Consumer Financial Protection Bureau

CYCLE OF BOOM AND BUST IN PRIVATE STUDENT LOAN MARKET

OVERVIEW

The Consumer Financial Protection Bureau and the U.S. Department of Education have released a report on private student loans that describes the risky practices and debt that stemmed from the boom and bust of the private student loan market in the past ten years. Outstanding student loan debt in the United States is currently over $1 trillion -- $864 billion of federal student debt and approximately $150 billion of private student loan debt.

Prior to the financial crisis, private student lending boomed. Many of the riskiest loan originators were nonbanks who marketed and securitized loans made by banks and credit unions but were not subject to the same oversight. In the Dodd-Frank Wall Street Reform and Consumer Protection Act, Congress leveled the playing field and named these nonbank private student loan originators as a sector subject to the CFPB's oversight. Congress also created an ombudsman in the CFPB for private student loans.

Congress also mandated that the CFPB and the U.S. Department of Education study the private student loan market and provide recommendations to help student borrowers. The study has been completed and such recommendations include: asking that Congress enhance the role of schools in the private student loan origination process, examine the appropriateness of the bankruptcy discharge standard, and modernize the regulatory framework to ensure a competitive, fair market where consumers fully understand their debt obligations and lenders have appropriate data to make underwriting decisions. For this study, the CFPB received loan data from nine lenders on over five million loans made between 2005 and 2011, as well as data from five nonprofit lenders.

PRIVATE STUDENT LOANS RISKIER THAN FEDERAL STUDENT LOANS

In the run up to the financial crisis, private student loans followed a path similar to that found in other lending markets, where many borrowers took on more risk than they understood. Borrowers saw loans available at low rates in marketing materials, and lenders were willing to provide those loans to borrowers in some cases with insufficient regard to the ability of borrowers to repay. Many borrowers took on too much debt, and risked payment shock from variable rate loans, while lacking critical consumer protections that can serve as a life raft during a tough economy.

Interest rates are a gamble: Most private student lenders use risk-based pricing, meaning that, before regulations changed in 2010 creating new disclosures, consumers often saw the lowest possible rate – not necessarily the rate they would actually receive -- when they applied. This is far different than federal student loans, which are fixed at specified rates.

- While marketing materials might show a low rate, there can be a material difference in the initial rate presented and the actual rate received. Prior to 2010, federal law did not require a disclosure showing the actual interest rate on a borrower's loan until after the lender documented the loan, approved the credit and readied the check for mailing.
- Interest rates for private student loans can vary from quarter to quarter or even month to month, based on the current interest rate environment.

