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A BORROWER WILL BE 114 WHEN BONDS BACKED BY HER STUDENT LOANS MATURE

Billions in bonds wouldn't be paid off in time, so issuers extended maturities by decades to avoid downgrades

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Julie Chinnock is 50 years old and owes about $250,000 in student loans. She was happy to get a new payment plan that lowered her monthly bill, but the holders of two bonds backed by her loans were probably less cheerful.

The two bonds were due in 2043 and 2054, but Ms. Chinnock and other borrowers were paying less each month under a new government plan that tied debt payments to income. Because borrowers were taking longer to pay off their loans, there was a risk the bonds backed by the loans wouldn't be paid off in time. Bond-rating firms were watching and getting ready to downgrade the highly rated bonds, potentially causing losses for investors.

The issuer of the bonds and the investors who owned them hatched a plan to avoid the downgrades. Their solution: make sure bonds were paid off in time by extending their maturity dates by decades. The bonds that include a big chunk of Ms. Chinnock's loans now mature in 2083, when she will turn 114.

Today, the bonds are rated triple-A. Altogether, issuers have extended maturities on about $11.5 billion of outstanding bonds backed by mostly older-vintage student loans, extending maturity dates by as much as 54 years.

"I certainly wish that there was a better system for affording education in this country," says Ms. Chinnock, a nurse anesthetist in Seattle who sold her house to help pay down her student loans.

Altogether, Americans owe about $1.5 trillion in student loans, a small slice of which is held by investors who bought bonds backed by the loan payments. The standoff between investors and ratings firms over the bonds' potential defaults shows how long it will take some borrowers to pay off their debt. It also shows the potential burden faced by the federal government, which guarantees most of the investor-held loans and owns the majority of the remainder.

For investors, these bonds are appealing because the government guarantee means there is little risk and because they pay a healthy yield, which is generally higher than riskier bonds backed by credit-card debt. Investors can always sell the bonds if they don't want to hold them to the maturity date.

Bond-ratings firms like Moody's Corp. and Fitch Ratings follow strict rules. They will downgrade a security if they don't think it will pay off by the due date, even when the underlying loans are guaranteed by the federal government. "Even in the event all principal will eventually be received after the maturity date, this still must be treated as a default, technical or otherwise," Sandro Scenga, a spokesman for Fitch, said in a statement.

Investors who hold on will eventually get paid back, but a downgrade might cause them to suffer a temporary loss. “People don’t want to buy bonds that get downgraded,” said Theresa O’Neill, a research analyst at BofA Securities.

Some bonds went on a ratings roller-coaster ride, including a $406 million chunk of triple-A debt that Moody’s downgraded to junk on Nov. 1, 2016. Later that month, the maturity date was moved from 2026 to 2055. Within weeks, Moody’s upgraded the bond back up to triple-A.

Other bonds ended up with widely divergent ratings. A $30 million chunk of a 2008 student bond deal is either triple-A, if you believe Moody’s, or deep inside junk territory, if you believe Fitch. That bond is also now due in 2083.

A Moody’s spokesman said the firm’s ratings may differ from those of other firms “and that is precisely their value – they reflect our view, no one else’s.” He said the firm updates its ratings to account for new information, such as a change in the maturity date.

Congress created the maturity issue when it let borrowers tie their payments to their income. The program, known as income-based repayment, began in 2009. The program capped federal student loans’ monthly payments at 15 percent of discretionary income, which meant some loans wouldn’t be paid off when the securities they backed came due.

These particular bonds were sold by private lenders that originated federally guaranteed student loans. About $262 billion of those loans remain outstanding and 26 percent are in default, Education Department data show. Under the guarantee, the federal government pays off the loans when borrowers die.

Congress ended that program in 2010 and replaced it with direct lending via the Education Department. These newer loans, which are held by the government, total about $1.2 trillion, of which 10 percent, or about $120 billion, are in default, department data show.

In 2015, Moody’s put approximately $37 billion worth of bonds originated by the private lenders on review for potential downgrades as it revamped its methodology to account for slower repayments. Big student loan bond issuers Navient Corp. and Nelnet Inc. argued the moves were overly punitive.

Bond fund manager TCW Group Inc. reached out to Navient to figure out how to avoid downgrades on the securities, according to Scott Austin, co-head of TCW’s $86 billion securitized products portfolio. TCW owned one of the bonds that includes Ms. Chinnock’s student loans. A provision included in the deals allowed issuers to extend their final maturities – but only if all bondholders agreed.

Getting 100 percent approval from bondholders was tricky since it is hard to know who owns a bond at any given time. Navient reached out to investors at industry conferences and at its own investor day meetings, worked the phones and used a social network to identify owners and ask if they would be willing to extend the final maturities by many years, often decades.

TCW’s Mr. Austin readily agreed because doing so “mitigated the risk that the rating agencies would have to downgrade the bonds,” he said in an interview. So did Columbia Threadneedle Investments, which owned on behalf of a bank one of the bonds backed by Ms. Chinnock’s debts. A downgrade would mean the bank would have to hold more capital against the bond because it would be considered riskier, according to Jason Callan, a senior portfolio manager at the firm.

In total, Navient managed to get 100 percent bondholder approval on 62 securities with about $9.1 billion outstanding, or about 14 percent of its $65.7 billion book of federally guaranteed student loan bonds. Nelnet won approval for about $2.4 billion, or about 12 percent of its book, according to data compiled by the companies and Wall Street Journal research.

The threat of downgrades got the attention of federal regulators at the Consumer Financial Protection Bureau. In a 2015 report, the agency's student loan ombudsman cited issuers' "economic incentive to ensure that bonds backed by these loans perform on schedule" as a concern because it might mean issuers steer borrowers toward temporary payment pauses and away from income-based repayment plans that provide longer-term relief.

In January 2017, the CFPB sued Navient for allegedly "failing borrowers at every stage of repayment. " Navient says the CFPB's allegations are false and is fighting the lawsuit.

None of the drama over the bonds' struggles did anything to change Ms. Chinnock's plight. Ms. Chinnock earned two bachelor's degrees, two masters and a doctorate. She says she kept going back to school to boost her income to pay off her accumulated debt. In 2017, she sold her house in Portland, Ore., and used about $185,000 to pay down her student loans. She now rents and has deferred saving for retirement and buying a new car to make ends meet while servicing her student debt.

"I take responsibility for the loans," Ms. Chinnock says.