TOO SMALL TO HELP

The Plight of Financially Distressed Private Student Loan Borrowers

April 2009

Student Loan Borrower Assistance

The Student Loan Borrower Assistance Project (SLBA)
is a program of the National Consumer Law Center (NCLC).

7 Winthrop Square, 4th Floor
Boston, MA 02110
(617) 542-8010
www.studentloanborrowerassistance.org

Too Small to Help: The Plight of Financially Distressed Private Student Loan Borrowers

Written by
Deanne Loonin
Staff Attorney
National Consumer Law Center

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TABLE OF CONTENTS

EXECUTIVE SUMMARY

The Boom and Bust of the Private Student Loan Industry

The private student loan industry generated huge profits for lenders and investors for many years. Over time, however, the defects in these expensive, unsustainable products became clear and the loans began to fail. The industry hit a wall, exposing the risks of making unsecured, expensive loans to borrowers with little or no ability to repay.

There are some signs of a market recovery and the remaining lenders seem to have learned some lessons. Most have reduced their origination volume and re-evaluated underwriting criteria. The shape of the future depends to a large degree on how the federal government responds. If the government chooses to bail the lenders out by purchasing large portions of bad debt, the lenders will suffer no consequences for their irresponsible actions. They could return to irresponsible lending. This is even more likely to occur if Congress fails to impose stricter regulations going forward.

Too Small to Help

Regardless of how the future market plays out, there are countless borrowers stuck with loans that they have no hope of repaying. Lenders and the government have decided that, unlike the lenders that made these loans, the borrowers are "too small" to help. In reality, their numbers are large, but their political power is not.

This report focuses on these financially distressed borrowers, examining how lenders are dealing with the increasing private student loan delinquencies and why. We then ask what else they could and should be doing to help borrowers get out from under debilitating debt loads.

Our Study of Programs For Financially Distressed Borrowers

Given their role in creating the crash, it is reasonable to expect lenders to do everything possible to help borrowers with unaffordable loans. Distressingly, this has not occurred. In our experience representing borrowers through the Student Loan Borrower Assistance Project (www.studentloanborrowerassistance.org), we have found private lenders to be universally inflexible in granting long-term repayment relief for borrowers. Lenders that had no problem saying "yes" to risky loans are having no problem saying "no" when these borrowers need help.

Survey Results

We sent a questionnaire to five for-profit lenders and one non-profit lender asking for information about their programs for financially distressed private loan borrowers. Although some no longer make private loans, all were heavily involved in the business in recent years. The lenders surveyed represent about 75% of the private student loan market with Sallie Mae by far the biggest player. We also surveyed one non-profit lender. Only Sallie Mae and the non-profit lender provided responses to our questionnaire.

We also searched the Internet, finding only very general information about options for troubled borrowers.

The lack of comprehensive information about potential options is very troubling and detrimental to borrowers seeking solutions. Even more troubling is that in our experience representing borrowers these options have rarely been mentioned when they have called for assistance.

Based on the survey results, our experiences representing borrowers, and other research, we found that lenders appear to be offering some flexible repayment options for financially distressed borrowers. Private lenders, however, do not offer income-based repayment. In addition, these lenders rarely cancel loans or offer reasonable settlements. For example, private lenders generally do not discharge student loan debt upon death of the original borrower or co-signer. Further, loan modifications are rarely offered.

The options are particularly limited for borrowers in default. Yet these are generally the borrowers most desperate for assistance. This is also in sharp contrast to the federal programs where borrowers in default have various ways to select affordable repayment plans and get out of default.

In the past, forbearance was the only option offered to these most distressed borrowers. However, these policies have changed radically in recent months as most creditors have sharply restricted forbearance availability. The problem for borrowers is not so much that forbearances are less available, but that there is little or no other options to help them manage their debts over the long-term.

Recommendations to Improve Assistance for Private Loan Borrowers

1. Mandate Loss Mitigation Relief

A key barrier to improved assistance programs is that lenders have not been *required* to provide redress for their irresponsible actions. This report shows that voluntary efforts have been few and far between.

Loss mitigation efforts should be encouraged across the board, but they should be *required* of any creditor that receives federal funds. Investors should support such policies, recognizing that collecting some money is better than spending more money on aggressive collection efforts and getting little or nothing in return.

Lenders must also be required to provide information to investors, regulators and the public comparing numbers of collection actions and recoveries from such actions to the performance of loan modifications.

Barriers to Loss Mitigation Programs

Restrictions in Securitization Agreements?

Servicers may feel constrained in cases where the loans have been securitized. This has occurred in the mortgage context where servicers often claim that the pooling and servicing agreements do not let them modify loans. In reality, most securitization documents give broad authority to servicers to service loans in accordance with customary standards, often also stating that the servicers must act in the best interests of investors. In any case, we have not heard creditors or servicers use this excuse in the student loan context.

To further test this issue, we thoroughly reviewed a number of student loan pooling and servicing agreements. We did not find any explicit barriers to modifications in any of those agreements.

The Cost of Modifications

Even if servicers know they have discretion to modify and restructure loans, they may choose not to exercise it because of the additional expense. Loan modifications can be labor intensive, although student loan modifications should be less complex than modifying mortgage loans. Unlike mortgage modifications, there is no underlying asset that requires valuation for student loans.

Additional investigation is needed to assess whether servicers are holding back on student loan modifications because of cost. If so, there are ways to address this problem, including additional compensation for servicers. This has been suggested in the mortgage context and is part of the Obama Administration's new homeowner relief plan.

Accounting Problems

It is possible that lenders feel constrained by accounting and other regulations which generally require consumers to repay settled debts within three to six months and lenders to recognize forgiven amounts as losses during this time period. However, we have not heard this concern expressed directly in the student loan context. In addition, federal regulators can if necessary act to allow creditors to make these settlements and eliminate or reduce any tax liability for consumers.

2. Restore Bankruptcy Rights

Creditors succeeded in persuading Congress in 2005 to make private loans as difficult to discharge in bankruptcy as federal loans. Current bankruptcy law treats students who face financial distress in the same severe way as people who are trying to discharge child support debts, alimony, overdue taxes and criminal fines.

It is difficult to separate fact from fiction when trying to understand the logic behind this policy, but one thing is clear—the restrictions came about without any empirical evidence that students were more likely to "abuse" the bankruptcy system. It is long past time to restore these rights to borrowers. Restoration of bankruptcy rights will also provide a strong incentive to student lenders to provide aggressive modifications outside of bankruptcy in order to reduce losses.

3. Loan Cancellations for Fraud Victims

Not all borrowers will benefit from modifications. Only those that are in serious financial trouble, but still have some income to pay toward their loans, will qualify. Many of the most vulnerable borrowers will be left without relief. As one step to providing relief for these borrowers we recommend that all borrowers that received private loans to attend unlicensed, unaccredited, schools that closed or are currently in bankruptcy receive full loan cancellations.

