PAYING THE PRICE: THE HIGH COST OF PRIVATE STUDENT LOANS AND THE DANGERS FOR STUDENT BORROWERS

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EXECUTIVE SUMMARY

Private student loans are made by lenders to students and families outside of the federal student loan program. They are not subsidized or insured by the federal government and may be provided by banks, non-profits, or other financial institutions. The borrowing limits in the federal loan programs, the skyrocketing cost of higher education and aggressive lender marketing have fueled the growth of private student loans. Although still a smaller percentage of overall student loans, the yearly growth of private loans is outpacing that of federal loans. Private loans now comprise about 24% of the nation's total education loan volume.

Private student loans are almost always more expensive than federal loans. This is especially true for borrowers with lower credit scores or limited credit histories. Private loans also do not have the same range of protections for borrowers that government loans have. Further, borrowers are more likely to borrow unaffordable amounts since, unlike most federal loans, there are no loan limits for private loans.

Supply and Demand in the Private Student Loan Market

The Demand: Who is Borrowing and Why?

The skyrocketing cost of college combined with relatively stagnant loan limits in the federal loan programs have contributed to increased demand for private student loans. A further contributing factor is the shift in federal assistance away from grants toward loans.

The majority of private loan borrowers are undergraduates. However, professional students are more likely to borrow and receive higher amounts. There is some evidence that students are turning to private loans before exhausting their federal loan options.

The Supply Side: The Student Loan "Push" Market

Private loans help mask the reality that many borrowers cannot afford to attend the college of their choice. Instead of selecting a less expensive alternative, many borrowers take out private loans. These decisions are encouraged by lenders' targeted, aggressive marketing.

It is extremely important to promote choice in higher education, regardless of a student's financial resources. The question is whether this goal is attained through increased private loan borrowing. Most important is whether the private loans are sustainable so that the debt does not bury students later down the road.

A main reason for the increased supply of private student loans is the profitability of this business. The private loan market has been profitable primarily because originators sell the loans with the intention of packaging them for investors. The market for securitized student loans jumped 76% in 2006, to $16.6 billion, from $9.4 billion in 2005. Student loans asset-based securities (ABS) accounted for about nine percent of total U.S. ABS issuance in 2005.

Lenders must sell a certain amount of loans in order to generate sufficient pools of loans to sell to investors. As a result, creditors make and sell loans to borrowers, but with the specific goal of selling them to investors. Loan products are thus developed *for* the repackaging rather than to provide the most affordable and sustainable products for borrowers.

Key Problems for Borrowers and Review of Private Loan Terms

Ratings agencies and other interested parties have traditionally reported relatively low default rates for private student loans. There are signs, however, that the situation is growing worse and that a growing number of loans are beginning to fail.

In some cases, the loans are so expensive that they are destined to fail. In addition, many borrowers run into unexpected life traumas such as disabilities or divorces that ruin their dreams of upward mobility. Regardless, the student loan debt that was supposed to be an investment in their futures is dragging them down.

NCLC reviewed twenty-eight private loans issued between 2001 and 2006, looking for warning signs and potential problems. Key findings included:

1. Pricing

All of the loans in our survey had variable rates. The lowest initial rate in our sample was around 5% and the highest close to 19%. The average initial disclosed annual percentage rate (APR) for the loans in our survey was 11.5%.

Some of the margins were shockingly high. Multiple loans in our survey had margins of close to 10%. This means that the variable rates for those loans were set at the prime rate plus nearly 10%. The average margin was about 4.8%. A borrower taking out a loan with a margin of 4.8% at the time this report was written would have an initial interest rate of 7.25% plus 4.8% or 12.05%. As a comparison, the average margin for one-year adjustable rate mortgage loans in 2006 was 2.76%.

None of the loans we examined contained a rate ceiling. A few set floors. These floors are particularly unfair for borrowers in an environment of declining interest rates.

Nearly all of the loan notes we examined stated explicitly that the borrower's school was a factor in pricing the loan. Some lenders will not offer loans to students at particular schools. Others will offer the highest rates to students at "riskier" schools, generally meaning those schools with higher default rates. Pricing based on institution has raised concerns about possible discrimination against borrowers in protected racial groups.

2. Origination and Other Fees

There are no limits on origination and other fees for private student loans. According to the loan disclosure statements we reviewed, there were origination charges in all but about 15% of the loans. For those with origination fees, the range was from a low of 2.8% up to a high of 9.9%. The average in our survey was 4.5%.

Most of the lenders in the private student notes we surveyed reserved the right to charge additional fees for other services. Every lender charged late fees, generally defined as payments made ten days after the due date, but in some cases fifteen days. The typical fees were up to $15 or 5% of the payment due, whichever is less, or in some cases the greater of that amount.

A number of the lenders in our survey reserved the right to charge fees to arrange deferments or forbearances for borrowers. One lender also set out a list of other charges including $10 to provide copies of loan payment histories, $15 per hour for research with a one hour minimum and $5 for loan verifications.

3. Disclosures

Private loans under $25,000 are covered by the Truth in Lending Act (TILA). We do not know the percentage of private lenders that comply with the law. However, at least some TILA disclosures were provided for all of the loans in our survey. We found a number of problems with these disclosures.

The current TILA regulations allow considerable flexibility in the timing and form of disclosures for private student loans. In some cases, we found that the lenders did not follow the regulations. In other cases, although the lenders were in compliance with current rules, we believe that the disclosures are likely to be confusing for many borrowers.

Most lenders provided two APR disclosures, one for the interim period before repayment began and one describing the rate once repayment began. However, not all disclosed the proper rates.

4. Flexible Repayment Plans

Private loan creditors may offer flexible arrangements, but they are not required to do so. None of the loan notes we surveyed specifically provided for income-based repayment. A few stated that borrowers would be able to choose alternative repayment plans in certain circumstances. However, the specific criteria and circumstances were not spelled out in the agreements. Only a few mentioned that graduated repayment was possible. In these cases, the loan contract stated that these plans would be offered only <u>if available</u>. There is no information provided about when such plans are available.

In our experience representing borrowers through the Student Loan Borrower Assistance Project, we have found private lenders to be universally inflexible in granting long-term repayment relief for borrowers. Even in cases of severe distress, the creditors we have contacted have offered no more than short-term interest-only repayment plans or forbearances. This experience holds true for both for-profit and non-profit lenders.

5. Postponing Payments

As with flexible repayment, private loan creditors are not required to offer forbearance or deferment options. In most of the loan notes in our survey, the lenders provided an in-school deferment option. However, interest generally accrued during this period and borrowers were given the choice of paying the interest while in school or approving capitalization once they enter repayment.

No forbearance rights were specified in nearly half of the loans in our survey. Creditors may offer these plans, but they do not inform borrowers about available choices ahead of time in the loan notes. All of the lenders who provided forbearances explained that the option was available for no more than six months, regardless of the number of forbearances requested. A number of lenders in our survey disclosed that they would charge fees to process forbearance and deferment requests. The fees were generally up to $50 for forbearances.

6. Work-Outs and Cancellations

In our experiences representing borrowers in financial distress, lenders, including non-profit lenders, have not been willing to cancel loans or offer reasonable settlements. The lenders have said they will cancel loans only in very rare circumstances. Private lenders generally do not discharge student loan debt upon death of the original borrower or co-signer. A number of loans in our study stated explicitly that there will be no cancellation if the borrower or co-signer dies or becomes disabled.

7. Mandatory Arbitration Provisions

Sixty-one percent of the loan notes in our survey contained mandatory arbitration clauses. These clauses are just one example of lenders' systematic strategy to limit a borrower's ability to challenge problems with the loans or with the schools they attend. Mandatory arbitration clauses are very controversial and are hallmarks of predatory loans.

8. Default Triggers

Borrowers are in default on federal loans if they fail to make payments for a relatively long period of time, usually nine months. They might also be in default if they fail to meet other terms of the promissory note. There are no similar standardized criteria for private loan defaults. Rather, default conditions for private student loans are specified in the loan contracts. In most cases, borrowers will not have a long period to resolve problems if they miss payments on a private student loan. Private loans may go into default as soon as one payment is missed.

A few of the default "triggers" in the loans we reviewed were particularly troubling. For example, the typical loan we reviewed stated that borrowers could be declared in default if "in the lender's judgment, they experience a significant lessening of ability to repay the loan" or "are in default on any other loan they already have with this lender, or any loan they might have in the future."

The last category closely resembles the heavily criticized "universal default clause" common in many credit card agreements. A borrower could be current on the loan in question, but still go into default if he misses payments on a separate loan with that creditor. Another troubling trigger is the lender's discretion to declare a default if the lender believes that the borrower is experiencing a significant lessening of her ability to repay the loan. If interpreted broadly, a borrower could be placed in default if she requests a temporary postponement of loan payments due to job loss or some other factor.

9. The Holder Notice and Other Borrower Defenses

In order to minimize risk and make the loans more attractive for investors, private lenders have aggressively sought to limit a borrower's ability to raise defenses to the loan based on violations of the law or that the lender breached the contract or that the consumer does not owe the amount claimed. These rights are extremely important in the private loan context where many creditors have close arrangements with schools that allow them to market their private loan products. There have been very serious problems with some of these schools, including examples of schools that were not properly licensed or certified, pressuring borrowers to take out private loans.

Some lenders have sought to evade potential liability in these cases. They have done so in a number of ways. Many simply do not include the holder notice in the loan notes. Nearly 40% of the loans in our survey followed this potentially illegal approach. Other lenders include the notice but attempt to deny borrowers its benefits by placing contradictory clauses in the notes. In our survey, 90% of the notes that included the FTC notice undermined it in some way by attempting to prohibit borrowers from raising defenses.

10. Misleading and Deceptive Information About Borrower Bankruptcy Rights

Student loan creditors have pushed hard to limit the safety net for borrowers who get in trouble. One of the most notable examples is the 2005 Congressional decision to make private student loans as difficult to discharge in bankruptcy as federal loans. This was a severe blow to consumers. The rationale for limiting bankruptcy rights for federal borrowers is also suspect, but is even less reasonable for private loan borrowers. These borrowers are often stuck with very high rate loans and fees. In contrast, most other unsecured debt is dischargeable in bankruptcy.

Lenders have argued that the bankruptcy provision was necessary to encourage lenders to offer private loans at reasonable rates. In fact, there is no evidence that loans were more expensive prior to the bankruptcy change or less expensive afterwards. Volume has grown steadily throughout the years without regard to borrower bankruptcy rights, which have only been limited for private loans since 2005.

Regardless of the rationale for the bankruptcy limitations, 61% of the loan notes in our survey included a clause that mischaracterized a borrower's rights in bankruptcy. While it is useful for borrowers to know that they may have trouble discharging the loans in bankruptcy, it is not useful, and potentially a violation of consumer protection laws, to mislead borrowers about their rights.

Other problems included:

- **Waiver Clauses.** One of the notes in our survey contained a clause requiring the borrower to repay the loan even if she is under eighteen (a minor) when he signs it. These types of "wavier clauses" are illegal under most state unfair and deceptive acts and practices laws.

- **Venue Restrictions.** All of the notes in our survey stated that any actions initiated by the lender or consumer would have to be filed in the lender's home state. These clauses are yet another effort by lenders to avoid potential liability and prevent borrowers from challenging improper or illegal behavior. Clearly most borrowers with limited resources will be unable to file lawsuits far from where they live. These clauses apply not only in cases where borrowers are affirmatively suing lenders, but also if the lender is suing the borrower.

Parallels to the Mortgage Market: A Sad Déjà Vu

We cannot say with certainty that the student loan market is headed for the same fate as the subprime mortgage industry, but there are ominous signs. Defaults are growing, variable rates are climbing, and growing numbers of borrowers are unable to make payments. For example, seventeen months after First Marblehead arranged a 2005 package of student loans, 2% had defaulted. A comparable 2006 package, also seventeen months after issue, had a default rate of 3.98%. Sallie Mae reported that it wrote off $142.6 million for borrowers missing payments on student loans in the July-September 2007 quarter, more than doubling a $67.2 million write-down of a year earlier. Fitch is also noting increasing forbearance levels among many private lenders.

The parallels between the two industries are critical not only because of the effects on the larger credit market, but because of the ways in which these trends impact two of our most important social goals—access to homeownership and education. The report describes a number of parallels, including:

Parallel #1: Market Problems

Analysts say rising defaults, coupled with federal subsidy cuts, are beginning to strain the student loan industry. A few lenders have stated that they will cut back on lending, especially to "high risk" for-profit institutions. It is not yet clear whether this trend will spread.

A tighter market for private student loans, if it occurs, might make credit less available, but this should help pull aside the curtain and show the reality that in the long-run expensive credit does not promote equal access to education. Private loans are not a solution to the problem of rising costs.

The truth is that less credit may be a good thing for borrowers if it means less predatory credit. Borrowers will still be able to utilize the more affordable federal loan programs. If there is a mass exodus of lenders participating in the federal guaranteed loan program, borrowers can still use the government's Direct Loan program.

Parallel #2: Outsourcing of Social Goals

Higher education and asset accumulation through homeownership are keys to upward mobility in this country. Both social goals have been largely outsourced to private market forces.

Parallel #3: Lack of Regulation and Enforcement

Because national banks and other national financial institutions are involved, federal rather than state regulators are usually responsible for oversight of both the mortgage and student loan industries. To date, oversight in both industries has been woefully inadequate.

Parallel #4: Risk-Based Pricing

Nearly all of the private student lenders utilize credit scores to price their products. Similarly, over 90% of mortgage lenders and credit-card issuers use credit scores as part of the lending decision.

The notion of charging the highest price to the supposedly riskiest borrowers is problematic on a number of levels. It presumes that the credit industry is sophisticated enough to properly identify who is "risky" and who is not, how to price "risk" and that those setting the "risk" price are sufficiently knowledgeable and honest not to conflate genuine risk with illegitimate factors. However, research in the subprime mortgage market suggests that higher interest rates and fees may create the risk, rather than compensate for it.

