



# Consumer Protection and Higher Education Financing Alternatives

Testimony Before the U.S. Congress Joint Economic Committee

Hearing on Financing Higher Education: Exploring Current Challenges and Potential Alternatives

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Chairman Coats, Ranking Member Maloney, and members of the committee, thank you for holding this hearing today.

I am currently a Senior Fellow at the Center for American Progress. I recently departed as assistant director of the Consumer Financial Protection Bureau, CFPB,<sup>1</sup> where I led the agency's work on student financial services. I also served as the CFPB's first student loan ombudsman, a new position established by Congress. My comments today are my own and do not represent the views of any other individual or organization.

The financial crisis has contributed to a major rise in student debt in America. In my testimony today, I will discuss the opportunities and challenges with private capital participation, including the emergence of new products, such as those that obligate future income. While investigating alternative models of financing higher education through private capital sources is worthwhile, this must be informed by a careful examination of past problems in the marketplace. The emergence of new products is a reminder of the need to modernize our student loan consumer protection framework and ensure fair competition.

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## Swelling student debt

This month marks the seventh anniversary of the collapse of Lehman Brothers and the acceleration of the global financial crisis.<sup>2</sup> Families across the country saw their home values plummet, their retirement savings crater, and their jobs vanish.

While rising tuition is often blamed on the growth in average student debt held by graduates, the financial crisis is also a major culprit. With states slashing support for higher education and the crisis destroying trillions of dollars in household wealth, more and more families turned to student debt to access college. And in these seven years, student debt has doubled to a total of \$1.3 trillion owed by more than 40 million Americans.

Of course, this does not include many other forms of debt triggered by the expenses of going to college. For example, many students and their families might take out a home equity loan, seek a loan from their retirement fund, or borrow from family and friends. Others drain their savings, which leads some to stay afloat by using credit cards.

As long as college remains expensive, private credit products will probably always be a part of the puzzle. In theory, private capital participation could provide the marketplace with valuable price signals and lead to better service. However, this has generally not been the case in the student loan market in recent history.

Prior to 2010, private financial institutions originated most student loans under the Federal Family Education Loan Program. Through this program, banks and specialty lenders such as Sallie Mae offered loans to students subject to a maximum interest rate. These loans were ultimately guaranteed by the federal government. Theoretically, lenders could compete against each other by competing on lower interest rates.

Unfortunately, lenders did not vigorously compete on price and instead sought to gain market share by pushing schools to place them on the institution's preferred lender list. Rather than aggressively bargaining on behalf of students, many schools and school officials were conflicted.

According to an industrywide investigation by New York Attorney General Andrew Cuomo in the mid-2000s, lenders provided compensation, gifts, and perks to schools and school officials, given the financial aid office's ability to drive loan volume to particular lenders. The attorney general found cases in which student loan industry executives paid heavy consulting fees and transferred stock to school officials.<sup>3</sup>

By the end of 2007, the eight largest lenders in the market—Citibank, Sallie Mae, Nelnet, JPMorgan Chase, Bank of America, Wells Fargo, Wachovia, and College Loan Corporation—had all agreed to a new code of conduct. Many paid millions to settle charges of wrongdoing in connection with these practices.<sup>4</sup> In 2008, Congress belatedly restricted many of these aggressive practices in the Higher Education Opportunity Act.

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## Recent challenges in the private student loan market

The Financial Crisis Inquiry Commission carefully documented the delayed regulatory response to problems in the subprime mortgage market. Despite years of warnings, the Federal Reserve Board of Governors failed to use its authority under the Home Ownership and Equity Protection Act to rein in harmful lending practices. As the commission's report noted, in July 2008, "long after the risky nontraditional mortgage market had disappeared and the Wall Street mortgage securitization machine had ground to a halt, the Federal Reserve finally adopted new rules."<sup>5</sup> The lax oversight of the mortgage market proved to be catastrophic for the broader economy.

Less well-known is the lack of response by the Federal Reserve Board and other regulators to effectively police the private student loan market. In 2004, nearly \$8 billion in private student loan asset-backed securities were issued. Two years later, more than \$16 billion were issued.<sup>6</sup> Similar to the mortgage market, the demand for these securities fueled a subprime boom. More loans were being marketed directly to consumers, and increasing number of borrowers did not utilize cheaper federal loan options first. Only after the market dried up did the Fed begin to address problems through rulemaking.

