United States Government Accountability Office
Washington, DC 20548

November 17, 2009

Congressional Committees

Subject: *Higher Education: Factors Lenders Consider in Making Lending Decisions for Private Education Loans*

Over the past few decades, the cost of tuition, room, and board for undergraduate students has increased, making it more difficult for some students and families to afford the cost of college. While students have historically relied on federal loans and grants and family contributions to pay for college, a growing number have turned to private education loans to help them cover the cost. In 2007-08, private loan volume, including private sector and state sponsored loans, totaled $19 billion, up from $3 billion in 1997-98, according to the 2008 College Board report on student aid.[1] Unlike federal loans, private education loans are not guaranteed by the federal government and are typically more costly for students than loans offered through federal programs.[2] Despite their generally higher cost, about 26 percent of students who obtained private education loans in 2007-08 did not obtain Federal Stafford loans, and more than one-half of these students did not apply for Federal financial aid, according to the Institute for College Access and Success. In 2007-08, 14 percent of undergraduate students obtained private education loans, according to the Institute for College Access and Success, and the average private loan amount was $6,533.[3]

This letter summarizes our briefings with your staff during which we discussed our work under the mandated study in section 1122 of the Higher Education Opportunity

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[1]In 2007-08, the federal government provided $66.8 billion in federal loans for postsecondary students. In the past several years, Congress raised limits on federal student aid, including loans. In general, the aggregate loan limits for an entire undergraduate education are $31,000 for dependent students and $57,500 for independent students. A student is classified as either financially dependent on his or her parents or independent when applying for financial aid. This classification is important because it affects the factors used to determine a student's financial aid eligibility.

[2]The Department of Education (Education) administers the Federal Family Education Loan (FFEL) Program and the William D. Ford Federal Direct Loan (Direct Loan) Program, both of which consist of what are generally known as Stafford Loans and Parent Loans for Undergraduate Students. Under the Direct Loan Program, loan funds come directly from the federal government. For the FFEL Program, loans funds come from participating private financial institutions and are guaranteed by the federal goverment.

[3]This estimate, based on the 2007-08 National Postsecondary Student Aid Study, has a margin of error of plus or minus $173 at the 95 percent confidence level.

Act of 2008 (HEOA).[4] The mandate directed GAO to assess the impact of private lenders' use of nonindividual factors—factors other than the borrower's own credit worthiness, such as the cohort default rate or graduation rate of the school the student attends— in making loan decisions.[5] The mandate also directed GAO to assess whether lenders' use of such factors may affect students' access to private education loans and may have a disparate impact on the pricing of these loans by race, gender, income, and institution type. To address the issues raised in the mandate, we framed our study around three key questions:

1. What are the key characteristics of private education loan borrowers and the types of schools they attend?

2. How do lenders use nonindividual factors—including cohort default rate, graduation rate, and accreditation—in making lending decisions for private education loans?

3. What is the impact of using these factors on loan products and rates students pay and their access to loans, by gender, race, income, and institution type?

While we were able to obtain some information on the characteristics of borrowers, the types of schools they attend, and lenders' use of nonindividual factors, we were not able to obtain information that allowed us to assess the impact of lenders' use of these factors on students. To determine the key characteristics of private education loan borrowers and the schools they attend, we analyzed selected data on undergraduate student borrowers from Education's 2007-08 National Postsecondary Student Aid Study (NPSAS) which contains information on private borrowing activity, as well as the characteristics of borrowers.[6] We assessed the reliability of selected NPSAS data.[7] To determine how lenders use nonindividual factors in their lending decisions, we interviewed several major lenders. We also reviewed the Securities and Exchange Commission filings of several major lenders and interviewed federal banking regulators who oversee private education lenders, including the

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[4]Pub.L.No.110-315 (Aug. 14, 2008).

[5]Cohort default rate refers to the percentage of a school's borrowers who enter repayment on certain FFEL Program or Direct Loan Program loans during a particular federal fiscal year.

[6]NPSAS is a comprehensive nationwide study designed to determine how students and their families pay for postsecondary education, and to describe some demographic and other characteristics of those enrolled. The study uses data from nationally representative sample surveys of students in postsecondary education institutions, including undergraduate, graduate, and first-professional students. Students attending all types and levels of institutions are represented, including public and private not-for-profit and for-profit institutions, and less-than-two-year institutions, community colleges, and four-year colleges and universities.

