A Report Card For Education Finance: Part 3

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In the first two articles of this series — "A CFPB Report Card For Education Finance: Part 1" and "A CFPB Report Card For Education Finance: Part 2" — we discussed the purpose and scope of the request for information published by the Consumer Financial Protection Bureau in connection with its report on private education loans ("PEL") and the comments submitted in response to the RFI.

Section 1070 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") required the bureau to work with the secretary of education to produce a report to Congress on private student loans ("PSLs"). Dodd-Frank § 1040 required the report to address the following areas: (1) the history and structure of the PSL market; (2) the characteristics and behavior of consumers in the PSL market; (3) consumer protections applicable to the PSL market; (4) fair-lending compliance in the PSL market; and (5) recommendations for statutory changes to improve consumer protections in the PSL market.

Dodd-Frank § 1040 required the report to be submitted by July 21, 2012. The bureau met the statutory deadline by submitting the report on July 20, 2012. Although the report is presented as the joint work product of the bureau and the U.S. Department of Education, the report appears to be largely the bureau's work. This article discusses the report.

The report is 131 pages with 85 of the pages constituting the actual report and the remaining pages constituting supporting material. The supporting material includes appendices, a glossary and notes. The body of the report is comprised of an executive summary, an introduction, five parts discussing the required topics listed above, and recommendations from the bureau and the DOE.

The report makes heavy use of quantitative and qualitative information provided by nine major PSL lenders regarding their loans, their loan portfolios and their credit criteria. Please note, however, that after submitting the report, the bureau has stated that its use of the data supplied by the nine lenders may be flawed and that additional clarifying analysis of the data will be published by the bureau by the end of August. In addition, five state-affiliated nonprofit lenders provided loan portfolio data. The report references other comments submitted in response to the RFI, including nearly 2,000 consumer comments. The report also uses additional information from five other databases.

After the executive summary and introduction, "Part One: Lenders, Loan Markets and Products" begins with a background and history of the market. To provide context for the findings of the report, part one first explains the expansion and contraction of the PSL market in the last decade. The report also notes that state-affiliated programs have reported a growth of PSL origination through 2008, similar to the for-profit market, followed by a contraction in 2009 and 2010. Finally, the report mentioned institutional lending by schools in passing, noting that institutional lending has reported an increase in lending since 2008. The report was noticeably silent, however, regarding the more controversial aspects of institutional loans made by for-profit schools.

"Part Two: Borrower Characteristics and Behaviors" generally discusses borrowers' repayment behaviors, the demographics of PSL borrowers and prevalence of PSL use. Readers interested in the demographic detail discussed by the bureau are advised to read part two of the report closely; for present purposes we note only that the data in part two indicates that while a majority of student loan payments are a fraction of monthly income (5 percent to 10 percent of monthly income), many graduates have difficulty making these payments.

In summary, parts one and two set a general theme that PSLs pose some risks to borrowers but also note that PSLs can provide value to students. The report concedes that current market conditions result in low interest rates for some PSL borrowers but suggests that interest rates will increase when market conditions change. Because of such factors as the interest rate risk associated with PSLs and the payment flexibility afforded by government loans, the report suggests that for most borrowers PSLs compare unfavorably to government loans. We note, however, that the report compares PSLs to only one type of government loan and ignores the current weak performance of government loans, both of which call the bureau's comparison into question.

Part three discusses various consumer protection issues including disclosures required by the Truth in Lending Act ("TILA"), the financial aid process, school certification, and bankruptcy treatment of PSLs. Recent changes to TILA, both before and in Dodd-Frank, have substantially changed the consumer protection requirements applicable to PSLs since the market contraction.

The bureau notes in the report the unique disclosures requirements applicable to PSLs (and to no other consumer installment loan product) that have been required since 2010. The new TILA disclosures have been in effect for two financial aid cycles but the bureau notes that it will be until 2013 before the effectiveness of those disclosures can be determined. The bureau did not explain why it was necessary for PSL borrowers to have separated from school before it could determine the effectiveness of TILA disclosures related to loan origination.

Part three of the report also considers the gaps created by the financial aid process that are not addressed by TILA. The bureau asserted that existing consumer protection laws apply only after the consumer begins shopping for a loan, which for a student usually happens only after being accepted to a school. Under current practices, debt decisions (how much to borrow and at what cost) come too late in the process for students to make informed decisions. The bureau suggested that students would be better served by having access to all pertinent loan information before making an enrollment decision, but passed over the fact that in other consumer transactions, consumers bargain for price before considering financing options.

Another issued addressed in part three is over-borrowing. The historical data reviewed by the bureau suggests that direct-to-consumer marketing and funding without school certification leads to over-borrowing. Current lenders' risk appetite is low, which causes lenders to demand school certification for almost all student loans. While the bureau suggested that the risk appetite could change given the widespread support for school certification from multiple participants in the PSL market and the disfavor of direct-to-consumer funding, it is questionable whether lenders would really return to making PSLs without school certification.

Part three concludes with a discussion of the bankruptcy treatment of PSLs, which currently cannot be discharged without showing undue hardship, a high standard. The report reviews the special bankruptcy treatment of PSLs that dates back more than 20 years, culminating in the 2005 amendments to the bankruptcy code that excludes from discharge in bankruptcy all loans made for qualified education expenses. The report questions whether PSLs share the characteristics of other nondischargeable benefits, which are primarily debts owed to the public, in the case of a federal loans, or situations where the creditor lacked discretion to enter into the debtor-creditor relationship, in the case of a victim of a crime.

