Consumer Financial Protection Bureau

1700 G Street, N.W., Washington, DC 20552

February 3, 2014

Dear Colleagues:

In November, I wrote to a number of private student loan servicers to learn more about their payment processing policies to inform the CFPB's market monitoring and consumer education initiatives.[1] Some of you have inquired as to what the CFPB learned from these responses. Below is a discussion of some of our findings from the responses to the voluntary information request, supplemented by follow-up discussions with industry participants.

Summary of Key Findings

- Many borrowers remit payments through online, third-party bill pay services, but many servicers responded that they cannot honor specific payment allocation instructions communicated through this payment method.

- Many online payment platforms maintained by servicers allow borrowers to direct payments to a specific loan, but others do not. Some servicers with inflexible systems that do not allow targeted payments engage in a workaround, requiring the borrower to contact their servicer following a payment and request a reallocation.

- Many respondents indicated that they are making other changes to improve communications to borrowers about payment processing policies.

- Many servicers are not well-equipped to accept payment instructions in advance of a payment made by a third party, such as those made by the Department of the Defense on behalf of servicemembers receiving loan repayment assistance.

- Some servicers have recently changed their payment allocation policies. These participants now allocate payments from borrowers in excess of the scheduled payment amount or

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[1] The information request letter is available at http://files.consumerfinance.gov/f/201311_cfpb_letter-to-student-loan-servicers.pdf

statement balance due to balances with the highest interest rate, which is generally more favorable to borrowers.

Background

Borrowers, loan holders, and third-party servicers may have mismatched incentives at certain points in the repayment process.

Consider a borrower with $30,000 in private student loans spread over multiple loans at multiple rates. These loans are part of a securitized pool and managed by a single servicer. If the borrower is looking to pay off these loans more quickly, the outcomes for the trust and its bondholders, the servicer, and the borrower vary based on how extra payments are processed.

Third-party student loan servicers – those market participants that manage billing and receivables on behalf of a loan's owner – generally receive a flat monthly fee per account serviced, per month. The monthly rate generally varies depending on the status of the loans in the borrower's account (e.g., "in school," "in repayment"), but, typically, student loan servicer compensation is not tied to any specific services performed on behalf of a borrower.

In the example above, when borrower payments in excess of the scheduled payment amount or statement balance due are allocated to loans with the highest interest rate, the borrower is better off, but the trust and its bondholders, as well as the third-party servicer may not be. When student loan borrowers prepay, loan holders receive less interest revenue[2] and third-party servicers may receive less compensation (given the shorter loan duration).

While these differences may be small, servicers may not have the financial incentive to allow borrowers to target prepayments to a specific loan. Ironically, creating obstacles for borrowers to direct payments to a specific loan can *increase* future servicing revenue. Incentive misalignment was one cause of significant harm to consumers in the mortgage servicing industry. This may also be a contributing factor to the frustration experienced by many private student loan borrowers who submit complaints to the CFPB about payment allocation issues.

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[2] For student loans held in asset-backed securities, owners of residual claims may have more direct exposure to prepayments. In some cases, the owner of the residuals may reside in the same corporate entity as the servicer.

Summary of Responses to Information Request Letter

Respondent Number	Payment processing policy absent borrower instructions	Honors standing payment allocation instructions	Honors instructions electronically provided through third party bill pay services	Proactively communicates to borrowers who send prepayments without instructions
1	Satisfy all outstanding monthly payments. Remainder applied to loan with the highest interest rate.	Yes	Unclear response	Declined to respond
2	Satisfy any outstanding late fees, accrued interest, and then principal due. Remainder applied to loan with the highest interest rate.	Yes	No	Declined to respond
3	Satisfy any outstanding late fees, accrued interest, and then principal due. Remainder allocated pro rata across loans.	Yes	No	No
4	Satisfy any accrued interest, principal, and fees. Remainder applied to loan with the highest interest rate.	Under some circumstances	No	Declined to respond
5	Satisfy any outstanding late fees, accrued interest, and then principal due. Remainder allocated pro rata across loans.	Yes	No	No
6	Satisfy any outstanding late fees, accrued interest, and then principal due. Remainder allocated pro rata across loans.	No	No	Declined to respond

Responses to Information Request Letter

Respondents to the information request letter represented many corporate forms: third-parties servicing notes held by banks or in a securitized pool, large depository institutions servicing loans in-house, and small depository institutions.

There appear to be two critical issues that many respondents consider when evaluating their processes. The first pertains to whether the methods in which a borrower can make a prepayment toward a specific loan are simple and transparent. The second pertains to prepayment allocation policies when borrowers do not provide (or unable to provide due to constraints associated with a specific payment method) accompanying instructions.

Anonymized responses are provided in the accompanying table, and discussed below.[3]

Responses from servicers varied as to whether a private student loan servicer can honor standing instructions provided by borrowers seeking to alter the standard allocation policy or allow special accommodations to the borrower's account. Some servicers responded that they are unable to modify the standard allocation policy because their servicing platforms are not configured to adjust the standard allocation procedure for individual borrowers. However, some servicers noted that they would need to manually reallocate payments retroactively, as of the date the payment was received, if the borrower requests payment allocation that differs from the standard policy. Some servicers told us that they prefer to receive this request electronically, via e-mail or the online messaging system on the servicer's website.