These consumers have been hit particularly hard. They are stuck with debts they cannot repay from worthless schools. In the current environment, where creditors are rewarded with bail-outs for prior bad acts and where no one wants to take responsibility for the meltdown, taking action in this area is one small way to hold creditors liable for the damage they have done.

4. Re-Regulate the Industry

Among other reforms, re-regulation must include:

- Mandated Underwriting
- Limits on Interest Rates and Fees
- Remedies for Fraud Victims
- Improved Disclosures, and
- Private Remedies and Access to Justice

The lenders that created this mess can and should be part of the solution. This report shows that so far, they have not done much on a voluntary basis to provide assistance. Yet without relief, student borrowers will never be able to help fulfill our social and economic need for a productive, educated work force.

TOO SMALL TO HELP

The Plight of Financially Distressed Private Student Loan Borrowers

April 2009

Introduction

Securitization fueled the explosive growth of the private student loan industry. During the boom years, the focus was on quick profits. Over time, however, the defects in these expensive, unsustainable products became clear and the loans began to fail. The industry hit a wall, exposing the risks of making unsecured, expensive loans to borrowers with little or no ability to repay.

Many lenders left the private student loan business during this crisis period. The dust is now starting to settle and the market is showing some signs that it will rebound. The remaining lenders, at least for now, are adopting more responsible practices. We do not yet know if this era of increased lender responsibility will continue but borrowers should hope that it does. Ultimately, private student loans are useful only if they are affordable and can be repaid. The road to equal access to higher education will never be paved with predatory private loans.

Private student loans have been a benefit for some students, particularly middle and higher income students that need additional funding to pay for more expensive colleges. There is no evidence, however, that these high cost products have helped narrow the class or race gap in higher education graduation rates. 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. For example, low-income families are about 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.[1] President Obama highlighted this persistent problem in his 2010 budget proposal, calling for innovative programs to increase low-income student completion rates.[2]

Regardless of how the future market plays out, there are countless borrowers stuck with loans that they have no hope of repaying. Some finished school, some did not. Some went to four year colleges and universities, others to proprietary schools. Lenders and the government have decided that, unlike the lenders that made these loans, the borrowers are "too small" to help. In reality, their numbers are large, but their political power is not. To the extent that their problems are heard, it is generally through the voices of investors angry at crashing stocks and declining revenues.

This report focuses on these financially distressed borrowers. We examine how lenders are dealing with the increasing private student loan delinquencies and why. We then ask what else they could and should be doing to help borrowers get out from under debilitating debt loads. These policies are not just for borrowers, but for taxpayers and investors as well. Providing relief to borrowers can also make good business sense.

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.[3]

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. However, in recent years, many lenders bypassed the schools and marketed their private student loan products directly to consumers.

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

- **Underwriting.** With the exception of PLUS loans for parents and graduate/professional students, federal loan borrowers do not have to meet creditworthiness standards. Private loans, in contrast, are priced according to credit worthiness standards.
- **Pricing.** All federal loans have interest rate caps, in most cases with fixed rates set at 6.8% or lower for subsidized loans. 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.
- **Loan Limits.** There are loan limits for the various federal loan programs. The only exception is PLUS loans for parents and graduate/professional students. For private loans, 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.
- **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.
- **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. As in the mortgage market, federal enforcement actions to curb problems in the private student loan market have been virtually nonexistent.
- **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.

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 Private Student Loans

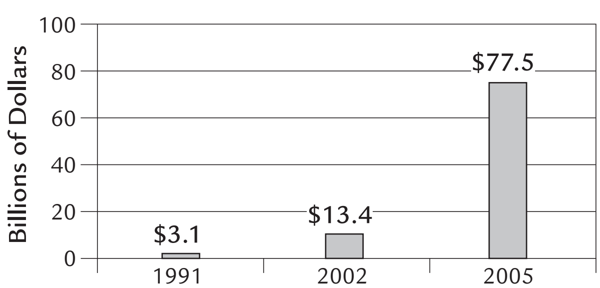
By 2003, the total volume of private loans had surpassed the amounts awarded annually under the Student Educational Opportunity grants and federal work study. As of 2008, borrowing from private sources equaled about 23% of total education loan volume.[4] Private loans grew from $3 billion in 1997-98 to $19.1 billion in 2007-08.[5]

The private loan market was profitable primarily because originators sold the loans with the intention of packaging them for investors. Lenders must sell a certain amount of loans in order to generate sufficient pools of loans to sell to investors. As a result, creditors made and sold loans to borrowers, but with the specific goal of selling them to investors. Loan products were thus developed *for* the repackaging rather than to provide the most affordable and sustainable products for borrowers.

Asset-backed securities (ABS) backed by student loans grew from $3.1 billion in 1995 to $13.4 in 2001 to $77.5 in 2005.[6] In 2007, Fitch reported that Sallie Mae, the largest private student lender by far, relied on ABS for approximately 64.5% of its managed funding.[7]

The business has been extraordinarily profitable. For example, Sallie Mae's return on equity, which was over 30% in 2006, was one of the highest among American companies.[8] Their executives reaped the rewards. From 1999 through 2004, former chairman and current vice-chairman and CEO Albert Lord took home over $200 million.[9]

Growth in Student Loan Asset-Backed Securities



Hitting the Wall

Warning Signs

The recent crash in the market should not have been so surprising. The writing was on the wall but, as so commonly occurred during the bubble economy, most chose not to read the warning signs. Most ratings agencies continued to rate private student loan pools highly, even after signs of trouble began to emerge.

A few ratings agencies expressed some caution. The Fitch Ratings Company pointed out in 2007 that the relatively healthy performance of private student loans, including low charge-off rates, was unsustainable over the long-term.[10] Fitch cited the floating interest rates and increasing pressure on borrowers to repay in a rising rate environment as factors that could increase charge-offs.[11] Fitch highlighted the importance of lender loss allowances, noting that Sallie Mae's had fallen over time and needed to be bolstered to handle future charge-offs. Still, they hedged these warnings by stating that credit losses in the student loan sector at that point compared favorably to other consumer lenders like American Express and Capital One.

Not everyone was blinded by the dazzling profits. Bethany McLean of *Fortune*, who was instrumental in uncovering the Enron scandal, questioned the private student loan business model in a 2005 article. She focused on the potential defaults noting that "[t]hese are after all basically unsecured loans to people without jobs."[12] McLean warned of the lack of historical measurements by which to gauge default potential.

> "These are after all basically unsecured loans to people without jobs."
>
> —Bethany McLean, *Fortune*, 2005

Some argue that lenders deliberately misled investors. For example, recent shareholder and false claims lawsuits focus on Sallie Mae's alleged practice of using the forbearance process to manipulate delinquency rates.[13] Regardless of

SECURITIZATION 101: COMMON TERMS

Lender. The originator of the loan.

Seller/Wholesale Lender. The party that sells the loans to the issuer. The seller can be the original lender, or an affiliate of the original lender. Alternatively, the original lender can sell the loans to a wholesale lender who, in turn, becomes the seller of the loans to an issuer.

