



Improving Consumer Protections for Private Student Loans

June 4, 2007

Private or “alternative” student loans are the fastest growing and most profitable part of the student loan industry. Ten years ago, only five percent of total education loan volume was in private loans. Today they represent an estimated 20 percent of what all undergraduate, graduate, and professional students and their families borrow to pay for school. In 2005-06, lenders issued \$17.3 billion in private student loans.

More and more students and parents are turning to these risky loans to help bridge the widening gap between college costs and available aid. The interest rates and fees can be as variable and onerous as credit cards, and private loans lack even the limited borrower protections that come with federal student loans. Colleges routinely offer private loans as part of student financial aid packages, and lenders also aggressively market private loans directly to consumers. Yet private loan borrowers do not have access to the kind of information and consumer rights that other types of borrowers can count on. The following four steps would help right that wrong.

1) Treat private student loans like other consumer debt in bankruptcy.

Since 2005, *private* student loans have been as difficult to discharge in bankruptcy as *federal* student loans. There is some justification for making federal loans very hard to discharge: they are backed by taxpayer dollars, and they come with some borrower protections in cases of economic hardship, unemployment, death, and disability, as well as several repayment options. But private loans involve only private profit and come with no such guaranteed protections. Shielding private loans from bankruptcy means that repayment demands can essentially extend forever, leaving even the most destitute borrowers with no way out. This makes lenders less cautious about making high-cost private loans to people who may not be able to afford them, as well as to students at schools with low completion and job placement rates. Giving private loans such high status in bankruptcy also puts other creditors at a significant disadvantage.

Policy Solution: Amend current federal bankruptcy law so that private student loans have to meet the same criteria as other forms of consumer debt to be exempted from discharge.

2) Clearly label private student loans as different from federal loans.

A lack of clear and consistent distinctions between types of loans means borrowers do not always realize that they are taking out private student loans, or how different their terms are from federal loans. The number of private loan borrowers who do not first exhaust their federal loan options is growing despite the lower risks and costs of federal loans. Confusion arises when schools or lenders package federal and private loans together (such as a Sallie Mae Stafford Loan with a Sallie Mae Signature Loan). Also, some aid packages include private loans branded with the college’s name (such as an Acme College Gate Loan), which leads students and parents to assume that they are special and safer than loans from other sources. Borrowers need more and better information about the loans they are being offered and what options they have before they are asked to commit to a private loan.

Policy Solutions: (a) Require colleges to clearly distinguish private from federal loans in financial aid awards and other materials. (b) Ban the use of college names and/or insignias as part of a private loan brand. (c) Require that all materials about private student loans, whether issued by lenders or colleges, state that private loans are not backed by the federal government and can cost more than federal loans. (c) Require lenders and colleges to inform prospective borrowers about the availability and terms of federal loans before they take out a private loan. (e) Require lenders to notify the student's college before issuing a private student loan.

3) Make it easier to compare private student loans.

It is very difficult for even the most sophisticated and motivated consumers to compare the actual terms and conditions of private student loans. Interest rate and other terms on private loans are based on the individual borrower's credit rating and other factors that each lender may weigh differently. Yet many lenders do not provide complete information about what a private loan will really cost until the borrower signs a promissory note. In fact, loans above \$25,000 do not require basic Truth-in-Lending Act disclosures of rates and terms. Also, lenders can describe their interest rates, fees, repayment plans, and discounts in very different ways that make it hard to shop around. Many advertise interest rates that are the lowest possible rate rather than the potential range, which could be wider than 10 percentage points. Some based their rates on an index, such as the prime rate, but highlight the amount they charge above that rate (e.g., they offer a rate of prime plus 3% but it looks like the total rate is 3%). As a result, borrowers are left with very little ability to compare their real options before committing to a particular lender or loan. And once they do commit, there is no guaranteed cooling-off period or requirement that cancellation terms and procedures are clearly displayed.

Policy solutions: (a) Require all rate quotes for private student loans to include full APR and other items required by the Truth in Lending Act (TILA), and require that borrowers receive accurate quotes before they are presented with a promissory note to sign. (b) Require a minimum cooling-off period during which the borrower can cancel the loan with no prepayment penalty. (c) Ensure that all student loans, regardless of size, are subject to TILA.

4) Protect borrowers who are harmed by conflicts of interest or fraud.

When a college goes out of business, does not offer the classes students signed up for, or uses other deceptive tactics to get them to enroll and take out private loans to pay the bill, most students are left to fend for themselves. The same holds true for borrowers who are steered into unnecessarily costly private loans -- or to lenders that engage in fraud or false advertising -- because their school stands to benefit in some way. When lenders and schools have referral or business arrangements, and students end up with private loans they cannot afford to pay, they ought to be able to get their money back instead of getting hounded by collections agencies and having their credit ratings ruined. Under current law, only students at for-profit private colleges have any real consumer protections in this situation, and they are quite difficult to enforce. When schools and private lenders have referral relationships, they should both be held accountable for loan-related harms caused to students by either party. That would help protect students from exploitation, discourage lenders from affiliating with shady schools, and encourage colleges to carefully vet the private lenders they work with.

Policy solution: Extend the borrower protections and remedies in the Federal Trade Commission (FTC) Holder Rule to cover students at all types of colleges and universities (not just private for-profit schools as under current law), and all types of student loans and loan holders.