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The Public Realities of Private Student Loans

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The use of private loans to finance students' college education has increased dramatically in the last decade. Insufficient public financial aid support, a complex federal aid application process, aggressive marketing by private lenders, and an unwillingness by some parents to borrow under the federal PLUS program are leading students to take out what can be costly student loans. These loans can lead to an immense debt load, especially for young borrowers. Officials at the federal, state and institutional levels must work collectively to provide greater transparency and consumer protection in the private student lending industry so that students have access to clear, impartial information on financing postsecondary education.

Context

The use of private loans to finance postsecondary education has increased at an alarming rate. According to the College Board, the private loan industry now lends more than $17 billion annually, up from $1.5 billion ten years ago. After adjustments for inflation, this represents an increase of approximately 750 percent, as opposed to a 61 percent increase in total federal student lending during the same time period. The Institute For College Access & Success reported last year that private loans grew by 12 percent in 2006 and by an average of 27 percent in each of the prior five years.

The socioeconomic profile of these private loan borrowers, according to the American Council on Education (ACE), is that of full-time, dependent students from middle and upper-middle income families. Most students use these loans to bridge a funding gap left by increasing tuition prices, fixed federal loan limits, and an unwillingness of parents to borrow.

Private loans are primarily utilized for financing at costlier private institutions and for graduate- and professional-level studies. According to the Institute for Higher Education Policy, given their proportionately larger enrollments, undergraduates represent the majority of all private loan borrowers. Only a fraction (5 percent), however, utilize private loans, as compared to nearly one-quarter of graduate and professional students. However, traditional undergraduates at public institutions are increasingly taking out these loans as the cost of attendance rises. The number of undergraduate borrowers is equally split among public and private four-year institutions, although public institutions enroll approximately twice as many students. In addition, students attending for-profit institutions have assumed a greater proportion of private loans, with a 15 percent share of private loan borrowers.

Insufficient increases in state support for higher education in recent years have resulted in sizeable tuition hikes that have widened the gap between the price of attending college and available financial aid. Despite additional state and institutional grant dollars, it is nearly impossible to keep up with the over 30 percent increase (in constant 2007 dollars) in the cost of attendance at public four-year institutions in the last five years. Additionally, the non-need-based share of state grants has grown rapidly over the last decade, which often fails to aid students from lower-income backgrounds.

Similarly, financial aid awards from federal programs such as Stafford Loans, Pell Grants and Perkins Loans have not kept pace with tuition increases. For example, subsidized Stafford Loans' share of financing for postsecondary education fell from 54 percent in 1996-1997 to 32 percent in 2006-2007, with the unsubsidized share remaining constant. PLUS Loans (which are intended for the parents of students) are also available to cover the cost of attendance, but some parents are unwilling to incur this debt.

Need-based institutional aid, work-study, and other forms of aid have also failed to keep pace with cost of college attendance. The growing price of a college education, combined with insufficient sources of public financial aid at all levels, has created a rapidly growing vacuum being filled by private (or "alternative") student loans.

In addition to challenges in obtaining sufficient individual financing needed to cover college costs, the convoluted federal financial aid process may also be facilitating the growth of private loans. The Free Application for Federal Student Financial Aid (FAFSA) and the process to request and receive federal financial aid can be intimidating, complex and time-consuming for many students and parents. The FAFSA consists of more than 100 questions spanning eight pages.

Additionally, confusion arises from the intertwined—yet fundamentally distinct—relationship between private banks and public loans. The federal government allows private banks to offer publicly guaranteed loans through the Federal Family Education Loan Program (FFELP). For example, the private lender Sallie Mae markets Stafford and PLUS Loans, which are fixed-rate loans guaranteed by the government. Sallie Mae also offers private loans, which are not guaranteed and have variable rates. Students could easily confuse the two programs.

Further, companies that provide private college financing aggressively target potential borrowers, regardless of their eligibility for or utilization of federal loans. Marketing through direct mail, e-mail, the Internet and television have raised consumer awareness of private loans as a means to finance postsecondary education. These advertisements address common concerns among students about postsecondary financing: complex forms, the need for co-signers, length of time to receive money, and often a high dollar amount needed by students. Students can borrow these loans directly or through the guidance of a financial aid officer.

The complexity of the federal loan process and aggressive marketing by private lenders has no doubt confused consumers. ACE reports that 44 percent of private borrowers do not receive the maximum available Stafford Loans for which they are eligible. Further, ACE reports that half of private loan borrowers with no federal loans did not even bother to fill out the FAFSA. This may indicate consumer confusion, as federal loans are almost always less expensive than their private counterparts.

Observations

The unfavorable terms of private student loans are creating sizable costs for students and may have larger economic implications. Although private loans are seldom the least expensive option for education financing, they are increasingly becoming the sole outlet for some students because of rising costs and caps on federal borrowing by students.

Students who borrow private loans will likely pay more, as these loans almost always have higher interest rates than federal loans and often rival those of credit cards. The National Consumer Law Center recently released a report that found all private loans to have variable interest rates, with initial average rates ranging from 5 to 19 percent and an average initial APR of 11.5 percent. The report also listed the average private loan origination fee at 4.5 percent, as compared to 2.5 percent with federal loans. The current credit crunch affecting Wall Street may raise these rates even higher in the future.

