

# **Investigating possible benefits of student loan-backed securitization in the context of the Malaysian higher education**

Shafinar Ismail  
Brunel University, UK  
Universiti Teknologi Mara (UiTM), Malaysia

Antoaneta Serguieva  
Brunel University, UK

## **ABSTRACT**

The introduction of asset-backed securitization (ABS) in Malaysia has benefited the economy. Though only spanning over eight years, the securitization process and its continuous innovation have contributed to resolving and risk managing problems such as lease, auto loans, credit cards receivables and commercial mortgages. We particularly focus herein on the student loan problem, which has not yet been implemented as a securitization process in Malaysia. This work considers the characteristics of Malaysian higher education, suggests a structure for student loan securitization, and studies the potential of the asset-backed securitization process in resolving the problem. The expectation is that the new financial instrument will benefit both the students and the government.

Keywords: securitization, student loan backed securitization, debt financing, conceptual framework, innovation



## Introduction

Student loan-backed securitization (SLBS) has been applied worldwide, in developed countries as well as recently in some developing countries. This is a way to help higher education (HE) for all, for example, research done by Fried and Breheny (2005), Hartung et al. (2006) and Larrain and Zurita (2007), indicates that the roles of educational loans are important to provide an opportunity to students to further their studies in HE, particularly students from low and middle income backgrounds. The function of educational loans is to reduce the government expenditure on higher education, which is attributed to the growing demand for HE and due to the increasing educational cost incurred per student entry to HE institutions. However, there is a variety of challenges to the financing of HE worldwide, as well as to the administration of educational loans to students (Francis Atuahene, 2006). At the same time, as education is considered a route to economic development and progress (Woodhall, 2002; Salmi, 2005), educational loans are becoming a major feature of financial support for students, particularly in developing countries (Ziderman, 2004).

Student loan-backed securitization, also known as student loan-backed bonds (Lazzaro, 2008), is a creative process of raising funds. A definition along these lines is provided in Fan et al. (2004), emphasizing that the funds are raised through the issuance of marketable securities backed by future cash flows from revenue producing assets. This modern understanding of the ABS process differs from the traditional definition given when the problem initially occurred and narrowly considered. Asset securitisation differs from collateralised debt or traditional asset-based lending in that the loans or other financial claims are assigned or sold to a third party, typically a special-purpose company or trust. This special-purpose vehicle (SPV) in turn issues one or more debt instruments (the asset-backed securities) whose interest and principal payments are dependent on the cash flows coming from the underlying assets (Giddy, 2000).

Student loans are loans offered to students to assist payment of the costs of education. These loans usually carry lower interests and are usually issued by the government. Often, they are supplemented by student grants that do not have to be repaid (Student Consolidation Loan, 2008). The role of student loans can be defined as financial aid, given to students by a federal or private lender, that is specifically intended for education costs. Student loans are highly desirable in order to secure additional funding resources in HE (Vandenberghe and Debande, 2005).

Most countries have their own systems as well as programmes to finance their HE students (Chapman and Harding, 1993; Barr, 2003), consisting both of government and private loans. By setting up specific bodies or organizations to manage them (Chapman, 2006), the government can offer loans to a wide variety of students. For example, Malaysia formed the National Higher Education Fund Corporation (NHEFC) in 1997 to organise and provide loans for HE students (NHEFC, 2008). NHEFC offers loans representing the federal government to enable selected students pursue their studies in the Malaysian universities and colleges. Similarly to the corresponding bodies in other countries, NHEFC is funded directly by the government using the government budget. Most countries, however, have realised that they cannot rely on the government budget. Economically, governments have limited resources and they are shared among a number of social needs such as public healthcare, housing, and education (Ziderman, 2005).