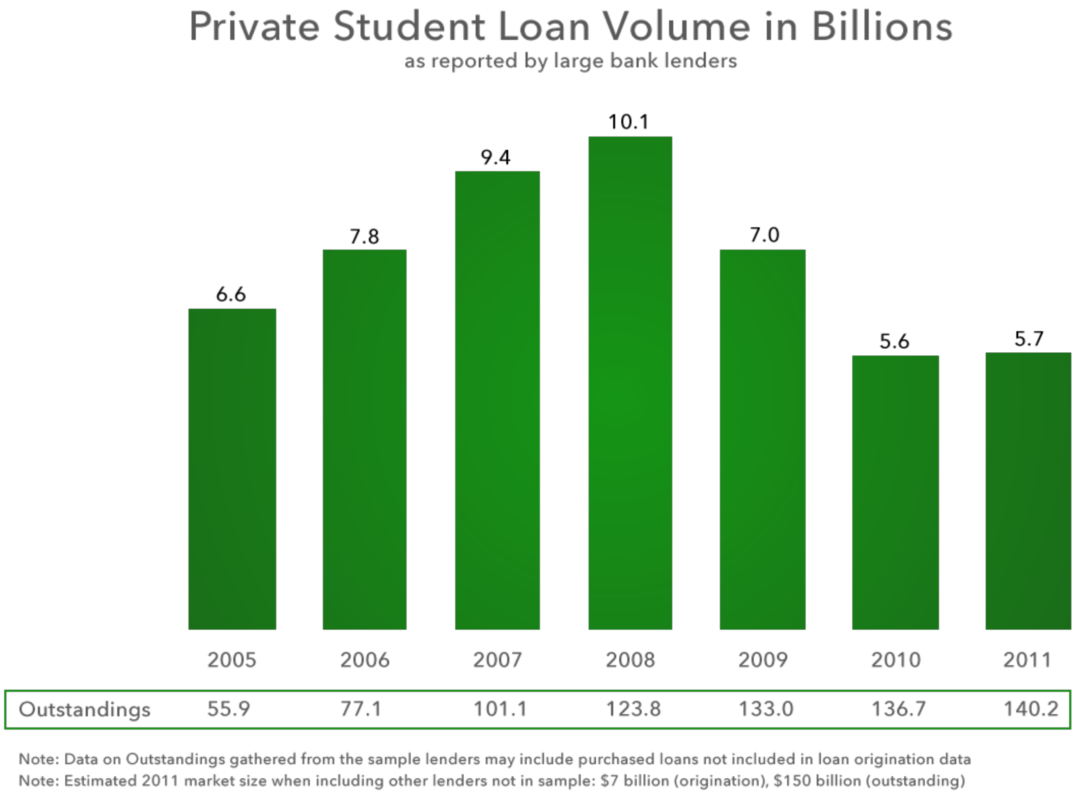
- With interest rate indices near zero, and at historic lows, private student loans with variable interest rates have little room to fall, with the potential to increase substantially from current prices; many have no maximum rate.
- For example, the most commonly used interest rate index that private student loans are based on changed by over five percent in the last five years. For college freshmen starting this fall, it will be difficult to predict what their monthly payment might be on a variable rate private student loan after graduation four years from now. Many private student loan borrowers could face payment shock at their first bill.

Generally more expensive than federal loans: Over the long term, the average borrower pays a higher interest rate for private student loans than for the fixed-rate federal Stafford loan.

- The current interest rate environment is historically low. Starting in 2008, the average private student loan borrower who took out a loan in 2005 would have seen her rate drop below the unsubsidized Stafford rate. But if average borrowers who take out loans today should keep those loans when rates return to historical levels, they will always pay more than the federal rate.
- Those private student loan borrowers who paid the highest rates in 2011 would have paid between 13 percent and 20 percent interest in the typical rate environment of the last 20 years.
- The current rate for unsubsidized federal Stafford loans is a fixed rate of 6.8 percent.

Fewer consumer protections than federal loans: While private student loan products were originally created to mimic the structure and features of federal loans, they do not have the same protections for struggling borrowers that federal loans have, especially during tough economic times.

- Federal student loans are eligible for a host of flexible repayment options. As just one example, the Income-Based Repayment program (IBR) allows borrowers to cap their student loan payments at a reasonable percentage of their income.
- Federal student loans provide protections when the borrower dies or becomes permanently disabled. But a parent co-signing a private student loan might be stuck with the debt, even if something happens to their child.
- When a federal student loan borrower defaults, there are programs to help the borrower get back on the road to repayment and even reverse the default notation on their credit report. Private student loans generally do not carry this option.



RISKY LENDING PRACTICES FUEL PRIVATE STUDENT LOAN BOOM

Like the mortgage market, rising prices and demand from investors in asset-backed securities helped drive rapid growth in private student lending. With little skin in the game, many lenders employed risky practices like avoiding the school's financial aid office and loosening underwriting standards. Many borrowers accepted more money than they needed. The result: More borrowers and more debt.

Investor demand creates incentive for quantity over quality: In the years leading up to the financial crisis, some lenders made money by originating and immediately selling private student loans to investors in the asset-backed securities market, instead of holding on to them. This meant that some lenders had more incentive to increase the number of private student loan borrowers and the amount of debt, and less incentive to assure that the borrowers could afford the loans.