Further, the goal of risk-based pricing is to measure the risk *for the lender*. Abuses in the subprime mortgage market have revealed, however, that loan prices are not based solely on risk and that, in fact, opportunity pricing has reigned. Prices are significantly beyond those needed to cover risk-related costs. Moreover, they have not considered the borrower's risk—that is, affordability—but rather the originator and investor's risk.

Charging the highest rates and adjusting the rates to the most vulnerable consumers has been a recipe for disaster in the mortgage industry. The question is whether a similar crisis is on the horizon for student loan borrowers.

Parallel #5: Alleged Benefits for Lower-income and Consumers of Color

In the wake of the subprime foreclosure crisis, many industry representatives and policymakers argue that subprime lending has been a net gain for higher-risk borrowers, including low-income borrowers and communities of color. Similar claims are made in the student loan industry.

There is more data available in the mortgage industry and it shows that in fact, many lower income consumers and consumers of color could have obtained better credit. Instead, the worst products were pushed on them with aggressive marketing and reverse redlining. This has hardly been a boon for these communities. Moreover, contrary to popular assertions, subprime lending has not contributed to homeownership. Since 1998, subprime lending has led to a net loss of homeownership for almost one million families.

Similar trends are appearing in the private student loan market. Despite the widespread availability of student loans, there is still a pervasive gap in access to higher education among lower-income individuals and individuals of color. Statistics also show lower college completion rates for minority students.

Parallel #6: Predatory Terms

Many of the problems we found in the student loans we reviewed can also be found in subprime mortgage products, including:

- High rates;
- High Fees; and
- Mandatory arbitration clauses.

Parallel #7: Disclosures for Mortgages and Student Loans are Inadequate or Not Properly Given

In the current market, with complex products driven by securitization and products made for Wall Street rather than Main Street, borrowers can not rely on disclosures to ensure they get the loan they want and can afford. Consumers have limited understanding of the credit market. Lenders, in contrast, design, develop and market subprime loans; they can be expected to understand the products and the risk. Most consumers are not able to use disclosures to assess the fit between their situation and their loan.

Parallel #8: Push Marketing

The practice of creating products for investors began in the mortgage market and has been exported to credit cards and student loans and other industries. Securitization by Wall Street has resulted in loans made for investment rather than for family wealth-building. Loan products have been developed for the repackaging rather than to provide the most affordable and sustainable products for borrowers.

Parallel #9: Servicing and Work-Out Problems

The "atomization" of the lending process, where so many different parties are involved in origination and servicing, also means that each party along the chain can deny responsibility. Originators no longer hold the loan, and, in many cases, are thinly capitalized. Investors try to hide behind holder in due course status, despite the fact that they are profiting from the abuse. Due to the pervasiveness of securitization, these problems occur in both the mortgage and student loan industries.

It is difficult for consumers to fight back especially since they have no choice of a servicer. The servicers are working on behalf of the securitizers and trustees that contract with them. A related problem in both industries is the refusal of most creditors to assist borrowers in trouble.

Parallel #10: Lack of Reliable Data and Information

Publicly available data about mortgage loans, while more plentiful than that for other credit products, is still scarce. The lack of this type of information in the private student loan context is a major impediment to understanding the scope of the problem and helping borrowers.

POLICY RECOMMENDATIONS

Higher education is the gateway to a secure economic future for many Americans. It is no secret that access to higher education is diminished by soaring costs. More and more, students are risking their financial futures by taking out expensive loans to finance education. Unfortunately, market failures and abusive lending practices are stripping the benefits of higher education from millions of students. This is especially true in the private student loan market where there is little regulation despite the high cost of these loans and lack of protections for borrowers.

Below is a policy framework to help preserve access to affordable higher education by addressing problems with private student loans. This framework is followed in the report by more detailed recommendations.

Any new student financial assistance legislation should be based on the following principles:

- Eliminate unsustainable loans and develop fair underwriting standards;
- Eliminate incentives for schools and lenders to steer borrowers to abusive loans;
- Improve disclosures so that borrowers can know the true cost of private loan products and understand the difference between private and government loans;

- Require accurate and accountable loan servicing;
- Ensure effective rights and remedies for borrowers caught in unaffordable loans;
- Preserve essential federal and state consumer safeguards; and
- Improve assistance to distressed borrowers.

PAYING THE PRICE: THE HIGH COST OF PRIVATE STUDENT LOANS AND THE DANGERS FOR STUDENT BORROWERS

INTRODUCTION

The effects of the subprime lending meltdown are being felt far beyond the mortgage market. Consumers are also struggling with other types of high-rate credit. Investors with stakes in credit cards and student loans are getting increasingly nervous.

In the past, student loans were less vulnerable to market changes because most of the loans were originated or guaranteed by the federal government. Federal law regulates loan terms and requires lenders to provide a number of borrower protections. The newer private student loan market, in contrast, is much more susceptible to the volatility that has affected other credit markets.[1] Private student loans, many of which are both subprime and predatory, have proliferated in recent years and now comprise about 24% of the nation's educational loan volume.

This report focuses on the growth of the private student loan market and its consequences. We first summarize the trends in the industry, including a comparison of private student loans to federal loans. We also discuss who is borrowing these loans and why. The next sections focus on problems with private student loans, including a discussion of parallels to the subprime mortgage crisis. The final section presents policy recommendations to protect borrowers.

WHAT ARE PRIVATE STUDENT LOANS?

Private student loans are made by lenders to students and families outside of the federal student loan program. They are not subsidized or insured by the federal government and may be provided by banks, non-profits, or other financial institutions.

Private student loans are similar to federal student loans in a number of ways. Both can be used to help finance educations and can be certified only up to certain amounts. Until recently, both private and federal loans were generally processed through school financial aid offices. Many schools include information about private loans in student aid packages. However, some financial aid officers have been wary of these products and have developed procedures to discourage use of private loans such as requiring students who want private loans to go through a formal petitioning process.

In recent years, many lenders have bypassed the schools and marketed their private student loan products directly to consumers. For example, First Marblehead Corp., a leading player in packaging student loans into structured securities, received approximately 64% of its

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[1] Private loans are also known as private-label or alternative loans. Throughout this report, we refer to these products as "private loans" or "private student loans."

private student loan applications on-line in 2005.[2] A borrower still generally has to provide proof of enrollment in school in order to obtain a private student loan.

Despite these similarities, there are a number of very important differences between federal and private loans, including:

- **Underwriting.** With the exception of PLUS loans, federal loan borrowers do not have to meet creditworthiness standards to obtain federal loans. The assumption is that it is unfair to price student loans based on credit scores since students generally have artificially low credit scores due to their limited credit histories. Private loans, in contrast, are priced according to credit worthiness standards. In September 2002, the Institute for Higher Education Policy found that only two of 259 private loan products it reviewed were credit-blind.[3]

- **Pricing.** All federal loans have interest rate caps, in most cases with fixed rates set at 6.8%. In contrast, nearly all private loans have variable interest rates with no upper limits. Many of these loans are very expensive, with interest rates up to 15% or higher. A number of products in our survey had variable rates set at prime plus a margin of almost 10%.[4]

- **Loan Limits.** There are loan limits for the various federal loan programs. The only exception is PLUS loans. Parents or graduate students may take out PLUS loans equaling the cost of attendance minus any other financial aid received. For private loans, the PLUS loan exception is the rule. There are no regulations setting a maximum dollar amount on how much a student can borrow. Generally, lenders allow students to borrow up to the cost of attendance minus other aid.

- **Borrower Protections.** Federal loans come with a range of borrower protections that are mandated in the federal Higher Education Act, including income-based repayment, deferment and cancellation rights. In contrast, private lenders are not required to offer any particular relief.

- **Flexibility.** Unlike federal loans, private loans can be used to supplement student need and are usually available throughout the year. Some private lenders also offer products for nontraditional students or those in nontraditional programs that do not qualify for federal aid.

- **Application Process.** Private loan borrowers are not required to fill out the complicated federal application form, known as the "FAFSA." Many companies tout the simplicity of the private loan application and approval process. The

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[2] Joseph Keeney, "The Supply Side of Student Loans: How Global Capital Markets Fuel the Student Loan Industry", in Footing the Tuition Bill 136, 138 (Frederick M. Hess ed., 2007).

[3] Catherine A. Wegmann, Alisa F. Cunningham, Jamie P. Merisotis, The Institute for Higher Education Policy, "Private Loans and Choice in Financing Higher Education" at 15 (July 2003).

[4] A margin is the number added to the index to determine the interest rate on a variable rate loan.

Astrive company, for example, describes the student loan application process as requiring just "five easy steps." NextStudentLoans also promotes its fast, easy online application.

- **Regulation.** Federal loans are regulated through the Higher Education Act (HEA). Private loans, in contrast, are regulated (or not) in much the same way as other types of private credit, such as credit card installments or mortgage loans. Oversight largely falls within the jurisdiction of federal regulators because banks and financial institutions are now entitled to federal preemption of state laws. As in the mortgage market, federal enforcement actions to curb problems in the private student loan market have been virtually nonexistent.

  The federal Truth in Lending Act (TILA) applies to most private student loans, as long as the amount involved is less than $25,000. Federal student loans are not covered by TILA, but the HEA contains its own disclosure-related provisions. A key difference is that TILA allows borrowers to bring private enforcement actions while the HEA does not. However, TILA only mandates disclosures about private student loan credit as opposed to regulating substantive terms such as rates and fees.[5]

  The Department of Education has traditionally stated that private student loans are not within its oversight authority. Congress could, however, regulate private student loans through the HEA or other federal laws. Proposals pending in 2008 would do that, although mainly with respect to enhanced disclosures and transparency.

- **Information and Data Collection.** Significant data about federal student loan borrowing is available through the National Center for Education Statistics and other related resources. Information about federal loan defaults is available on the Department of Education's web site, broken down into numerous categories including type of institution. Borrowers are also able to access information about their federal loans through the National Student Loan Data System (NSLDS). There is no similar comprehensive resource for private loans. Lenders do not publish proprietary data on their loans. The data that is available is based on various estimates. The CollegeBoard, for example, uses data from an informal pool of the largest non-federal loan sponsors.[6]

- **Marketing.** Unlike federal loans, private loan products have widely varying terms. There are many sources of profit for lenders, some derived from fees charged at origination. The marketing is often misleading. For example, lenders might advertise rates "as low as" certain amounts. Actual rates will be disclosed only after a borrower provides her personal credit history.

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[5] See generally National Consumer Law Center, Truth in Lending (6th ed. 2007).

[6] See generally College Board, "Trends in Student Aid 2007" (2007), available at http://www.collegeboard.com/prod_downloads/about/news_info/trends/trends_aid_07.pdf.

Most private lenders also offer federal loans. This allows them to develop a brand identity that they hope will lead federal loan borrowers to choose the same company for their private loans. In the worst case scenario, private lenders push borrowers into their private products.

- **Shopping for Loans.** Although there is a need for better and more focused information about federal loans, confusion is minimized to some extent by the standardized terms of these loans.

  The situation is much different for private loans. To date, there are few reliable resources borrowers can use to shop around and compare products. According to an investigation by New York Attorney General Andrew Cuomo, at least some web sites that claim to offer comparison services are in reality serving as cover for particular lenders.[7] Part of the problem, according to Robert Shireman, Executive Director of the Project on Student Debt, is that loan comparison sites have to find a revenue stream, which means they have to provide some kind of benefit to the lenders who are willing to pay them.[8]

  Due to the recent scandal in the industry involving improper ties between schools and lenders, borrowers who have traditionally turned to financial aid offices for information are understandably less secure that they are receiving objective advice.[9] Further, the private student loan industry has become so diverse and complex that it is difficult for many financial aid offices to keep up with new developments and provide accurate and timely advice to students.

- **Collection.** Both federal and private lenders use third party collection agencies to pursue delinquent and defaulted borrowers. Private student lenders have fewer collection powers than federal collectors. This gap is closing, however, as private lenders have fought to obtain many of the same collection rights as the government. They succeeded in persuading Congress in 2005 to make private loans as difficult to discharge in bankruptcy as federal loans. Since 2005, nearly all student loan borrowers must prove "undue hardship" in court in order to discharge their loans. Courts have been very restrictive in applying this standard.[10]

  Private lenders also often argue in litigation that they have similar collection rights as the government even though the basis for these claims is shaky at best. Both private and federal collectors charge collection fees. Depending on state

7 Andy Guess, Inside Higher Ed, "Consumer Reports for Student Loans" (Oct. 22, 2007).
8 Id.
9 See, e.g., U.S. Senate Health, Education, Labor and Pensions Committee, "Report on Marketing Practices in the Federal Family Education Loan Program", June 14, 2007, available at: http://kennedy.senate.gov/imo/media/doc/Student%20Loan%20Report.pdf.
10 See generally National Consumer Law Center, "No Way Out: Student Loans, Financial Distress and the Need for Policy Reform" (June 2006), available at: http://www.studentloanborrowerassistance.org/uploads/File/nowayout.pdf.

law and loan contracts, the collection fees may actually be lower for private loans.

Although in theory, private student loans may have some advantages over federal loans in terms of flexibility and less restrictive collection tactics, the bottom line is that private loans are almost always more expensive than federal government loans. This is especially true for borrowers with lower credit scores or limited credit histories. Unlike most government loans, there are no loan limits that will help prevent over-borrowing. Private loans also do not have the same range of protections for borrowers that government loans have.

THE GROWTH OF THE PRIVATE STUDENT LOAN INDUSTRY: HOW DID WE GET HERE?

In order to understand the growth of private loans, it is important to take a step back and trace the evolution of government financial aid. Before World War II, American colleges historically provided financial aid directly to their students. The 1944 G.I. bill signaled a new type of government involvement in education aid as well as recognition of the connection between higher education and economic productivity. [11] The G.I. bill guaranteed military personnel a year of education for 90 days service, plus one month for each month of active combat duty, with a maximum award of 48 months of benefits.

