STATEMENT OF

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on

PRIVATE STUDENT LOANS: REGULATORY PERSPECTIVES

before the

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
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Chairman Johnson, Ranking Member Crapo and members of the Committee, thank you for the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding private student loans (PSLs). Higher education has long provided a pathway to prosperity, as individuals with college degrees historically have had higher incomes and lower rates of unemployment than those without. Students and their families have financed higher education through loans, both Federal and private, for many years. While this model works well when graduates are able to obtain employment and use their degrees to move into higher paying jobs, the severity of the recent financial crisis and a relatively slow recovery have resulted in persistently high rates of unemployment and underemployment, which have negatively impacted the newly graduated who are trying to enter or advance through the workforce. Today, many consumers are struggling with student debt loads in a still fragile economic environment.

In my testimony, I will discuss data on the student loan market, including data on its size and performance. I also will discuss our approach to the supervision of private student loan lenders, including the regulations and guidance that apply to private student loans. In addition, I will describe the ability of insured depository institutions (IDIs) to work with consumers to manage their student loan obligations within the current supervisory environment.

In particular, I will describe the FDIC's efforts to communicate to the banks we supervise that, for borrowers experiencing difficulties, prudent workout arrangements are in the best long-term interest of both the bank and the borrower.

Data Regarding Student Loans

Data regarding the overall market for PSLs are difficult to discern because there is no standard source for collecting the data. These data are not broken out separately in the C*onsolidated Reports of Condition and Income*, otherwise known as Call Reports, which banks file quarterly, as student lending is a fairly small portion of aggregate consumer lending and relatively few IDIs make these loans. Rather, data on PSLs, like unsecured installment loans, are contained within a broader category called "other loans to individuals."

Nonetheless, based on recent studies, there appear to be about 39 million borrowers with a student loan, with an average balance of about $25,000.[1] As of year-end 2012, total student loans outstanding were about $966 billion.[2] Of this total student loan debt, the Consumer Financial Protection Bureau (CFPB) has estimated the size of the PSL market to be about $150 billion as of year-end 2011, which represents about 15 percent of student loans outstanding, compared to 85 percent for the Federal student loan (FSL) market.[3]

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[1] Donghoon Lee, *Household Debt and Credit: Student Debt,* February 28, 2013, The Federal Reserve Bank of New York Consumer Credit Panel and Equifax, http://www.newyorkfed.org/newsevents/mediaadvisory/2013/Lee022813.pdf.

[2] Ibid.

[3] CFPB, *Private Student Loans, Report to the Senate Committee on Banking, Housing, and Urban Affairs, the Senate Committee on Health, Education, Labor, and Pensions, the House of Representatives Committee on Financial Services, and the House of Representatives Committee on Education and the Workforce.* August 29, 2012.

Debt from FSLs and PSLs has risen significantly since 2007, and student loans (FSLs and PSLs combined) are now the largest category of consumer loans, not including first mortgages.[4] With regard to originations, growth has been centered in FSL originations, which have climbed from about $70 billion in the 2006-2007 school year to over $100 billion per year in the past three academic years.[5] In contrast, the PSL market has shrunk considerably over the same time period, with originations peaking at about $23 billion in the 2007-2008 academic year before falling to about $8 billion per year in the past three academic years. In terms of new volumes, PSLs are currently only about 7 percent of overall originations. While the market for PSLs is relatively small, PSLs provide a secondary source of funds for students and families seeking to fill the gap between FSLs and other financial resources and the total cost of students' higher education.

IDIs supervised by the FDIC hold about $14 billion in outstanding PSLs and originated about $4 billion in the 2011-2012 academic year. Reported past due rates (30 days or more delinquent) are just under 3 percent of total student loan balances, and the upper end of the charge-off range is at just over 1.5 percent per year. In addition, IDIs that we supervise are currently requiring cosigners, usually parents, on about 90 percent of the loans they underwrite. The majority of loans are underwritten at a variable rate of interest, with average interest rates currently in the 6 to 7 percent range. Loan terms vary, usually between five and fifteen years.

[4] Donghoon Lee, 2013.
[5] College Board Advocacy & Policy Center, *Trends in Student Aid 2012*.

