Issues concerning mortgage-backed student loans are examined, with attention to the new tax law, policy and practical concerns that a college should address before starting this type of loan program, public policy issues, and two types of plans. The Tax Reform Act of 1986 phases out the deductibility of consumer interest charges and as a result will cause the expense of most loans to increase. However, loans secured by a home mortgage are fully deductible, and special consideration is offered for home loans used to finance educational and medical expenses. The following requirements that must be met are discussed: qualified residence interest, qualified indebtedness, and qualified educational expenses. Colleges should consider administrative and logistical problems before beginning a mortgaged-backed lending program, including title searching and mortgage recording. Public policy issues include: whether higher education may abuse the tax law for self-serving reasons, whether colleges will compete unfairly with the commercial sector, and whether the plans are fair to students and their families. Information is provided on two prototypical programs offered by the University of Pennsylvania and the Massachusetts Education Loan Authority. (SW)
Mortgage-Backed Student Loans

As the cost of a college education has risen and the enrollment base has diminished, higher education officials have begun to reconsider the options available for financing a college education. Some college officials have challenged the long-held notion that, when it comes to money, an institution's principal interaction with a family should be in the financial aid office. Instead, a new concept is emerging: Colleges and state financing organizations must go beyond passive involvement or simple needs analysis.

Taking the lead from the private retail sector, financially progressive college officials now understand that the form of finance can be almost as important as net price. For example, cars are regularly sold on the basis of how well a monthly payment will fit into a family's budget.

Most notable in this effort has been the University of Pennsylvania, where the "Penn Plan" has, since 1984, offered an ever-increasing "menu" of financing options, including guaranteed tuition through single or extended payments, long-term financing for non-aided students, and a revolving line of credit for general educational expenses.

Other colleges and universities have followed suit, directing their "packaging" efforts primarily at middle- and upper-middle-income families. Loan arrangements have become the centerpiece of the financing, there is, after all, only so much grant aid available.

Until recently, the cost of this debt financing has been eased by the fact that taxpayers who itemized could deduct the interest charges from their taxable income. For many families, the after-tax cost of borrowing may have been only half of the interest charges. Consequently, the financial packaging was not only convenient, but could be relatively inexpensive.

The Tax Reform Act of 1986 made sweeping revisions of the tax laws. The deductibility of consumer interest charges is being phased out. As a result, the net expense of most loans will increase. The law, however, left one opportunity for borrowers: Loans secured by a home mortgage (mortgage-backed loans) are still fully deductible. And, more importantly, the law offered special consideration for home loans used to finance educational and medical expenses.

In effect, the new law has created obstacles and opportunities for higher education. The significance of this dual challenge/opportunity is amplified by the fact that federal student loans—GSL, NDSL, and particularly the PLUS loans intended for middle-income parents—have become significantly more expensive with the new nondeductibility provision.

If colleges, universities, and state agencies are able to create mortgage-backed student loans, they can retain the prior advantages of their loan programs. And they (along with health care providers) will hold a financing advantage over other products and services. In this issue of Capital Ideas, we will explore mortgage-backed student loans. Douglas Wofford is the primary author.

The New Tax Law

As of January 1, 1987, consumer interest deductibility began a five-year phase-out. By 1991 consumer interest expenses will no longer be deductible from adjusted gross income for federal tax purposes. Interest expenses for qualified residences remain deductible. Because this section of the code gives special treatment to mortgage-backed debt used to finance educational and medical expenses, it allows higher education to provide relatively effective financing terms for a large percentage of its students. But certain hurdles must be cleared. There must be qualified residence interest, qualified indebtedness, and qualified educational expenses.

Qualified Residence Interest. Although Congress disallowed general consumer interest deductions, the interest charges for home mortgages continue to be deductible, too many voters depend on that deduction to help finance their home purchase. To be "qualified," the interest must meet several requirements.

- There must be an indebtedness secured by the taxpayer's property. At the time interest is paid or accrued, the property must be a qualified residence of the taxpayer. Both first and second homes qualify. Furthermore, certain re-
The new tax law offers special opportunities for colleges and state agencies to establish mortgage-backed student loans. However, the private financial sector will certainly step in and provide appropriate products. Considering the logistical complications of implementing such programs, it's reasonable for college officials to ask, "Why bother to set up such a program?"