The G.I. bill was even more popular than its drafters envisioned. To keep up with demand, the government added the College Scholarship Service, a prelude to National Defense Student Loans, which later became the Perkins loan program.

The federal family education loan program (FFELP), also known as the guaranteed loan program, was created in the Higher Education Act of 1965. Banks were initially reluctant to participate. Congress encouraged participation by covering a large percentage of any losses through loan guarantees. When banks were still reluctant to join the program, Congress created a government-sponsored enterprise—the Student Loan Marketing Association (known as SLMA or Sallie Mae) as a secondary market for guaranteed student loans.[12]

Over time, the focus in the federal loan program shifted toward providing more benefits for middle income students. Among other changes, in the 1992 Higher Education Act, Congress created the unsubsidized loan program. This allowed students of any income level to get federally guaranteed student loans. This was followed by the new Federal Direct Loan Program, which allowed students to borrow money directly from the government.[13]

Since the 1965 HEA, the government has relied on a market-based student loan system. This system came about for a number of reasons, including government fears about the budget consequences of holding large loan portfolios. Without the banks acting as

[11] John R. Thelin, "Higher Education's Student Financial Aid Enterprise in Historical Perspective", in Footing the Tuition Bill 19, 22-24 (Frederick M. Hess ed., 2007).
[12] Id. at 32-35.
[13] Id. at 38.

intermediaries, the loans would be listed as outstanding on the government's books, potentially increasing the federal deficit.[14] When the model did not immediately attract private lenders, the system was not abandoned, but rather subsidized, first to ensure that banks would originate the loans and later to ensure a secondary market for those loans. From the outset, the federal student loan system was not a free market.[15] It has always been a subsidized industry.

The limits in the federal loan programs and the reliance on a market model helped fuel the growth of private student loans. By 2003, the total volume of private loans had surpassed the amounts awarded annually under the Student Educational Opportunity grants and federal work study. Borrowing from private sources now equals about 24% of total education loan volume.[16]

Although still a smaller percentage of overall student loans, the yearly growth of private loans is outpacing that of federal loans. In 2005-06, federal loan volume equaled nearly $69 billion while private loan volume was slightly more than $16 billion. However, according to the Institute for Higher Education Policy, some project that Stafford loan volume will grow annually by only 8%, whereas private loan volume will grow by 25%.[17] Subsidized Stafford loans declined from 54% of total education loans in 1996-97 to 32% in 2006-07.[18]

There is no question that a very profitable student loan industry has thrived and survived the various historical twists and turns. The harder question is whether students have benefited.

SUPPLY AND DEMAND IN THE PRIVATE STUDENT LOAN MARKET

The Demand: Who is Borrowing and Why?

The skyrocketing cost of college combined with relatively stagnant loan limits in the federal loan programs have contributed to increased demand for financial aid. The cost of college has been rising steadily for years. In just the school year from 2006-2007 to 2007-2008, tuition and fees for in-state students at public four year colleges and universities rose 6.6%. The increases were over 6% as well for students at private four year colleges and universities and at for-profit institutions.[19]

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14 Joe Nocera, "The Profit and The Pauper," New York Times Education Life at 15 (July 29, 2007).

15 Andrew Rudalevige, "Opportunity Costs: The Politics of Federal Student Loans" in Footing the Tuition Bill 42, 69 (Frederick M. Hess ed., 2007).

16 College Board, Press Release, "Federal Student Aid to Undergraduates Shows Slow Growth, While Published Tuition Prices Continue to Rise" (Oct. 22, 2007).

17 Institute for Higher Education Policy, "The Future of Private Loans: Who is Borrowing, and Why?" at iii (December 2006).

18 College Board, "Trends in Student Aid 2007" at 2 (2007), available at http://www.collegeboard.com/prod_downloads/about/news_info/trends/trends_aid_07.pdf.

19 Id.

The number of jobs requiring college degrees has also grown dramatically. Fifty years ago, just 15% of the adult population pursued higher education, and only 15% of new American jobs were thought to require it. Today, more than half of the population pursues postsecondary education, and an estimated 60% of new American jobs call for a college degree.[20]

A further contributing factor is the shift in federal assistance away from grants toward loans. Increases in grant dollars between 1996-97 and 2006-07 covered only an average of about a third of the increase in private college tuition and fees and half of the increase in average public four-year college tuition and fees.[21]

The majority of private loan borrowers are undergraduates. However, professional students are more likely to borrow and receive higher amounts.[22] In 2003-2004, nearly a quarter of all professional students took out a private loan, compared with 5% each of all undergraduate and all graduate students.[23]

Among undergraduates, seven percent of dependent students took out private loans with an average amount of $6,350.[24] Three percent of independent students took out private loans with an average amount of $5,054.[25] However, 33% of all private loan borrowers were independent.[26] These borrowers tended to have lower family incomes than dependent students and were more likely to work full-time while enrolled in school. Those who chose to take out private loans, according to the Institute for Higher Education Policy, may have been trying to focus more on school rather than having to work full-time to pay for school or take fewer classes.[27] Private loan borrowing increased most for full-time dependent students enrolled in for-profit institutions.[28]

There is some evidence that students are turning to private loans before exhausting their federal loan options. A 2003 study by the State PIRGs Higher Education Project found that nearly 75% of private loan borrowers took on private loans without first exhausting federal grant, work-study, and loan options and/or available family contributions.[29]

Another study by the Institute for Higher Education Policy found that most private loan borrowers are also taking out federal loans, but that not all are exhausting federal aid.

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[20] Frederick M. Hess and Juliet Squire, "The Student-Loan System Needs a Major Overhaul", The Chronicle of Higher Education (September 21, 2007).
[21] College Board, "Trends in Student Aid 2007" at 2 (2007), available at http://www.collegeboard.com/prod_downloads/about/news_info/trends/trends_aid_07.pdf.
[22] Institute for Higher Education Policy, "The Future of Private Loans: Who is Borrowing, and Why?" at v (December 2006).
[23] Id. at vi.
[24] Id. The Department of Education considers students to be dependent if they are under 24 years old, not enrolled in a masters or doctoral program, unmarried, not veterans of the U.S. Armed Forces, or do not have children who receive more than half of their support from them.
[25] Id.
[26] Id. at 16.
[27] Id. at 26.
[28] College Board, "Trends in Student Aid 2007" at 13 (2007), available at http://www.collegeboard.com/prod_downloads/about/news_info/trends/trends_aid_07.pdf.
[29] Kate Rube, State PIRGs' Higher Educ. Project, "Private Loans: Who's Borrowing and Why?" (April 2003).

According to this study, 80% of dependent undergraduate private borrowers and 76% of independent undergraduate private borrowers in 2003-04 also received a federal Stafford loan. Of those who received a Stafford loan, only 82% of dependent and 53% of independent students received the maximum amount.[30]

Many private lenders will disclose, at least on their web sites, that borrowers should try to get federal loans first. However, some sites send borrowers directly to private loan companies.[31] In any case, the advice to exhaust federal loan eligibility conflicts with marketing strategies that are centered on the desirability of getting a loan as quickly as possible.

Demand for private student loans may be affected by the new federal program which allows graduate and professional students to obtain federal PLUS loans. Previously PLUS loans were available only to parents borrowing on behalf of their children. However, the majority of private loans in total volume are for undergraduates who are ineligible for PLUS loans. The Fitch rating service has stated that the creation of a grad PLUS program is likely to have only a nominal impact on private loan origination volume, at least in the short term.[32] The long-term impact, if any, remains to be determined.

Fitch has stated that demand for private student loans should continue to grow as long as federal programs fail to meet need and as long as college costs continue to rise. Student loan growth is not tied to the same factors that drive consumer lending, such as economic cyclicality and housing prices. In fact, the market exhibits some counter-cyclicality. In general, demand for student loans is linked to enrollment and tuition expenses.[33]

Demand may also remain strong as long as students' parents continue to face financial pressures and are less willing or able to help finance expensive educations for their children. Some financial aid directors have noted a trend toward parents wanting their children to take charge and be liable for their education costs.[34]

The Supply Side: The Student Loan "Push" Market

The original Higher Education Act sought to provide college access to needy students. Over time, it has been transformed into a program that increasingly subsidizes college choice. Private loans help mask the reality that many borrowers cannot afford to attend the college of their choice. Instead of selecting a less expensive alternative, many borrowers take out private loans. These decisions are encouraged by lenders' targeted, aggressive marketing.

It is extremely important to promote choice in higher education, regardless of a student's financial resources. The question is whether this goal is attained through increased

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[30] Institute for Higher Education Policy, "The Future of Private Loans: Who is Borrowing, and Why?" at vi (December 2006).
[31] The Institute for College Access and Success, "Shopping for Student Loans: Treacherous Territory" (April 25, 2007), available at: http://views.ticas.org/2007/04/shopping_for_student_loans_tre.html.
[32] Fitch Ratings, "Special Report: An Education in Student Lending 2007" at 5, 8 (February 5, 2007).
[33] Id. at 8.
[34] See Sandra Block, "Private Student Loans Pose Greater Risk", USA Today (Oct. 25, 2006).

private loan borrowing. Most important is whether the private loans are sustainable so that the debt does not bury students later down the road.

A main reason for the increased supply of private student loans is the profitability of this business. In recent years, lenders like Sallie Mae have attained unprecedented growth and profits largely through their private loan products. Such loans contributed 23% of Sallie Mae's "core" earnings in 2006 in what *Fortune* has called an extraordinarily profitable business. Although currently experiencing problems, Sallie Mae's return on equity, which was over 30% in 2006, is one of the highest among American companies, and its executives are compensated lavishly. [35] In a 2006 Institute for Higher Education Report, an investment banker is quoted as saying private student loans are likely "the fastest growing segment of consumer finance-and by far the most profitable one."[36]

The private loan market has been profitable largely because originators sell the loans with the intention of packaging them for investors. The market for securitized student loans jumped 76% in 2006, to $16.6 billion, from $9.4 billion in 2005. [37] Student loans asset-based securities (ABS) accounted for about nine percent of total U.S. ABS issuance in 2005. [38]

Lenders must sell a certain amount of loans in order to generate sufficient pools of loans to sell to investors. This is a key characteristic of a "push market", where products are offered not only in response to consumer need, but also due to investor demand. As a result, creditors make and sell loans to borrowers, but with the specific goal of selling them to investors. Loan products are thus developed for the repackaging rather than to provide the most affordable and sustainable products for borrowers. As discussed in detail below, this model has prevailed in the mortgage market as well.

Both federal and private loans are securitized. There are currently a small number of large investors. The more risk-averse investors prefer federal loan pools and private loan pools that are rated AAA. [39] With only a few exceptions to date, securitization of federal and private student loans have been marketed separately to investors.

Private lenders have worked hard to sell their products to investors by touting their profitability and by addressing risk concerns. The prospectuses contain detailed descriptions of how the companies are addressing potential risks for investors. For example, most private lenders charge borrowers guarantee fees and then purchase insurance with companies like The Education Resource Institute (TERI). [40] The companies prominently advertise the fact that private student loans are generally not dischargeable in bankruptcy.

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[35] Bethany McLean, "The Surprising Profits of Student Loans", Fortune (April 16, 2007).

[36] Institute for Higher Education Policy, "The Future of Private Loans: Who is Borrowing, and Why?" at 14 (December 2006).

[37] Associated Press, Jitters Spread to Student-Loan Market (Dec. 10, 2007).

[38] Joseph Keeney, The Supply Side of Student Loans: How Global Capital Markets Fuel the Student Loan Industry" 136, 146 in Footing the Tuition Bill (Frederick M. Hess ed., 2007).

[39] Id.

[40] TERI is the oldest and largest private, nonprofit guarantor of private student loans. Loan guarantees are provided for a fee and ensure the lender 100% principal repayment, along with capitalized and/or accrued interest on defaulted loans. TERI's fees are dependent on the loan type and risk profile of the borrower.

Another reason for increased supply of private loans is that the federal loan products have become less profitable over time. Most recently, Congress made significant cuts in subsidies for participating lenders. Many lenders see the writing on the wall and are diversifying their products, especially by expanding into the more lucrative private student loan market. Most lenders in the federal loan program also sell private loans.[41] Lenders in some cases developed private products to help provide supplements to students and to remain on school preferred lender lists. As federal loans become less profitable, many are leveraging their federal products to promote sales of private loans.

The push market is sustained through aggressive marketing. As with credit cards and other industries, student loan consolidators, brokers and companies are encouraging students to borrow. Television and radio advertisements are starting to appear as frequently as the pre-subprime mortgage crisis advertisements for home refinancings.

TAKING A CLOSER LOOK AT PRIVATE STUDENT LOANS: KEY PROBLEMS FOR BORROWERS

Introduction

Lenders are required to disclose potential problems and risks to investors. As a result, more information about potential risks is given to investor than to borrowers. The underlying question is whether most students would finance their educations using private loans if they understood the potential dangers. This section examines this question more closely, focusing on whether the private loan products are affordable and sustainable for student borrowers and their families.

Although it is hard to measure in dollar amounts, the human cost of unaffordable private loan debt is alarming. For example, a social worker in Massachusetts racked up over $100,000 in private student loan debt. The starting salary for a social worker in her area is around $25,000. She has been working in a job she loves for ten years, but earns less than $40,000 annually. She believes, with good reason, that she will never be able to pay off her student loan debt. She will not benefit from the new public service loan forgiveness program because it applies only to federal loans. Federal PLUS loans for graduate students were not available when she went to school. She is stuck, along with many other borrowers from all economic classes who simply cannot afford to repay their private student loans.

In some cases, the loans are so expensive that they are destined to fail. In other cases, borrowers ran into unexpected life traumas such as disabilities or divorces that ruin their dreams of upward mobility. Regardless, the student loan debt that was supposed to be an investment in their futures is dragging them down.