Issuer/Depositer. The seller transfers the notes to an issuer, also sometimes called a depositor. The issuer issues securities that represent undivided interests in the cash flows from a particular pool of loans. The issuer then sells the securities and transfers legal title in the loans to a trust entity.

Servicer. The entity that collects monthly payments from borrowers and passes on the required cash flows to the trustee. The servicer retains a fee from borrower payments and can usually also keep late charges, bad check charges and other costs. In many securitization transactions, the seller retains the right to service the loan, so the seller and servicer may be the same entity.

Trustee. Usually a commercial bank, the trustee acts on behalf of the trust and investors. It is essentially an administrative function, to represent the trust, to monitor the effectiveness of the servicing, to manage and oversee the payments to the bondholders, and to administer any reserve accounts.

Custodian. The custodian may hold the notes and mortgages for safekeeping as an agent for the trust.

Underwriter. The investment firm or firms that provide the initial capital to purchase the securities from the issuer and then, at a profit, sell them to its customers, institutional investors, and mutual funds. The underwriter plays a key role in structuring the entire transaction.

Rating Agency. The rating agency provides an evaluation of the credit quality of the securities. AAA bonds are the highest quality with the smallest risk of default.

Insurer. In order to achieve an AAA rating, pools have to be "credit enhanced." Often these enhancements come in the form of insurance. The most common forms of credit enhancement in student loan pools are excess spread and over collateralization. Excess spread is the positive difference between the interest collected from borrowers and interest owed to bondholders.

Pooling and Servicing Agreements(PSA). These are the primary contractual documents underlying securitization transactions. The PSA broadly governs the formation of the trust, the servicing of the loans in the trust, and the duties of various parties to the trust agreement.

intent, Sallie Mae and the other lenders clearly underestimated the potential for high delinquency and default rates.

A savvy investor could have detected these looming time bombs by carefully reading the pooling and servicing agreements (PSAs). These are the primary contractual documents underlying securitization transactions. The PSA broadly governs the formation of the trust, the servicing of the loans in the trust, and the duties of various parties to the trust agreement.

A 2006 Sallie Mae PSA, for example, warned investors that private loans are made to students who may have higher debt burdens than student loan borrowers as a whole and that they have typically already borrowed the maximum federal loans. As a result, according to the information in the PSA, these borrowers may be more likely than other borrowers as a whole to default or have higher rates of forbearances.[14] In addition, the company disclosed that private loans are not secured by any collateral and not insured by any guaranty agency or any government agency.

An earlier PSA from Key Corp. cautioned investors that the company had only been originating unguaranteed student loans for a limited time and that an immaterial number of these loans had entered repayment status as of the date of the securitization sale. As a result, they admitted that they lacked meaningful prepayment, loss or delinquency data on the unguaranteed student loans.[15] They even warned that default rates for student loans made to students attending proprietary and vocational schools are significantly higher, except for a few selected, accredited proprietary schools which grant degrees.[16]

Market Distress

The market ultimately tanked largely because too many loans in the pools were no longer performing. Lenders began reporting huge increases in delinquency and default rates. In October 2008, Sallie Mae reported a loss of $159 million in the most recent quarter, fueled by the acceleration of delinquent private loans.[17] Fitch in 2009 stated that from a net-charge off perspective, the rates had been deteriorating for the main private student lenders since 2006.[18] As of early 2009, thirty-nine lenders had stopped making private student loans.[19]

In February 2009, Fitch announced that the performance for U.S. private student loan ABS is under increased pressure.[20] The agency speculated that rising unemployment will continue to have a worsening effect on private student loan performance through 2009 and well into 2010. According to the February release, certain private student loans trusts are exhibiting losses that are 1.5 to 2 times greater than initial expectations. Trusts with higher concentrations of "direct to consumer" loans are experiencing particularly great variability in performance. Lenders were advertising direct to consumer loans as an easier way to get student loans and avoid the hassle of interacting with the school financial aid offices.

Sallie Mae and others have attributed much of the poor performance to their "non-traditional" loan portfolio. These loans are described as loans to borrowers that are expected to have a high default rate due to numerous factors including having a lower tier credit rating or low program completion and graduation rates usually at "non-traditional schools." Even where the borrower is expected to graduate, non-traditional loans tend to go to borrowers with low expected incomes relative to the cost of attendance.[21] Both Sallie Mae and Citi's Student Loan Corporation have identified lending to students attending schools with lower graduation rates and lower earning potential as the main source of credit deterioration.[22] Non-traditional loans at both for-profit and non-profit schools represented about 14% of Sallie Mae's private education loan portfolio, but accounted for 54% of charge-offs in the company's portfolio in 2008. [23] Even Sallie Mae's then-CFO Jack Remondi admitted that this is ". . . [o]bviously, a business model that does not make sense."[24]

In discussing the company's lending to "non-traditional" students, Sallie Mae CEO Al Lord said in a June 5, 2008 interview that "[i]t was obviously a mistake and I'm not going to step away from responsibility because I was either chairman or CEO when those loans were made. We got a little too confident in our own view that credit scores are of limited meaning for undergraduates. Maybe as early as 2004, we started lending with less selectivity. The culture of the company has been a FFELP [federal guaranteed loan program] culture for 35 years. That meant you made every loan to every student. I guess with 35 years of experience of saying yes, we were just not very good at saying no."[25]

These belated admissions can be useful in policy debates because they expose the inexcusable wishful thinking that masked as business planning over the years. However, these *mea culpas* do not do much for troubled borrowers.

> "I guess with 35 years of experience of saying yes, we were just not very good at saying no."
> —AL Lord, Chairman, Sallie Mae (June 2008)

The reality is that many loans were so expensive that they were destined to fail. In a March 2008 report, NCLC reviewed twenty-eight private loans issued between 2001 and 2006, looking for warning signs and potential problems. 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 were 11.5%.[26]

The high fees made these loans even more expensive. There are no limits on origination and other fees for private student loans. According to the loan disclosure statements we reviewed, the lenders charged 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% of the loan amount. The average in our survey was 4.5%.

A Market Recovery?

There are some signs that the market might be slowly recovering. In early 2009, the private student lending market fell as much as 25% as the securities market dried up.[27] Fitch reported only two private student loan deals in 2008, a $140 million deal from My Rich Uncle and a $400 million deal from the Massachusetts Educational Financing Authority.[28] However, in January 2009, Sallie Mae secured $1.5 billion worth of financing from Goldman Sachs for a batch of private student loans. [29]

It is unlikely that the securitization market will bounce back quickly or ever return to previous levels. Fitch, for example, warned in February 2009 that the weak job market, lack of home equity financing, and negative student loan industry performance are all leading to diminished investor interest in private student loan securitizations.[30] Yet it is also unlikely that private student loans will disappear completely. Sallie Mae representatives said that the company expects to make the same volume of private loans in 2009 as in 2008 and may fund even more if they are able to access government TALF funding.[31] Fitch predicts that the private loan market will remain most relevant for international graduate students with no access to federal loans and undergraduate borrowers whose parents cannot access PLUS loans.[32]

The remaining lenders seem to have learned some lessons. Most have reduced their origina-

THE HUMAN COST

Although it is hard to measure in dollar amounts, the human cost of unaffordable private loan debt is alarming. We hear from these borrowers every day. Those that attended inferior schools are particularly incensed because they received nothing in return for their crushing debt loads. Below are just a few examples.

