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SPOTLIGHT REPORT

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Biden's Unilateral Student Loan Forgiveness

What's Happening: Pressure has been mounting in recent days for the incoming Biden administration to forgive a significant portion of borrowers' federal student loan debt in its first 100 days. Although many detractors are citing tax challenges, accusations of regressiveness, and the limited impact some economists believe it will have on the broader economy, we believe the transformative political and psychological impact on an estimated 45 million borrowers will be the key rationale for a President Biden to trigger such a move.

Why It Matters: We expect that President Biden will look past all of the objections listed above and that he will choose to enact unilateral federal student loan debt forgiveness for several reasons. First, it will help bolster the middle class and borrowers who are trying to become middle class by, in his mind, levelling the playing field with more wealthy students whose parents paid for their education. Second, this policy and the emotional impact it will have on many of the borrowers it will help will be critical to keeping together his progressive coalition, including younger voters, who were so important to his election win. Third, due to historical wealth disparities, black and Hispanic borrowers often take out larger amounts of loans than white borrowers, and we expect Biden to spin this move as a way to spur wealth building among these communities of color. In terms of what the forgiveness looks like, we expect it will be for a set dollar amount that is somewhere between \$10,000 and \$50,000, with a bias towards the lower figure; the president will direct the Internal Revenue Service (IRS) to not tax the amount forgiven (there are multiple options to get this result discussed below); and it will apply to all federal Direct Loans, with an opportunity for legacy Federal Family Education Loan Program (FFELP) loans to refinance into a Direct Loan to receive the benefits. **What this means for investors is that it would: introduce new prepayment risk for many, if not all FFELP loan holders; frighten private student loan holders who may believe that this will drum up support for an extension of such forgiveness into private loans (which we deem unlikely and explain in the last section**

below); reduce volumes for federal student loan servicers and debt collectors; and potentially reduce originations for private loan refinancings as well as de novo private loans due to borrowers hoping for another round of forgiveness in the future.

What's Next: We expect to see political pressure on this issue to increase in the weeks to come, although we do not expect that Biden will make any policy announcements in this regard before his inauguration. There is a chance, however, that the famously loose lipped Biden lets slip that this policy is coming, but that is not our base case. We will also look for who Biden selects as his secretary of Education for guidance on how this policy priority may play out, since it will be that individual who will have to technically implement the forgiveness and sign his or her name to the order. Once this person has been nominated and confirmed by the Senate, then we expect that forgiveness will be announced within the first 100 days of a Biden administration as part of its effort to help middle class borrowers, create wealth for African-Americans and other communities of color, stimulate the economy, and help support the recovery from Covid-19.

Types of Students Loans

When discussing student loans, it is important to determine what types of loans are in play, and what can be done regarding each type of loan with either unilateral action or an act of Congress.

Federal Direct Loans are the most common type of loan and they make up the vast majority of the 45 million borrowers in the United States. To put into perspective the number of people who have federal student debt, versus other well known federal programs, there are 25 million people receiving the Earned Income Tax Credit (EITC) and 38 million people receive food stamps, now called SNAP. Direct Loans are made directly by the federal government and they sit in a portfolio on the books of the Department of Education -- the only private sector involvement in these loans are the contractors hired by the Department of Education to service them and interact with borrowers. These are the loans that can be most easily modified either by Congress, or by unilateral executive action based on a novel interpretation of the Higher Education Act, which we will analyze below.

The next type of federal student loan is the Federal Family Education Loan Program (FFELP), which are loans that were made before the program ended in 2010 under the Obama administration. In this program the government used subsidies and guarantees to work with private lenders to issue student loans on behalf of the federal government. Many of these legacy loans still exist and make up a significant portion of outstanding federal loans and they are particularly prevalent among older borrowers who have been paying off their loans for over ten years already. Some of these loans are held by the federal government, but the majority are securitized and owned by private investors. These loans are also typically serviced by the same companies used by the federal government's Direct Loans.