We do not yet know the extent to which private student loans will fail. This is a relatively new market and to date, the creditors have provided limited data on default and

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[41] A review of materials from seven of the largest private student loan lenders found that all sold both federal and private student loan products. Christopher Mazzeo, "Private Lending and Student Borrowing", in Footing the Tuition Bill 74, 77 (Frederick M. Hess ed., 2007).

write-off rates. Ratings agencies and other interested parties have traditionally reported relatively low default rates for private loans. There are signs, however, that the situation is growing worse.

For example, seventeen months after First Marblehead arranged a 2005 package of student loans, 2% had defaulted. A comparable 2006 package, also seventeen months after issue, had a default rate of 3.98%.[42] Sallie Mae reported that it wrote off $142.6 million for borrowers missing payments on student loans in the July-September 2007 quarter, more than doubling a $67.2 million write-down of a year earlier.[43] Fitch is also noting increasing forbearance levels among many private lenders.[44] Analysts have speculated that one reason might be less availability of credit to consumers, so that students who typically borrowed to make payments cannot do that any longer.[45]

Ultimately, the success for investors will depend on whether private loan creditors have properly estimated the risk of the loans they are making.[46] It also depends on whether the demand for private loans is as great as the companies and others think it will be and whether students will earn enough to pay them back. Private lenders say they have made good estimates, but many stock analysts are not so sure. In the words of one industry veteran, "The high interest rates lenders charge students who have marginal credit...will be crippling in the long run, both to the individuals and to the nation." [47]

Fitch Ratings also stated in a 2007 report that the current low charge-off rates in the industry would be unsustainable over the long-term. According to Fitch, this makes an appropriate allowance for loan losses more important. They noted with concern that one of the largest lenders, Sallie Mae, has instead reduced allowances over time.[48]

Others assert that the industry will suffer if Congress passes proposed legislation addressing some of the problems in the industry. Some argue that lenders might counteract the costs of proposed legislation by reducing borrower benefits, passing origination fees onto borrowers, and cutting back on loans extended to higher-risk borrowers.

If this sounds familiar, it's because it unfortunately is. Informed observers and consumer advocates issued similar warnings about the high-cost and adjustable rate mortgage products that lenders and their associates pushed on consumers in recent years. Charging the highest rates and adjusting the rates to the most vulnerable consumers has been a recipe for disaster in the mortgage industry. The question is whether a similar crisis is on the horizon for student loan borrowers.

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42 Keith J. Winstein, "First Marblehead Shares Battered by Possible Student Loan Defaults", The Wall Street Journal (December 6, 2007).

43 Associated Press, "Jitters Spread to Student-Loan Market", (Dec. 10, 2007).

44 Fitch Ratings, "Special Report: An Education in Student Lending 2007" at 13 (February 5, 2007).

45 Keith J. Winstein, "First Marblehead Shares Battered by Possible Student Loan Defaults", The Wall Street Journal (December 6, 2007).

46 See generally Richard Lee Colvin, "Marketing Opportunity: Challenges and Dilemmas", in Footing the Tuition Bill 157-181 (Frederick M. Hess ed., 2007).

47 Richard Lee Colvin, "Marketing Opportunity: Challenges and Dilemmas", in Footing the Tuition Bill 157, 181 (Frederick M. Hess ed., 2007).

48 Fitch Ratings, "Special Report: An Education in Student Lending 2007" at 13 (February 5, 2007).

There are ominous signs, but the data is still incomplete. The next sections of this report focus on other ways to predict whether problems are likely to arise. The first section includes a review of private loan documents, looking specifically for warning signs of problems for borrowers. This is followed by a discussion of the causes of the crisis in the mortgage industry and the parallels between the mortgage and private student loan industries.

Review of Private Loan Terms

The sections below are based on general research as well as our review of twenty-eight private student loans issued between 2001 and 2006. The loans in our survey were originated by six different lenders, including Sallie Mae, Wachovia, Key Bank, GMAC Bank, Bank of America, and Wells Fargo.

We highlight key terms below, first comparing each category to the federal student loan programs and then describing specific problems with the private loans.

1. Pricing

Pricing is a clear and important difference between federal and private loans. Interest rates on federal loans are fixed and there are specific interest rate caps. For loans made on or after July 1, 2006, Stafford loans have a fixed 6.8% interest rate. PLUS loans incurred after July 1, 2006 also have fixed interest rates up to 8.5%.[49] Congress recently passed legislation that will reduce these rates for certain loans over time.[50]

Most private loans, in contrast, have variable interest rates. All of the loans in our survey had variable rates. The lowest initial rate in our sample was around 5% and the highest close to 19%. The average initial disclosed annual percentage rate (APR) for the loans in our survey was 11.5%.

Some of the margins were shockingly high. Multiple loans in our survey had margins of close to 10%. This means that the variable rates for those loans are set at the prime rate plus nearly 10%. The average margin was about 4.8%. A borrower taking out a loan with a margin of 4.8% at the time this report was written would have an initial interest rate of 7.25% plus 4.8% or 12.05%. As a comparison, the average margin for one year adjustable rate mortgage loans in 2006 was 2.76%.[51]

None of the loans we examined contained a rate ceiling. A few set floors. For example, one note states that the variable rate will never be less than 9.25% regardless of changes to the prime rate. These floors are particularly unfair for borrowers in an environment of declining interest rates.

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[49] 20 U.S.C. §1077a(l)(2). 34 C.F.R. §682.202 (FFEL); 34 C.F.R. §685.202 (Direct).
[50] The College Cost Reduction and Access Act, P.L. 110-84.
[51] Inside Mortgage Financing Publications, The 2007 Mortgage Market Statistical Annual, Volume 1: The Primary Market.

The lack of upper limits on student loan rates contrasts with adjustable rate home mortgage transactions in which creditors must disclose the maximum interest rate that may be imposed during the term of the obligation.[52] The Truth in Lending Act does not set the maximum interest rate. This is at the discretion of the creditor. However, there must be a limit and this must be disclosed. State usury limits generally do not apply since most student lending is through banks or other entities that are not subject to applicable usury rates in states in which they do business. They are only bound by any limits set by their home states, which are typically deregulated and do not set rate limits.

Most private lenders price their loans based on credit scores. As a result, those borrowers with the most blemishes or no credit history will get the highest priced loans. Mark Kantrowitz of Finaid.org concludes that fewer than 10% of student borrowers qualify for the best rates and more than 75% get the worst.[53]

There are some innovators in the industry, such as MyRich Uncle, that instead price some of their loans based upon a borrower's projected earnings. The company takes into account such information as grades, major and school attended.[54]

Nearly all of the loan notes we examined stated explicitly that the borrower's school was a factor in pricing the loan. Some lenders will not offer loans to students at particular schools. Others will offer the highest rates to students at "riskier" schools, generally meaning those schools with higher default rates. A review of Sallie Mae loans found that rates for products targeted to supposedly higher-risk borrowers, such as community college students and adults returning to school, could be as high as prime plus nine percent.[55]

Loan pricing may even vary among students in the same school system. Nancy Coolidge, coordinator of student financial support for the University of California's ten campuses, reported to the *New York Times* that students at some U.C. campuses were getting less desirable terms. At Santa Cruz, for example, students with the worst credit were paying up to 19.32% to Education Finance Partners and 14.25% to Sallie Mae with fees of up to 8%. The university decided to use the system's volume to improve rates, requesting bids for the top spot on the preferred lender list.[56]

Pricing based on institution has raised concerns about possible discrimination against borrowers in protected racial or gender groups. New York Attorney General Andrew Cuomo sent a letter to Congress in which he compared this approach to redlining in the mortgage industry.[57] In fact, this type of pricing should be described as reverse redlining, a practice of targeting marketing of the most expensive credit products at borrowers in protected classes. A lawsuit filed in January 2008 against Sallie Mae alleges that the company

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[52] 12 U.S.C. §3806; Reg. Z 12 C.F.R. §226.30(a). See generally National Consumer Law Center, Truth in Lending §4.8.2 (6th ed. 2007).
[53] Laura Pappano, "Lessons From the Loan Scandal" New York Times Education Life at 16-17 (July 29, 2007).
[54] See, e.g., Anne Marie Chaker, "How One Firm Mined the Student-Loan Mess" The Wall Street Journal at D1 (August 2, 2007).
[55] Christopher Mazzeo, "Private Lending and Student Borrowing", in Footing the Tuition Bill 74, 81 (Frederick M. Hess ed., 2007).
[56] Laura Pappano, "Lessons From the Loan Scandal" New York Times Education Life at 16-17 (July 29, 2007).
[57] Id.

discriminates against minority borrowers by taking colleges' default rates into account when setting interest rates. Institutions that serve large numbers of minority students often have higher default rates than other colleges do.[58]

2. Origination and Other Fees

There are limits on origination fees in the federal loan programs. There are no origination or other fees or charges permitted for Perkins loans and limited fees allowed for Direct and FFEL Stafford loans. The previous limits were set at 4%. However, the Higher Education Reconciliation Act of 2005 made changes to reduce and eventually eliminate origination fees for Stafford loans.[59] There are also origination fees for PLUS loans, up to 4%.[60]

Federal lenders are required to disclose the amount and method of calculating the origination fee.[61] In addition, federal loan borrowers should not be charged for any costs related to processing or handling of any applications or data required to determine a student's eligibility to borrow.[62]

There is no such regulation of origination and other fees for private student loans. The Institute for Higher Education Policy described fees in private student loans ranging from 0 to 11%.[63] About 85% of the loans in our survey had origination charges. For those with fees, the range was from a low of 2.8% up to a high of 9.9%. The average in our survey was 4.5%.

Most of the lenders in the private student notes we surveyed reserved the right to charge additional fees for other services. Every lender charged late fees, generally defined as payments made ten days after the due date, but in some cases fifteen days. The typical fees were up to $15 or 5% of the payment due, whichever is less, or in some cases the greater of that amount.

A number of the lenders in our survey reserve the right to charge fees to arrange deferments or forbearances for borrowers. One lender also sets out a list of other charges including $10 to provide copies of loan payment histories, $15 per hour for research with a one hour minimum and $5 for loan verifications.

3. Disclosures

Private loans under $25,000 are covered by the Truth in Lending Act (TILA). We do not know the percentage of private lenders that comply with the law. However, at least some

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58 Kelly Field, "Borrowers Accuse Sallie Mae of Racial Discrimination", The Chronicle of Higher Education (January 18, 2008).
59 20 U.S.C. §1087-1(c). 34 C.F.R. §682.202(c) (FFEL); 34 C.F.R. §685.202(c)(Direct).
60 20 U.S.C. §1087-1(c)(6).
61 20 U.S.C. §1087-1(c)(4).
62 20 U.S.C. §1094(a)(2).
63 Institute for Higher Education Policy, "The Future of Private Loans: Who is Borrowing, and Why?" at 6 (December 2006).

TILA disclosures were provided for all of the loans in our survey. We found a number of problems with these disclosures.

The current TILA regulations allow considerable flexibility in the timing and form of disclosures for private student loans.[64] In some cases, we found that the lenders did not follow the regulations. In other cases, although the lenders were in compliance with current rules, we believe that the disclosures are likely to be confusing for many borrowers. Reform is needed, as discussed below in the recommendations section, to help make the disclosures more useful for borrowers.

The Truth in Lending regulations include special rules for interim student credit extensions.[65] These are defined as credit plans that involve extensions of credit for education purposes where the repayment amount and schedule are not known at the time the credit is advanced.[66] For interim credit extensions under a student credit program, the creditor is not required to disclose the finance charge, payment schedule, the total of payments, or the total sale price. The Federal Reserve Board Commentary elaborates that creditors must make complete disclosures at the time the creditor and consumer agree on the repayment schedule for the total obligation. The creditor may delay the required disclosures until the due date of the first payment. The rationale is that the repayment amount and schedule are unknown at the time credit is advanced. The disclosures given at the time the interim note is executed should reflect two annual percentage rates, one for the interim period and one for the repayment period.

We could not ascertain based on a review of the notes whether the borrowers received the subsequent disclosures at the time of repayment. Most lenders provided two APR disclosures, one for the interim period before repayment began and one describing the rate once repayment began. However, not all disclosed the proper rates. Although creditors are allowed to disclose two separate APRs, if they choose to add the capitalized interest to the finance charge in the initial disclosure, the APR must reflect that decision. We found, for example, in a 2005 loan note that the lender added the estimated capitalized interest that would accrue prior to repayment to the finance charge, which was correct, but nevertheless understated the APR by nearly 4%. The APR after repayment begins should have been 15% rather than 11%. The lower APR was based on having added the capitalized interest to the amount financed rather than the finance charge. One explanation for this error is that the lender was trying to avoid calling attention to a larger APR. Regardless of motive, this miscalculation is a clear violation of the Truth in Lending Act.

Borrowers should get much clearer information about what the terms of the loan will be once repayment begins. One way to do this would be to require lenders to provide estimates of all important terms that will apply once repayment begins at the time of disbursement. The lender could note that these are estimates, but this will give the borrower a better sense of what the terms will be when she goes into repayment. Lenders may provide this information under current rules, but are not required to do so.

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64 TILA explicitly does not apply to federal student loans. 20 U.S.C. §1083(c). The HEA does, however, have its own disclosure provisions.

65 Reg. Z, 12 C.F.R. §226.17(i).

66 Commentary to Reg. Z, 12 C.F.R. §226.17(i).

In a 2007 study of student loan disclosures, Consumers Union highlighted the importance of providing straightforward disclosures of rates and terms of private loans at the time the borrower receives loan approval.[67] Consumers Union's research found that consumers want lenders to provide the information once the lender has approved the loan and set an interest rate.[68] Federal regulators should also test various student loan disclosures as they are now doing for credit cards and other credit products to get a better sense of what works best for borrowers.

