would be subject to the same restrictions unless it became a full-service student lending entity as described later in this report.

Student Loan Debt

Between the federally insured student loans and the private alternative student loans, there are many lending options for students to choose. For FY 2007, MHEC data shows that Maryland Higher Education institutions reported $840,800,000 in federal student loans disbursements to undergraduate and graduate students. MHEC has limited data on private alternative loans. Nationally, approximately $70 billion in student loans will be made during the 2008-09 award year.

Recent national loan data reveals that the average 4-year college graduate has student loan debt of approximately $20,000; the average 2-year college graduate has student loan debt of approximately $10,000; 25% of all 4-year graduates have loan debt of more than $25,000. These figures include private alternative loans, but do not include PLUS (Parent Loans for Undergraduate Students), where one in ten parents will borrow for their child's education.

MHEC data also shows that low-income Maryland students at two and four-year schools have high remaining need after all sources of aid have been awarded, including student loans. At two-year institutions the average unmet need for each student after receiving loans was $4,255 and at four-year institutions the average was $8,939. Considering the high levels of unmet need and student reliance on loans, a broader discussion needs to take place to determine whether a State loan program is in the student's best interest compared to funding through grants and scholarships.

Current Lending Market

Recent conditions in the financial markets are affecting many lenders' ability to secure funding through the sale of bonds in traditional markets.

- The Vermont Student Assistance Corporation, a public non-profit organization that provided educational loans, stated that because of the upheaval in the financial markets caused by the sub-prime mortgage problems, they could no longer sell bonds under the process of auction-rate securities. Instead, future bond issuances will be through variable-rate demand obligations.

- The Pennsylvania Higher Education Assistance Authority (PHEAA) announced this spring they would not be making any new loans for the 2008-09 award year and will only assist borrowers in finding alternate lenders and servicing prior PHEAA loans. The reasons cited were problems in the financial and credit markets that made issuing and selling bonds to finance student loans impossible. They also cited the recent cuts in student loan subsidies as another factor in their decision.

- In August 2008, the State of Kentucky purchased a $50 million bond from their state's Higher Education Student Loan Corporation to supplement that agency's ability to make student loans for the 2008-09 award year. Problems in the financial markets had made borrowing more difficult and this move by the State was seen as their only option in keeping their student loan program active for all students.

Any bonds issued by or on behalf of Maryland for student loans under IRC 144(b)(1) or 150(d) would be subject to the same volatility.

Recently, Congress passed the Ensuring Continued Access to Student Loans Act of 2008 (P.L. 110-227) that will allow the U.S. Department of Education to guarantee the purchase of all loans from lenders of Stafford and PLUS Loans made only during the 2008-2009 award year AND to offer lenders access to short-term liquidity to assist in bond financing. In addition, the Department is doubling the capacity of the Direct Loan Program should more institutions move from making loans under the Federal Family Education Loan Program to Direct Lending where borrowers make application directly to the Department of Education.

Earlier fears that student loans would not be available for the current award year have not materialized. Schools in the metro DC/VA/MD areas have not reported any decrease in the availability of student loans. The "guarantee to purchase" by the U.S. Department of Education and increased access to short-term liquidity for lenders has provided additional stability for the industry for the current award year.

Administrative Structure of State Non-profit Loan Organizations

States that have established non-profit organizations to make student loans financed by qualified private activity bonds under the IRC have grown from just lender to full service agencies. The range of duties they now perform include loan guarantee and origination, buying and selling other student loan portfolios, servicing their loans as required under the Higher Education Act, scholarship development, outreach activities and loan consolidations.

- The Student Assistance Foundation (SAF) provides the day-to-day management and student loan servicing for the state of Montana and the Montana Higher Education Student Assistance Corporation. They service a loan portfolio of approximately $4 billions dollars and employ 195. Their services include full-loan management, scholarship development and outreach activities. In 2008, SAF had to lay off 25 employees due to the loss of loan fees and instability in the financial markets.

- The Iowa Student Loan Liquidity Corporation (ISL) has 370 employees and services approximately $3.7 billion in student loans. ISL is a full-service agency that not only provides student loans, but a variety of training, outreach and partnerships with other state and private organizations.

- The Vermont Student Assistance Corporation (VSAC) has 372 employees and is a full-service student loan and state aid public non-profit corporation. In addition to originating student loans, VSAC operates the State's 529 savings plan, state grant and

Maryland, unlike other states, has chosen not to establish a full-service entity for student loans. If the state chooses to do so, more research needs to be performed to determine how such an entity should be structured and the range of services to be offered.

Conclusions

Before actions are taken to move in this direction, a discussion needs to take place regarding what is in the best interest of students. Students are already graduating with high levels of loan debt. Is it in the student's best interest to establish another loan program to increase student loan debt or are there alternative strategies that the State could use to decrease the reliance on student loans for the lower income students that typically have the highest default rates? These issues should be addressed before steps are taken to establish another Maryland student loan program.

Based on the research, Qualified Scholarship Funding Bonds can be used to support existing student loan programs; however, considering the evolving financial markets, it seems unwise to do so at this time. A Maryland student loan program, financed through bonds, would be subject to the same volatility faced by other states. Further, for the entity to be profitable, it would need to be established as a full-service lending entity. Additional research is required to determine what resources are needed to establish and maintain such a program.