A third type of student loan is fully private loans, which were made between a borrower and a financial institution (with or without a cosigner), such as a bank or a new fintech company like **Sofi**, many of which specialize in refinancing existing seasoned student loans (both private and federal). These loans are also typically securitized and held in portfolio by investors with the servicing either happening via the originator, or another company that is hired as a contractor. **These loans have no government guarantee or subsidy and if the federal government were to try to change the terms of these private contracts, they would need to pass a new law through Congress and appropriate money for payment to the owners of the loans, but there would still be significant legal hurdles if the new law were to change the existing contracts, particularly in a way that would cost the investor-owners money.**

President-elect Biden's Mindset Regarding Student Loan Forgiveness

As President-elect Biden has consistently emphasized during his presidential campaign, he is nicknamed "Middle class Joe" for a reason -- he views nearly all policy choices through the prism of "how does this decision impact the middle class and people who are striving to become middle class?"

While Senator Bernie Sanders (I-VT) and other more radical progressives will talk about their views of education as a public good and human right, Biden is far more practical about this type of choice. He will look at the people it will impact and how it will or will not improve their lives. Although he had initially not been supportive of student loan forgiveness, after he became the Democratic nominee, this was one area where his former opponent, Senator Elizabeth Warren (D-MA), made a big impact and Biden came out in support of limited forgiveness of $10,000 per borrower later in the campaign.

Another important win for Warren was that she convinced Biden and his team of the ability to do this forgiveness via executive action, rather than waiting for Congress to pass a law and appropriate money for such action. As we have seen with the stalled Democratic congressional demands in the HEROES Act for federal and private debt forgiveness, this is simply not a priority for Republicans and assuming the Senate remains under Republican control after the Georgia runoff elections, Biden will have no choice but to act unilaterally.

A final policy consideration that we do not expect to enter Biden's mind, but that will occupy his advisors, will be how this type of plan would bolster or deplete his political capital and approval rating, particularly among the disparate coalition that voted him into office as an alternative to President Trump, more than as an embrace of his transformational progressive institutionalist agenda. Although a policy choice of this magnitude is sure to anger a large swath of the country that did not attend college due to cost, or those who have made sacrifices to pay off their debt or attended a less prestigious and cheaper institution of higher education to be less indebted, we expect that overall it will be transformational and provide a boost to Biden's approval among the borrowers who will benefit, further cementing educated millennials and other post-generation X age cohorts into the Democratic coalition.

Policy Considerations

In addition to the political considerations and how this proposal would help the middle class, there are several critically important related policies that must be included to give the widest scope of borrowers the largest amount of relief.

The first decision is what dollar amount to be forgiven. We believe the dollar amounts under discussion vary, from the $10,000 per borrower that Biden seemed to settle on late in his presidential campaign, to a more generous figure of $50,000 pushed in a non-binding Senate resolution by Senate Minority Leader Chuck Schumer (D-NY), to full forgiveness from those progressives like Senator Bernie Sanders (I-VT), who say that if the government can unilaterally forgive debt, why not forgive all of it. We expect that Biden will choose a figure around $10,000 but certainly less than $50,000 for a few reasons.

First, $10,000 is around the amount of debt for the majority of borrowers who did not complete their education but still have loans owed to the federal government and the majority of people who are in default. These borrowers are perhaps the most impacted by this policy because they did not complete their education and therefore do not have the ability to command higher wages, but still owe what can be a substantial debt and defaults also wreak havoc with their ability to access credit. This dollar amount would wipe clean indebtedness for a majority of this group.

Second, limiting the total amount of forgiveness ensures that it is not overly regressive and rewarding to higher earning professionals with graduate degrees, such as in law, medicine, or business, that are not necessarily the target audience. There could be a requirement on the forgiveness counting towards only undergraduate loans, but this would be an added layer of complexity and could cut out a fair number of borrowers who would materially benefit.

Third, a lower dollar amount is also key to not having to institute means testing -- instead keeping the forgiveness universal -- while still only costing taxpayers an amount in the tens of billions, out of more than $1.5 trillion in total federal student debt.

Another issue that also needs to be addressed in any loan forgiveness plan is how to deal with the tax treatment of the loans. Typically a forgiven debt is viewed as income by the Internal Revenue Service (IRS), which would mean that taxes would be owed on the amount of debt forgiven, creating huge problems for millions of borrowers who would not necessarily have the funds to make such payments. Critics of student loan forgiveness repeatedly point to this issue as a reason why it is not worth pursuing unilaterally. Former Obama administration Council of Economic Advisors Chair Jason Furman is the most recent prominent progressive who has cast doubts on the plan using this as part of his argument. We expect that President Biden will ensure that his Treasury secretary is on board with this move and that the IRS commissioner will issue a ruling that either calls this forgiveness a retroactive qualifying scholarship or, more likely, that the forgiveness is a disaster payment related to the ongoing Covid-19 pandemic and dare someone to challenge this in court and prove that they have standing.