In addition, lenders should be required to provide cancellation rights to borrowers. Most of the lenders in our survey offered cancellation periods. However, under the Truth in Lending Act, it does not appear that they are required to do so. The number of days allowed for borrowers to cancel varied. In only one case were borrowers given thirty days to cancel. In about 44% of the loans we surveyed, borrowers were given three days. About 28% provided for a ten day cancellation period. Twenty-two percent of the loan notes we surveyed specified no cancellation period.

4. Flexible Repayment Plans

Federal loans come with a range of flexible repayment options, including specific programs such as rehabilitation for borrowers who have defaulted on their loans and income-based repayment plans.[69] Private loan creditors may offer flexible arrangements, but they are not required to do so. In a 2006 report, the Institute for Higher Education Policy noted that no private lenders in their study offered income-based repayment.[70] None of the loan notes we surveyed specifically provided for income-based repayment. A few stated that borrowers would be able to choose alternative repayment plans in certain circumstances. However, the specific criteria and circumstances were not spelled out in the agreements. Only a few mentioned that graduated repayment was possible. In these cases, the loan contract stated that these plans would be offered only <u>if available</u>. There is no information provided about when such plans are available.

It appears that lenders are concerned about whether offering flexible repayment would affect their ability to sell their loan packages to investors. For example, industry observers such as Fitch Ratings have noted that a mandated income-based repayment policy could have a highly disruptive effect on the flow of low-cost capital to the industry. According to Fitch, if such policies were mandated for private loans, it could ultimately result in responsible borrowers subsidizing irresponsible ones through higher interest rates.[71] This

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67 Consumers Union, "Helping Families Finance College: Improved Student Loan Disclosures and Counseling" (July 2007), available at: http://www.consumersunion.org/pdf/CU-College.pdf.
68 Id. at 20.
69 For more information about federal loan repayment, see National Consumer law Center, Student Loan Law (3d ed. 2006 and Supp.) and the National Consumer Law Center's Student Loan Borrower Assistance Project web site at http://www.studentloanborrowerassistance.org.
70 Institute for Higher Education Policy, "The Future of Private Loans: Who is Borrowing, and Why?" at 6 (December 2006).
71 Keeney, "The Supply Side of Student Loans: How Global Capital Markets Fuel the Student Loan Industry" in Footing the Tuition Bill 136, 252 (Frederick M. Hess ed., 2007).

is another example of the conflict between developing the best product for investors versus developing the product that works best for borrowers.

Further, the depiction of borrowers who get into trouble as irresponsible is very troubling. Numerous studies show that most borrowers who get into trouble, at least on the federal loan side, do so because of unexpected life traumas. Others simply are unable to find jobs as expected after graduation. In a phone survey of student loan borrowers, the Texas Guaranty Agency found that repayers were likely to have jobs related to their training both during school and afterwards, while defaulters did not.[72]

In our experience representing borrowers through the Student Loan Borrower Assistance Project, we have found private lenders to be universally inflexible in granting long-term repayment relief for borrowers.[73] Even in cases of severe distress, the creditors we have contacted have offered no more than short-term interest-only repayment plans. This experience holds true for both for-profit and non-profit lenders. When asked about a long-term income-based repayment plan, we consistently hear lenders say that this is not in the best interests of borrowers because they will never pay down their balances if the payments are too low. This shows a lack of understanding of the dire circumstances of many borrowers. Most borrowers want to repay their loans as soon as possible. However, this is not realistic for many borrowers, especially those struggling with severe financial distress, disabilities, or other problems. They are first and foremost trying to avoid default and manage the debt situation.

5. Postponing Payments

The federal loan programs provide borrowers with a wide range of forbearance and deferment options. Deferments are available only prior to default. These include deferments for unemployed borrowers and those who can show economic hardship. There are time limits for most federal deferments, with the notable exception of military deferments. Both discretionary and mandatory forbearances are available.

As with flexible repayment, private loan creditors are not required to offer forbearance or deferment options. In most of the loan notes in our survey, the lenders provided an in-school deferment option. However, interest generally accrued during this period and borrowers were given the choice of paying the interest while in school or approving capitalization once they enter repayment.

No forbearance rights were specified in nearly half of the loans in our survey. Creditors may offer these plans, but they do not inform borrowers about available choices ahead of time in the loan notes. All of the lenders who provided forbearances explained that the option was available for no more than six months, regardless of the number of forbearances requested. Interest accrues during the forbearance period. A number of lenders

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72 Texas Guaranty Student Loan Corporation, "Predicting Which Borrowers Are Most Likely to Default" (1998), available at: http://www.tgslc.org/publications/reports/defaults_texas/ins_intro.cfm.
73 For more information about NCLC's Student Loan Borrower Assistance Project, see http://www.studentloanborrowerassistance.org.

in our survey disclosed that they would charge fees to process forbearance and deferment requests. The fees were generally up to $50 for forbearances.

6. Work-Outs and Cancellations

In our experiences representing borrowers in financial distress, lenders, including non-profit lenders, have not been willing to cancel loans or offer reasonable settlements. The lenders have said they will cancel loans only in very rare circumstances. For example, one lender told us that they will consider cancellations in circumstances where a borrower has a very serious disability. However, they require more than proof of a federal disability cancellation. Private lenders generally do not discharge student loan debt upon death of the original borrower or co-signer. A number of loans in our study stated explicitly that there will be no cancellation if the borrower or co-signer dies or becomes disabled.

No Way Out

Patrick K. was 22 years old in 2006, just a semester away from graduating from the University of Rhode Island, when his life changed forever. He suffered a terrible accident, falling down a long escalator and suffering severe brain damage. His parents, doctors and nurses have fought hard to keep him alive, but the prognosis is not good. Patrick is in a minimally conscious state and is incapable of consistent communication, fully dependent upon others for all of the activities of daily life.

Patrick's family has struggled to find resources to pay for his care. There was no appropriate care available in Massachusetts, so they are paying for private care in New Hampshire. They are also using up their retirement and other resources to retrofit their home so that it will be accessible for Patrick when they bring him home.

Patrick took out federal loans to finance his education and also worked during the summers to earn money for college. His federal loans were discharged based on permanent and total disability. He also used private loans to help fill the gap. To get a better rate, his mother co-signed on the loans. These were not the highest rate private loans. Because Patrick's Mom co-signed, they were able to get a decent interest rate. The problem is the lack of a safety net when this tragedy occurred.

There are two loans, held by the non-profit Massachusetts Education Finance Authority (MEFA), with balances of about $22,000. Patrick's Mom has struggled to make the monthly payments. She has done so up until now, but the extra resources needed to pay for Patrick's care have put her over the edge. In addition, her husband was recently diagnosed with a serious illness. Patrick's Mom has asked MEFA to forgive the remaining balances. Alternatively, she has offered to settle the debt for less than the amount owed through payment of a lump sum. To date, the lender has refused, offering nothing more than short-term forbearances or short periods of interest only payments.

7. Mandatory arbitration clauses

Sixty-one percent of the loan notes in our survey contained mandatory arbitration clauses. These clauses are just one example of lenders' systematic strategy to limit a borrower's ability to challenge problems with the loans or with the schools they attend.

Mandatory arbitration provisions, buried in many kinds of consumer contracts, require consumers to waive their right to use the court system, and instead limit consumers to resolving their disputes with the lender through a binding arbitration process. This constraint puts the lender in a stronger position, because little discovery is available, the lender can pick the arbitration service provider (and repeat players bring more business, leading to an incentive for the arbiter to rule for the lenders), and decisions cannot be appealed. In addition, after it became clear that these clauses did not fully terminate the ability to bring class actions, lenders also are requiring class action prohibitions within arbitration.

Mandatory arbitration clauses are very controversial and are hallmarks of predatory loans. The Center for Responsible Lending lists mandatory arbitration clauses as one of the seven signs of predatory lending.[74]

8. Default Triggers

Borrowers are in default on federal loans if they fail to make payments for a relatively long period of time, usually nine months. They might also be in default if they fail to meet other terms of the promissory note.

There are no similar standardized criteria for private loan defaults. Rather, default conditions for private student loans are specified in the loan contracts. In most cases, borrowers will not have a long period to resolve problems if they miss payments on a private student loan. Private loans may go into default as soon as one payment is missed.

All of the contracts we studied specified other criteria for default in addition to missing payments. A promissory note used by one bank, for example, listed the following default triggers. You are in default if you:

- Fail to make monthly payments when due, or
- Die, or
- Break other promises in the loan Note, or
- Begin a bankruptcy proceeding, or assign assets for the benefit of creditors, or
- Provide any false written statement in applying for any Loan subject to the terms of this Note or at any time during the term of the Loan, or
- Become insolvent, or
- In the lender's judgment, experience a significant lessening of your ability to repay the Loan, or
- Are in default on any Loan you already have with this lender, or any Loan you might have in the future."

The last category is particularly troubling because it closely resembles the heavily criticized "universal default clause" common in many credit card agreements. A borrower could be current on the loan in question, but still go into default if he misses payments on a separate loan with that creditor. Another troubling trigger is the lender's discretion to declare a default if the lender believes that the borrower is experiencing a significant lessening of her ability to repay the loan. This clause appeared in a few other loans we examined as well. If interpreted broadly, a borrower could be placed in default if she requests a temporary

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74 Center for Responsible Lending, "Common Abuses: Seven Signs of Predatory Lending", available at: http://www.responsiblelending.org/issues/mortgage/sevensigns.html.

postponement of loan payments due to job loss or some other factor. The borrower might recover from her financial difficulties in a short period of time, but could still be declared in default because the lender decided that she had significantly less ability to repay the loan.

There were other troubling criteria in the loans we examined. For example, one states that the lender has the right to accelerate the loan and declare a default if the borrower or the co-borrower dies. While it is common for lenders to keep the debt alive through the probate process even if the borrower dies, it is unclear why a borrower should be in default if the co-borrower dies. In contrast, loans are discharged in the federal programs if the borrower dies.

9. The Holder Notice and Other Borrower Defenses

In order to minimize risk and make the loans more attractive for investors, private lenders have aggressively sought to limit a borrower's ability to raise defenses to the loan based on violations of the law or that the lender breached the contract or that the consumer does not owe the amount claimed. This is a serious issue in the federal loan programs as well. However, there are some key protections for federal loan borrowers, including a "holder notice" requirement. The required notice, which is based on the Federal Trade Commission holder notice, must be placed in most federal loans. The notice states that if the loan is made by the school, or if the loan is used to pay tuition and charges of a school that refers loan applicants to the lender, or that is affiliated with the lender in certain ways, the holder of the Note is subject to the claims and defenses that the borrower could assert against the school.[75] Creditors should at least be subject to state unfair and deceptive acts and practice laws if they fail to include the notice as required. In the federal loan programs, failure to do so should also be a violation of the federal Higher Education Act, subject to Department of Education oversight.

These rights are extremely important in the private loan context where many private loan creditors have close arrangements with schools that allow them to market their private loan products. There have been very serious problems with some of these schools, including examples of schools that were not properly licensed or certified, pressuring borrowers to take out private loans.[76]

Some lenders have sought to evade potential liability in these cases. They have done so in a number of ways. Many simply do not include the holder notice in the loan notes. Nearly 40% of the loans in our survey followed this potentially illegal approach. In some cases currently pending, national lenders have argued that they are allowed to ignore the holder notice requirement. They claim that the Federal Trade Commission Rule does not apply to them because the FTC does not regulate banks and that state laws requiring placement of such notice are preempted.[77] They disclaim any responsibility for illegal conduct by the schools. If the school is unlicensed or makes misrepresentation to coerce

[75] 34 C.F.R. §682.209(k).
[76] See generally National Consumer Law Center, Student Loan Law §9.7 (3d ed. 2006 and Supp.).
[77] Two court decisions in the Northern District of Ohio are split on this issue. The earlier court agreed with the bank's justification. See *Abel v. Keybank U.S.A.,* 313 F. Supp. 2d 720 (N.D. Ohio Mar. 3, 2004). The later decision agreed with the borrowers that the state law requiring notice should apply. *Blanco v. Keybank USA,* 2005 WL 4135013 (N.D. Ohio Sept. 30, 2005). Appeals are pending.

students into signing up and taking out a loan, some national lenders simply say "it's not our problem."

Other lenders include the notice, but attempt to deny borrowers its benefits by placing contradictory clauses in the notes. In our survey, 90% of the notes that included the FTC notice undermined it in some way. In most cases, these contradictory clauses stated that if the student is dissatisfied with the school or fails to complete the course, the student still must repay the note in full. This directly contradicts the holder notice which explicitly allows borrowers to raise claims related to school closure or other school-related claims against lenders. These legal claims are particularly important in cases of proprietary school fraud. Among other school-related claims, plaintiffs have alleged that schools have operated without proper licensing, falsely and illegally guaranteed jobs, and failed to provide proper equipment or materials.

These efforts to evade liability are harmful to future borrowers as well. Contrary to the basic purpose of the FTC holder notice, the lenders are placing the responsibility to police the schools on the students. Yet students have no recourse if they are given erroneous information by the schools. It seems counterintuitive that a lender would want to fund bad loans. However, this system persists because the lenders generally get rid of the loans as soon as possible by selling them to investors, as discussed above.[78]

10. Misleading and Deceptive Information About Borrower Bankruptcy Rights

Student loan creditors have pushed hard to limit the safety net for borrowers who get in trouble. One of the most notable examples is the 2005 Congressional decision to make private student loans as difficult to discharge in bankruptcy as federal loans. This was a severe blow to consumers. The rationale for limiting bankruptcy rights for federal borrowers is also suspect, but is even less reasonable for private loan borrowers.[79] As discussed throughout this report, these borrowers are often stuck with very high rate loans and fees. In contrast, most other unsecured debt is dischargeable in bankruptcy.

Lenders have argued that the bankruptcy provision was necessary to encourage lenders to offer private loans at reasonable rates. They clearly see this as a selling point for investors. In fact, there is no evidence that loans were more expensive prior to the bankruptcy change or less expensive afterwards. Volume has grown steadily throughout the years without regard to borrower bankruptcy rights, which have only been limited for private loans since 2005.

