# Response to CFPB request for information regarding an initiative to promote student loan affordability (Docket No. CFPB-2013-0004)

*By Mark Kantrowitz, publisher of Fastweb.com and FinAid.org*

Thawing the capital markets for student loans will spur refinance and modification activity in the private student loan marketplace.

## Options for Financial Relief are Limited

Many students who are delinquent or in default on their student loans want to repay their debt but are unable to afford the monthly loan payments. They need some form of financial relief, such as deferments/forbearances, flexible repayment plans, interest rate and principal reductions or other methods of temporarily or permanently reducing the monthly loan payments.

In some cases the borrowers are unaware of their options, such as the income-based and pay-as-you-earn repayment plans for federal education loans, and short-term deferments and forbearances. Borrowers who drop out are four times more likely to default on their federal student loans, perhaps because they do not undergo exit counseling like students who graduate.

In other cases borrowers have private student loans. Private student loans are not eligible for income-based repayment and forbearance options are limited. Graduated and extended repayment plans may not be available. These borrowers have been unable to negotiate flexible deferment and repayment options with their lenders.

Even some borrowers who aren't delinquent are having trouble refinancing their private student loans to obtain lower interest rates and/or lower monthly loan payments.

The problems may get worse when interest rates start rising again. Interest rates are currently at unusually low levels, with nowhere to go but up. Every percentage point increase in a 15-year private student loan is about a 6% increase in the monthly loan payment.

## Lack of a Robust Market for Refinancing Private Student Loans

There are two main sources of options for financial relief. One is to seek compromise with the current holder of the loan. This may involve using the existing terms of the loan or seeking to change the terms of the loan. The other approach is to refinance the loan as a way of switching holders and loan terms.

Private student loans do not have prepayment penalties, so nothing, in theory, prevents a borrower from refinancing his or her loans. But there are few options for refinancing private student loans at a better interest rate. There are only a half dozen private consolidation loan programs, and the total capital for consolidating private student loans is limited, even though there is a potentially profitable business opportunity. Opportunities for refinancing private student loans with a non-education loan are limited, in part because borrowers are at the start of household formation and do not yet have assets that can serve as collateral.

Most borrowers have a thin or nonexistent credit history when they first enroll in college. The borrower's credit score, along with the credit score of the cosigner, decreases with each successive year in school, since the credit utilization increases with each year's new loans. By the time the student graduates, his or her credit score is at its lowest point and the interest rates on new loans are at their highest. Since private consolidation loans are new loans that are based on the borrower's current credit score, consolidating immediately after graduation will not result in a lower interest rate.

But the borrower's credit score is not static. If the borrower repays all of his or her debts (not just the student loans) on time as per the agreement for several years, his or her credit score will improve. Since the credit history of a recent college graduate is often quite short, good behavior can have a disproportionately greater impact on the credit history, leading to rapid and significant improvement in the borrower's credit score. This, in turn, will lead to a lower interest rate, potentially reducing the monthly payment, accelerating the repayment trajectory and/or saving the borrower money. So there *should* be a thriving marketplace for consolidating private student loans a few years after graduation.

Even borrowers who do not manage their credit responsibly may present an opportunity for refinancing their loans at lower cost. Many of these borrowers do not have bad credit scores because of a lifetime of bad credit habits, but because of a lack of experience in managing money. Many aren't necessarily aware of just how sensitive their credit score is to repayment behavior. Borrowers often say "but I was just a few days late." That's all it takes to ruin a credit score. A little financial literacy and debt management education might go a long way toward improving the credit quality of a student loan portfolio.

But the opportunities to refinance private student loans are limited, partly because of a lack of lender capital to make new loans, and partly because lenders are wary of adverse selection, where borrowers who are struggling to repay their loans seek a refinance as a cure to their problems. The last thing any lender wants to do is "buy a default."

### Non-Bank Lenders Depend on the Capital Markets, Which are Still Frozen

An important part of the problem is that the capital markets are still frozen.

Before the subprime mortgage credit crisis there were a total of five dozen lenders making private student loans, many of which were non-bank financial institutions. Today there are only two dozen, almost all of which are banks who rely on customer deposits to fund their loans. The non-bank financial institutions were dependent on the capital markets to fund their loans. These non-bank financial institutions were often a source of innovation and competition in the private student loan industry.

Typically these non-bank lenders would use a credit warehousing agreement to fund new loans. A credit warehousing agreement is a line of credit with a large international bank, anywhere from a few hundred million dollars to tens of billions of dollars. But credit warehousing agreements are limited and cannot be used indefinitely to make new loans. Once the credit limit is reached, the lender has to stop making new loans. Credit warehousing agreements are also expensive, with a high cost of funds. So as soon as the loan volume reaches a critical mass, the lender would securitize the debt. Securitization involves transferring title to a portfolio of loans to a trust and selling shares in the trust to investors. The investors then receive payments from the lender at a risk-adjusted variable interest rate that represents a much lower cost of funds to the lender than the credit warehousing agreement. Securitization returns capital to

the lender to allow the lender to pay off the high-cost credit warehousing facility. It also provides the lender with part of their future profits up front. The lenders then try to repeat the process as quickly and frequently as they can.