- Annual private student loan origination nearly doubled between 2004 and the start of the 2008 financial crisis, reaching over $20 billion.
- The volume of private student loans that were securitized more than doubled from 2004 to 2006. They peaked in 2006 at $16 billion, which represented nearly three-fourths of private student loans made that year.

Underwriting standards weaken and direct-to-consumer lending grows rapidly: During the boom, lenders began to bypass the school certification process with "direct-to-consumer" lending. These loans were marketed through mass media and online advertising, sold directly to consumers, and disbursed to the student instead of the school. This process meant that lenders were not checking to make sure that students were actually enrolled or looking at the students' full financial aid package to ensure that loans were not exceeding the amount needed. Lenders made money by originating and then selling private student loans—so there was less incentive to ensure that the borrower could repay the loan.

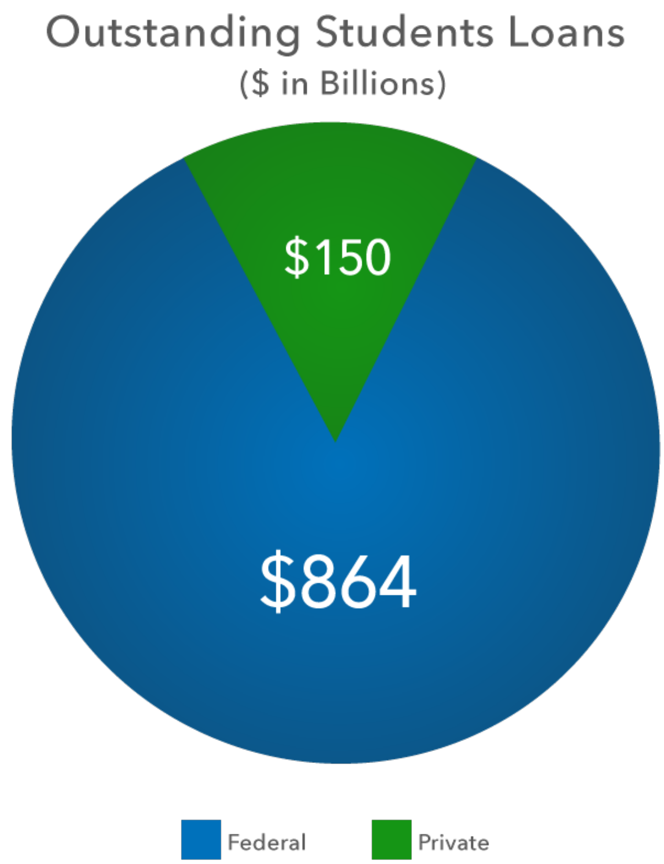
- In 2005, 60 percent of undergraduate loans were certified by the school's financial aid office. By 2008, only 27.8 percent of undergraduate loans were school certified. In other words, 3 of every 4 loans did not even give the opportunity for a financial aid officer to counsel students on their options.
- As schools were cut out of the process, loan amounts rose as a percentage of tuition. In that same year, undergraduates in the sample borrowed nearly 150 percent of tuition in private student loans, before taking any federal loans or grants into account.
- Lenders also lowered the minimum credit score required to receive a private student loan so that they could originate and then sell off more loans.

For-profit colleges increase private lending: For-profit colleges often made deals with private student lenders to offer loans to their students. For-profit colleges are required to collect at least 10 percent of their revenue from sources outside of federal student aid (such as Pell Grants and Stafford Loans). Private student loan borrowing can help them meet this requirement.

- In the 2007-2008 school year, 46 percent of students at for-profit four-year colleges took out a private student loan, compared to 25 percent of students at private nonprofit four-year colleges.
- While most lenders today avoid lending to students attending many for-profit schools due to historically high default rates, some of these colleges are arranging new loan programs for their students. The new programs often have high interest rates and high predicted default rates.