The answers are:

- It is a valuable service for families.
- Colleges and universities are, in some respects, in a better position to offer the service than the private financial sector.
- The programs can provide institutions that provide the service a tactical advantage relative to other institutions.

The "valuable service" response is especially relevant to state loan authorities. Their purpose is to provide effective financing for higher education. For many families in the current tax environment, this cannot be achieved without mortgage backed debt.

Institutions might be motivated by the service issue but there are also reasons why they can provide this type of financing more effectively than private financial institutions.

Second, colleges and universities might charge lower interest rates, or guarantee the debt to a bank which would enable the bank to charge lower rates. A commercial lender has no particular interest in establishing the loan except for the interest it receives. The institution clearly has more at stake. The use of family debt financing may even reduce college financial aid expenditures. Moreover, the college has a more involved relationship with the student. If the college does its job well, a positive bond will be formed with the student. If the college does its job well, a positive bond will be formed with the student. If the college does its job well, a positive bond will be formed with the student.

Federal student loans—GSL, NDSL, and particularly the PLUS loans which are intended for middle-income parents—have become significantly more expensive with the new nondeductibility provision.
may be advantages to creating a mortgage-backed program, they should ask themselves the following questions:

1) **Who are the clientele?** Are our students and their families using debt now? Obviously a large percentage should be homeowners. What tax bracket are they in? Do they itemize? (Experts predict that only about 30 percent of taxpayers will itemize under the new law) The more financially sophisticated the family, the more they will appreciate the advantage but the less they will need it.

2) **What is our niche in the market?** As more institutions offer the financial convenience of mortgage-backed loans, there will be increasing pressure on other colleges and universities to follow suit.

3) **Can this financial option help further institutional goals—not only numeric enrollment goals but also goals of access and diversity?** It is possible, for example, that by offering financing alternatives to middle- and upper-income families, an institution can increase unrestricted funds for lower-income families. The institution is thus able to broaden the access to higher education by packaging appropriate financial aid options for different income levels.

4) **What expertise can we bring to bear on the implementation of a mortgage backed program?** Does the institution have the talent within its ranks to carry out such a program? Can it recruit the help needed?

5) **Does the college have the financial resources or is there a bank which would provide the necessary financing?**

**Summary.** What it comes down to is that the mortgage-backed option is more than just an exciting new trend created by the Tax Reform Act. Instead, this new option must be examined in light of an institution’s mission, its constituency, and its resources.

**Practical Considerations**

Although changes in the tax law may make mortgage-backed lending a desirable option, colleges and agencies should consider the administrative and logistical problems before embarking on such a program.

**The Mortgage.** Central to these programs, as the name suggests, is the idea that a college or university would hold a family’s mortgage as security on a loan. In a home purchase, the mortgage is not the loan—or the note—itself. Instead, it is an agreement that stays in the background as long as the borrower continues to pay on the loan. The mortgage only becomes an issue if the borrower does not pay. The mortgage is the security that backs the loan, spelling out the rights of the lender in recovering proceeds of the original loan from the property.

The National Conference on Uniform State Laws defines a mortgage as “any form of instrument whereby title to real estate is reserved or conveyed as security for the payment of a debt or other obligation.” The first step for the lender, then, is to determine if the mortgage security interest meets the following legal requirements, as defined by the National Conference on Uniform State Laws. Note that these are “typical” requirements; actual requirements vary from state to state.

- The mortgage must be a written instrument. The law frowns on oral agreements affecting real property.
- It must commit the borrower to pay the lender a specific sum under specific terms. The terms of the formal contract, including the amount to be repaid and the repayment schedule, must be spelled out.
- There must be a default clause allowing the holder of the note to proceed against the borrower personally for a breach of obligations under the terms of the note, as well as for a breach of the mortgage covenants. This points out that the note and the mortgage are two different instruments.

- The note must be properly executed and voluntarily delivered and accepted.
- The parties must have contractual capacity. The definition of “contractual capacity” varies slightly from state to state. Generally, but not always, it means that the borrower must have reached a certain age and be of sound mind and body.

Institutions and agencies with mortgage-backed programs have already discovered that divorce cases can affect contractual capacity. In some cases, mortgage-backed loan applications have been delayed until a divorce case was settled, property was transferred, and one of the parents was determined to be the title-holder with full contractual capacity.