Non-repayment of student loans keeps increasing every year due to reasons such as unemployment and students continuing with a study for another degree (Khan, 2008). In order to maintain sufficient resources for current and future students, as well as to reflect the significance of the government inspiration to support student loans, NHEFC requested in 2007 a loan of Ringgit Malaysia 2 billion (USD 0.57 billion) from the government budget,

however the request was rejected. The reason was that the government budget had to focus more on social needs such as healthcare, housing and public facilities for citizens. To resolve the funding problem for the HE system, NHEFC has no choice but to borrow money from the Employees Provident Fund (EPF) under the Ministry of Finance, as an alternative resource. The critical question raised here is how long NHEFC will need to borrow money in order to provide loans for students. Will that be enough to support the increasing numbers of students every year? What other resources could support NHEFC in its role as the main educational loans corporation in Malaysia? Based on these unresolved issues, the researchers here are motivated to testify that SLBS is set to become the best alternative resource for NHEFC, without burdening the social obligations of the Malaysian government. The role of the government in the SLBS process is as a guarantor rather than issuer, and therefore the burden on its financial capacity is reduced. On the other hand, the private capital markets and banking systems become key players in the process, and hence are actively involved in providing financial resources to students.

In addition, a review of literature on student loans indicates that the problem is not a research priority in Malaysia. The majority of investigations have taken place in the United States (Hartung et al., 2005). This paper thus attempts to investigate whether student loan backed securitization is suitable as an alternative financing in the Malaysian HE, in order to relieve the pressure currently imposed on the government budget. We will analyse and consider possible effects of introducing student loan securities as a type of asset-backed securitization. Student loan securities have been implemented in other countries; however, it is a new concept for Malaysian HE.

### **Practices in Developed and Developing Countries**

The process of asset securitisation is a new and innovative financing method used for funding and risk management purposes (Giddy, 2000). The technique of asset securitisation involves the separation of good assets from a company or financial institution and the use of those assets as backing for high-quality securities that will appeal investors. The assets, financial claims or contract securing future revenue flows, are typically sold to a special-purpose entity that is independent of the originator's credit (Giddy, 2000). Student loan-backed securities market in the US has been used successfully to help provide funding for the costs of education. Student loans are characterised with an increased demand due to the rising HE costs, the higher resources needed by students and their families to fund their education, and the enlarging population and increasing amount of people pursuing degrees. Student loans has been identified as one of the four core asset classes financed through ABS (Fried and Breheny, 2005) and it is expected they will continue developing in the future.

Similarly, in developing countries such as Chile (Brunner, 2007; Larrain and Zurita, 2007), student loan backed-securitization helps provide funding for the costs of education even though there it is still a new process. The Chilean system stands out for being the most privatized and opened to the market within the developing countries (Fried and Abuhadba, 1991; Brunner, 2007; Larrain and Zurita, 2007). Chile is also unique in the strength with which the forces of supply and demand operate, and in its high dependence on private financing. It can be assumed from its institutional structure and level of participation of private registration, that private financing plays an important role in addition to the relative importance of the corresponding state and family (Larrain and Zurita, 2007). This is consistent with structuring the loans in order to channel the resources of private investors, both through the banking system as well as the capital market. It also helps the states and the federal government in efficiently using their cash resources, and focus these on other social functions (Larrain and Zurita, 2007).

However, in most European countries, public financing has been considered as the traditional approach for supporting HE (Vandenberghe and Debande, 2005). Even though tuition fees have been introduced in various countries, they only contribute a small amount to the funding needs of HE institutions. Nevertheless, the transfer of the financial burden to students in Europe could be justified by the high rate of return received on investing in their HE, once they graduate. It measures in terms of earning premium and lower risk of unemployment, as well as the positive impact on the quality of life (Vandenberghe and Debande, 2005).