Juanita, 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.

Francine is a single mother raising a disabled daughter. While she was married, she went back to school to try to finish her undergraduate degree. The family moved a lot and she frequently transferred schools. Her husband had abused her for many years and she ultimately fled with her daughter. She was unable to finish college. She has a combination of federal and private loans. The private loan debt has grown to over $75,000. Francine has been able to set up flexible repayment and get deferments for the federal loans, but her private lender refuses to offer her any options to reduce the debt or payments. She earns about $35,000 annually and simply cannot afford to pay her private loans. Just like Juanita, Francine says she would pay an affordable amount, but the lender refuses to work with her.

tion volume and re-evaluated underwriting criteria.[33] Sallie Mae, the largest student lender, has tightened underwriting, terminated certain school relationships and reduced volume.[34] The company has said that they plan to curtail less profitable student loan origination and acquisition activities that have less strategic value, including originations of private loans for high default rate and lower-tier credit borrowers.[35] In March 2009, the company announced that it will be replacing its existing private loan product with a shorter-term loan that requires borrowers to make payments while they are in school.[36]

First Marblehead, a company that provides outsourcing services for private education lending, reported in 2008 that it was designing new programs with more selective underwriting criteria.[37] The company also changed its servicing approach and developed an early awareness program for high risk borrowers.

A thriving student loan market characterized by responsible lending will likely provide benefits to many borrowers, particularly middle and higher income borrowers who have exhausted federal loan eligibility and need additional funds to attend more expensive schools. However, a return to the predatory market days would not support students' or society's interest in promoting equal access to higher education. There are other ways to achieve this important social and economic goal, including increased grant assistance, broad reductions in college tuitions, and increased investment in public education.

The reality is that responsible lending, including careful underwriting based on ability to repay, means that many borrowers that were previously able to get private loans are no longer be able to do so. These borrowers still have some options. They should first exhaust federal grant and loan resources. In addition, the recent proposals in the Obama administration budget aim to provide targeted assistance through increased grants and more affordable federal loans to the lowest-income students. The less creditworthy borrowers who are now unable to get private loans were previously getting the highest priced loans. Many have found that the debt loads are insurmountable. The fact that private loans are less available will help future students avoid these debt traps. However, it does not alleviate the need to find cost effective and efficient ways to help at-risk students go to college.

Government Intervention

The shape of the future depends to a large degree on how the federal government responds. If the government chooses to bail the lenders out by purchasing large portions of bad debt, the lenders will suffer no consequences for their irresponsible actions. They could return to irresponsible lending. This is even more likely to occur if Congress fails to impose stricter regulations going forward.

To date, the main government intervention is the Term Asset-Backed Loan Facility (TALF). The TALF program is intended to restore liquidity to the asset-backed securities (ABS) markets for consumer assets. The Federal Reserve of New York will make up to $200 billion of loans, which will be fully secured by eligible ABS. Eligible collateral will include cash ABS with a long-term credit rating of AAA. Eligible ABS cannot be on review or watch for downgrade. Further, lenders must obtain the AAA grade without the benefit of third party guarantees. Eligible ABS must be issued after January 1, 2009 and all or substantially all of the underlying credit exposures of eligible student loan ABS must have had a first disbursement date on or after May 1, 2007.[38]

Fitch noted in early 2009 that government programs like the TALF may temporarily increase investment in private loan deals, but they will not truly re-ignite interest to previous levels.[39] Fitch believes that going forward, the ABS market will improve only if lenders can convince investors that underwriting criteria is effective enough to identity and exclude the riskier borrowers and schools that yielded significant deterioration.[40]

Too Small to Help

Given their role in creating the crash, it is reasonable to expect lenders to do everything possible to help borrowers with unaffordable loans. Distressingly, this has not occurred. 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.[41] Lenders that had no problem saying "yes" to risky loans are having no problem saying "no" when these borrowers need help.

> **The ABS market will improve only if lenders can convince investors that underwriting criteria is effective enough to identity and exclude the riskier borrowers and schools that yielded significant deterioration.**
>
> —Fitch Ratings, Jan. 2009.

Our Study of Programs For Financially Distressed Borrowers

Survey Results

To test our experiences with borrowers, we sent a questionnaire to five for-profit lenders and one non-profit lender asking for information about their programs for financially distressed private loan borrowers. Although some no longer make private loans, all were heavily involved in the business in recent years. The lenders surveyed represent about 75% of the private student loan market with Sallie Mae by far the biggest player. The other for-profit lenders surveyed were Citi, Chase, Key Bank, and Wells Fargo.

Congress created Sallie Mae in 1972 to provide a secondary market for student loans. Due to changes in the federal student loan industry, including the creation of the government's Direct Loan program in the 1990's, Sallie Mae ultimately won Congressional approval to become a fully private company.[42] By 2004, Sallie Mae had reached its goal of complete privatization and has dominated the federal and private student lending sectors. According to Student Lending Analytics, a company that provides information about student loans, Sallie Mae accounted for about 42.5% of private student loan originations in 2007.[43] Citibank was a distant second at 10.5%.

Non-profit lenders comprise a small percentage of the private student loan market. However, we decided to survey one of these lenders for comparison purposes. The non-profit lender selected was Vermont Student Assistance Corporation (VSAC). The questionnaire is attached at the Appendix.

Only Sallie Mae and VSAC provided responses to our questionnaire, as summarized in the following pages. One lender refused to answer, claiming that this information was "proprietary." The others simply stated that they were declining to respond. Citi did not respond at all.

VSAC provided more comprehensive information than the information provided by Sallie Mae, although Sallie Mae does deserve credit as the only for-profit lender that responded. VSAC is offering a number of flexible options as well as intensive counseling during the difficult economic times.

Additional Information About Private Loan Assistance Options

Given the low response rate to our survey, we searched the Internet for additional information. For the most part, we uncovered only very general information about options for troubled borrowers. General student assistance web sites describe numerous private loan terms, including loan limits, rates, fees and term. However, they do not describe repayment, cancellation or deferment options.

