Testimony before the

U.S. SENATE COMMITTEE ON HEALTH, EDUCATION, LABOR AND PENSIONS

regarding

"Ensuring Access to College in a Turbulent Economy"

March 17, 2008

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Mr. Chairman and Members of the Committee, the National Consumer Law Center (NCLC) thanks you for inviting us to testify today on ensuring access to college. We offer our testimony here on behalf of our low-income clients. The National Consumer Law Center is a nonprofit organization specializing in consumer issues on behalf of low-income people. We work with thousands of legal services, government and private attorneys, as well as community groups and organizations, from all states that represent low-income and elderly individuals on consumer issues.[1] NCLC's Student Loan Borrower Assistance Project provides information about student loan rights and responsibilities for borrowers and advocates. We also seek to increase public understanding of student lending issues and to identify policy solutions to promote access to education, lessen student debt burdens and make loan repayment more manageable.[2]

Introduction: The Sky Is Not Falling

As a society, we face many challenges in improving access to higher education. There is a very troubling gap in access to higher education and college completion rates

[1] In addition, NCLC publishes and annually supplements practice treatises which describe the law currently applicable to all types of consumer transactions, including *Student Loan Law* (3d ed. 2006 and Supp.).
[2] *See* the Project's web site at http://www.studentloanborrowerassistance.org.

based on economic class and race. Despite the widespread availability of student loans, low-income families are still 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.

We also face the challenge of expanding access during a time of decreased financial support for public higher education institutions, including community colleges. These problems are exacerbated by skyrocketing college costs and concerns about the preparation levels of high-risk students entering college.

These are all serious concerns, some perhaps appropriately characterized as at a "crisis" level. Access to federal student loans is very clearly not on this list. Despite the current volatility in the credit markets, students and parents should have no problems accessing the existing federal student loan programs. In contrast, there may be some disruption in the availability of private student loans, particularly the highest cost loans. However, this is hardly a crisis. Rather, a tighter market for private student loans, if it occurs, should help pull aside the curtain and show the reality that in the long-run expensive credit does not promote equal access to education. Private loans are not a solution to the problem of rising costs.

To the extent there is a crisis for students today, it is that heavy reliance on loans to finance education means that many students come out of college buried in debt. These problems are exacerbated by draconian collection powers that allow the government to pursue student loan borrowers to their graves and even seize Social Security payments.

Access to Federal Student Loans is Secure

The overall economic crisis has not, will not and should not affect access to federal loans. A few lenders have recently left the business, but there are still over 2,000 lenders participating in the guaranteed loan programs. The few institutions that have experienced problems have been able to line up new lenders. Even the Pennsylvania Higher Education Authority, in its press release announcing its exit from the federal guaranteed loan program, stated that its decision should have minimal effect on students. Some banks, particularly those that are not reliant on outside investors to raise capital, see an opportunity to move more aggressively into federally backed student lending.

Even if more lenders start pulling out of the federal guaranteed loan programs, there is adequate back-up to protect students. These safeguards include the federal Direct loan program and lender as last resort provisions. If a borrower's current lender leaves the program, the borrower will still be able to get virtually the same loans through the Direct loan program or from other FFEL lenders. Borrowers may have to pay slightly more if some of the current incentives are reduced or eliminated, but the additional costs should be minimal and in many cases offset by reductions in interest rates for subsidized loans. Further, the recent expansion of PLUS loans to graduate and professional students makes federal loans even more available to borrowers.

There is no reason to prop up lenders simply to preserve the status quo. The heavy subsidies in the guaranteed loan program evolved in response to lenders' initial reluctance to participate in the program when it was first created. Times have changed. Federal guaranteed loans have been and will continue to be a profitable business. In addition, the Direct loan program, created in the 1990's, helps ensure that borrowers have other choices.

The Department of Education has shown every indication that it is monitoring the situation and has wisely tried to alleviate panic. Congress should follow their lead. It is destructive to mislead students and their families about a crisis that does not exist.

The Dangers of 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. The borrowing limits in the federal loan programs, the skyrocketing cost of higher education and aggressive lender marketing have fueled the growth of private student loans. Although still a smaller percentage of overall student loans, the yearly growth of private loans is outpacing that of federal loans. Private loans now comprise about 24% of the nation's total education loan volume.

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

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

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

Charging the highest rates and adjusting the rates to the most vulnerable consumers has been a recipe for disaster in the mortgage industry. Similar trends are emerging for private student loans. In some cases, the student loans are so expensive that they are destined to fail. In addition, many borrowers run into unexpected life traumas such as disabilities or divorces that ruin their dreams of upward mobility. Regardless, the student loan debt that was supposed to be an investment in their futures is dragging them down.

We work with borrowers every day to help them address these problems. If you ask our client John D. whether there is a crisis, he would not point to a lack of access to credit, but rather the fact that the credit he did get is ruining his future plans. A few years ago, he took out a federal loan and a high-cost private loan to attend a local proprietary school. John withdrew after one semester because the program the school promised he would be able to take was not being offered. John is 23 years old and suffers from severe depression. He has been unable to recover and go back to school and now faces a lawsuit for collection of his private loans.

You will likely hear similar sentiments from the approximately 2,500 former students of Silver State Helicopters, a Nevada-based for-profit flight school that recently went into bankruptcy. Most of these students received private loans to cover costs and are stuck with incomplete educations from a school that has closed, while also facing demands from lenders insisting on repayment.