Since the crisis, regulators have shown a greater commitment to enforcing existing laws. Recently, private student loan providers have also faced consequences to address serious misconduct that harmed student loan borrowers.

### Sallie Mae/Navient: Illegal conduct targeting military service members

Last year, the U.S. Department of Justice ordered Sallie Mae and Navient to pay \$60 million for violations of the Servicemembers Civil Relief Act, or SCRA, after referrals of complaints from the CFPB.<sup>7</sup> The Department of Justice described the companies' conduct as "intentional, willful, and taken in disregard for the rights of service members."<sup>8</sup> The defendants wrongfully conditioned benefits under the SCRA upon requirements not found in the law, improperly advised service members that they must be deployed to receive benefits under the SCRA, and failed to provide complete SCRA relief to service members after having been put on notice of these borrowers' active duty status.

The illegal conduct of Sallie Mae and Navient harmed nearly 78,000 service members. Approximately 74 percent of these refunds are attributable to private student loans. Refunds ranged from \$10 to more than \$100,000.<sup>9</sup> Given the seriousness of the violations, the defendants agreed to proactively query a U.S. Department of Defense database and automatically provide SCRA benefits.

## Sallie Mae/Navient: Billing disclosure misrepresentation, illegal late fee harvesting, discriminatory lending, and electronic funds transfer violations

In 2014, the Federal Deposit Insurance Corporation ordered Navient to pay restitution and penalties of an additional \$37 million for allocating borrowers' payments across multiple private student loans in a manner that maximized late fees and deceived borrowers about how they could avoid late fees.<sup>10</sup>

The consent order also noted violations of the Equal Credit Opportunity Act—which protects borrowers from being discriminated against due to their race, gender, religion, and other factors—as well as violations of the Electronic Fund Transfer Act, which protects borrowers in the case of erroneous transfer errors.<sup>11</sup>

## Discover Financial Services: Illegal student loan-servicing practices, inflated billing statements, and illegal debt collection practices

Two months ago, the CFPB ordered Discover to pay \$18.5 million in fines and penalties to approximately 100,000 victims.<sup>12</sup> Discover purchased nearly all of Citibank's private student loan business and retained many of its operating procedures. The CFPB investigation found that Discover was inflating billing statements,<sup>13</sup> illegally called borrowers early in the morning and late at night, and engaged in other illegal debt collection conduct.

## Other alleged misconduct in the private student loan market

In 2014, the CFPB sued ITT Educational Services for unfair and abusive conduct, including pressuring students into taking out high-cost loans.<sup>14</sup> The CFPB also sued Corinthian Colleges for predatory private student lending and strong-arm debt collection tactics in violation of the law.<sup>15</sup> State attorneys general have also alleged misconduct related to lending abuses.<sup>16</sup>

According to a report analyzing court filings, researchers have raised serious concerns about potential “robo-signing” in private student loan collection cases.<sup>17</sup> In the years leading up to the financial crisis, banks such as JPMorgan Chase, Bank of America, and Citizens Bank<sup>18</sup> originated private student loans that were subsequently pooled and securitized. In an analysis of court filings related to the National Collegiate Student Loan Trusts, the report describes that pleadings lacked clear evidence that the plaintiff actually owned the loan in question. These alleged practices bear a close resemblance to the serious breakdowns in the mortgage-servicing market that led to illegal foreclosures.

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## Developments in private capital participation

In recent years, entrepreneurs have identified a number of unmet needs in the marketplace. Notably, the number of offers to refinance high-rate student loans has grown very rapidly. They are typically offered to borrowers who have obtained employment, so lenders can use current income to underwrite loans. According to the CFPB's Consumer Complaint Database, these providers have received relatively few complaints from borrowers. This product market is still quite small and generally serves graduates of four-year institutions who earn above-average incomes.

Other market participants have offered products that obligate a portion of future income rather than a typical fixed amortization schedule. These products are sometimes referred to as income-share agreements.<sup>19</sup> In some respects, income-share agreements might cure one of the major pitfalls of private student loans: the lack of an affordable repayment option during a sustained period of hardship. However, similar to other private loans, these products may be very difficult to evaluate and compare since future income is often highly uncertain.

Many of these new market entrants have been keenly aware of the need to offer these products in a fair and transparent fashion. After all, if any abuses are uncovered during the infant stages of the market's development, future consumer demand may be severely curtailed.