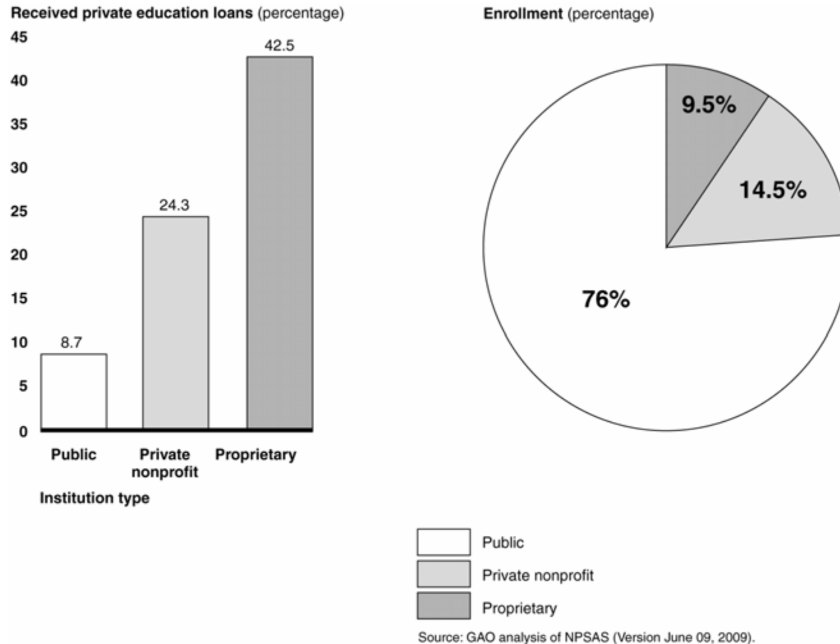
[7]We assessed the reliability of selected NPSAS data by (1) reviewing agency documents, (2) reviewing the response rates for the variables used in our analyses, and (3) computing confidence intervals. In addition, agency officials reviewed our analyses. The overall response rate for NPSAS was 96 percent. Missing variables were imputed and were replaced with valid data from donor records. All of the NPSAS percentage estimates used for this report have standard errors of 2.5 percentage points or less, and the standard error for the average total private loans was $88 based on the Balanced Repeated Replication method. The item response rates for the variables used in this report are above 75 percent except for the private loan variable which had a response rate of 67 percent. We were unable to perform an item nonresponse bias analysis for private loans because the restricted NPSAS 2007-08 file was not available during the time we conducted our work.

Federal Reserve System, Office of Comptroller Currency and the Federal Deposit Insurance Corporation.[8] We also interviewed representatives from other financial institutions, industry researchers, experts and officials at Education and reviewed relevant laws and regulations. To determine whether the use of nonindividual factors has an impact on student access to loans and rates by student demographics and institution type, we interviewed officials at higher education associations and officials from a nonrepresentative sample of eight institutions of higher education, selected to include representation from Historically Black Colleges and Universities (HBCU), as well as public and private nonprofit, and for-profit institutions (also known as proprietary schools). In addition to interviewing several major lenders, we also requested their underwriting methodology for private education loans, borrower data and information on the terms and conditions associated with their loans. Citing the proprietary nature of the underwriting practices and the terms and conditions of private education loans, none of the major lenders we contacted would allow us access to their underwriting criteria or loan data. Consequently, we were unable to determine how the use of nonindividual factors impacts students' access to private loans; the products and rates available to students at certain institutions; or the pricing of these loans by race, gender, income, and institution type. Finally, we provide information on how the private student loan lending landscape has changed since the HEOA, which mandated our study, was passed. We conducted our work from April 2009 to November 2009 in accordance with all sections of GAO's Quality Assurance Framework that are relevant to our objectives. The framework requires that we plan and perform the engagement to obtain sufficient and appropriate evidence to meet our stated objectives and to discuss any limitations in our work. We believe that the information and data obtained, and the analysis conducted, provide a reasonable basis for any findings and conclusions in this product.

Students who attended certain types of schools were more likely to take out private loans; and in addition, there were small differences that were statistically significant for private loan borrowers with respect to dependent and independent students, family income, gender, and greater differences between some race and ethnicity groups. Specifically, according to NPSAS, nearly one-third of the students at the highest cost institutions ($25,000 or more per year) took out private loans. In addition, while students attending proprietary schools accounted for approximately 10 percent of the undergraduate population, over 40 percent of them borrowed private loans (see fig. 1), according to NPSAS data. The proportion of undergraduate students attending HBCUs who borrowed private education loans did not differ significantly from borrowers at all other institutions.

[8]In August 2009, the Federal Reserve Board published a final rule amending Regulation Z, which implements the Truth in Lending Act (15 U.S.C. 1601 et seq.), a consumer protection law that regulates certain credit practices and promotes the informed use of consumer credit by requiring uniform disclosures. The rule implements provisions of the HEOA, by adding disclosure requirements and prohibiting certain practices for creditors making private education loans. Under the rule, creditors who extend private education loans must provide disclosures about loan terms and features on or with the loan application and must also disclose information about federal student loan programs that may offer less costly alternatives. Additional disclosures must be provided when the loan is approved and when the loan is consummated 74 Fed. Reg. 41194 (Aug. 14, 2009).