The process and level of borrower involvement required to request an accommodation diverging from the servicer's standard policy varies by servicer. Some respondents require significant interaction with borrowers to comply with an allocation preference. They require borrowers to contact them after every prepayment, through e-mail, the online messaging system on the servicer's website, U.S. mail, or by telephone, in order to request that the funds be allocated differently. This "hassle factor" may deter borrowers from providing instructions.

Other servicers provide options to minimize borrower involvement. Some respondents may offer to manually monitor the borrower's account and reallocate future payments based on borrower

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[3] In the process of reviewing responses, we did not seek to assess whether servicer policies were compliant with existing law.

instructions without requiring the borrower to contact the servicer. In addition, some servicers stated that a borrower can direct funds toward a specific loan by using the servicer's online servicing platform, allowing the borrower to target their payments without having to contact the servicer each month.[4]

I. Most respondents noted that they cannot honor payment allocation instructions provided through third-party online bill pay services because instructions may not be transmitted along with the payment

Many third-party bill pay providers allow a borrower to insert special instructions into a memo or other notation field when initiating a payment online. Payments made through online bill pay systems can initiate the electronic transmission of payment to the recipient or produce a paper check remitted by mail.

If the online bill pay provider provides a paper check, the borrower's instructions are often provided on the memo line of the check. However, most of the servicers who responded receive "batch payments" electronically from these bill pay providers. My colleagues and I reviewed a number of bill pay provider interfaces, as well as the accompanying terms and conditions. In most cases, if a bill pay provider captures written instructions from the borrower, this information may not be transmitted to a servicer that receives electronic batch payments.

II. Most online payment platforms maintained by servicers allow borrowers to target excess payments to a specific loan

Respondents noted that a large portion of borrowers utilize direct debit options provided by their servicer. When a borrower initiates a payment in excess of the scheduled payment amount or statement balance due, some online platforms allow excess payments to be applied to a specific loan, while others will apply the servicer's standard allocation policy.

Some respondents instruct borrowers make two separate payments: enroll in auto-debit (where the scheduled payment amount is automatically withdrawn from the borrower's bank account)

[4] One respondent noted that they are able to modify the standard payment processing policy if the borrower opts to enroll in their direct debit program. By enrolling in the direct debit program, the servicer is able to distribute future payments based on borrower's standing instructions toward to a specific loan. However, standing instructions for future payments made through means other than through the direct debit program requires the borrower to contact the servicer to reallocate the payment.

and then make an additional payment through the online servicing platform to initiate a second payment targeted toward a specific loan.

III. Respondents did not indicate that they send targeted communications to borrowers who send prepayments without instructions

When using certain payment mechanisms (such as a third-party bill pay service), borrowers may be unable to provide allocation instructions. We were surprised to find that none of the respondents stated that they send targeted communications to borrowers who send prepayments through payment mechanisms where allocation instructions cannot be included.

Some servicers noted that policies could be found on their websites. However, multiple respondents noted that there is significant opportunity to improve transparency and communication of these policies.

IV. Respondents state they generally cannot accommodate borrower instructions in advance of a specific payment made by a third party, such as the large lump-sums provided by the U.S. Department of Defense on behalf of active-duty servicemembers

Respondents noted that they process payments based on instructions that accompany the payments.[5] Since third parties cannot access the borrower's account online, they may not have sufficient information to provide instructions. In this situation, respondents noted that all excess payments are allocated based on the servicer's standard allocation policy. As noted in the accompanying table, some respondents are unable to accept standing or advance payment allocation instructions.

Some respondents who do not accept these standing instructions noted that the servicemembers may need to contact their servicer to request a "reallocation."

V. Some servicers have changed their prepayment allocation policies when borrowers do not send instructions.

Generally, private student loan servicers responded that excess payments are applied based on the logic programmed into their IT platforms. Of those companies that provided detailed payment

[5] The CFPB continues to receive complaints that specific instructions accompanying payments have not been honored.

application methodology, respondents stated that on a per loan basis, payments are first applied to outstanding fees, interest, and then principal.

Recently, some servicers have adjusted their standard payment processing policies to apply remaining funds in excess of total amount due toward the loan with the highest interest rate, which will generally reduce the total interest paid by the borrower over the life of the loan. For servicers that do not accept standing instructions or transparently communicate a simple prepayment method, this policy change may help servicers ensure compliance with the Truth-in-Lending Act's prohibition on private student loan prepayment penalties.

In addition to providing information specifically requested in the information request letter, I also received inquiries asking for a perspective on an appropriate standard allocation policy when borrowers have both fixed and variable rate loans

Of course, providing a simple and transparent way for borrowers to target payments allows for borrowers to make their own choice. But, for servicers looking to adopt borrower-friendly policies in absence of specific instructions, our preliminary analysis suggests that applying excess funds toward the loan with the highest *current* interest rate will save the borrower interest in the short run and also over the life of the loan.

As part of the joint report conducted by the CFPB and the Department of Education on private student loans, we examined interest rate structure and noted that a wide range of indices were used. Our early analysis suggests that these index rates would have to increase suddenly and dramatically (in an historically aberrant fashion) for it to be economically worthwhile for a borrower to be better off directing excess payments to a variable rate loan with a comparatively-lower current interest rate, holding all else equal. As always, we welcome any input you may wish to share on this topic.

Thank you again to all of the respondents who participated, and we look forward to further discussion on ways to enhance transparency, remove obstacles, and increase choice for private student loan borrowers.

Sincerely,

Rohit Chopra

Rohit Chopra
Assistant Director & Student Loan Ombudsman