While most new market entrants have good intentions, common-sense rules of the road are a critical element to guard against bad actors and protect honest, ethical market participants. Industry, consumers, and policymakers share a goal in making sure the market is sufficiently competitive and free of distortionary conflicts of interest.

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## Consumer protection and competition

While income-share agreements will likely do little to nothing to address the existing student debt stress affecting our country, they remind us that it is critical to remedy the serious deficiencies in the private student loan market today and to modernize the consumer protection framework so that new market entrants can successfully challenge current incumbents. Congress should modernize the consumer protection framework with the following principles in mind.

### 1. Terms and conditions should be clear and transparent, not buried in the fine print

In 2008, after years of troubling practices in the private student loan industry, Congress enacted legislation requiring new disclosures. The Federal Reserve Board of Governors implemented these new disclosures in 2010. Unfortunately, these disclosures seemed

designed primarily to fit the business model of existing players, mostly large financial institutions, rather than spurring competition that benefits consumers.

Income-share agreements provide a particular challenge since using the existing disclosures would be awkward. For example, any imputed annual percentage rate would need to be based on a future estimated income. There would be additional complexity if the share of income devoted to repayment of the obligation varied by level of income—for example, 3 percent of the first \$25,000 of income, 5 percent of income between \$25,001 and \$150,000, and 10 percent of income more than \$150,000.

Providers of income-share agreements should work together with regulators on how to use these existing disclosures, perhaps with supplementary information to ensure greater clarity.<sup>20</sup> Over time, the CFPB<sup>21</sup> should develop an improved e-disclosure regime that will give consumers the ability to compare traditional amortizing products to nontraditional products. This should include the ability to compare repayment options made available to borrowers with federal student loans, as well as how borrowers can prepay obligations.

Schools can also play a productive role to ensure responsible lending. For examples, school certification of private loans—whereby schools certify that students have unmet need—can meaningfully reduce risk. At the same time, policymakers must also guard against school conflicts of interest. If schools are able to financially gain from relationships with market participants, such arrangements should be fully disclosed and comply with existing law.

## 2. When servicing and collecting on obligations, consumers should be treated fairly

Regulators have uncovered patterns of improper practices in the servicing and collections process. As noted above, providers have allocated payments in ways that maximize fees and distorted billing statements. Securitization and other investor participation arrangements can also have unintended consequences stemming from skewed incentives.

Unlike mortgages and credit cards, there is no specific set of minimum standards for student loan borrowers when it comes to servicing, potentially leading to a race to the bottom and severely disadvantaging honest market participants.

Since the industry has failed to develop a robust code of conduct, policymakers will likely find that they need to put into place new borrower protections to prevent further abuse. New market entrants should also adhere to the principles enshrined in the Fair Debt Collection Practices Act.

### 3. Military service members and veterans should not be penalized for their service

The improper foreclosures of military families by JPMorgan Chase, Wells Fargo, Bank of America, and Citibank,<sup>22</sup> along with the Sallie Mae/Navient scheme to overcharge service members with student loans, should serve as a stark reminder that policymakers must beef up oversight and protections for these borrowers.

The Servicemembers Civil Relief Act should also be amended to allow service members to retain their preservice obligation rate cap even if they refinance into a different student loan product. Policymakers should also consider criminal penalties for certain egregious violations.

Providers of income-share agreements would be wise to steer clear of any poor treatment of service members and veterans by developing a clear set of processes to ensure these consumers are not unfairly penalized.

### 4. Regulators and the public must have confidence that the market is free of discrimination

Higher education is intended to help aspirational individuals make the most of their potential, rather than limiting them based on factors beyond their control. Pursuant to the Home Mortgage Disclosure Act, mortgage originators meeting minimum thresholds must report certain attributes of loan applications to a public database, including the race and gender of the applicant and the reason for denial. Policymakers should consider similar requirements for providers of private financing for education. Availability of this data would also create needed transparency for the market.

Providers of private student loans and income-share agreements should work cooperatively with one another and with regulators on a standardized data architecture to minimize costs associated with reporting this data, while also protecting privacy.