Scattered and inconsistent information is available on the Internet. Key Bank does not have much information about private loans on their site, perhaps because they stopped making these loans in fall 2008. Chase states that flexible repayment terms are available. We could not find further de-

SURVEY RESPONSES

Sallie Mae

Sallie Mae listed the following as options available to private loan borrowers having trouble with loan repayment:

- **Forbearance.** Offered only up to 3 months in to the future, but can be used to resolve prior delinquency as well. Requires the payment of a forbearance fee of $50 per loan, cap of $150 per occurrence. Typically capped at 24 cumulative months.
- **Extended Repayment.** Ability to extend the repayment terms, dependent on balance owed.
- **Interest-only repayment plan.** Typically, 2 or 4 years of interest only payments and then full principal and interest for remaining terms.
- **In school deferment.** Borrowers can postpone payments if they return to school on at least a half-time basis.

If the borrower is not delinquent, these programs (with the exception of forbearance) are standard.

The company did not respond to the question about whether this information is available in writing. They did not respond to a follow-up question asking them whether they intentionally or inadvertently failed to respond to this question.

In response to the question about how borrowers typically find out about these programs, Sallie Mae stated that borrowers can get this information on their website, or from a representative on the telephone. All options, they said, are available at the borrower's request.

Sallie Mae stated that the options are available when borrowers are delinquent, but additional documentation may be required or the options may not be automatically granted. We requested clarification regarding whether there is a difference for borrowers who are delinquent and those who are in default, but did not hear back. This is an important distinction because only borrowers in default are subject to collection lawsuits. Borrowers are in default on federal loans if they fail to make payments for a relatively long period of time, usually nine months. 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. In addition, borrowers in default on federal loans have various ways to set up affordable repayment plans and get out of default.

Sallie Mae stated that the options are the same regardless of whether the loan is part of a securitization trust. They also responded that they service their own loans.

Finally, we asked whether they have made any changes to these options/programs to respond to the economic crisis. They said that they are currently working on a new option for delinquent customers which will allow borrowers to make lower payments by reducing their interest rate.

We requested additional information about this new option, including a time line for implementation, but did not hear back.

tail. The Chase site describes the deferment options with some additional specificity. These are all related to deferment while in school.

Many of the lenders describe consolidation loan products. For some time, many lenders promoted consolidation as a solution if a borrower expressed concerns about potential debt loads. As in the mortgage market, lenders often promised borrowers that they could always refinance later and get a better deal. Just as in the housing market, the refinancing bubble ended abruptly and it is now very difficult to consolidate private loans. It never should have been touted as a long-term repayment strategy, but now it is not even readily available.

With respect to repayment, Wells Fargo describes benefits that can reduce interest rates. The repayment options in the "repayment plan" section mainly refer to federal loans. There is a category for interest-only repayment that says

VERMONT STUDENT ASSISTANCE CORP.

In response to the questions about options for borrowers having trouble making payments, the nonprofit lender Vermont Student Assistance Corp. described the following options for private loan borrowers experiencing trouble with repayment:

They said that they can offer a reduced payment plan or forbearance on the private loan during periods of financial difficulty. Other options for private borrowers include:

- Extend loan term up to 30 years (with significant counseling on the increased finance charge that the borrower will pay over longer terms)
- Reduced Payment Forbearance period, generally offered for 3 to 6 months, with a maximum of 12 months (they emphasize this option in order to build a habit of repayment with the borrower):
  - Generally offered for 3 to 6 months
  - Maximum of 12 months
  - Currently no restriction on the number of reduced payment forbearances per borrower
  - Borrower must be experiencing temporary financial difficulty
  - Borrower must have a long-term plan to repay the loan.
- Forbearance:
  - Generally offered for 1 to 6 months at a time
  - Maximum of 12 months at a time
  - Currently no restriction on the cumulative number of forbearances per borrower
  - Borrower must be experiencing temporary financial difficulty
  - Borrower must have a long-term plan to repay the loan

Currently, there are no specific qualifying conditions for forbearances.

They said that extension of term is standardized, but that the other options are offered on a case-by-case basis, determined by the counselor, sometimes in consultation with a supervisor. The extension is described in writing and available publicly on website and in loan materials.

When asked about how a borrower typically finds out about these options, VSAC responded that availability of temporary and permanent options to lower loan payments are discussed during loan origination and during counseling calls or due diligence calls (if borrower becomes delinquent in payments). Borrowers may also proactively contact the lender to discuss options to reduce their monthly payment.

VSAC further responded that the programs are only available if the borrower is current or delinquent. If a borrower has defaulted on repayment, there are no options to extend term or reduce/suspend payments. They said that there is no difference in servicing based on financing structure.

Finally, we asked whether the company has made any changes to these options/programs to respond to the economic crisis. They responded that they have increased counseling during the origination period, including information about the benefits of borrowing under the federal PLUS program instead of using private loans. The company also requires borrowers to take the maximum federal Stafford loan before even considering private loans and all private loans are certified by the school financial aid offices. In addition, VSAC has increased calls to borrowers before loans become severely delinquent and makes earlier and more intense calls to any borrower showing previous financial difficulty.

VSAC services its own loans pre-default and uses an unaffiliated collection company for post-default servicing.

only that many loan types allow for up to four years of interest-only payments and that borrowers should call to sign up. The site also describes forbearances for private loans, but only for in-school/residency programs and in-school summer bridge students. Citi's site says only that standard repayment is up to twenty years.

Sallie Mae's site generally describes their various products. It notes when there is a grace period. Sallie Mae also states that several repayment plans are available for some products, including standard, graduated and extended. Others just state that flexible repayment is available. For the career training loans, the site states that borrowers may take up to 15 years to repay the loan. It also describes an interest-only repayment option that is available during school only. There is a $10 deferred repayment option that allows deferments for up to 12 months, not to exceed the anticipated graduation date on the application. It is not clear from the site how available these options are for borrowers in delinquency or default.

In a 2006 report, the Institute for Higher Education Policy noted that no private lenders in their study offered income-based repayment.[44] Lenders may be 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.[45]

Key Findings

Lack of Information

The lack of comprehensive information about potential options is very troubling and detrimental to borrowers seeking solutions. The information on creditor web sites is sparse and mostly relates to federal loans. In response to our survey request, Salle Mae at least provided general information, although it failed to respond to our efforts to clarify their responses. The other for-profit lenders refused to respond. Only the non-profit lender VSAC responded comprehensively.

Even more troubling is that in our experience representing borrowers, these options are rarely mentioned when they have called for assistance. In the private loan sector, it is unclear whether anyone is actually being offered flexibility or restructuring. This could be because most of our clients are in default or late-stage delinquency, but lenders have not provided any explanation to us for this refusal to consider flexible solutions.

Lack of Assistance for Borrowers in Default

It appears that there are few, if any, choices for borrowers in default. Yet these are generally the borrowers most desperate for assistance. This is also in sharp contrast to the federal programs where borrowers in default have various ways to select affordable repayment plans and get out of default.

Borrowers are in default on federal loans if they fail to make payments for a relatively long period of time, usually nine months. 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.

In the past, forbearance was the only option offered to these most distressed borrowers, although many lenders charge fees for forbearances, generally up to $50 for each forbearance. These policies have changed radically in recent months as most creditors have sharply restricted forbearance availability.