### **Malaysian Higher Education**

The existing bodies providing loans for students in HE in Malaysia are limited to a few organizations such as MARA, JPA and the Ministry of Higher Education (MOHE). The HE sector in Malaysia comprises of public and private institutions, governed by the Ministry of Higher Education and its agencies as well as by the Department of Private Education. Universities in Malaysia have to find the best alternatives to reduce their dependency on the government budget, in order to sustain their role in providing HE for students. According to Lee (1997), the government provides resources such as educational loan to enable students to pursue HE in local and overseas institutions, in order to achieve the national goal to turn Malaysia into a developed nation by year 2020 (Badawi, 2004). Vision 2020 states that Malaysian government is committed to achieve student enrolments up to 200,000 for each public university. Furthermore, the government is keen to meet the policy target of having 40 per cent of youth aged 19 to 24 admitted into HE. By 2020, the government expects that 60 per cent of high school students would be admitted to public universities, while the rest will go to private colleges or universities (Mok, 2007). Public universities in Malaysia have, in the recent years, attempted to diversify their financial resources by charging tuition fees from students, increasing the number of students, branching out to work closely with businesses and industry, and offering professional courses, consultancy and community services (Mok, 2007). Over the past two decades, the priority given by the Malaysian government to human resource development and the vision of the importance of HE, have translated into significant investments in developing the sector. According to the Eighth Malaysia Plan, education in general accounts for 20 per cent of the total government expenditure. Nearly 47 per cent of the total development allocation for education is set aside for HE, which is equivalent to Ringgit Malaysia 8.9 billion (USD 2.5 billion) out of Ringgit Malaysia 18.7 billion (USD 5.3 billion) (Salmi, 2005).

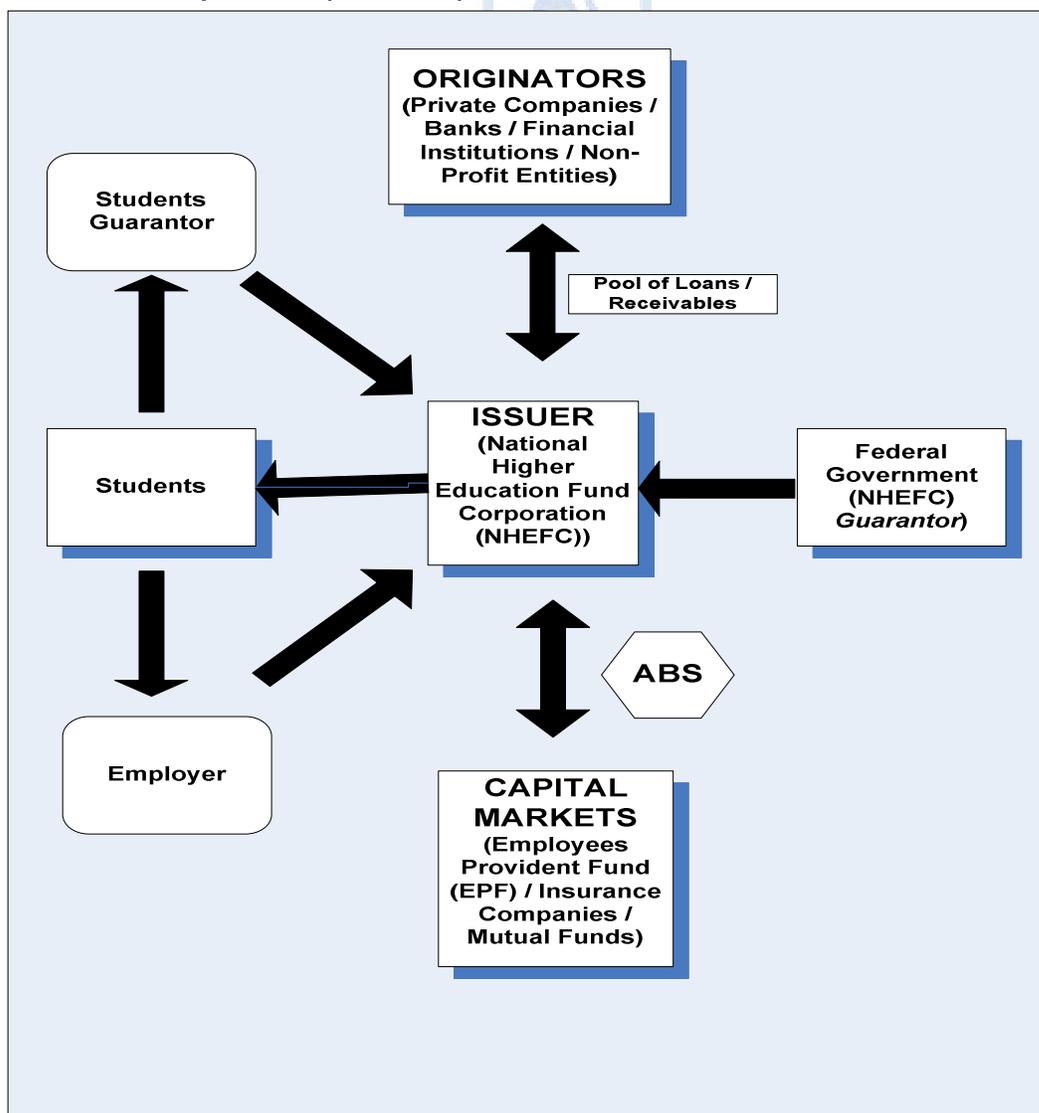
In order to drive the education sector forward, the National Higher Education Fund Corporation was founded under the National Higher Education Fund Act in 1997 (Act 566) to manage funds for the purpose of HE. The functions of this body are to offer and give educational loans in the form of financial assistance to students, and to provide administration, supervision and collection of loan settlement services (NHEFC, 2008). Furthermore, this body also takes part in collecting deposits, and designing and offering saving schemes for HE. The original objective of NHEFC is to ensure efficient loan financing for students who are eligible to pursue studies at institutions of higher learning. This is in line with government aspirations that no student should be denied access to HE because of financial reasons. NHEFC has played the role for almost ten years in helping students to pursue to HE. However, due to non-repayment of loans, NHEFC has to find alternatives to maintain the resources and the student loan backed securitization can be alternative way of creating resources.