### 5. Private credit products to finance higher education should help consumers build credit history

Student loan products are among the first credit obligations for consumers today. Ensuring that providers are furnishing accurately is critical. Under the Higher Education Act, federal student loan credit information must generally be furnished to consumer reporting agencies in accordance with the Fair Credit Reporting Act, but there is no similar requirement for other products to finance a postsecondary education.

Congress should consider enacting a similar requirement with a phase-in period for the industry to modernize data standards to ensure furnishing accurately reflects the loan status.<sup>23</sup>

## 6. Products must provide for a clear path for consumers to manage through periods of distress

For students graduating in the midst of the financial crisis, they found that their degree was worth much less than they had anticipated, leading many into delinquency and default.

Prior to 2005, bankruptcy was one option to manage through this challenge. Currently, restructuring private student loan debt is almost impossible compared with other forms of credit. According to a study conducted by the CFPB and the U.S. Department of Education, the 2005 changes to the bankruptcy code did not lead to lower prices for consumers or meaningfully expand access.<sup>24</sup> Multiple studies have concluded that there does not appear to be any systemic abuse by the bankruptcy code by student debtors. Borrowers with private student loans are effectively trapped with few loan modification options—a stark contrast to federal student loans.

If Congress repeals the favorable treatment to lenders that do not offer flexible repayment options, this would provide a strong incentive for lenders to work constructively with borrowers to avoid default. When products include safety nets in times of distress, they might better serve borrowers without sacrificing investor returns.

Finally, industry and policymakers should take steps to promote competition and avoid actions that simply give incumbents more market power. Open data standards and application program interfaces, or APIs, can help spur technology-enabled comparison shopping, similar to markets for everything from plane tickets to diapers.

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## Conclusion

While today's hearing is examining potential alternatives to existing loan products, we must not delude ourselves into thinking that new loan products are a silver bullet. One of the best alternatives to existing policy is to reverse the trend of disinvestment in public higher education. If Americans must commit more and more of their future income to achieve their dream of going to college, then we will continue to undermine the role of higher education as a means to climb the economic ladder.

Perhaps more importantly, we must address the existing debt burdens of Americans, which undoubtedly ballooned as an aftershock of the financial crisis. Helping borrowers manage their payments and avoid default by cleaning up student loan servicing and spurring opportunities to refinance should be high on the list.



In addition, as Congress seeks to reauthorize the Higher Education Act, broader reforms are also needed to increase accountability for schools and financial institutions, such as efforts to give all participants skin in the game. There must also be serious efforts to improve access to performance and outcome data.

Just as policymakers are rethinking the role of private capital in the aftermath of the conservatorship of Fannie Mae and Freddie Mac, we must also determine whether and how private capital participation can benefit students. Providing greater regulatory clarity for new products in this market and beefing up the consumer protection framework will yield benefits for both consumers and honest market participants.