In a 2009 report, Fitch describes the prevalence of lenient forbearance policies throughout the industry.[46] The company noted that lenders began to impose more restrictive forbearance criteria starting in 2008, after realizing that the economic downturn would have a more prolonged impact on a borrower's ability to repay.[47]

Sallie Mae has described changes in their forbearance policies. Previously, according to allegations in shareholder lawsuits, they heavily encouraged forbearance as a way of keeping delinquency rates lower.[48] The company now says that they are applying far more analysis to forbearance requests to make sure that borrowers are both committed to repaying their debt and have the actual ability to benefit from a forbearance.[49]

The more restrictive forbearance standards may be an appropriate response from an investor point of view because forbearance is intended mainly to provide relief for borrowers with temporary financial difficulties. The problem for borrowers is not so much that forbearances are less available, but that there is little or no other options to help them manage their debts over the long-term.

Cancellations and Settlements Are Rarely Available

In our experience 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, it requires 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 March 2008 study stated explicitly that there would be no cancellation if the borrower or co-signer died or became disabled.

Further, loan modifications are rarely offered. The few lenders that responded to our survey did not even describe loan restructuring as an option. Our experience from representing borrowers is that lenders do not offer long-term interest or principal reductions or other restructuring.

Rather than focusing on working with borrowers, lenders have described efforts to ratchet up collection. Sallie Mae, for example, has announced steps to resolve higher risk accounts, including a more aggressive use of collection efforts.[50]

Recommendations to Improve Assistance for Private Loan Borrowers

1. Mandate Loss Mitigation Relief

A key barrier to improved assistance programs is that lenders have not been *required* to provide redress for their irresponsible actions. Lenders tend to blame the economy for the large numbers of distressed borrowers as if the economic crisis is unconnected to their irresponsible behavior.

The analysis above shows that voluntary efforts have been few and far between. Similar trends occurred in the mortgage industry where most creditors failed to act on their own to stem the foreclosure tide.[51]

Loss mitigation efforts should be encouraged across the board, but they should be *required* of any creditor that receives federal funds through TARP or TALF or other government programs. Among the primary student lenders, for example, as of early February 2009, Citi, Wells and Key Corp. had all received significant federal TARP infusions. These are general funds aimed at strengthening the institutions and increasing liquidity. They are not specific to student loans. Other institutions are expected to receive loans through the TALF program.

There is ample precedent in the mortgage sector tying loss mitigation and other consumer benefits to receipt of federal funds. Citigroup, for example, agreed in early 2009 to expedite mortgage modifications as a condition of its second receipt of TARP funds.

Investors should support such policies, recognizing that collecting some money is better than spending more money on aggressive collection efforts and getting little or nothing in return. In the mortgage sector, researchers have shown that the returns from modifications are often greater than taking on the expense of foreclosure and seizing undervalued assets. For example, Professor Alan White found the average loss for the 21,000 first lien mortgages in his sample for November 2008 liquidated that month was $145,000, representing an average loss of 55% of the amount due. Losses on second lien mortgages were close to 100%. In comparison, for the modified loans with some amount of principal or interest written off during that time period, the average loss recognized was $23,610.[52] Given this data, White describes servicers' decisions to foreclose as "mystifying."

These types of modifications are likely to make even greater business sense in the student loan context due to the unsecured nature of student

LEARNING FROM THE OBAMA ADMINISTRATION'S MODIFICATION PLAN FOR HOMEOWNERS

The blue print for a student loan mandatory modification program can be found in the Obama administration's Home Affordable Modification Program. This program will provide relief to many homeowners in default and those facing the risk of imminent default. The program:

- Supports affordable loan modifications based on modest debt-to-income ratios with substantial decreases in payments and interest rates;
- Stops foreclosures while loan modification analyses are occurring;
- Requires participating institutions to apply the program to their whole portfolio and to take reasonable steps to secure additional authority where needed;
- Incentivizes principal forgiveness as well as interest rate reduction;
- Permits servicers to make and counselors to recommend more aggressive modifications when appropriate;
- Waives unpaid late fees for borrowers;
- Provides various incentive fees for servicers.

More detail can be found at http://www.financialstability.gov.

loans. A student lender that sues and gets a judgment has no collateral to seize. Presumably, many of these borrowers will be "collection proof." Others, especially those that went to fraudulent trade schools, could potentially raise legal claims against the creditors. We were unable to compare the numbers and evaluate how funds seized through collections compare to payments received through modifications. In order to fully understand this analysis, lenders must be required to provide information to investors, regulators and the public comparing numbers of collection actions and recoveries from such actions to the performance of loan modifications. The Obama administration's homeownership plan, for example, will require servicers to provide data about loan modifications, borrower and property characteristics, and income.[53]

Meaningful assistance should include loan restructuring and flexible repayment. Servicers should have the authority to modify loan terms, change interest rates, forbear or forgive principal, extend maturity dates, offer forbearances, repayment plans for arrearages, flexible repayment and deferments. Congress and the Administration should also act to ensure that borrowers receiving relief through these programs do not face tax consequences.

Many current lender efforts, such as enhanced counseling and default prevention programs, may help in the future, but are insufficient to assist those already in trouble. As Professor Kurt Eggert notes in the mortgage context, "Early intervention and modeling software will not help a borrower who fundamentally cannot afford a loan."[54] Meaningful mitigation means developing long-term solutions that work for both borrowers and investors. The modifications have to be substantial enough so that the risk of redefault is low.

Barriers to Loss Mitigation Programs

Restrictions in Securitization Agreements?

It is short-sighted not to work with borrowers that can afford to repay. We can only speculate about the reasons why lenders are not doing more, other than the fact that no one has required them to do so.

One possibility is that servicers may feel constrained in cases where the loans have been securitized. This has occurred in the mortgage context where servicers often claim that the pooling and servicing agreements do not let them modify loans. In reality, most securitization documents give broad authority to servicers to service loans in accordance with customary standards, often also stating that the servicers must act in the best interests of investors.[55] In any case, we have not heard creditors or servicers use this excuse in the student loan context. In fact, Sallie Mae and VSAC stated that they service the loans the same whether they are securitized or not. In addition, Sallie Mae has stated that they securitized a lower percentage of their non-traditional loans, the most troublesome loans.[56]

To further test this issue, we thoroughly reviewed two recent Sallie Mae PSAs from 2006 and 2007, a 2000 Key Bank PSA, and a 2006 National Collegiate Trust, administered by First Marblehead Data Services. We did not find any explicit barriers to modifications in any of those agreements. The Sallie Mae agreements specified that servicers must use the same standard of care used to service other student loans owed by Sallie Mae, in compliance with applicable guarantee agreements and other applicable state and federal law. The Sallie Mae agreements admonish the servicer not to do anything to impair the rights of the investors. However, the agreements are explicit that servicers *can* reschedule, revise, defer or otherwise compromise payments due on any student loan during applicable interest only, deferment, or forbearance periods or otherwise as long as the servicer uses the same standards it uses for similar student loans owned by Sallie Mae.