A study by Mark Kantrowitz of Finaid.org analyzed the prospectuses for two groups of securitizations, SLM and National Collegiate Student Loan Trusts. He found only a slight

[78] See generally Tom Domonoske, "The Finance Industry Fuels Revival of Trade School Scams", The Consumer Advocate, Vol. 9, No. 4 (Oct./Nov./Dec. 2003).
[79] See generally National Consumer Law Center, "No Way Out: Student Loans, Financial Distress and the Need for Policy Reform" (June 2006), available at: http://www.studentloanborrowerassistance.org/uploads/File/nowayout.pdf.

overall increase in the availability of private student loans to borrowers with credit scores less than or equal to 650 after the change in the bankruptcy law.[80]

To date, the lenders have prevailed in preserving this limit on borrower bankruptcy rights. The House of Representatives rejected a February 2008 amendment to the Higher Education Act offered by Representative Davis to restore limited dischargeability rights to private student loan borrowers.

Regardless of the rationale for the bankruptcy limitations, sixty-one percent of the loan notes in our survey included a clause that mischaracterized a borrower's rights in bankruptcy. While it is useful for borrowers to know that they may have trouble discharging the loans in bankruptcy, it is not useful, and potentially a violation of consumer protection laws, to mislead borrowers about their rights.

The first problem with the clauses we examined was that they require borrowers to acknowledge legal facts about their loans. For example, they say that the borrower understands that this is an education loan made under a program that includes Stafford and other loans and funded in part by non-profit organizations and therefore is not dischargeable in bankruptcy, except pursuant to 11 U.S.C. §523(e)(8). In fact, not all student loans meet the technical definition of a "qualified education loan" and the borrower will not know this when he signs the note.

The clauses also attempt to advance the legal argument that because the loans are guaranteed by non-profit organizations, they will fall into the "difficult to discharge" category. This is a specious legal argument that has prevailed in some courts, but certainly not in all.[81]

In addition, the clauses do not adequately explain that borrowers can get bankruptcy relief if they can prove undue hardship. Only one of the notes in our survey included an explanation that the loan is not automatically discharged and that the borrower must prove undue hardship in order to discharge the loan.

Bankruptcy courts have consistently refused to place any weight on these supposed "waiver" clauses. However, these clauses may deter a borrower from later filing for bankruptcy because he will mistakenly believe that this relief is not available. Such clauses should violate consumer protection laws, such as state unfair and deceptive acts and practices laws.

Additional Concerns

We found a number of other problems in the loans we examined, including:

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[80] Mark Kantrowitz, "Impact of the Exception for Private Student Loans on Private Student Loan Availability", (August 14, 2007), available at: http://www.finaid.org/educators/20070814pslFICOdistribution.pdf.

[81] See generally National Consumer Law Center, Student Loan Law ch. 7 (3d ed. 2006 and Supp.). This issue is relevant to loans made before the 2005 bankruptcy law changes.

- **Waiver Clauses.** One of the notes in our survey contains a clause requiring the borrower to repay the loan even if he is under eighteen (a minor) when he signs it. These types of "wavier clauses" are illegal under most state unfair and deceptive acts and practices laws.[82]

- **Venue Restrictions.** All of the notes in our survey stated that any actions initiated by the lender or consumer would have to be filed in the lender's home state. These clauses are yet another effort by the lenders to avoid potential liability and prevent borrowers from challenging improper or illegal behavior. Clearly most borrowers with limited resources will be unable to file lawsuits far from where they live. Since most lenders are based in just a few states where consumer protections are weak, such as Delaware and South Dakota, it is even less likely that the lender's home state will be convenient for the borrower.

  These clauses apply not only in cases where borrowers are affirmatively suing lenders, but also if the lender is suing the borrower. They state that the lender may bring collection or other actions against the borrower in the lender's home state. It is equally difficult, of course, for a borrower to try to defend a lawsuit outside of her home jurisdiction.

  At a minimum, these clauses should violate state unfair and deceptive acts and practices (UDAP) laws, to the extent those state laws apply to national lenders. It is a UDAP violation to file collection suits in improper counties or in districts other than where the consumer resides or signed the contract, even where the state venue statute authorizes the choice of district. It is also against these laws for creditors to attempt to have consumers waive the right to a convenient venue.[83]

  National banks, as noted above, have sought to avoid liability by arguing that state laws do not apply to them. These arguments should be challenged. However, there are also federal laws that may apply. For example, the federal fair debt collection practices act prohibits a debt collector from taking legal action to collect a consumer obligation in a judicial district other than where the consumer resides or signed the contract.[84] The category of debt collectors includes attorneys. The rights provided in this section may not be waived.

PARALLELS TO THE MORTGAGE MARKET: A SAD DEJA VU

We cannot say with certainty that the student loan market is headed for the same fate as the subprime mortgage industry, but there are ominous signs, as discussed above. The parallels are critical not only because of the effects on the larger credit market, but because of

[82] See generally National Consumer Law Center, Unfair and Deceptive Acts and Practices §4.2.15.4 (6th ed. 2004 and Supp.).
[83] Id. at §.5.1.1.4.
[84] 15 U.S.C. §1692i.

the ways in which these trends impact two of our most important social goals--access to homeownership and education.

Parallel #1: Market Problems

Investors are showing signs of discomfort about asset-based securities comprised of student loans just as they have done with mortgage loans. Analysts say rising defaults, coupled with federal subsidy cuts, are beginning to strain the student loan industry.[85] First Marblehead in a December 2007 announcement, for example, cited challenging times as the company slashed its quarterly dividend to 12 cents a share from 27.5 cents a share, and said it would not bundle any more student loans for investors during the fourth quarter.[86] Sallie Mae in late 2007 lowered its earnings forecast for 2008 by more than 13%, blaming the new law that cut federal subsidies and the need to conserve cash to offset bad loans.[87]

Some analysts believe that the failure in the mortgage market could spread to student loans. Some see only short-term problems, while others view soaring loan defaults and a potential cut in credit ratings as indicators of greater problems to come.

The explosive growth of private student loans is likely to slow down. For example, the rate of growth in the private student loan market rose only 6% in the 2006-07 academic year, after growing at an annual rate of 27% for the preceding five years.[88]

A credit crunch in other markets could affect the availability of student loans or could lead to more expensive private loans. In early 2008, several big for-profit education companies announced that they had been told by Sallie Mae and other lenders that they would severely restrict or cut back entirely on student loans to their students.[89] This has not yet developed into a larger trend and it may be that the lenders will curtail business mostly in poorly performing schools, including many proprietary schools.

The question of whether a tighter credit market, if it occurs, will harm students is complex. Many believe that other lenders will pick up any slack and make the loans. Others argue that lenders will figure out ways to stay in business and thrive. For example, their federal loan assets may become even more desirable and profitable to investors. A director for Moody's stated that while he does not expect major fallout, to the degree there is one, there might be some switching from private schools to less expensive public schools, such as community colleges.[90]

A tighter market might make credit less available, but this should help pull aside the curtain and show the reality that in the long-run expensive credit does not promote equal access to education. Private loans are not a solution to the problem of rising costs.

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85 Associated Press, "Jitters Spread to Student-Loan Market" (Dec. 10, 2007).
86 Id.
87 Associated Press, "Sallie Mae Lowers 2008 Profit Forecast" (Dec. 12, 2007).
88 Paul Basken and Goldie Blumenstyk, "Housing Market's Credit Crisis Raises Worries in Higher Education", The Chronicle of Higher Education (Dec. 14, 2007).
89 Doug Lederman, Inside Higher Ed, "The Credit Crunch Takes a Toll" (Jan. 23, 2008).
90 Paul Basken and Goldie Blumenstyk, "Housing Market's Credit Crisis Raises Worries in Higher Education", The Chronicle of Higher Education (Dec. 14, 2007).

Parallel #2: Outsourcing of Social Goals

Higher education and asset accumulation through homeownership are keys to upward mobility in this country. Both social goals have been largely outsourced to private market forces. A previous section of this report discussed the evolution of the federal student loan programs into a market-based system relying heavily on loans. Similar patterns can be seen in the federal government's mortgage policies.

Homeownership, as with student loans, was originally fostered through government-insured mortgage programs. In the face of skyrocketing foreclosures during the Depression, the U.S. Congress in 1934 enacted the National Housing Act, which created the Federal Housing Administration (FHA) and the FHA mortgage insurance program. The program was intended to be self-sustaining. FHA insurance guarantees lenders against financial loss due to foreclosure and other costs arising from delinquency or default. While the initial goal primarily was to bail out institutions and provide work in the banking industry, it also aimed at improving the housing situation of Americans.[91]

After the housing market had been stabilized, the FHA's goals steadily progressed through the years toward preserving and promoting home ownership, particularly for low-income and marginalized households. In the 1970s to 1980s, the FHA further focused its efforts on expanding mortgage opportunities for low-income borrowers. This included a substantial rise in high loan-to-value ratio lending, to assist those home purchasers without sufficient capital to make a down payment of ten to twenty percent.

In the last two decades, FHA lending has dropped precipitously, while many FHA-eligible borrowers instead found themselves with subprime loans. A GAO report found that this development was primarily attributable to restricted product choices and cumbersome origination procedures, paired with dynamic developments in the private loan market.[92] While much of the subprime market is comprised of refinancings, the portion attributable to home purchase loans seems to have replaced FHA's role in that market.

Contrary to popular assertions, subprime mortgage lending has not advanced the social goal of increased access to sustainable homeownership. Since 1998, subprime lending has led to a net loss of homeownership for almost one million families. Similarly, despite the access to private student loan credit, there is still a pervasive gap in access to higher education and college completion rates among lower-income individuals and individuals of color.

Parallel #3: Lack of Regulation and Enforcement

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[91] Kenneth T. Jackson," Crabgrass Frontier: The Suburbanization of the United States" at 203 (1985). See also Federal Housing Administration, "The FHA Story in Summary" (1959), available at: http://www.hud.gov/local/or/working/fha25year.pdf.

[92] U.S. Government Accounting Office, "Federal Housing Administration: Decline in the Agency's Market Share Was Associated with Product and Process Developments of Other Mortgage Market Participants", GAO-07-645 (June 29, 2007).

Because national banks and other national financial institutions are involved, federal rather than state regulators are usually responsible for oversight in both the mortgage and student loan markets. To date, oversight in both industries has been woefully inadequate.

A major reason we arrived at this point is because of the deregulation of consumer lending beginning in the 1980's. Federal laws passed in 1980 and 1983 preempted both state usury ceilings on mortgage lending secured by first liens (whether purchase money or not),[93] as well as state limitations on risky "creative financing" options, such as negatively amortizing loans, balloon payments, and prepayment penalties.[94] Federal deregulation also set the stage for many states to remove rate caps and other limitations on other home lending, including second mortgage lending. Unfortunately, subprime loan pricing does not reflect a functioning, transparent market. For example, during an environment of historically low interest rates, subprime adjustable rate mortgages, often with relatively high introductory rates resetting to unaffordable levels, were the dominant product in the subprime arena.

Amid a generally deregulated environment, there is one federal law in the mortgage area aimed at regulating the high-cost loan market. The Home Ownership and Equity Protection Act ("HOEPA"), passed by Congress in 1994, covers loans above certain interest rate and fee triggers and adds certain disclosure requirements and prohibitions to those loans. HOEPA has had the positive effect of acting as a ceiling on loan prices and causing investors to establish policies against buying HOEPA loans. However, the ceiling is so high that predator practices have simply migrated to lower-priced loans.[95] In addition to calls for general regulation of loan products, there are also efforts underway to enhance HOEPA by lowering the triggers and including more prohibitions.[96]

Congressional deregulation has been exacerbated by court decisions and by the regulators' effort to further extend federal preemption. In 1978, the U.S. Supreme Court's decision in *Marquette National Bank of Minneapolis v. First of Omaha Service Corp.,*[97] gave national banks the right to use their "most favored lender" status from their home state and export it across state lines, preempting the law of the borrower's home state. Although the National Bank Act's provisions explicitly address only national banks (and were drafted in a time of no interstate banking), lenders that can claim the privilege of exporting "interest" from their

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93 Depository Institutions Deregulation and Monetary Control Act of 1980, § 501 (DIDA), codified at 12 U.S.C. § 1735f-7a.

94 The Alternative Mortgage Transaction Parity Act of 1982 (AMTPA), codified at 12 U.S.C. § 3800, *et seq.* While some of the AMTPA limitations have been reversed by HOEPA, state protections on lending abuses still are limited by federal regulators' efforts to preempt state laws.

95 National Consumer Law Center, "Comments to the Federal Reserve Board regarding Home Equity Lending Market", Docket No. OP-1253 (August 15, 2006), available at http://www.nclc.org/issues/predatory_mortgage/content/HOEPACommentsAug06.pdf.

96 Mortgage Reform and Anti-Predatory Lending Act of 2007, H.R. 3915 (passed Nov. 15, 2007) *available at* http://thomas.loc.gov/cgi-bin/query/D?c110:4:./temp/~c110Jzv150::; Homeownership Preservation and Protection Act of 2007, S. 2452 (introduced Dec. 12, 2007), *available at http://thomas.loc.gov/cgi-bin/bdquery/z?d110:s.02452:.* These bills also include extensive provisions beyond HOEPA aimed at abusive mortgage origination, appraisal and servicing practices.

97 439 U.S. 299 (1978).

home state include federally-chartered savings banks and state-chartered banks with FDIC insurance and federal credit unions.[98]

The result of these broad power grabs has been that limited federal regulation often has eclipsed the state's abilities to protect their borrowers. Moreover, the OCC has asserted that state and local governmental bodies may not take administrative or judicial action against national banks and their operating subsidiaries, even to enforce state laws that do apply to national banks.[99]

During the height of the most recent wave of abusive mortgage loans, federal regulators took almost no public action. There has been a similar lack of regulatory activity in the student loan area.