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## Endnotes

- 1 The Consumer Financial Protection Bureau was established by the Dodd-Frank Wall Street Reform and Consumer Protection Act. The CFPB oversees large depository institutions and nonbanks for compliance with federal consumer financial laws, including student loan market participants.
- 2 September 2008 also marked a number of other noteworthy events, including the placement of Fannie Mae and Freddie Mac into conservatorship, the largest bank failure in U.S. history (Washington Mutual), the bailout of AIG, and the so-called deathbed conversions of Goldman Sachs and Morgan Stanley into bank holding companies.
- 3 See, for example, New York State Office of the Attorney General, "Cooperation Agreement and Assurance of Discontinuance in the Matter of Student Loan Xpress Inc. and CIT Group Inc." (2007), available at <http://www.ag.ny.gov/sites/default/files/press-releases/archived/CIT%20Cooperation%20and%20AoD.pdf>.
- 4 New York State Office of the Attorney General, "Cuomo Announces Settlement With Student Loan Company," Press release, December 11, 2007, available at <http://www.ag.ny.gov/press-release/cuomo-announces-settlement-student-loan-company>.
- 5 Financial Crisis Inquiry Commission, "Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States" (2011).
- 6 Consumer Financial Protection Bureau and U.S. Department of Education, *Private Student Loans* (2012), available at <http://www.consumerfinance.gov/reports/private-student-loans-report/>.
- 7 U.S. Department of Justice, "Justice Department Reaches \$60 Million Settlement with Sallie Mae to Resolve Allegations of Charging Military Servicemembers Excessive Rates on Student Loans," Press release, May 13, 2014, available at <http://www.justice.gov/opa/pr/justice-department-reaches-60-million-settlement-sallie-mae-resolve-allegations-charging>.
- 8 The full text of the complaint is available at <http://www.justice.gov/sites/default/files/crt/legacy/2014/05/14/salliecomp.pdf>.
- 9 U.S. Department of Justice, "Nearly 78,000 Service Members to Begin Receiving \$60 Million Under Department of Justice Settlement with Navient for Overcharging on Student Loans," May 28, 2015, available at <http://www.justice.gov/opa/pr/nearly-78000-service-members-begin-receiving-60-million-under-department-justice-settlement>.
- 10 Federal Deposit Insurance Corporation, "FDIC Announces Settlement with Sallie Mae for Unfair and Deceptive Practices and Violations of the Servicemembers Civil Relief Act," Press release, May 13, 2014, available at <https://www.fdic.gov/news/news/press/2014/pr14033.html>.
- 11 The full text of the consent order with Sallie Mae Bank (2014) is available at <https://www5.fdic.gov/EDOBlob/Mediator.aspx?UniqueID=5007e0b4-911a-435c-9a0a-9d984ec5f53f>. The full text of the consent order with Navient (2014) is available at <https://www5.fdic.gov/EDOBlob/Mediator.aspx?UniqueID=668ab68c-7c2d-48e5-b880-1e329828a004>.
- 12 Consumer Financial Protection Bureau, "CFPB Orders Discover Bank to Pay \$18.5 Million for Illegal Student Loan Servicing Practices," Press release, July 22, 2015, available at <http://www.consumerfinance.gov/newsroom/cfpb-orders-discover-bank-to-pay-18-5-million-for-illegal-student-loan-servicing-practices/>.
- 13 When loans serve as collateral for asset-backed securities, private market participants may have sometimes have an economic incentive to manipulate billing statements and other borrower communications to ensure that adequate cash flows are available for coupon payments to bondholders while still maximizing interest accrual.
- 14 Consumer Financial Protection Bureau, "CFPB Sues For-Profit College Chain ITT for Predatory Lending," Press release, February 26, 2014, available at <http://www.consumerfinance.gov/newsroom/cfpb-sues-for-profit-college-chain-itt-for-predatory-lending/>.
- 15 Consumer Financial Protection Bureau, "CFPB Sues For-Profit Corinthian Colleges for Predatory Lending Scheme," Press release, September 16, 2014, available at <http://www.consumerfinance.gov/newsroom/cfpb-sues-for-profit-corinthian-colleges-for-predatory-lending-scheme/>.
- 16 Under the "90-10 rule," for-profit colleges must receive at least 10 percent of their revenue from sources outside of federal student loans and grants under Title IV of the Higher Education Act. This may be creating an incentive for colleges to aggressively recruit beneficiaries of the GI Bill and to develop exotic private student loan programs.
- 17 Robyn C. Smith and Emily Green Caplan, "Going to School on Robo-signing: How to Help Borrowers and Stop the Abuses in Private Student Loan Collection Cases" (Boston: National Consumer Law Center, 2014), available at <http://www.studentloanborrowerassistance.org/wp-content/uploads/2013/05/robo-signing-2014.pdf>.
- 18 In some cases, the originator of record may have been a predecessor financial institution acquired by these institutions. The prospectus for each securities offering provides further details.
- 19 There is no official term to describe these products, which are also sometimes referred to as human capital contracts.
- 20 Admittedly, this will be a difficult task, and the existing safe harbor model forms developed by the Federal Reserve Board of Governors may prove to be unusable.
- 21 The authority to prescribe disclosures under the Truth in Lending Act transferred from the Federal Reserve Board of Governors to the Consumer Financial Protection Bureau in 2011.
- 22 U.S. Department of Justice, "Service Members to Receive Over \$123 Million for Unlawful Foreclosures Under the Servicemembers Civil Relief Act," Press release, February 9, 2015, available at <http://www.justice.gov/opa/pr/service-members-receive-over-123-million-unlawful-foreclosures-under-servicemembers-civil>.
- 23 The current framework for furnishing credit information is outdated. However, there is no market incentive for industry to modernize it. Should Congress require furnishing by a specific future date, this might serve to jump-start action and reverse the existing complacency.
- 24 Consumer Financial Protection Bureau and U.S. Department of Education, *Private Student Loans*.