Borrowers confused by the new options and availability: Many borrowers thought that their private student loans would have similar features to a federal student loan. Even when deferments are available, interest continues to accrue, unlike a subsidized Stafford Loan or a Perkins Loan.

- Some believed they would not qualify for federal student loans and thought that a private student loan was an economic substitute.
- Adding to the confusion, some lenders offered both federal student loans and private student loans. Prior to the financial crisis, financial institutions offered most federal student loans, backed with a government guarantee. Many of the largest lenders of private loans also offered federal loans.



<u>BORROWERS TRAPPED AND STRUGGLING AS PRIVATE STUDENT LOAN MARKET BUSTS</u>
As the financial crisis unfolded, Wall Street investors began to shun asset-backed securities backed by private student loans. Lenders now find that they need to hold on to the loans that they make, giving them skin in the game and leading to more prudent lending standards. This has helped to reduce risks on new loans, but many borrowers who took on private student loan debt before the crisis are stuck. Undergraduate borrowers who entered college in 2005 and took on private student loans find themselves entering the labor force in a tough economy. Without federal student loan repayment flexibility and options through the courts to restructure their debts, many borrowers are struggling.

Lending standards tighten in wake of financial crisis: Since 2008, lenders have improved their underwriting and marketing practices. With investors skeptical about buying securities backed by packaged loans, lenders are forced to hold on to student loans, leading to much more cautious practices.

- After 2008, lenders rapidly increased the share of loans with a creditworthy co-signer, from 67 percent in 2008 to over 85 percent in 2009. By 2011, over 90 percent of private student loans were co-signed.

- Also by 2011, 90 percent of private student loans to undergraduates required the school to certify the student's need for financing.
- Overall credit scores of borrowers and co-borrowers have also increased since 2008. Weighted average FICO scores from 2005 to 2011 varied by as much as 40-60 points as credit standards first dipped and then, after the financial crisis, rapidly increased.
- In the study's sample, the 25th percentile FICO score increased from 599 in mid-2007 to 653 in mid-2009. Reducing lending to the least creditworthy borrowers was the primary driver of higher average FICOs in the sample.

Borrowers are defaulting on their private student loans: Given the tough economy after the financial crisis, many young graduates are unable to find employment to meet their debt obligations. For the relatively high number of private student loan borrowers currently having difficulty with repayment, it is hard to avoid default and equally hard to get back on track.

- The cumulative defaults on private student loans reached over $8 billion in the study's data set, with the average amount in default at $9,700.
- A private student loan default has significant consequences for a young person's credit. It might be more difficult to qualify for a new loan, rent an apartment, or even find a job if an employer uses a credit check as part of the hiring process. Even if a consumer can obtain credit, the price may be substantially higher with derogatory events in a consumer's credit profile.

Borrowers are unable to discharge private student loans in bankruptcy: In 2005, the bankruptcy code was changed to treat private student loans differently from other consumer debt, like credit cards. Borrowers now have a tougher time making the case for restructuring their debt in bankruptcy proceedings. But it isn't clear that the change in the bankruptcy code directly reduced the cost of private loan products or expanded access to credit. As a result of the bankruptcy code change, borrowers are trapped in loans that would not have been made under current lending standards.

- The study's data set included over 850,000 loans in default. This volume may be the consequence of loose underwriting standards. However, without the flexible repayment options of federal student loans or bankruptcy options, these borrowers may be stuck.

Borrowers are unable to refinance or modify loans*:* The Bureau received nearly 2,000 comments from individual borrowers about their experience with private student loans, and many reported their lender was unwilling to modify or adjust repayment terms.

- Borrowers feel they have little leverage to negotiate reduced loan payments with their lenders.
- Forbearance availability is much lower than it has been in the past. In the sample, the portion of loans in forbearance went from 13.7 percent in 2005, peaked at 17 percent in 2007 and then plummeted to just 3 percent today.
- Even borrowers dutifully making payments told us they are unable to refinance and reduce their payments.