Similarly, Patrick K. was 22 years old in 2006, just a semester away from graduating from the University of Rhode Island, when his life changed forever. He suffered a terrible accident, falling down a long escalator and suffering severe brain damage. His parents, doctors and nurses have fought hard to keep him alive, but the prognosis is not good. Patrick is in a minimally conscious state and is incapable of consistent communication, fully dependent upon others for all of the activities of daily life. Patrick's family has struggled to find resources to pay for his care. They are also using up their retirement and other resources to retrofit their home so that it will be accessible for Patrick when they bring him home.

Patrick took out federal loans to finance his education and also worked during the summers to earn money for college. His federal loans were discharged based on permanent and total disability. He also used private loans to help fill the gap. To get a better rate, his mother co-signed on the loans. Because Patrick's Mom co-signed, they were able to get a decent interest rate. The problem is the lack of a safety net when this tragedy occurred.

NCLC Report on The High Cost of Private Student Loans

In a March 2008 report, NCLC reviewed twenty-eight private loans issued between 2001 and 2006, looking for warning signs and potential problems.[3] Key findings included:

1. Pricing

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

[3] See National Consumer Law Center, "Paying the Price: The High Cost of Private Student Loans and the Dangers for Student Borrowers" (March 2008), available at: http://www.studentloanborrowerassistance.org/uploads/File/Report_PrivateLoans.pdf.

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

None of the loans we examined contained a rate ceiling. A few set floors. These floors are particularly unfair for borrowers in an environment of declining interest rates. Nearly all of the loan notes we examined stated explicitly that the borrower's school was a factor in pricing the loan. Pricing based on institution has raised concerns about possible discrimination against borrowers in protected racial groups.

2. Origination and Other Fees

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

3. Flexible Repayment Plans

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

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

4. Postponing Payments

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

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

5. Work-Outs and Cancellations

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

6. Mandatory Arbitration Provisions

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

7. Default Triggers

Borrowers are in default on federal loans if they fail to make payments for a relatively long period of time, usually nine months. They might also be in default if they fail to meet other terms of the promissory note. There are no similar standardized criteria for private loan defaults. Rather, default conditions for private student loans are specified in the loan contracts. In most cases, borrowers will not have a long period to resolve problems if they miss payments on a private student loan. Private loans may go into default as soon as one payment is missed. In many cases, lenders reserve the right to declare defaults if in the lender's judgment, the borrower experiences a significant lessening of ability to repay the loan or is in default on any other loan they already have with the lender, or any loan they might have in the future.

8. The Holder Notice and Other Borrower Defenses

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

Some lenders have sought to evade potential liability in these cases. They have done so in a number of ways. Many simply do not include the Federal Trade Commission (FTC) holder notice in the loan notes. [4] Nearly 40% of the loans in our survey followed this potentially illegal approach. Other lenders include the notice but attempt to deny borrowers its benefits by placing contradictory clauses in the notes. In our survey, 90% of the notes that included the Federal Trade Commission (FTC) notice undermined it in some way by attempting to prohibit borrowers from raising defenses.

These efforts to evade liability are harmful to future borrowers as well. Contrary to the basic purpose of the FTC holder notice, the lenders are placing the responsibility to police the schools on the students. Yet students have no recourse if they are given erroneous information by the schools.

9. Misleading and Deceptive Information About Borrower Bankruptcy Rights

Student loan creditors have pushed hard to limit the safety net for borrowers who get in trouble. One of the most notable examples is the 2005 Congressional decision to make private student loans as difficult to discharge in bankruptcy as federal loans. This was a severe blow to consumers. The rationale for limiting bankruptcy rights for federal borrowers is also suspect, but is even less reasonable for private loan borrowers. These

[4] The FTC notice states that any holder of a consumer credit contract is subject to all claims and defenses which the consumer could assert against the seller. The notice must be inserted whenever the seller finances a sale or a creditor has a relationship with the seller and that creditor finances the sale. 16 C.F.R. §433.2.

borrowers are often stuck with very high rate loans and fees. In contrast, most other unsecured debt is dischargeable in bankruptcy.

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

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

10. Venue Restrictions

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

Market Volatility and Private Student Loans

There is no question that there is volatility in the private credit market. The causes and solutions are less clear. In fact, much of the volatility should be viewed as a market response to the growing private loan failure rate. Regardless, the changes to date in the private market should not be overstated. Some private student lenders have announced they are getting out of the business or more commonly that they will stop making loans to the highest risk borrowers. This has not yet developed into a larger trend and it may be that the lenders will curtail business mostly in poorly performing schools, including many proprietary schools.

This is not only a needed market correction, but an opportunity to curb predatory student lending, which is harming the very students we most want to help get into and succeed in college. Tightening, if it occurs, is likely to shake out loans that never should have been made and that are harming students. It could also force schools and lenders to think twice before pushing these high priced products.

Policy Recommendations

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

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

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

- Eliminate unsustainable loans and develop fair underwriting standards;
- Eliminate incentives for schools and lenders to steer borrowers to abusive loans;

- Improve disclosures so that borrowers can know the true cost of private loan products and understand the difference between private and government loans;
- Require accurate and accountable loan servicing;
- Ensure effective rights and remedies for borrowers caught in unaffordable loans;
- Preserve essential federal and state consumer safeguards; and
- Improve assistance to distressed borrowers.

Conclusion

We are in a time of change, not crisis. Change understandably makes people nervous, but it is not a cause for panic, especially since there is no evidence that the changes in the federal loan programs are hurting students and their families.

Rather than responding to economic changes by preserving an imperfect system, it is time to improve access to higher education by fixing what is wrong with student financial aid. This requires recognition that the road to equal access will not be paved with predatory loans.

Thank you for the opportunity to testify today.