Figure 1: Percentage of Undergraduate Students Who Borrowed Private Education Loans and Enrollment by Institution Type, 2007-08

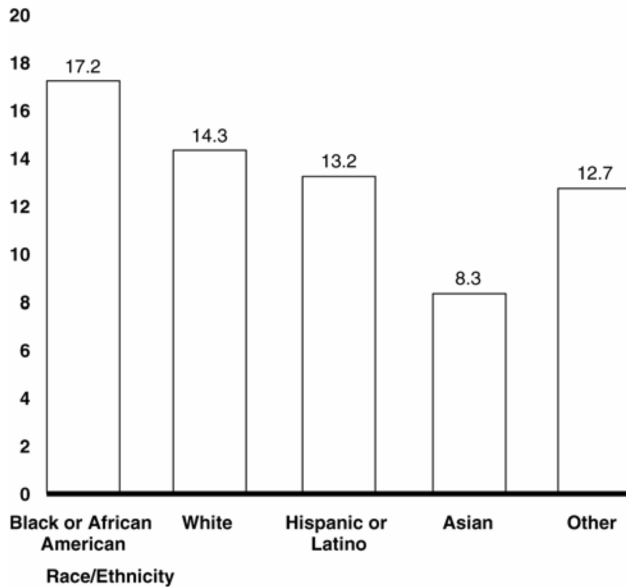


Source: GAO analysis of NPSAS (Version June 09, 2009).

Moreover, a slightly higher percentage of dependent undergraduate students borrowed private education loans (15 percent) compared to independent students (13 percent), and a higher percentage of dependent students from middle and high income families (17 percent and 15 percent, respectively) borrowed private loans compared to dependent students from low income families (about 12 percent).[9] In addition, a slightly higher proportion of female students borrowed private education loans (about 15 percent for females and 13 percent for males). While there were varying differences in the percentages of undergraduate students borrowing private education loans by race/ethnicity, Black or African American students were the highest percentage of borrowers (see fig. 2).

[9]Using income groups of Education's database, GAO defined middle to high income families as those with an annual income of $30,000 or more.

Figure 2: Percentage of Undergraduates Who Borrowed Private Education Loans by Race/Ethnicity, 2007-08



Source: GAO analysis of NPSAS database.

Notes: "Other" includes the following NPSAS categories: American Indian or Alaska Native, Native Hawaiian or other Pacific Islander, Other, and More than one race.
There was no difference detected between "Hispanic or Latino" and "Other." All other comparisons were significant at the 95 percent level.

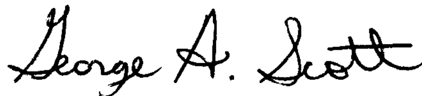
Private lenders may use nonindividual factors to select the institutions at which they will lend to students and to establish loan terms and conditions, including interest rates, according to lenders and industry experts. Similarly, guarantors, agencies that insure student loans against default, of private education loans may use nonindividual factors to determine the institutions at which they will guarantee student loans. Some of the key nonindividual factors that lenders use include program length (e.g., two-year versus four-year program), type of school, school graduation rates, and schools' cohort default rates, according to lenders and industry experts. Although the inclusion of nonindividual factors as well as the thresholds and relative importance vary by lender, many of the lenders who we interviewed said that the cohort default rate is the most commonly used nonindividual factor. Lenders generally view longer programs of study, high graduation rate, and low cohort default rate as more favorable conditions when making lending decisions, according to experts and lenders we interviewed. Lenders, researchers, and industry experts confirmed that lenders have historically used nonindividual factors to help them make lending decisions, especially because students often lack sufficient credit history upon which to base decisions. Education also uses a school's cohort default rate to determine school eligibility for participation in selected federal student aid programs, and lenders who participate in federally guaranteed student loan programs also use the cohort default rate and other nonindividual factors to select schools where they will lend to students, according to Education officials.

Finally, the student loan lending landscape has changed significantly since the HEOA, which mandated our study, was passed. Many of the lenders offering private loans have exited the market in response to limited access to capital resulting from the credit crisis, according to researchers, lenders, and experts we interviewed. In 2008-

09, the private loan volume totaled about $12 billion, according to the 2009 College Board report on student aid. Lenders who have continued their private student loans programs reportedly tightened their lending practices, which have limited some students' access to these loans, according to some researchers we interviewed.[10] In response to the tightening of credit, some school officials we interviewed reported that their schools are offering students more institutional funds—grants, scholarships, and loans—to help them finance college costs. Also, according to officials from credit unions and experts, credit unions are increasingly offering private education loans.

We provided a draft of this letter to Education for review and comment. Education provided technical comments which we incorporated as appropriate.

As agreed with your staffs, this letter satisfies the reporting requirement specified in the mandate. We are sending copies of this letter to the cognizant congressional committees and Education. This letter also will be available on the GAO Web site at http://www.gao.gov. Should you or your staffs have any questions, please contact me at (202) 512-7215 or Scottg@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report include Sherri Doughty, Tranchau (Kris) Nguyen, Charlene M. Johnson, Stacy Ann Spence, Erin Preston, Susannah Compton, Cindy Gilbert, Doreen Feldman, Debra Johnson, Sheila McCoy, Grant Mallie, James Rebbe, and Karen O'Conor.



George A. Scott
Director, Education, Workforce
and Income Security Issues

[10]Some examples of how lenders have tightened lending practices for private education loans include requiring higher credit scores for approval, approving lower loan amounts, charging higher interest rates, increasingly requiring interest payments while students are in school, and more frequently only approving borrowers who have a credit-worthy cosigner.

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