Parallel #4: Risk-Based Pricing

As discussed above, nearly all of the private student lenders utilize credit scores to price their products. Similarly, over 90% of mortgage lenders and credit-card issuers use credit scores as part of the lending decision.[100]

The notion of charging the highest prices to the supposedly riskiest borrowers is problematic on a number of levels. It presumes that the credit industry is sophisticated enough to properly identify who is "risky" and who is not, how to price "risk" and that those setting the "risk" price are sufficiently knowledgeable and honest not to conflate genuine risk with illegitimate factors. However, research in the subprime mortgage market suggests that higher interest rates and fees may create the risk, rather than compensate for it.[101]

Further, the goal of risk-based pricing is to measure the risk *for the lender*. Abuses in the subprime mortgage market have revealed, however, that loan prices are not based solely on risk and that, in fact, opportunity pricing has reigned. Prices are significantly beyond those needed to cover risk-related costs.[102] Moreover, they have not considered the borrower's risk—that is, affordability—but rather the originator and investor's risk.[103]

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98 *Greenwood Trust v. Massachusetts*, 971 F.2d 818 (1st Cir. 1992) *cert. denied*, 506 U.S. 1052 (1993) (allowing a Delaware-chartered state bank to export high late charges on its Discover card to Massachusetts, where such fees otherwise would not have been allowed); *Gavey Properties/762 v. First Fin. Sav. & Loan Ass'n.*, 845 F.2d 519 (5th Cir. 1988); *Cappalli v. Nordstrom FSB*, 155 F. Supp. 2d 339 (E.D. Pa. 2001) (applying *Smiley* principles in the HOLA context). For a more detailed discussion of this critical issue, see Keest and Renuart, National Consumer Law Center *The Cost of Credit*, §§ 3.4 & 3.5. (3d ed. 2005 and Supp.).

99 12 C.F.R. §7.4000.

100 Federal Trade Commission, "Report to Congress Under Sections 318 & 319 of the Fair and Accurate Credit Transactions Act of 2003" at 79 (Dec. 2004).

101 See generally National Consumer Law Center, The Cost of Credit §11.3 (3d ed. 2004 and Supp.).

102 Alan M. White, *Risk-Based Mortgage Pricing: Present and Future Research,* Housing Policy Debate, Vol. 15, Issue 3 (2004).

103 National Consumer Law Center, "Comments to the Board of Governors of the Federal Reserve System regarding the Board's Authority under HOEPA to Prohibit Unfair Acts or Practices in Connection with Mortgage Lending"(August 15, 2007) available at: http://www.nclc.org/issues/predatory_mortgage/content/HOEPA_CommentsAug07.pdf.

The consequences of risk-based pricing in the mortgage market are now well known. Foreclosure rates across the country have skyrocketed in the last few years. To date, there is no light at the end of this tunnel. The cost for student loan borrowers may not be as visible, but is equally distressing. Using a model that reserves the highest prices and most abusive terms for the most vulnerable borrowers is simply unsustainable both for consumers and investors.

Parallel #5: Alleged Benefits for Lower-income and Consumers of Color

In the wake of the subprime foreclosure crisis, many industry representatives and policymakers argue that subprime lending has been a net gain for higher-risk borrowers, including low-income borrowers and communities of color. Similar claims are made in the student loan industry.

There is more data available in the mortgage industry and it shows that in fact, many lower income consumers and consumers of color could have obtained better credit. Instead, the worst products were pushed on them with aggressive market and reverse redlining. This has hardly been a boon for these communities.

Low-income and minority homeowners borrow from subprime lenders in disproportionate numbers, even when they have good credit. Fannie Mae reports that about one half of the families who receive subprime loans actually qualify for prime loans.[104] In 2006, over 60% of subprime borrowers actually qualified for prime loans.[105] Research shows that African-American and Latino individuals and families are much more likely to receive high interest rate loans than white individuals and families, even with the same credit profile.[106]

Moreover, contrary to popular assertions, subprime lending has not contributed to homeownership. Since 1998, subprime lending has led to a net loss of homeownership for almost one million families. Subprime lending has resulted in net homeownership loss for each of the last nine years.[107] The most recent foreclosure numbers show the corrosive effect of subprime abuses in stark form. At the end of the third quarter of 2007, over 10% of

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104 *See* Business Wire, "Fannie Mae has Played Critical Role in Expansion of Minority Homeownership", Mar. 2, 2000, available at http://findarticles.com/p/articles/mi_m0EIN/is_2000_March_2/ai_59698598/pg_1.
See also Anthony Pennington-Cross, Anthony Yezer, and Joseph Nichols, Credit Risk and Mortgage Lending: Who Uses Subprime and Why? Washington, D.C.: Research Institute for Housing America, Working Paper 00-03 (finding that probability of African American borrower receiving subprime loan increased by 1/3 compared with white borrower, controlling for risk).

105 Rick Brooks and Ruth Simon, "Subprime Debacle Traps Even Very Credit-Worthy: As Housing Boomed, Industry Pushed Loans To a Broader Market" Wall Street Journal at A1 (Dec. 3, 2007).

106 Center for Responsible Lending, Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages (May 2006), *available at* http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf.

107 Testimony of Michael D. Calhoun, Center for Responsible Lending Before the U.S. House Committee on Financial Services Subcommittee on Financial Institutions and Consumer Credit, *The New Regulatory Guidance on Subprime Hybrid Mortgages: Regulators and Response (*March 27, 2007), *available at* http://www.responsiblelending.org/pdfs/House-Calhoun-Mar27-final.pdf.

subprime loans were already in foreclosure and more than another 15% were over 90 days late.[108]

Similarly, despite access to credit (often very high rate credit), there is still a pervasive gap in access to higher education among lower-income individuals and individuals of color. Department of Education and census numbers for 2001 show that approximately 37% of the white population, 26% of the African-American population, and 15% of the Hispanic population enrolled in four-year institutions when they reached the age to do so.[109]

Statistics also show lower college completion rates for minority students. While 75% of the bachelor's degrees conferred by degree-granting institutions in 2000-01 went to white students, only nine percent went to African-American students and six percent to Hispanic students.[110] Despite the widespread availability of student loans, low-income families are still 32% less likely to send their children to college than families with higher incomes. Further, students from low-income families attend public four-year institutions at about half the rate of equally qualified students from high-income families.[111] Most agree that these disparities are due to cost barriers as well as problems with academic preparedness and information/outreach efforts.

Parallel #6: Predatory Terms

We discussed in detail above the most abusive terms in the private student loans we reviewed. Many of these same problems are prevalent in subprime mortgage products, including:

- High rates;
- High Fees; and
- Mandatory arbitration clauses.

Parallel #7: Disclosures for Student Loans and Mortgages are Inadequate or Not Properly Given

The main federal protection for mortgage loans and private student loans is the Truth in Lending Act, a statute that applies to almost all types of consumer credit transactions and primarily provides a disclosure regime. The notion when it was passed in 1968 was that with proper information, the market would be transparent and borrowers could shop for credit. However, many fees are not included in the TILA cost disclosures, and even where they are, key disclosures in the mortgage context are often provided only at closing, when it is too late for them to be useful.

Delays in the provision of disclosures are allowed for most private student loans. This creates even greater confusion for many borrowers. Disclosures should be clearer and provided earlier in the process.

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108 Mortgage Bankers Association, *National Delinquency Survey,* Third Quarter 2007.
109 See Greg Forster, The Embarrassing Good News on College Access, The Chronicle of Higher Education, March 10, 2006.
110 U.S. Department of Education, Digest of Education Statistics (2002).
111 EPE Research Center, "College Access" (Sept. 10, 2004).

Disclosures are important, but not enough. In the current market, with complex products driven by securitization and products made for Wall Street rather than Main Street, borrowers can not rely on disclosures to ensure they get the loan they want and can afford. Consumers have limited understanding of the credit market.[112] Lenders, in contrast, design, develop and market subprime loans; they can be expected to understand the products and the risk. Most consumers are not able to use disclosures to assess the fit between their situation and their loan.[113] Substantive regulation of terms and fees is also essential.

Parallel #8: Push Marketing

The practice of creating products for investors began in the mortgage market and has been exported to credit cards and student loans and other industries. The 1990s brought huge growth in the use of asset-backed securities to fund an ever-increasing supply of mortgage credit. Creating capital flow in this way for subprime mortgage lenders took off following 1994. In that year, approximately $10 billion worth of subprime home equity loans were securitized.[114] By the end of 2005, the volume of securitized loans had leaped to about $507 billion.[115]

Securitization by Wall Street has resulted in loans made for investment rather than for family wealth-building. Loan products have been developed for the repackaging. Until recently, the securitization process allowed significant defaults to occur, especially in low-income and minority neighborhoods, without repercussions for investors. Mortgage-backed securities generally are divided into strips, or tranches, which insulate many investors from the effects of abusive loans. Only when the industry overstepped its bounds significantly did the investors start to suffer.[116]

Predatory lenders and their henchmen (brokers, home improvement contractors, and mobile home dealers) often push homeowners into abusive loans. Homeowners often view themselves as having few choices and thus are susceptible to the aggressive yet friendly sales techniques. At closing, where the abusive loan may be more apparent, borrowers often feel

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112 William C. Apgar & Christopher E. Herbert, U.S. Dept. of Housing and Urban Dev., "Subprime Lending and Alternative Financial Service Providers: A Literature Review and Empirical Analysis" at x (2006) ("[G]iven the . . . complexity of . . . the cost of [mortgages], even the most sophisticated borrower will find it difficult to evaluate mortgage options."); James M. Lacko and Janis K. Pappalardo,, Federal Trade Commission, Improving Consumer Mortgage Disclosure: An Empirical Assessment of Current and Prototype Disclosure Forms" at ES-11 (2007), available at: http://www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf (prime borrowers have difficulty answering questions about their loans; difficulty increases as loan becomes more complex).

113 Alan M. White & Cathy Lesser Mansfield, *Literacy and Contract*, 13 STAN. L. & POL'Y REV. 233, 238 (2002) ("96% of American adults cannot extract and compute credit cost information from contract and disclosure documents").

114 Daniel Immergluck & Marti Wiles, "Two Steps Back: The Dual Mortgage Market, Predatory Lending, and the Undoing of Community Development" at 12, Woodstock Institute (Nov. 1999).

115 *Top 25 B & C Lenders in 2005*, Inside B & C Lending (Feb. 17, 2006) at 2.

116 *See, e.g.,* Greg Morcroft, "Merrill Downgrades Bear, Lehman, Citi; Credit Dent Seen", American Banker, Aug. 28, 2007 (noting that Merrill Lynch downgraded ratings on Citigroup Inc., Lehman Brothers Holdings Inc. and Bear Stearns Cos.).

like they cannot walk away from the table. Few borrowers actually are able to read any of the enormous stack of documents they are given to sign at closing. Even those who discover abusive terms often have no realistic option of walking away.

According to the Mortgage Bankers Association, mortgage brokers now originate 45 percent of all mortgages, and 71% of subprime loans.[117] Lenders often pay brokers to bring them loans. Some lenders also compensate brokers based upon the volume of loans that brokers steer their way.

These types of players are already emerging in the student loan market. Loans are often marketed by third party brokers or consolidators working on behalf of the lenders.

Parallel #9: Servicing and Work-Out Problems

The "atomization" of the lending process, where so many different parties are involved in origination and servicing, also means that each party along the chain can deny responsibility. Originators no longer hold the loan, and, in many cases, are thinly capitalized. Investors try to hide behind holder in due course status, despite the fact that they are profiting from the abuse.[118] Due to the pervasiveness of securitization, these problems occur in both the mortgage and student loan industries.

In this environment, the servicer is normally the only entity that interacts or communicates with borrowers. In the mortgage industry, a significant percentage of consumer complaints involve servicing, not origination.[119] According to Professor Kurt Eggert, abusive servicing occurs when a servicer, either through action or inaction, obtains or attempts to obtain unwarranted fees or other costs from borrowers, engages in unfair collection practices, or through its own improper behavior or inaction causes borrowers to be more likely to go into default or have their homes foreclosed. These practices are distinguished from appropriate actions that may harm borrowers, such as a servicer collecting appropriate late fees.[120]

Similar trends are emerging in the student loan market where borrowers complain of improper billing procedures and improper charging of fees. Many have complained of lenders' failure to respond when borrowers request information needed to help avoid or resolve problems.[121] The web site, consumercomplaints.com, includes numerous stories from consumers of servicing problems with private student lenders.[122] It is difficult for consumers

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117 MBA Research Data Notes, "Residential Mortgage Origination Channels" (September 2006), available at: http://mortgagebankers.org/files/Bulletin/InternalResource/44664_September2006-ResidentialMortgageOriginationChannels.pdf.

118 This discussion is based on an in-depth analysis of securitization and its contribution to subprime lending abuses from Testimony of Kurt Eggert before the Senate Banking, Housing, and Urban Affairs Committee's Subcommittee on Securities, Insurance, and Investments, *Subprime Mortgage Market Turmoil: Examining the Role of Securitization,* April 17, 2007, *available at* http://banking.senate.gov/_files/eggert.pdf.

119 Kurt Eggert, "Limiting Abuse and Opportunism by Mortgage Servicers", 15 Housing Policy Debate 753 (2007).

120 Id. at 756.

121 See, e.g., Savedoff v. Access Group, Inc., 2007 Wl 649278 (N.D. Ohio Feb. 26, 2007) (granting summary judgment for plaintiff borrowers in case challenging lender's practice of permissibly increasing interest rates

to fight back especially since they have no choice of a servicer. The servicers are working on behalf of the securitizers and trustees that contract with them. A related problem in both industries is the refusal of most creditors to assist borrowers in trouble.