Scope of Biden’s Unilateral Forgiveness

Once President-elect Biden has made his decision to pursue forgiveness, his team will need to draft the specifics of the plan. With the information available to us now, we expect it will have these characteristics:

1. Dollar amount to be forgiven will be around $10,000 to $50,000 per borrower;
2. All federal Direct Loans will be included and FFELP loan holders can access this forgiveness by refinancing into a Direct Loan and we expect that it will be automatically applied to Direct Loans;
3. This unilateral forgiveness will not apply to purely private student loans;
4. The Treasury Department will either make payments on behalf of the borrowers each month up to the agreed dollar threshold, or the Education Department will just tell its servicers to reduce the outstanding balances for its borrowers;

5. The IRS will be directed by the Treasury secretary to classify the debt forgiveness in a way that does not create a taxable event for the 45 million borrowers who would be impacted; and
6. The forgiveness will be universal and is unlikely to be means tested, nor will the forgiven amounts increase based on the type of school attended (e.g. Historically Black Colleges and Universities), although there could possibly be a carveout for graduate school debt as opposed to undergraduate debt.

What This Means for Other Student Loan Market Participants

For investors, the most immediate impact will be on those who hold FFELP loans on their books as a long-term credit investment, as well as equity investors in private student lenders such as **Sallie Mae (SLM)**.

We expect that the Department of Education will conduct significant outreach to FFELP borrowers to push them to refinance their loans into Direct Loans and be able to access the forgiveness. This will introduce dramatic prepayment risk into these securities and revenues for companies such as **Navient (NAVI)**, and if enough borrowers opt for this option, then the loans behind these securities will be extinguished far ahead of their expected date, although the owner of the securities would be receiving guaranteed payments from the federal government, removing any credit risk.

There could also be some impact on the valuation of private student loan portfolios, but Congress would have to pass a new law to allow forgiveness of these loans and there is little indication that Republicans are going to change their minds on this issue, particularly when Biden will have already partially forgiven loans for 45 million people. We expect that the issue of student loan debt will actually retreat off of the agenda in the wake of this mass forgiveness, further decreasing the odds that a new law is passed that would extend a similar type of program to fully private loans. At the same time, with Covid-19 vaccines likely being distributed in the coming months, the ability to use the pandemic as an excuse to push what was once a radical policy will also recede.

Student loan servicers who work with FFELP and Direct Loans, such as **Nelnet (NNI)**, will also be negatively impacted, as they will have fewer accounts to service, as well as they will be under strict watch from the Biden administration and specifically a reinvigorted Consumer Financial Protection Bureau (CFPB) to ensure that refinancing of FFELP loans into Direct Loans happens smoothly and that the new and reduced balances for Direct Loans are accurate. We expect that with this many borrowers being impacted, there will inevitably be investigations and litigation against student loan servicers as a result of this monumental task.

Similarly, debt collectors will also be negatively impacted. There is a high likelihood of many collectors trying to continue to collect when a borrower's account that was in default has been cured and the balance brought down to zero. We similarly expect investigations and litigation from the CFPB and Education Department for these types of mistakes and preventing them from happening is sure to cost a substantial amount of money with new hires and new technology, without the government necessarily paying any more as part of its contract.

Another set of companies in the student loan ecosystem are private refinance companies, such as **Citizens Bank (CFG)**, that often are appealing to borrowers with federal loans who also have stable jobs and good credit. We expect that the volume of loans for these refinancing firms will temporarily decrease and could decrease substantially as borrowers choose instead to take advantage of the forgiveness, rather than consolidate and refinance with a more competitive private market rate. This will be temporary, but it could have a huge impact for a few quarters while Biden's plans play out.

Similarly, this forgiveness could also be a negative signaling mechanism for current and future students with good credit to take out federal Direct Loans at a higher interest rate compared to private loans because of the chance for a second round of forgiveness in the future. This could see volumes of new private loan applications fall in the aftermath of such a policy.