### Proposed Conceptual Framework for Student Loan-Backed Securitization

We propose here a conceptual framework for student loan-backed securitization to be implemented in Malaysia. The point of departure for the framework is the Chilean system (Larrain and Zurita, 2007), however it is modified to suit with the characteristics of the HE system in Malaysia.

In Chile, there are six key participating agents throughout the process, i.e. students, HE institutions, government, capital market, financial system and the Managing Commission. The Chilean system process, as explained by Larrain and Zurita (2007), requires students to provide proof of their socio-economic status in order to apply. The higher education institutions (HEIs) provide partial guarantees for second year students onward during the study period. On the other hand, a specific body is formed, known as the System’s Managing Commission, to centralize all applications in a single system and determine the maximum number of students that can receive the benefit from the system. Then, it securitizes the loan

**Figure:** Proposed student loan-backed securitization process corresponding to the characteristics of the Malaysian HE systems.



portfolio obtained from the banks and receives and maintains custody of HEIs' loan guarantees. The function of the government is to determine the amount of resources available for guarantees and the amount of cash resources available to repurchase loans from banks. Banks or originators grant loans to students with direct disbursements to the HEIs and select the loans to be sold to the Managing Commission, as well as manage loans in the approved portfolio including the loans sold back to the Managing Commission. The capital market, in terms of pension funds, insurance companies, and mutual funds as long term investors, obtain the securitized portfolios, both those owned by the Managing Commission and the banks that decide to securitize them (Larrain and Zurita, 2007).