Private loans also lack the important consumer benefits of federal student loans. For instance, federal Stafford Loans are not subject to a credit review and interest rates are fixed; these loans allow for cancellation in cases of death or severe disability, and now offer income-based repayments plans. In contrast, some private lenders have deferral options, but the interest accrues and compounds during the deferment period.

Private loans also lack the loan limits that prevent students from borrowing needlessly. Many private loan programs advertise limits of $150,000 or more, and students can take out large sums of money without receiving sufficient guidance about alternate available options. While private loans offer long repayment periods, students still may not receive a post-graduation salary commensurate with their loan repayment obligations.

Also of concern is the disproportionate harm that private loans can cause to lower-income borrowers, particularly because these students are more likely to attend proprietary institutions and less likely to have parental financial support. If parents do not sign off on a PLUS Loan, and federal and state aid are exhausted, then the student may be driven to the private market. In the private market, if the student does not have a co-signer or has a poor credit history, the loan interest rates can increase significantly.

The economic consequences of increasing private student loan debt are not insignificant. Collectively, heavy loan debt—both public and private—may discourage students from choosing careers in public service or lower-paying professions, starting a business, purchasing a home, considering postgraduate study, or even finishing school.

Another consequence of the increase in private loan borrowing is the rising default rates on student loans. According to a recent article published in the Wall Street Journal, the nation's largest guaranty agency, United Student Aid Funds, Inc., witnessed a 22 percent increase in default rates in fiscal year 2007. A similar organization, American Student Loan Corp., saw a 14 percent increase in defaults.

Finally, it is considerably more onerous to "discharge," or expunge student loan debt through bankruptcy proceedings, which can further compound student debt troubles. Efforts to make the process of discharging private student loans less cumbersome—and more on par with the rules associated with erasing credit card debt—have come up empty. A provision to change the federal bankruptcy law, which was overhauled in 2005, and loosen restrictions on private loan bankruptcy recently failed passage in the U.S. House of Representatives.

Growing concerns about the detrimental effects of private lending and unethical practices have generated considerable visibility and reaction. Worrisome trends associated with private student loans, suspect advertising, and unethical behavior between college officials and private lenders have broadened the profile of the student loan industry. Major newspapers such as *The Washington Post*, *The New York Times*, *The Wall Street Journal* and *USA Today* have highlighted these issues.

In addition to the media, elected officials have also revealed ethical lapses in private lending. In 2007, New York Attorney General Andrew Cuomo (D) uncovered a broad array of inappropriate practices. Cuomo issued subpoenas and accused some direct-to-student private lenders of intentionally misleading and deceiving students. His office noted, for example, that one private lender advertised interest rates of 7.15 percent, but fewer than one in five of these loans had interest rates between 6 and 8 percent, and in actuality, a staggering 40 percent had interest rates over 16 percent.

Cuomo also found blatant conflicts of interest between some institutional financial aid officers and private lenders. The investigation revealed institutional kickbacks, all-expense paid vacations for financial aid staff, and numerous other inappropriate practices aimed at increasing the loan volume and profit of private lenders, while not necessarily providing the best financing options for students.

The New York Attorney General's investigation is not the first time complaints have been filed. In 2006, the United States Student Association filed a complaint with the Federal Trade Commission urging an end to the "false and deceptive" advertising of popular lender Loan to Learn®. This company boasts on its website that it is "simply the best, most logical way to pay for a higher education today," despite *The Washington Post* reporting last year that interest rates for some of its borrowers were as high as 18 percent.

These inappropriate practices, combined with the complexity of the entire public and private financial aid process, have frustrated consumers and have caused the market to work inefficiently. With this in mind, The Consumers Union, the publisher of *Consumer Reports*, released a report titled "Helping Families Finance College: Improved Student Loan Disclosures and Counseling" citing that "consumers lack readily accessible and understandable information about the cost of college" and that our institutions use "a scatter-shot approach—some successful and unsuccessful—to educate and advise families about how to finance a college education." The report lists seven recommendations to increase transparency so that consumers can make better-informed decisions about college financing.

Policymakers, institutional leaders and others are responding with solutions that promote greater transparency and consumer protection. At the federal level, lawmakers have included numerous regulatory provisions in the pending update to the Higher Education Act (HEA) legislation that would seek to stop the most egregious abuses in the relationships between colleges and lenders highlighted by Cuomo. Amendments pertaining to private loans in the current HEA bill include the following requirements:

- Lenders must inform institutions of the amount of the proposed private loan being offered to the student.
- Applicants have up to 30 days following the approval of a loan to accept it with no changes in terms or conditions.
- Lenders must fully disclose to borrowers the terms and conditions of private loans at three different stages of the loan application process, including during loan marketing and solicitation; and they must obtain a written acknowledgement of receipt of these disclosures from the borrower.
- Borrowers are allowed up to three days to change their minds after private loan consummation.
- Institutions must certify private loans.
- Lenders and institutions must prominently disclose all loan terms, conditions and incentives.