**Minimum Requirements.** If a college plans to hold a mortgage as a security on a mortgage-backed loan, it should check to see that the note, at a minimum, includes the following:

- Appropriate identification of the mortgagor and the mortgagor.
- Proper description of the property that is to be mortgaged.
- Covenants of seizin (the state of owning the property that is being conveyed). This simply states that the borrower does, indeed, have title to the property. A routine title search is usually executed to ensure that the title is clear and to ward off any problems of other liens in case foreclosure becomes necessary.
- Provision for release of dower (the interest in a husband’s real estate given by law to the widow for support after his death) by the mortgagee.

**Appraisal.** Although not absolutely required, many lenders ask for a recent appraisal of the property value (even for a second or third mortgage). Opinion is split on whether an appraisal should

For some families the decision to select one institution over another may be determined, in part, by the convenience of fitting payments into the family budget without having to arrange financing through their own bank.
be required in an educational loan program. The cost of an appraisal is a burden for the family. Because it is not required legally, some institutions have eliminated it to save money. Others require the appraisal because it is standard procedure and protects the lender from lending more money than the home is worth.

**Verification.** Mortgage lenders generally verify the title and have the mortgage duly recorded into the public record in the local county or township. Typically, this requires the involvement of a national title company.

**Recording.** The recording of a mortgage is the act of having it copied by a public official into a local public record that is kept specifically for that purpose. The records are kept in the county (or township) in which the property is located. Before the mortgage is legally part of the record it must be "admitted to the record." This simply means that all the formalities peculiar to that locality must be observed. The date and time of the recording are entered so that, in the event of a default, lenders may file against the secured property in the order in which they were recorded—something of a first-come, first-served situation.

**Fulfilling the minimum requirements of establishing a mortgage obligation is not very onerous. . . .** There are, however, reasons beyond debt security, why colleges may wish to go beyond the minimum requirements.

**Public Policy Issues**

Higher education should not undertake mortgage-backed student loans without fully considering the impact of these programs on public perceptions of our sector and the possible public policy repercussions. There are at least four areas of concern. Might higher education appear to be abusing the tax law for self-serving reasons? Are colleges and universities competing unfairly with the commercial sector? Are the plans fair to the students and the families? Is it good policy to formally remove students from the debt agreement? Congress has begun to view higher education as just another special interest group, out to protect its own turf. This occurred, for example, during the debate over tax reform. If, indeed, a number of colleges, universities, and agencies become involved in mortgage-backed loan program and if some of these programs choose to be structured with only the minimum legal requirements, the pre-disposition of some members of Congress to treat higher education as just another special interest group may be reinforced.

On the other hand, colleges could be viewed as taking fair advantage of a specific opportunity written into the tax code by Congress. If the ability to deduct interest on mortgage-backed loans for educational purposes is there to increase higher education access and choice by middle-income families, then the more widely these loans are available, the more the public interest is served.

Serving the public good can be difficult to define and definitions are colored by perception. Colleges and agencies must carefully consider how their mortgage-backed loan programs are perceived. And the cues will be taken from both substance and form. Substantively, how do higher education programs compare with commercial ones? Is there more to the mortgage-backing than interest deductibility? For example, if a family pledges property in support of a loan, do they pay a lower interest rate? Are they treated differently in any way than families who do not pledge their home? How is the program marketed? Does the descriptive material sound like an abuse of the tax code?

Small businesses have argued that non-profit organizations, and colleges and universities in particular, are competing unfairly with businesses in areas that are not central to their mission. The sale of computers, clothing, non-textbook books, records, and tapes are some of the examples mentioned. A recent attempt to defend these activities before a Congressional committee was poorly received.

Should higher education be in the lending business at all? An argument can be made that this type of financing is, indeed, being undertaken for the convenience of students. Nevertheless, at the present time higher education is on the defensive. Institutions can sidestep the issue by forming an alliance with a local bank, combining the best expertise from both groups. This provides benefits on both sides, which the University of Pennsylvania has demonstrated in their program. Not every school will be able to find willing partners, however.

More important is the question of whether it is reasonable for families to undertake this debt. There is growing public concern about rising levels of indebtedness. These plans should not exploit the possibility of the tax advantage if the actual debt is unreasonable for a particular family. There are already consumer protection proposals in Con
Implementation of the Mortgage-Based Program: Two Types of Plans

To date, only a handful of institutions and states have completed the extensive research and planning necessary to introduce mortgage-backed programs. Fewer still have begun offering mortgage-backed loans. But these institutions and states will be the models for future planning.