But when the capital markets froze, lenders were unable to securitize their loan portfolios. Once they made loans to the limit of their credit warehousing facilities, they had to stop making new loans. These lenders can continue to service their current loan portfolios, but cannot increase the volume of loans they service.[1]

Until the capital markets thaw, we probably will not see many non-bank lenders re-entering the private student loan marketplace.[2] A lot of capital is currently locked up in credit warehousing agreements. So even if these lenders wanted to offer private consolidation loans to refinance existing private student loans, they are unable to do so because they do not have the capital to make new loans.

Securitization also presents other problems. Securitizing a loan makes it more difficult to modify the loan as compared with a loan held on the balance sheet of the lender. Securitization limits options for modifying the terms of a loan, even if it would be in the best interest of both the borrower and investor. Similar restrictions apply to loans funded by bonds.

(If a borrower is at high risk of default, the loan holder should prefer to sell the borrower's loans at a discount to recover cash. The much lower risk-adjusted price might then enable the new holder to offer more flexible repayment terms to the borrower and still earn a profit. For example, the new holder might be able to offer the borrowers an income-based or income-sensitive repayment plan, yielding a more affordable monthly payment.)

Student loan auction rate securitizations (SLARS) represent a more specialized version of the problem. SLARS attempted to treat securitizations of long-term obligations like short-term investments. Every so often (usually once a month) investors could buy and sell SLARS in an auction-like process. Companies would park their cash in SLARS, knowing that they could sell the investment at the next auction. But demand for SLARS fell short of the supply, and when the market makers stopped buying the remaining surplus SLARS, the marketplace collapsed. Nobody was willing to buy SLARS if there was a risk that they wouldn't be able to sell their investment later and would be forced to hold the SLARS until maturity. Investors stopped buying SLARS because investors stopped buying SLARS.

## The CFPB Should Explore Options for Thawing the Capital Markets

The Consumer Financial Protection Bureau (CFPB) should explore ways to thaw the capital markets. There are many possibilities, such as acting as a market maker, using a mechanism like TALF or acting as a secondary market for buying securitizations and loan portfolios. The CFPB could also provide some form of credit enhancement to boost investor confidence in securitizations, such as by providing standby

[1] Given that five years have passed since the start of the subprime mortgage credit crisis, borrower payments may have returned as much as a fifth of the principal balance of the loans. Some non-bank financial institutions could use this capital to make new loans.

[2] There has been a recent increase in securitization activity, especially for loans of the riskiest credit quality. However, the cost of funds to lenders is still high. Investor demand for securitizations, although much improved, is still somewhat weak.

loan purchase authority or other guarantees for SLARS and other frozen financial structures.[3] This might jump start the student loan market. Such measures might even be provided at no cost or even a slight profit to the federal government.

Another approach might involve issuing a tender offer to purchase all the shares in a securitization, to allow the securitization to be dissolved. That would certainly be attractive to investors who are currently stuck in SLARS, unable to liquidate their investments for cash. The federal government might even be able to buy the portfolio at a discount, given investor interest in regaining access to their cash. The terms of the loans could then be modified for borrowers who are struggling to repay their loans, and then the loan portfolio would become part of a new securitization.

The CFPB could also address some of the problems that lead to a dysfunctional market. place for student loans. There is no secondary market for buying and selling student loans because of a lack of transparency. Student loan securitizations are among the most opaque forms of structured finance. It is usually not possible to drill down to see the individual loans in the portfolio and their cash flows. A lack of good cash flow data prevents student loan securitizations from being sold except in marketplaces for distressed assets.

The restoration of a healthy marketplace for student loan portfolios would enable non-bank financial institutions (and in some cases, banks and hybrid entities) to sell their loan portfolios to raise the capital to make new loans. Some of these lenders would then re-enter the student loan marketplace, expanding opportunities for good quality borrowers to refinance their loans. Even the current holders of the loans might offer to refinance these loans or offer innovative benefits to borrowers, since competition from market re-entrants might force the holders to act defensively.

The main limitation is that government involvement usually requires the loan portfolios to satisfy stringent quality standards. But loan portfolios consisting of distressed borrowers are unlikely to satisfy those standards, even if the risk would subsequently be reduced by allowing borrowers to refinance their loans or requiring borrowers to undergo debt counseling. One workaround might involve "averaging up" by mixing portfolios of low quality assets with higher quality assets.

### Other Ideas for Providing Financial Relief to Borrowers

There are a variety of other ideas for expanding options for financial relief to borrowers:

1. Borrowers could be required to undergo financial literacy and debt management counseling before refinancing their loans. This would add value by improving the credit quality of the loan portfolio. The CFPB could develop a model counseling curriculum and evaluate its effectiveness through a prospective, case-controlled randomized study.