Initially, the decision to make student loans virtually nondischargeable was based in part on the perception that if student loan debt was dischargeable would encourage students to purchase an intellectual asset that cannot be repossessed, while reaping the benefit from the asset for the remainder of the borrower's lifetime.

The report, however, was dismissive of this moral hazard concern that is typically raised as the primary reason for not treating PSLs like other consumer loans in a bankruptcy. The report instead noted that co-signed loans now make up more than 90 percent of newly originated PSLs, and that cosigners, because they do not receive the education, do not have the same incentive as borrowers for attempting to discharge a PSL through bankruptcy.

The bureau also argued that current bankruptcy law (the Chapter 7 means test; the required use of Chapter 13 for many consumers) tends to alleviate if not eliminate moral hazard concerns. The bureau concluded its consideration of PSLs and bankruptcy by suggesting changes to the bankruptcy code such as the mandatory use of Chapter 13 by PSL borrowers or the dischargeability of PSLs after three to five years of attempted repayment.

Part four of the report addresses fair-lending issues related to PSLs, which after the possibility of changes to the bankruptcy code, are the most significant issues for PSL lenders. Part four begins by noting the unique nature of PSLs compared to other consumer debt products: PSLs are unsecured, the lender is unable to limit or reduce the credit commitment, and borrowers often have little or no credit history and uncertain future incomes. To compensate for these factors, the report notes that some lenders use the only published data that correlates with the likelihood that the education program prepares the student for gainful employment, the DOE's cohort default rate (the "CDR").

For each school, the CDR is the percentage of the school's borrowers entering repayment on federal student loans during a particular period who default prior to the end of the period. The CDR is one factor the DOE uses to determine a school's eligibility for federal student loan programs. A school is ineligible for federal loan programs if the school's three most recent CDRs are above 25 percent or the most recent CDR is above 40 percent. The report noted that Congress did not design or intend the CDR to be used by PSL lenders to determine school eligibility, underwriting or debt pricing, especially at lower levels of default, but did not point to anything that restricts the use of the CDR in that manner.

The use of the CDR has fair-lending implications under the Equal Credit Opportunities Act. The ECOA prohibits discrimination on a prohibited basis, which under current law includes discrimination resulting from the disparate impact of a lending practice. A lending practice has a disparate impact when it has a disproportionately negative impact on a prohibited basis, even though the practice is neutral on its face and the creditor has no intent to discriminate, unless the practice meets a legitimate business need that cannot reasonably be achieved by means that are less disparate in their impact.

The bureau's strong support for the disparate impact doctrine is apparently not affected by last term's attempt to have the U.S. Supreme Court reconsider the applicability of disparate impact analysis in credit transactions. While that case was withdrawn by the petitioners before the Supreme Court fully considered the issue, we note that the court has another opportunity to review the disparate impact doctrine this term.

Private student lenders' use of the CDR at very low default levels for underwriting purposes is a concern to the bureau because racial and ethnic minority students are disproportionately concentrated at schools with higher CDRs. As a result, the use of the CDR to determine loan eligibility and pricing may have a disparate impact on minority students by reducing their access to credit. Most PSL lenders use the CDR to determine school eligibility cutoff, in other words whether the lender will accept applications from a particular school's students.

While the bureau did not conclude in its report that PSL lenders are engaged in disparate impact discrimination, it specifically stated that the use of the CDR may reduce credit access and increase prices for minority student borrowers. The report noted that the bureau would need access to application-level data in order to draw definitive conclusions regarding the fair-lending implications of the use of the CDR.

The report concludes by listing the recommendations of both the bureau and the DOE to Congress regarding the needs of participants in the PSL market. The bureau made the following recommendations: (1) Congress should require school certification of PSLs; (2) Congress should consider changing the bankruptcy treatment of PSLs; (3) Congress should revise the definition of "private education loan" in TILA to include lines of credit but exclude U.S. Department of Health and Human Services loans to students in the health profession; (4) Congress should consider establishing a borrower accessible database that would include information about federal loans and PSLs to promote better borrower understanding; and (5) determine whether additional data is needed with respect to post-graduation outcomes to avoid the potential fair-lending issues associated with CDR.

The DOE made essentially the same recommendations as did the bureau, except that it did not address fair-lending issues. Except for the fair-lending recommendation, both sets of recommendations require congressional action for implementation. The recommendation to determine what additional data is needed to avoid fair-lending issues with the CDR, unlike the other recommendations, is not addressed to Congress. Given the bureau's enforcement power under the consumer protection laws, the bureau could act on at least some aspects of this recommendation without further congressional action.

Other than providing the recommendations, the bureau did not expressly state what its next steps in the PSL market will be. The bureau staff has indicated that due to its need to publish final regulations on a number of topics per the mandate of Dodd-Frank, it is unlikely that the bureau will consider any rulemaking with respect to PSLs until sometime in 2013.

However, rulemaking aside, the bureau can proceed with civil investigative demands and enforcement actions in the PSL industry as it has in other consumer finance industries. Given the attention paid to fair-lending issues in the report, PSL lenders should expect the bureau to continue gathering information about PSLs, but with a new focus on their loan pricing and credit criteria.