Two prototypical programs are offered by the University of Pennsylvania and the Massachusetts Education Loan Authority (MELA). In the Penn Plan, the university starts the loan application process with families, and then works with a bank and title company to administer the program. The loans can only be used at the University of Pennsylvania. MELA, on the other hand, is a state loan authority that works with many institutions in Massachusetts. MELA buys loans from universities and then offers the borrowers the option of securing their loans with a second mortgage.

The Penn Plan: A University Loan Program

The University of Pennsylvania was one of the first institutions in the nation to offer mortgage-backed lending, instituting the plan in an incredible four-and-a-half months from inception to the public announcement of the plan. This efficient job was possible only because of the Penn Plan, the three-year-old alternative financing arm of the university. And Penn's mortgage-backed lending can best be understood within the context of that plan.

The Penn Plan was established in 1984 to meet the needs of families who were not eligible for aid and to provide new financing options to them. It offers families a "wide menu" of financing options, including guaranteed tuition prepayment (with or without debt financing). Revolving lines of credit are available in different versions for unaided families, for non-tuition expenses, and for part-time students who need to borrow for books and computers. The other option is a monthly budgeting plan that allows extended payments over 10 or 12 months, interest-free.

After studying the situation, the Penn Plan's attorneys decided that a mortgage-backed loan could protect families' interest deductibility. And so, early last December, the implementation began.

Through the Penn Plan, the university had already established a strong working relationship with Philadelphia National Bank (PNB). By negotiating with the bank and with Commonwealth Land Title Company, Penn worked out a plan by which college officers would do the initial counseling of families interested in the plan. Once the application was filled out, the bank and title company would actually process the loan.

Unlike other Penn Plan loans, which are typically processed in about four weeks, mortgage-backed loans may take up to eight weeks. Diane-Louise Wormley, assistant director of the Penn Plan notes, "Instead of the loan going from PNB (bank) through us and to the parents as in all our non-secured products, the mortgage-backed loan papers have to go from PNB to Commonwealth (title company), the attorneys, and the family, and then cycle back through Commonwealth and back through PNB."

As a result of the extra time required, Penn realized that students' accounts might not be credited in time for the August draw-down. This meant changing policy and putting temporary credits on the accounts of students who had been approved for the loans, so that the students could still register without worry of late fees.

The decision to secure a loan is the family's, but Penn Plan counselors work with the student and family to make sure they understand all the ramifications of the option. They also suggest that families consult their own tax advisor.

To date, about one-third of all new loan applicants have opted for the secured loans. Of those students applying only for the prepayment program, half are taking out second-mortgage loans.

"Obviously," says Wormley, "there are a lot of
Penn realized that students' accounts might not be credited in time for the August draw-down. This meant changing policy... so that the students could still register without worry of late fees.

families who are interested in the program but for some reason can't or don't want to participate. That's fine; we didn't want to have 100 percent participation. The point is, it's serving a need. That has always been our goal."

Based on the Penn Plan's experience, Wormley offers the following tips to institutions considering a mortgage-backed program.

1) Give yourself enough lead time. The Penn Plan already had an extensive loan program in place, with the staff, legal counsel, computer system, and institutional support to make it work. Adding the mortgage-backed program, then, was just like adding another item to the menu. Even so, the short time taxed the facilities and staff. Make sure to allow sufficient time for computer programming and publication preparation.

2) Establish a strong working relationship with those parties which will be integral to the program. Key participants include: your attorneys (you will rely on them heavily), the title company, and the bank, which must be flexible enough to handle a variety of problems. (For example, when siblings apply for secured loans, the bank must handle two students, two loans, but just one house.)

3) Become well-versed in state statutes regarding second mortgages. Texas, for instance, is the only state in which Penn's mortgage-backed program is not offered. The Texas Constitution's "homestead protection" disallows second mortgages.

4) Decide how much you want to be involved with the actual administration of the mortgage-backed loans. In Penn's case, the decision was: Not at all. The Pennsylvania National Bank does it.

5) Consider the money that will be required up front. Because the Penn Plan had already established a mutual level of trust with PNB, the bank was much more willing to enter into the mortgage-backed program. Smaller colleges, and those institutions without such a relationship, might be expected to guarantee the loans with a substantial financial commitment to convince a bank to take a risk on an unproven program.