2. Options for financial relief should be standardized as much as possible, by encouraging all lenders to offer the same set of core repayment and forbearance plans. For example, every lender

[3] Government involvement would not only increase confidence in the market, but would also effectively cap lender cost of funds. This would indirectly reduce borrower interest rates to the extent that lenders passed on the lower cost of funds to the borrowers instead of retaining the savings through a greater spread between borrower interest rates and lender cost of funds.

might offer a 6-month grace period after graduation before repayment begins, short-term forbearances, mid-term partial forbearances (interest-only payments), extended repayment plans and graduated repayment plans. Every lender should also offer death and disability discharges. (Unfortunately, lenders are unlikely to increase the term of the loan for fixed-rate loans, since longer repayment terms are likely to increase the average cost of funds.)

3. The exception to bankruptcy discharge of student loans should be repealed. Not only would this provide struggling borrowers with an option for financial relief through a clean slate, but it would encourage lenders to offer more compromises to borrowers, rather than risk losing the loans to bankruptcy discharge.

4. Lenders should offer borrowers options for rehabilitating their loans. These would provide ways for borrowers to restore good credit by once again making payments as per the agreement. Since the loan holder can control what is reported to the credit reporting agencies, nothing stops the lender from removing the delinquencies and default from the borrower's credit history as a reward for rehabilitating the debt.

5. Congress could choose to allow private student loan borrowers to refinance their loans into federal student loans, up to the borrower's remaining federal student loan eligibility. This might help borrowers who are struggling by providing them with more options for financial relief. It would also help teachers who inadvertently borrowed through private student loan programs to qualify for public service loan forgiveness.

## More Efforts to Prevent Over-Borrowing are Also Necessary

While the focus of the CFPB notice is to solicit ideas for providing repayment relief and refinancing opportunities for borrowers in financial distress, more also needs to be done before students borrow more debt than they can afford to repay. Solutions can include improving college cost and debt disclosures and counseling, increasing federal and state investment in postsecondary education (e.g., increasing federal and state funding for student grant programs) and providing financial literacy training to more high school and college students.

Loans limits on federal education loans should also be made more rational to make it more difficult for borrowers to over-borrow. For example, a student who is enrolled on a half-time basis can currently borrow the same amount as a full-time student. This just doesn't make sense. PLUS loan borrowers can borrow up to the full cost of education, regardless of current or future ability to repay. The credit underwriting for the PLUS loan does not involve debt-service-to-income ratios or credit scores. There is a potential for moral hazard especially for graduate and professional school programs.

The PLUS loan should be eliminated and replaced with Stafford loan limits based on the borrower's projected future ability to repay the debt. The aggregate limits on the Stafford loan should be set equal to a projection of the student's expected starting salary.[4] While it would be ideal to project future income based on the degree level, field of study and institution, practical considerations may require basing the loan limits on the average post-graduation income for just the degree level. (Even short-term projections

[4] If total student loan debt at graduation is less than the borrower's annual starting salary, the borrower will be able to repay the loans in ten years or less.

of starting salaries have limited accuracy, so the intention is to provide a *sanity check* on loan limits, not a perfectly precise prediction.) Aggregate limits would be rounded to provide some stability to the figures, and would automatically be adjusted every 3 years. Annual limits would be based on the remaining aggregate loan eligibility divided by the number of years left in the educational program, prorated according to the enrollment status. The loan limits would then provide borrowers with a signal as to affordable debt. This isn't a perfect solution, but it will yield reasonable loan limits. Any play within the joints (e.g., a student pursuing a Bachelor of Science degree in nursing should perhaps be allowed to borrow more than a student getting a Bachelor of Arts degree in basket-weaving) will provide an opportunity for private lenders to improve the efficiency of the marketplace.

More research needs to be conducted on predictors of default. For example, defaulted borrowers seem to be more sensitive to situations in which the total interest repaid over the life of the loan exceeds the amount borrowed. This can occur with longer repayment terms and higher interest rates. The trigger seems to be due to a logical fallacy, that the borrower is repaying more than the amount borrowed. (Borrowers repay more than the amount borrowed on any loan with a non-zero interest rate.) It is unclear, however, whether this increased sensitivity is a predictive of default. It may be that defaults cause borrowers to be more sensitive to such scenarios, perhaps because of the personal experience of the borrower with higher interest rates and longer repayment terms. Other potential predictors might include the amount of first-year student loan debt, debt-to-income ratios, and payments made progressively closer and closer to the due date. In any event, if the CFPB can identify reliable predictors of default, this might permit more loan counseling to be provided to borrowers at higher risk of default.

There also needs to be better quality statistics and data on the health of the student loan marketplace. Private student loans should be recorded in the National Student Loan Data System (NSLDS) to allow for tracking of federal and private student loan debt at the granularity of individual borrowers. This data could then be aggregated in various ways to evaluate the average debt at graduation and the percentage of borrowers graduating with excessive debt for particular degree levels, fields of study and institutions. There also needs to be more accurate data on delinquency and default and the utilization of deferments, forbearances and various repayment plans. These are all potential indicators as to the percentage of borrowers who are struggling to repay their student loans.