Supervision of PSL Lenders

Of the approximately 4,400 institutions supervised by the FDIC, only a small number of FDIC-supervised institutions originate PSLs, but these include two of the largest PSL originators. Unlike most lending, student lending is complicated by the fact that students often have no established credit history to indicate their creditworthiness, and that repayment will initially be partial, or delayed, often for several years, while the student completes his or her education. Also, PSLs generally are not dischargeable in bankruptcy. While this provides borrowers with a strong incentive to repay, IDIs and other lenders in the PSL market absorb all losses on these loans for borrowers who do not repay, which is why many originators require cosigners.

The FDIC supervises PSL lenders using the same framework of safety and soundness and consumer protection rules, policies, and guidance as for other loan categories. The interagency policy, *Uniform Retail Credit Classification and Account Management Policy* (Retail Credit Policy) applies to student loans as it does to other unsecured personal loans.[6] This policy, which has been in place since 1980, with some subsequent revisions, provides IDIs with guidance on classifying retail credits for regulatory purposes and on establishing policies for working with borrowers experiencing problems.

For safety and soundness purposes, the FDIC examines IDIs to ensure that they are following basic underwriting tenets when extending credit. For PSLs, like all loans, the ability and willingness to repay is necessarily the primary driver of safe and sound lending. Generally,

[6] See http://www.fdic.gov/regulations/laws/rules/5000-1000.html#fdic5000uniformpf.

the ability to repay is demonstrated by payments of principal and interest that reduce principal over a reasonable period of time.

During an examination of a PSL lender, FDIC examiners review the appropriateness of the lender's underwriting criteria; loan administration and servicing practices; compliance with applicable laws and regulatory reporting and accounting requirements; loan classification and allowance for loan and lease losses policies; audit and internal review practices; and modification, workout and collection policies and practices. Additionally, examiners review portfolio structure and performance, and related monitoring and controls to assess credit quality and management oversight. They also review individual loan files, on a sampling basis, to ensure consistency with supervisory guidelines, internal bank policies, and overall prudent lending standards.

The FDIC also examines student loan lenders for compliance with applicable federal consumer protection laws, including the Equal Credit Opportunity Act, the Truth in Lending Act and Regulation Z, the Fair Credit Reporting Act, the Gramm-Leach-Bliley Act rules on privacy of consumer financial information, the Electronic Signatures in Global and National Commerce Act (E-Sign Act), the Service Members Civil Relief Act, and the Community Reinvestment Act (CRA). In addition, Section 5 of the Federal Trade Commission Act, which addresses unfair or deceptive acts or practices, is applicable to this type of lending. As part of these compliance examinations, examiners review policies, procedures, and practices; marketing materials and practices; disclosures provided to borrowers; and any related consumer complaints.

Additionally, examiners review monitoring procedures implemented by the bank to ensure compliance with consumer protection regulations.

Working with Student Loan Borrowers

The FDIC appreciates concerns about repayment and workout options and encourages institutions to work constructively with borrowers who are experiencing difficulty. Examiners will not criticize banks for engaging in alternate repayment plans or modifications so long as such plans or modifications are consistent with safe and sound practices. With respect to workouts and modifications, the interagency Retail Credit Policy specifically states "extensions, deferrals, renewals, and rewrites of closed-end loans can be used to help borrowers overcome temporary financial difficulties." The Retail Credit Policy provides significant flexibility for IDIs to offer prudent workout arrangements tailored to their PSL portfolios. In particular, the policy states that it is the IDI's responsibility to establish its own policies for workouts suitable for their portfolio. Prudent workout arrangements consistent with safe and sound lending practices are generally in the long-term best interest of the financial institution and the borrower.[7]

IDIs supervised by the FDIC offer borrowers experiencing financial difficulties forbearance (cessation of payments) for periods ranging from three to nine months beyond the initial six month grace period after leaving school. A number of workout plans are also available to borrowers of FDIC-supervised IDIs, including rate reductions, extended loan terms, and in

[7]See for example the interagency *Policy Statement on Prudent Commercial Real Estate Loan Workouts*, October 2009, http://www.fdic.gov/news/news/financial/2009/fil09061a1.pdf and the interagency *Statement on Working with Mortgage Borrowers*, April 2007, http://www.fdic.gov/news/news/press/2007/pr07032a.html.

settlement situations, principal forgiveness. At the same time, it is important that modifications not leave the borrower in a worse position in the long term. For example, a modification that does not provide for payments to cover principal and interest or that allows a loan to remain in extended periods of forbearance can result in negative amortization, which leads to a growing loan balance that can dig a consumer deeper into debt.