However, for the Malaysian system, we propose a slightly different process, as the originators here should be private companies, banks, financial institutions or non-profit entities, in order to provide a pool of loans. The difference with the Chilean system is that the Managing Commission or the corresponding Malaysian body NHEFC is not involved as originator, since the financial institutions are expected to securitize independently part of the pool of loan portfolios. On the other hand, the role of issuer is proposed to be undertaken by NHEFC, as the main body organising student loans in Malaysia. The federal government as well as students will guarantee loans issued by NHEFC during their study period. Once students graduate, the employers are expected to be involved through salary deduction from students' accounts to repay the loan. On the other hand, the capital market involvement is proposed to take place through the Employees Provident Fund, Insurance companies and mutual funds. The proposed conceptual framework is expected to generate resources for NHEFC through securitization of student loan, relieving the burden currently imposed on the government budget to finance the student loans in Malaysia. The Figure presents the proposed conceptual model (Ismail et al., 2008b).

Another characteristic of the proposed model is that it will involve implementing principles of sustainable finance and Islamic finance when developing the structured securities. The first Islamic securitization in Malaysia was sukuk ABS introduced in 2005 (Ripain et al., 2006), and the process involved transactions where the underlying assets could not contain any elements contradicting syariah. On the other hand, the mere pooling of non-interest bearing assets alone does not automatically create an Islamic securitization scheme. For instance, apart from elimination of the interest factor, the underlying asset would also need to fully satisfy a set of conditions. These include the presence of the asset or certainty over its deliverability, performance or availability at a future date. Next, the underlying subject matter can be adequately identified, specified or characterized without any uncertainty and that the seller has ownership over the asset (Ismail et al, 2008a).

To understand further about the Islamic securitization, we will provide as an example the process involved in the lease-based securitization. It starts with the identification of a suitable underlying asset, and to be suitable the asset must be capable of both sale and leasing. In terms of the contractual flow, the process normally starts with the originator selling the identified asset to the special purpose vehicle (SPV). The SPV will then enter into a lease contract with the originator. The lease contract creates a stream of income in the form of rental payments in favour of the SPV. The SPV then issues the sukuk that are supposed to represent an undivided proportionate ownership over the leased asset. From the Islamic legal perspective, the buyers of the sukuk effectively buy a portion of the leased asset and thus become co-owners of the asset. As owners, the sukuk-holders are also the lessors to the originator, and are therefore entitled to the stream of rental payments. Finally, at the end of the lease period, reflecting the maturity of the sukuk, the originator will redeem the sukuk from the holders through buying back the underlying asset from them (Ismail et al, 2008a).

Based on the above explanations as well as the overall expectations, the Islamic securitization in Malaysia has received worldwide syariah compliance endorsement. It is

accepted in major markets in the Middle East and Europe. The endorsement ensures acceptability of the Islamic securitization by the international markets.

## Conclusion

The student loan-backed securitization process has the potential to resolve the problem in the Malaysian HE in providing funding for the costs of education. Students and families are expected to benefit from this research, as securitization of student loans would provide adequate financial resources to students. This research will also compliment the aspiration of Malaysia to develop a viable bond market, where ABS is expected to take place through highly rated corporate and government bonds in the Malaysian financial markets by 2010 (Capital Market Master plan, 2001). Thus ABS is expected to have significant growth in conjunction with an active bond market by 2010. Therefore, this research is timely and can contribute to the body of knowledge in the Malaysian bond market.

The authors believe that student loan-backed securitization is poised to perform well once introduced, and set to outperform most private debt securities. Therefore, it would become an important corporate debt financing for originators, and also appeal to Malaysian investors as a form of investment. The Malaysian ABS market has been consistently developing over the last eight years, and is currently overcoming recent doubts in the efficiency of structured instruments through incorporating in their design principles of sustainable finance and Islamic finance. The Malaysian ABS is improving its position significantly in terms of number and size of issues. By looking at the positive trends, the authors have a strong confidence that the introduction of student loan-backed securitization in the Malaysian capital market is expected to increase in momentum and provide a viable source of financing to the National Higher Education Fund Corporation.

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