BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

April 25, 2008

The Honorable Christopher J. Dodd
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Thank you for your letter of April 17, 2008, in which you expressed concerns about developments in the student loan market. We share your concerns.

You requested that the Federal Reserve consider allowing primary dealers to pledge certain student-loan-related assets as collateral at the Term Securities Lending Facility (TSLF). We are always reviewing all our policy tools, including the design of all of our lending facilities, to ensure that they are promoting our policy objectives as effectively as possible. However, as you may know, student-loan-related assets can already be pledged as collateral at the Federal Reserve's other three lending facilities: the primary credit facility and the Term Auction Facility, both of which serve depository institutions, and the Primary Dealer Credit Facility, which provides overnight credit to primary dealers. Credit extended through these facilities to depository institutions and primary dealers may be helpful in supporting the liquidity of other participants in the student loan market as well.

It is crucial to note, however, that the difficulties afflicting the market for student loans reflect a broader range of causes than just the liquidity problems currently facing the economy. The threshold determinant of whether lenders decide to extend new loans is whether they see that activity as a profitable business venture. The fact that a substantial number of lenders have exited this market in recent months suggests that lending to students is not, under current circumstances, profitable. The profitability of such lending is importantly influenced by the spread between the reimbursement that the government pays on such loans and the lending institution's cost of funds. As you know, under legislation enacted last year, the reimbursement rate was reduced substantially. In addition, with the onset of market turmoil beginning in August of last year, the cost of funds for many lenders has increased sharply. The decision of many lenders to withdraw from this market suggests that they see the adverse implications of these two developments--the reduction in reimbursement rate and the increase in the cost of funds--as prohibitive.

The Federal Reserve is working to promote the restoration of more-normal conditions across the broad landscape of financial markets. How quickly that restoration can be accomplished is impossible to know, but as it occurs, lenders in the student loan market and in many other markets should see risk spreads decline from their currently elevated levels. That decline will help on one side of the profitability equation.

The other side of the profitability equation--the reimbursement spread paid to lenders under this program--is under the control of the Congress and the executive branch. In particular, Congress may well wish to revisit the question of whether setting a fixed spread over the commercial paper rate is the best approach. You may decide that a more market-sensitive approach--flexible enough to provide a wider spread during times of market stress and a narrower one during normal times--could provide a more robust structure.

I believe strongly in the crucial importance of our nation's educational system and affirm the importance of ensuring that the financial system serves the students who need to obtain credit in order to further their education. The Federal Reserve is focused intently on being certain that our institution contributes to the appropriate availability of credit in this and other markets; I encourage the Congress to continue giving this issue the serious attention it deserves.

I appreciate the opportunity to provide the Federal Reserve's views on these important questions.

Sincerely,