A key issue in the mortgage industry is loan modification or work-outs. Despite the potential benefits of loan modifications to help homeowners, the magnitude of the foreclosure crisis dwarfs the current response from the financial services industry. A loan modification is a written agreement between the servicer and the homeowner that *permanently* changes one or more of the original terms of the note in order to help the homeowner bring a defaulted loan current and prevent foreclosure. Unfortunately, to date the commitments from the industry have not resulted in large-scale changes on the ground.[123] Much of the relief that has been provided has been short term in nature.[124]

As discussed above, the private student loan industry has also failed to step up to offer creative work-out solutions. In our experience representing borrowers, they refuse to grant longer-term solutions that might involve income-based repayment or partial or full loan forgiveness.

Parallel #10: Lack of Reliable Data and Information

Publicly available data about mortgage loans, while more plentiful than that for other credit products, is still scarce. The Home Mortgage Disclosure Act (HMDA) requires many lenders to report various data about loan applications and originations, including neighborhood, borrower and loan characteristics, such as loan type and some loan pricing information.[125] Information about loan features, such as loan fees, prepayment penalties and no-documentation loans, is not available from HMDA. Two private databases also generate information. The Mortgage Bankers Association publishes a quarterly delinquency survey, identifying percentages and numbers of loans in foreclosure, entering foreclosure, and past 90 days due (including those in foreclosure). These data are available by state and by loan type.[126] A private data service, Loan Performance, also is available at a high price, and

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during repayment but failing to provide for a corresponding increase in borrower's monthly payment obligations and for improper capitalization of interest).

122 See, e.g., http://www.consumercomplaints.com.

123 See generally Written Testimony of Tara Twomey, Of Counsel, National Consumer Law Center Before the United States House of Representatives Subcommittee on Housing and Community Opportunity, "Foreclosure Prevention and Intervention: The Importance of Loss Mitigation Strategies in Keeping Families in Their Homes" (November 30, 2007), available at: http://www.nclc.org/issues/predatory_mortgage/content/Twomeytestimony.pdf.

124 During the third quarter of 2007, short term repayment plans for subprime ARMs outnumbered loan modifications by almost 9 to 1, and the number of foreclosures started during the same quarter for those loans exceeded the total number of loan modifications and repayment plans by over 50 percent. Among subprime ARMs, 40% of foreclosures initiated during that quarter were attributable to failed repayment plans. Jay Brinkmann, An Examination of Mortgage Foreclosures, and Other Loss Mitigation Activities In the Third Quarter of 2007, Mortgage Bankers Association, January 2008, available at: http://www.mortgagebankers.org/files/News/InternalResource/59454_LoanModificationsSurvey.pdf.

125 12 U.S.C. §§2801-2810; 12 C.F.R. §§203.1-203.6.

126 *See* Mortgage Bankers Association website, available at: http://www.mortgagebankers.org/ResearchandForecasts/ProductsandSurveys/NationalDelinquencySurvey.htm.

provides more loan-level information than the other databases.[127] Currently, there is no publicly available database regarding mortgage servicing. Public discussions about the need for better loss mitigation have prompted calls for some reporting.

The gap in information for mortgage borrowers is serious, but at least some information is available. In contrast, the public can access none of this information for student loans, preventing them from finding out about private loan default rates at particular schools or average default rates for particular lenders. There is also no systematic and accessible way to find out about average interest rates, fees charged or loss mitigation options.

The lack of this type of information in the private student loan context is a major impediment to understanding the scope of the problem and helping borrowers.

POLICY RECOMMENDATIONS

Higher education is the gateway to a secure economic future for many Americans. It is no secret that access to higher education is diminished by soaring costs. More and more, students are risking their financial futures by taking out expensive loans to finance education. Unfortunately, market failures and abusive lending practices are stripping the benefits of higher education from millions of students. This is especially true in the private student loan market where there is little regulation despite the high cost of these loans and lack of protections for borrowers.

Below is a policy framework to help preserve access to affordable higher education by addressing problems with private student loans.

Any new student financial assistance legislation should be based on the following principles:

- Eliminate unsustainable loans and develop fair underwriting standards;
- Eliminate incentives for schools and lenders to steer borrowers to abusive loans;
- Improve disclosures so that borrowers can know the true cost of private loan products and understand the difference between private and government loans;
- Require accurate and accountable loan servicing;
- Ensure effective rights and remedies for borrowers caught in unaffordable loans;
- Preserve essential federal and state consumer safeguards; and

[127] Loan Performance's mortgage securities database is the industry's largest collection of non-agency mortgage-backed securities (MBS) and asset-backed securities (ABS) data. For more information, see www.loanperformance.com.

- Improve assistance to distressed borrowers.

Sustainable loans. Federal government student loans have loan limits, interest rate caps and other provisions to protect borrowers from abusive terms. The private student loan market does not. Many private lenders have abandoned careful lending standards to make loans that borrowers cannot repay. As a result, an increasing number of student borrowers are unable to keep up with their payments. This has caused many individuals to default on unnecessarily risky loans and suffer serious consequences.

Many lenders have argued that regulating the rates that lenders can charge could lead to fewer borrowers qualifying for private loans. While this is likely more of a threat than a reality, the truth is that less credit may be a good thing for borrowers if it means less predatory credit. Borrowers will still be able to utilize the more affordable federal loan programs. If there is a mass exodus of lenders participating in the federal guaranteed loan program, borrowers can still use the government's Direct Loan program. A major advantage of direct lending, which is run by the Department of Education, is that it is available to borrowers regardless of the school they attend.

It is particularly challenging to develop responsible underwriting in the student loan market. A solution promoted by consumer advocates in the mortgage area is to require lenders to originate loans only if the borrower has an ability to repay. This may not be as realistic or effective with student loans where many borrowers are young and it is more difficult to predict their future earning abilities. Yet the concept of lending only to those that are likely to be able to repay remains critical in the student loan market.

The lack of a security interest for student loans (other than the lender's attempts to take security interests in refunds) distinguishes these products from mortgages. Underwriting is more similar to credit cards than to mortgages. Current underwriting standards in the student loan industry, according to Fitch, are relatively untested.

One possibility to examine more closely is the model used by My Rich Uncle which prices loans based on projections of future borrower earnings and other borrower characteristics. This will very likely lead to inequities in that borrowers planning to enter more lucrative fields will have more access to credit. It also would present problems to any students who later choose a less financially rewarding career path (notwithstanding the social value of the job, such as teachers or social workers). This may, however, be a viable model for some segment of the market.

Additional evaluation and research is needed with respect to underwriting of student loans. The difficulty of predicting borrower ability to repay underscores the need to restrict the fees and rates that lenders can charge and regulate the use of variable rate credit. This will help make these loans more affordable so that the loans will be less likely to fail. Relief for those who get into trouble, as discussed below, is also essential.

Incentives for fair loans. The recent scandals in the student loan world have unmasked a high degree of collusion between lenders and schools, which in some cases, has led borrowers to take out riskier products. Too often the borrower does not benefit from arrangements between schools and lenders, failing to receive a tangible benefit such as a more affordable product even while the school profits from its affiliations with lenders. Preserving access to higher education requires strong laws that prohibit schools and lenders from steering borrowers into loans with excessive costs.

The Department of Education has taken an important first step by issuing regulations in this area. Congress is considering additional reforms. The key will be whether these laws are actively enforced. Among other actions, we recommend that Congress explicitly allow private enforcement of the Higher Education Act. This will allow borrowers to step in when the federal agencies fail to perform, as has been the pattern in the past.

A danger is that lenders and schools will attempt to halt state efforts in this area by pushing for preemption of state laws. It is much too early to even consider such a step. A particular danger of preempting state laws is that this effectively eliminates private remedies for borrowers since courts have found that there is no private enforcement under the Higher Education Act.

Improve Disclosures. The loan process is confusing for many borrowers and it is often difficult to understand whether the borrower is taking out a government or private loan. Disclosure laws should be strengthened so that borrowers can better understand these differences and the costs of each. This information should be provided as early in the process as possible so that borrowers can truly evaluate their options before they incur obligations.

We recommend:

- **Giving borrowers clearer, enforceable and early disclosures prior to the time they commit to the loan.**

- **Requiring lenders to provide cancellation rights to borrowers that apply after they receive the initial disclosures.**

- **Including clearer information in the disclosures about the terms of the loan once repayment begins**. One way to do this is to require lenders to provide estimates of all important terms that will apply once repayment begins at an earlier point in the process. The lender could note that these are estimates, but at least the borrower would have a better sense of what the terms will be when he actually goes into repayment. Lenders may provide this information under current rules, but are not required to do so.

- **Requiring federal regulators to test various student loan disclosures as they are now doing for credit cards and other credit products.**

- **Eliminating the $25,000 trigger for TILA coverage.**

We also recommend passage of additional reforms that are included in legislation such as the Student Loan Sunshine Act[128] such as:

- **Requiring schools to provide information about the student or parent's eligibility for federal assistance; and**

- **Requiring schools to provide information about the terms and conditions of private loans that are less favorable than the terms and conditions of other loans for which the student or parent is eligible.**

Accountable loan servicing. Companies that collect payments on student loans have tremendous influence on the success of the loan. Servicer errors and unfair practices in recent years have harmed borrowers. Problems typically arise when loan servicers refuse to provide documentation of payments made or otherwise refuse to assist borrowers. As it stands now, many servicers have incentives to profit from loan defaults. In a healthy and truly competitive market, loan servicers would charge reasonable fees and support borrowers' efforts to avoid default.

Basic rights and remedies. Victims of abusive lending practices have very little recourse because the industry often uses its market power to limit borrowers' access to justice. To be effective, consumer protection laws must: (1) give borrowers a private right of action, the right to pursue class actions, and the right to raise school-related claims and defenses against lenders in cases where the school and lender have a referral relationship or other close affiliation; (2) contain strong remedies and penalties for abusive acts; (3) provide effective assignee liability so that borrowers can pursue legitimate claims even when the originator has sold their loan; and (4) prohibit mandatory arbitration clauses that weaken victims' legal rights and deny them access to seeking justice in a court of law. Without these fundamental procedural protections, other consumer protection rules are unenforceable.

Preserve and advance existing protections. Current laws such as state unfair and deceptive acts and practices laws contain essential consumer protections designed to address some of the egregious practices in the student loan industry. These protections must be preserved. Any new law must build on these protections, bearing in mind that states are often in the strongest position to address new lending abuses that evolve over time. Legislative solutions must also preserve protections for borrowers outside the mainstream credit market-for example, those who are credit impaired; have limited or no credit histories; have limited English skills; or are located in high-poverty areas.

Reduce defaults and expand the safety net for the most vulnerable borrowers. Any new law should preserve the benefits of higher education by assisting borrowers already in distress. In addition to strengthening the market to benefit future borrowers, legislation should address the increasing numbers of existing student borrowers who are in trouble. Federal legislation could build on successful models in the mortgage context which require lenders to provide loss mitigation assistance. In addition, private student lenders should be required to offer

[128] H.R. 890 (110th Cong., May 10, 2007).

borrower protections, such as deferment and cancellation rights. Access to bankruptcy should also be restored for private loan borrowers.

CONCLUSION

When asked about the large profits in the student loan industry, a Sallie Mae representative responded that universities are huge businesses with huge endowments and then asked: Shouldn't their vendors be in business too?[129] The more important question is how much profit is too much and when do lender profits undermine our societal goal of promoting equal access to education.

As in the housing market, we are at this point because we allowed our government to outsource some of our most important social goals to the market. The courts have further enabled this trend. In many cases, the market works fine and provides the proper incentives to create profits and enhance social goods, but this isn't always true. The market has been distorted due to investor interests that often conflict with the best interests of borrowers.

Market corrections and increased regulation can go a long way toward curbing some of the worst abuses. This should be done. However, as long as we continue to rely on a market model, lenders will continue to make guaranteed profits, they will still pursue defaulted borrowers to their graves and they will still charge unaffordable fees and rates for many borrowers.

It does not have to be this way. This report uncovers the reasons why private loans are unsustainable for many borrowers. "Unsustainable" in human terms means individuals who pursue their dreams of upward mobility, only to find that these dreams are shattered due to unaffordable debt loads that they will never be able to repay.

It is time to look beyond reform and think about fundamental change in the way we promote access to higher education. It is time to ask the question posed by Joe Nocera in the *New York Times* regarding whether there are some things that are too important to trust to the profit motive. Shouldn't paying for a college education be one of them?[130]

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[129] Joe Nocera, "The Profit and The Pauper", New York Times Education Life at 15-16 (July 29, 2007).
[130] Id.

GLOSSARY

Direct Loans. Student loans that are made directly by the federal government to students, with the assistance of the school or other entity that originates the loan. Lenders and guaranty agencies are not involved in the process.

Federal Family Education Loans (FFEL). These are guaranteed student loans made by private lenders. The government reimburses the lender when borrowers default, or otherwise fail to pay back the loan. Before getting reimbursed, lenders are required to make certain efforts to collect the loans.

Index. A published rate often used to establish the interest rate charged on variable rate loans or to compare investment returns. Examples of commonly used indexes include Treasury bill rates, the prime rate, and LIBOR (the London Interbank Offered Rate).

Margin. The number added to the index to determine the interest rate on an adjustable rate loan. For example, if the index rate is 6%, and the current note rate is 8.75%, the margin is 2.75%.

Perkins Loans. Perkins Loans (formerly called National Direct Student Loans, and before that National Defense Student Loans) are low-interest loans for both undergraduate and graduate students with exceptional financial need. Perkins Loans are originated and serviced by participating schools and repaid to the school. The government does not insure the loans, but instead provides money to eligible institutions to help fund the loans.

PLUS Loans. These loans are available for parents borrowing for the education of dependent undergraduate children enrolled in school at least half time. "Grad PLUS loans" are also available for graduate and professional students. Unlike Stafford loans, PLUS borrowers are generally required to pass a credit check.

Stafford Loans. Stafford loans are for undergraduate, graduate and professional students enrolled at least half-time. Federal Stafford Loans are made to students through the Direct Loan program and the FFEL program.

Truth in Lending Act. A federal (national) law that requires that most lenders, when they make a loan, provide standard form disclosures of the cost and payment terms of the loan.