Concerns have been raised that troubled debt restructuring (TDR) accounting rules limit IDIs' ability to modify PSLs. The treatment of loans as TDRs is established by generally accepted accounting principles (GAAP), and banks are required by law to adhere to GAAP. Under GAAP, modifications of loans, regardless of loan type, should be evaluated individually, considering all facts and circumstances, to determine if they represent TDRs. A TDR occurs when a lender, due to a borrower's financial difficulties, grants a concession to the borrower that it would not otherwise consider. GAAP requires modified loans that are TDRs to be evaluated for impairment and written down, if necessary, with appropriate adjustments made to the allowance for loan and lease losses.

Potential or actual treatment as a TDR should not prevent institutions from proactively working with borrowers to restructure loans with reasonable modified terms. As stated above, the FDIC encourages banks to work with troubled borrowers and will not criticize IDI management for engaging in prudent workout arrangements with borrowers who have encountered financial problems, even if the restructured loans result in a TDR designation.[8]

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[8] Supra, Footnote 7.

It also is important that borrowers who are facing repayment difficulties receive clear and accurate information on opportunities for loan modifications and workouts. There is often a great deal of confusion about differences between FSLs and PSLs. Prior to 2010, FSLs were made through private financial institutions under the Family Federal Education Loan Program, and those loans have more repayment and modifications options than PSLs. The FDIC encourages its institutions to make clear to borrowers the modification and workout options that exist, and the eligibility criteria for such programs.

One complicating factor for modifications of PSLs is that about twenty-five percent of the estimated $150 billion PSLs outstanding are in securitization trusts.[9] In those cases, payment restructuring and modification options may be limited by the terms of the securitization pooling and servicing agreement. In securitizations, the traditional borrower and lender relationship is replaced by governing documents administered by a trustee for the benefit of multiple parties, including investors. As a result, the servicer and trustee are responsible for ensuring that a securitized pool of loans is managed in the best interest of investors, which substantially limits the ability to change the terms of underlying pooled assets. For example, noteholders may have conflicting incentives based on their seniority in the securitization capital structure, and servicers may not have sufficient legal ability to make modifications without the consent of noteholders or trust administrators. When repayment difficulties arise, the borrower will generally be dealing with the servicer, not the original lender.

[9] Securities Industry and Financial Markets Association (SIFMA), *U.S. ABS Issuance and Outstanding,* http://www.sifma.org/research/statistics.aspx. This report shows that PSL securitizations outstanding total $37.3 billion.

Finally, PSL borrowers, especially those who are performing on their loans as agreed, face significant challenges for refinancing higher rate PSLs. Refinancing an unsecured PSL can be difficult given the lack of participants in the refinance market, and the potentially high costs of marketing and customer acquisition that may be keeping additional participants from entering the refinance market. Moreover, many PSLs have variable rates and, in the current low interest rate environment, it may be difficult for consumers to negotiate a lower fixed-rate without collateral.

Additional FDIC Actions

The FDIC continues to seek solutions to challenges in the student lending area. The FDIC is finalizing a statement to the banks it supervises to clarify both that we support efforts by banks to work with student loan borrowers and that our current regulatory guidance permits this activity. In addition, the statement will make clear that FDIC-supervised institutions should be transparent in their dealings with borrowers and make certain that borrowers are aware of the availability of workout programs and associated eligibility criteria. We expect to issue this statement in the near future.

We also have formed an internal working group to engage various stakeholders, including PSL lenders and consumer groups, and we are discussing our current policies and refinancing challenges with other regulators, including the CFPB, to determine whether clarifications or changes may be needed.

Conclusion

The FDIC appreciates the opportunity to testify on this important issue. High levels of student debt can pose significant challenges for families, particularly during what has been a prolonged period of high unemployment. The FDIC remains committed to providing focused and effective oversight of institutions engaged in the PSL market to ensure that supervised institutions operate in a safe and sound manner and in compliance with applicable federal consumer protection laws.