Different versions of the HEA have passed the Senate and House and are now in conference committee in the hopes that final compromise legislation can be worked out. The outcome is uncertain, however, since President George W. Bush has threatened to veto the HEA over accreditation concerns and duplicative programs.

In contrast to state governments, which have been virtually silent on the subject, some college and university officials have recognized the challenges associated with private borrowing and are taking the lead in slowing the growing trend in private loan utilization. Barnard College, a private college in New York City, found that requiring students or parents to speak to a financial aid counselor before certifying private loans helped reduce private loans by 73 percent. While Barnard's approach is encouraging, it may not be feasible for many institutions because of the time involved to meet with every student seeking private financing. In addition, direct-to-consumer loans do not have to be reported to a financial aid counselor, and the institution is often unaware of the loans.

Colorado State University, a large public university, has taken a different approach. When asked to certify a private loan on behalf of a borrower, the university contacts the student who is seeking the private loan but has not completed a FAFSA or borrowed the maximum eligibility in federal loans. The university then counsels the student on meeting unmet financial need by utilizing strategies that may be more fiscally prudent. University officials estimate that they convince up to one-half of the students to utilize their federal benefits before applying for private loans. Again, while this result is encouraging, financial aid personnel are usually not notified of direct-to-consumer private loans.

Conclusion

College costs are likely to continue increasing in the coming years, along with unmet financial need. Private loans will therefore continue to serve as an integral source for students in financing their postsecondary education. Federal and state policymakers must act to ensure that the proper safeguards are in place to provide greater transparency of loan terms and consumer protection of those who utilize private financing to fund college costs. Finally, university administrators must seek to proactively communicate with and counsel students on available financing options so that the most favorable forms—public financial aid—are fully optimized before turning to less advantageous alternative financing mechanisms.

Facts at a Glance

Private student loans by the numbers:

- The amount of private student aid in 2006–2007—$17.1 billion
- The amount of private student aid in 1995–2006—$1.5 billion
- Current maximum undergraduate Stafford Loan award—$23,000
- Maximum award offered by some private lenders—$150,000

Resources

American Council on Education. Who Borrows Private Loans? Discusses the demographic profiles of private loan borrowers.
acenet.edu/AM/Template.cfm?Template=/CM/ContentDisplay.cfm&ContentID=23410&FusePreview=True&WebsiteKey=31cadfd9-b130-44b4-af2e-6603cbcc422b

College Board. Trends in College Pricing (2007). Provides nationwide data on the price of attending college.
collegeboard.com/prod_downloads/about/news_info/trends/trends_pricing_07.pdf

College Board. Trends in Student Aid (2007). Provides nationwide data on student aid.
collegeboard.com/prod_downloads/about/news_info/trends/trends_aid_07.pdf

Consumers Union. Helping Families Finance College: Improved Student Loan Disclosure and Counseling. Offers recommendations for improving the financial aid process.
consumersunion.org/pdf/CU-College.pdf

The Institute for College Access & Success. Testimony of Robert Shireman before the Iowa Legislature. Shares insights and analysis into challenges posed by private loans.
http://projectonstudentdebt.org/files/pub/Shireman_IA_testimony.pdf

Institute for Higher Education Policy. Private Loans: Who is Borrowing and Why? Provides insight into the borrowers of private loans.
ihep.org/assets/files/publications/a-f/FuturePrivateLoans.pdf

Loan to Learn®. About Loan to Learn. History of the private student loan company.
loantolearn.com/About/Default.aspx

National Consumer Law Center. Paying the Price: The High Cost of Private Student Loans and the Dangers for Student Borrower. Comprehensive resource on private student loans.
studentloanborrowerassistance.org/uploads/File/Report_PrivateLoans.pdf

New America Foundation. Colorado State Does Student Loans Right. Details the efforts of both Barnard College and Colorado State in regards to curtailing the proliferation of private loans.
newamerica.net/blogs/education_policy/2007/08/colorado_state

Office of the New York State Attorney General. Cuomo Testifies on Deceptive Practices in Student Loan Industry before the U.S. Banking Committee (2007). Highlights concerns over practices of the private loan industry.
oag.state.ny.us/press/2007/jun/jun06a_07.html

The Wall Street Journal. Student-Loan Problems Add to Debt Worry (2007). Discusses increasing default rates on private student loans.
http://online.wsj.com/article/SB119707966842718004.html

The Washington Post. Student Loan Nonprofit a Boon for CEO. Investigates the practices of Loan to Learn®.
washingtonpost.com/wp-dyn/content/article/2007/07/15/AR2007071501448_3.html

U.S. Department of Education. White House Releases Statement of Administration Policy on College Opportunity and Affordability Act of 2007. Outlines the Bush Administration's views on current HEA legislation.
ed.gov/news/pressreleases/2008/02/02062008.html

U.S. House Committee on Education and Labor. College Opportunity and Affordability Act of 2007. Details on the reauthorization of the Higher Education Act.
http://edlabor.house.gov/micro/coaa.shtml

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