The "best interests of investors" clause is not necessarily the barrier it might appear to be on first glance. As discussed above, although we could not find data on this issue, it is logical to assume that it will be in the best interests of investors in many cases to restructure loans and thereby ensure a continued stream of payments. For example, the FDIC's loan modification program for Indymac and the administration's new loan modification program focus on whether loan modifications are more beneficial to investors than foreclosure. In the mortgage context, many loan modifications that are good for investors have not been made to date. In any case, the other PSAs we examined did not contain the "best investor clause," requiring servicers only to perform the services and duties customary to the servicing of student loans with reasonable care and to do so in compliance with all applicable standards and procedures. Now that the industry standard for mortgage loans is evolving toward aggressive, standardized loan modifications, it is appropriate to figure out ways to do the same in other markets, including student loans.

The Cost of Modifications

Even if servicers know they have discretion to modify and restructure loans, they may choose not to exercise it because of the additional expense. Loan modifications can be labor intensive, although student loan modifications should be less complex than modifying mortgage loans. Unlike mortgage modifications, there is no underlying asset that requires valuation for student loans.

In the typical student loan PSAs we reviewed, servicers received two fees, a primary fee and a carryover servicing fee. The Sallie Mae system, for example, awards servicers a primary fee for any month equal to 1/12 of an amount not to exceed .70% of the outstanding principal amount of the trust student loans. The fee is payable in arrears out of amounts on deposit in the collection account, the cash capitalization account and the reserve account. The carryover fee is payable to the servicer on each distribution date out of available funds remaining after all payments owing on the notes have been made. The fee is the sum of:

- The amount of specified increases in the costs incurred by the servicer;
- The amount of specified conversion, transfer and removal fees;
- Any amounts descried above that remain unpaid from prior distribution dates; and
- Interest on any unpaid amounts.

The payment of these funds does not appear to be dependent on servicer performance.

To some extent, it should be easier to automate modifications for student loans. However, servicers will still be required to thoroughly evaluate a borrower's income and ability to pay so as to maximize the return to investors while reducing the likelihood that the borrower will default again.[57]

Additional investigation is needed to assess whether servicers are holding back on student loan modifications because of cost. If so, there are ways to address this problem, including additional compensation for servicers. This has been suggested in the mortgage context and is part of the Obama Administration's new homeowner relief plan.[58]

Accounting Problems

It is possible that lenders feel constrained by accounting and other regulations which generally require consumers to repay settled debts within three to six months and lenders to recognize forgiven amounts as losses during this time period. However, we have not heard this concern expressed directly in the student loan context. In addition, federal regulators can if necessary act to allow creditors to make these settlements and eliminate or reduce any tax liability for consumers.

2. Restore Bankruptcy Rights

It is nearly impossible at this point for student loan borrowers to get any type of long-term relief from servicers and creditors. Most are also shut off from bankruptcy.

Creditors succeeded in persuading Congress in 2005 to make private loans as difficult to discharge in bankruptcy as federal loans. Current bankruptcy law treats students who face financial distress the same severe way as people who are trying to discharge child support debts, alimony, overdue taxes and criminal fines.

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.[59] The system is strikingly arbitrary. Judges are granted extraordinary discretion to make these decisions, especially since the code provides no definition of "undue hardship." A study of 261 reported decisions affirmed the randomness in the application of the undue hardship test.[60] The study found few statistically significant differences between the debtors granted discharges and those that were not. The study also found that students seeking bankruptcy relief were in fact suffering financial distress. The authors conclude that judicial discretion has come to undermine the integrity of the undue hardship system.[61]

Many courts, recognizing the inequity of this system, have begun to create an *ad hoc* middle ground. Some allow partial relief by discharging a portion of the debt or by discharging some, but not all, of the loans. Some courts have allowed a restructuring of the loan, for example by discharging collection fees and accrued interest and even by delaying the student's obligation to start making payments, during which time no further interest accrues.[62]

Whether a borrower gets the benefit of a middle ground approach depends entirely on where she happens to live and the judge she happens to draw. This is unfair, but the judges have a point. They are flying by the seat of their pants because they understand that the current all or nothing approach does not work for everyone.

There might be ways to incorporate some of the *ad hoc* policies into the bankruptcy system through partial discharges or by separately classifying student loans in Chapter 13 plans so that borrowers can make a bigger dent in these nondischargeable debts during the course of the plan. *These middle ground approaches should be considered, but not as a substitute for full bankruptcy rights for the neediest borrowers*. If, however, the undue hardship system is retained for these borrowers, the standard should be refined to target those in the most distress and to ease the burden of proof. Congress should also restore the waiting period as an alternative ground for discharge. A five year waiting period has the benefit of allowing a more straightforward process so that borrowers who cannot access the system are not unfairly penalized and of weeding out those borrowers who can work, but are choosing not to. If they truly have assets and income, their loan holders can try to collect during the waiting period. At a bare minimum, full bankruptcy rights must be restored for financially distressed private loan borrowers.

It is difficult to separate fact from fiction when trying to understand the logic behind this policy, but one thing is clear—the restrictions came about without any empirical evidence that students were more likely to "abuse" the bankruptcy system.[63] It is long past time to restore these rights to borrowers. Restoration of bankruptcy rights will also provide a strong incentive to student lenders to provide aggressive modifications outside of bankruptcy in order to reduce losses.

3. *Loan Cancellations for Fraud Victims*

Not all borrowers will benefit from modifications. Only those that are in serious financial trouble, but still have some income to pay toward their loans will qualify. Many of the most vulnerable borrowers will be left without relief. As one step to helping these borrowers, we recommend that all borrowers that received private loans to attend unlicensed, unaccredited, schools that closed or are currently in bankruptcy, receive full loan cancellations.

This issue has received little attention, but is one of the most egregious consequences of predatory student lending. For years, lenders fought to get into this largely unregulated world. During this time, a particularly unholy alliance developed between unlicensed and unaccredited schools and mainstream banks and lenders.[64] The creditors did not just provide high-interest private loans to students to attend unscrupulous schools; they actually sought out the schools and partnered with them, helping to lure students into scam operations. They then turned around and, like subprime mortgage providers, made big profits on these loans by securitizing them and shifting the risky debt onto unsuspecting investors.

Inferior schools continue to open and close on a regular basis. In March 2009, the for-profit Connecticut School of Broadcasting abruptly shut its doors. Many students arrived for classes only to find that the doors were locked. These students were paying about $12,000 for a 16 week course.[65] The school was owned by a division of Credit Suisse.