6) Solicit the help of all areas of the college. The Penn Plan was designed using a cross-disciplinary approach, pulling in people from all branches of the university for weekly meetings to hash out the concept and the design.

7) Establish a policy on what to do in case of a foreclosure, and make sure the bank agrees to that policy.

8) Don't assume that banks won't work with a small school. The key element is the quality of the loan portfolio being presented to the bank.

MELA: A state loan plan.

Concerned about the widening gap between the cost of education and the ability of families to pay, the Massachusetts legislature in 1982 created the Massachusetts Education Loan Authority (MELA). Established to provide supplemental loan programs, MELA began lending money in the Spring of 1983.

The money is loaned through two separate programs, the Family Education Loan and the Graduate Education Loan, with the institutions acting as the lenders, and MELA buying the loan from the school. To raise the funds to buy loans from the institutions, MELA issues bonds in the tax-exempt market. Currently, 43 public and independent institutions within Massachusetts participate.

The basic loan processing procedure begins when a student applies to the school. The school reviews and sends the application to MELA's service representative. The representative in turn, completes a needs test analysis. If the family is approved for the loan, MELA returns the promissory note to the institution, which deals again with the family and student. MELA buys the note from the school and transfers the money to the institution to be credited to the student's account.

Since December 1986, MELA has also offered a mortgage-backed option. Because MELA wanted to keep the second-mortgage option separate from its unsecured loans, it arranged a two-step process for families. According to Assistant Director Katherine Read, "We have decided not to begin the home mortgage option application process until we have purchased the promissory note from the institution."

Students who apply for loans can check a box on their initial application to receive information about a secured loan. But it is only after MELA has purchased the note for that student that they send information about the program. At that point, the family can send their home mortgage information to the servicer, who conducts a title search and checks to see if the borrower has sufficient equity in the home.

If the borrower is approved for the second mortgage, MELA sends the family the proper mortgage forms to be completed, notarized, and returned. The servicer then records the mortgage in the state where the family resides.

According to Read, five points are key in the administration of MELA's mortgage-backed program:

1) Neither the interest rate nor the monthly payment changes when a borrower secures the loan. Because all second-mortgage borrowers start out with the first step in the two-step process—that of arranging for an unsecured loan—MELA maintains the same interest rate so that the...
such programs will benefit, and whether or not the rising levels of student indebtedness, whom an outside financial institution. Gram itself or if it would be better served by a bank determine if the institution can operate the program. Some interaction between all parties. Finally, the institution has to look at its current financial aid policies. It must further examine its relationship with the family and the student and the interaction between all parties. Finally, it must determine if the institution can operate the program itself or if it would be better served by a bank or an outside financial institution.

At the public policy level are the questions of the rising levels of student indebtedness, whom such programs will benefit, and whether or not they will be beneficial to the educational enterprise. This issue has attempted to highlight some of the questions and implications of mortgage-backed student loans. Additional information is available from the individuals listed below.

For more information: Contact Mr. Douglas Wofford of the Forum for College Financing Alternatives, Box 34, Teachers College, Columbia University, New York, N.Y. 10027 or call (212) 678-3293. Contact Diane-Louise Wormley directly about the Penn Plan at The Penn Plan, 227 Franklin Building, University of Pennsylvania, 3451 Walnut Street, Philadelphia, PA 19104-6205 or call (215) 898-5200. For more information about MELA’s plan, contact Katherine Read, Assistant Director, Massachusetts Education Loan Authority, 711 Atlantic Avenue, Boston, MA 02111 or call (617) 338-1253.
Directors:
Richard E. Anderson
Joel W. Meyerson

Staff
Gail Franck
Doug Welford

Consultants:
Coopers & Lybrand serves as technical consultants to the project.

Funding & Affiliation:
Funding for this project and the newsletter is provided by the United States Department of Education's Office of Educational Research and Improvement. The Forum for College Financing Alternatives is a project of the National Center for Postsecondary Governance and Finance. Executive offices are located at the University of Maryland, College Park.

The contents of this newsletter were developed under a grant from the Department of Education. However, the contents do not necessarily represent the policy of the Department of Education, and you should not assume endorsement by the Federal Government.

UPCOMING ISSUE:

COLLEGE SAVINGS PLANS