NOWHERE TO TURN

Joe is a 25 year old student at Salem State College in Massachusetts. Without a glaring problem from his past, he would be much like many other students at the state college. He works part-time to help meet expenses, is articulate, ambitious and personable. He took out federal loans to help defray expenses at the public college. Unfortunately, about five years ago, he saw an advertisement for a for-profit culinary school. He visited the school and was told about the amazing curriculum and strong job placement program. The price tag of about $35,000, they said, would be easily repaid through lucrative earnings after graduation. Joe was young and impressionable and eager to work in the culinary field, so he signed up. He found out almost immediately that the school's statements were empty promises. The teachers were inexperienced and the materials and equipment inferior. He asked about leaving and was told that he could not get a refund. He stayed and finished and was never given job placement assistance, despite his requests. He has since moved on and tried to put the experience behind him, but the loans will not go away. He thinks he will be able to mange the federal loans, but his two private loans with current interest rates of about 15% are unaffordable. He says he wants to pay something and has asked for a break, but the creditor offers only forbearances and in-school deferments. In response to Joe's request for assistance, the creditor replied that Joe's obligation was not negotiable. Joe is angry and frustrated and has nowhere to turn. His future plans to build assets and a family will be delayed as he tries to figure out a way to deal with this inescapable debt burden.

These consumers have been hit particularly hard. They are stuck with debts they cannot repay from worthless schools. Lenders that poured resources into ripping off students have spared no expense in trying to silence students who fight back by making it difficult for students to bring lawsuits in convenient forums, mandating arbitration, and claiming that state laws do not apply to them. In the current environment where creditors are rewarded with bail-outs for prior bad acts and where no one wants to take responsibility for the meltdown, taking action in this area is one small way to hold creditors liable for the damage they have done.

4. *Re-Regulate the Industry*

Among other reforms, re-regulation must include:

Mandated Underwriting

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. Although more difficult in the student loan context where many borrowers are young and it is more difficult to predict their future earning abilities, we urge that similar standards be imposed. The general concept of lending only to those that are likely to be able to repay remains critical in the student loan market.

Limits on Interest Rates and Fees

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.

Remedies for Fraud Victims

We recommended above that past victims of fraud receive complete loan cancellations. To help prevent this problem from surfacing again, all lenders must be required to include the FTC Holder notice in their products going forward. Further, for those receiving government funds, the term should be implied in all contracts previously made.

The holder rule (more accurately referred to as the Federal Trade Commission Preservation of Claims Rule), puts lenders on the hook when they have "referring relationships" with trade schools that defraud students or shut down unexpectedly.[66] When this occurs, the lender experiences heightened pressure to originate loans with upstanding schools so that they or subsequent loan purchasers will not shoulder the liability risk later. Under the provision, students are entitled to recover any payments they have made and to have their remaining indebtedness canceled.

In NCLC's March 2008 report, we found that most private student loan providers flaunt the rule.[67] Of the loans in our survey, we found that 40 percent did not include the holder notice in them at all. Nearly all the rest contained the notice but undermined it by including contradictory clauses—saying, for example, that students would be responsible for repaying the loans in full no matter how dissatisfied they were with the schools.

Improved Disclosures

Congress took an important initial step in 2008 when it passed new disclosure requirements for private student loans.[68] The Federal Reserve Board released proposed regulations in March 2009.[69] These proposals have some good features, including model disclosures that should help borrowers compare the cost of private student loans with other types of credit. Among other concerns, however, the proposal includes prominent disclosure of the interest rate and a less prominent disclosure of the APR. It is more accurate to look at the APR to determine the trust cost of a loan because it shows the full cost including many of the lender's fees. Other types of credit include an APR disclosure prominently at the top in a separate box. In addition, the Board does not require that lenders set a maximum rate cap.

Private Remedies and Access to Justice

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 as described above, 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.

Conclusion

For many years, private student loans generated steady, if unspectacular, profits. The business model was relatively conservative, providing loans mainly to graduate students and creditworthy borrowers. Armed with imperfect information and an all too tempting boom market, lenders adopted a new model in recent years. Unfortunately, making large and often very expensive loans to lower credit tier borrowers was destined to fail. Now that it has failed, lenders are starting to pick up the pieces and adopt more responsible practices. Hopefully the government will encourage this type of lending rather than a return to the predatory days.

As this economic lesson has unfolded, many borrowers have found that they have insurmountable debt loads. Some will never be able to repay. These borrowers need a safety net, including bankruptcy discharge rights and cancellation rights for fraud victims, to give them some hope of starting again. Without relief, these borrowers will never be able to help fulfill our social and economic need for a productive, educated work force.

Other borrowers can pay, but not at the levels currently required. The lenders that created this mess can and should be part of the solution. We have shown that so far, they have not done much on a voluntary basis to provide assistance at least that they are willing to reveal. At a minimum, those lenders receiving government funds must be required to expand loss mitigation and other assistance. Other incentives must be developed to bring the others along.

This report uncovers how an unsustainable business model helped crash our economy. These unsustainable products were taken out by individuals trying to improve their futures. "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. While it may be impossible to get all of these individuals back on track, it is clearly possible to help some. The fact that lenders are hardly trying is a national disgrace. We cannot truly begin to reshape the future and improve access to education without redress for those left behind.

APPENDIX

National Consumer Law Center's
Student Loan Borrower Assistance Project

Questions about Programs to Assist Financially Distressed Private Student Loan Borrowers

1. Please describe the options/programs you offer, if any, to private loan borrowers who are having trouble with loan repayment? If you offer different programs for different products, please describe the programs for at least 3 representative products. Please also specify if you do not have any such programs/options.

   (If you offer these programs, please describe each option in detail. e.g. if you offer forbearances, how long is the term; what are the qualifying conditions; are there restrictions on the number of forbearances per borrower etc.)

2. Are the programs described in #1 above standardized or are they determined on a case by case basis?
3. If the answer to #2 above is that the programs are standardized, are these programs described in writing? If so, are these available publicly?
4. How does a borrower typically find out about these options/programs?
5. Are there ways in which borrowers can automatically qualify for the programs described in #1? If not, is eligibility at the discretion of the servicer (or another entity)?
6. Are there different options depending on whether a borrower is delinquent rather than in default?
7. Are the options different if a borrower's loan is part of a securitization trust? If so, please describe.
8. Has your company made any changes to these options/programs to respond to the economic crisis? If so, please describe.
9. If the answer to #8 above is "no," please explain the main reasons why your company has not made changes and whether you are planning to do so.
10. Please name the entities that typically service your company's loans. Are these servicers affiliated with your company?

Please send responses to Deanne Loonin, National Consumer Law Center, dloonin@nclc.org; 617-542-8010.

Notes

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[8] Bethany McLean, "The Surprising Profits of Student Loans," CNNMoney.com (April 16, 2007).
[9] Id.
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[12] Bethany McLean, "When Sallie Met Wall Street," *Fortune* (Dec. 26, 2005).
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[24] SLM Corporation Q4 2007 earnings Call Transcript (Jan. 23, 2008), available at: http://seekingalpha.com/article/61303-slm-corporation-q4-2007-earnings-call-transcript?page=8.
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