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TENNESSEE COMPTROLLER OF THE TREASURY, JUSTIN P. WILSON

STUDENT LOAN SOURCES AND PRACTICES: A PRIMER

August 2009

STATE OF TENNESSEE

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Comptroller

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August 3, 2009

The Honorable Ron Ramsey
  Speaker of the Senate
The Honorable Kent Williams
  Speaker of the House of Representatives
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243

Ladies and Gentlemen:

Public Chapter 1103 (2008) directs the Office of Education Accountability to study practices and sources of student loans at Tennessee institutions of higher education. For the purposes of this report, the Office Education Accountability reviewed research literature, examined statutory and administrative requirements, and interviewed student aid personnel and government officials to discover sources and practices of student loan programs. This report reviews trends in college tuition and student borrowing patterns and summarizes the loan application and borrowing process for both federal and private student loans. The report also details school practices and consumer protection requirements including loan counseling, disclosure, and other loan terms and conditions. This review of student loan sources and practices provides a primer to policymakers and others seeking information about student loan programs.

Sincerely,

Justin P. Wilson
Comptroller of the Treasury

Student Loan Sources and Practices: A Primer

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INTRODUCTION

Postsecondary education has become essential for success in the 21st century. Today's employers increasingly seek out and reward those workers with postsecondary credentials and degrees. Job growth statistics for Tennessee confirm this trend: eight of the top 10 occupations projected to experience the fastest growth in Tennessee between 2004 and 2014 will require a college degree or postsecondary vocational award.[1]

Accompanying postsecondary education's rise in importance, the costs of attending college have increased significantly since the 1990s. Students are financing the rising costs of postsecondary education through a variety of methods, including scholarships, grants, work study programs and student loans. Student loan volume has seen tremendous growth over the last 15 years; student loans have now replaced grants as the largest source of student financial aid for college.[2]

Federal Student Loans: loans provided, guaranteed, or otherwise funded by the federal government under Title IV of the Higher Education Act of 1965

Private Student Loans: loans made outside the federal student loan program by banks or commercial lending institutions

In 2008, the Tennessee General Assembly passed Public Chapter 1103 directing the Office of Education Accountability (OEA) to study practices and sources of student loans at Tennessee institutions. In response, OEA produced *Student Loan Sources and Practices: A Primer* as an introduction to the complex world of student loans, providing policymakers with information on:

1. trends in college tuition rates and student borrowing patterns
2. types of loans (e.g., federal, private, state, and emergency) available to student borrowers
3. the federal student loan process: the student borrowing experience and concurrent institutional practices
4. the private student loan process: lender regulations, school practices, and the student borrowing experience

Tuition and Fees Rising

Tennessee has followed national trends in the rising costs of college over the last 10 years. Tuition and fees at Tennessee public postsecondary institutions more than doubled between 1997-98 and 2007-08. (See Exhibit 1.) The cost of attending four-year private institutions also increased, though at a lower percentage rate.

Exhibit 1: Average Undergraduate Tuition and Fees for Full-time Students in Tennessee

Type of Institution	1997-98	2007-08	Percent Increase	Inflation Adjusted Increase
4-Year Private	$11,047	$18,509	68%	27%
4-Year Public (in state)	$2,296	$5,366	134%	77%
2-Year Public (in state)	$1,133	$2,631	132%	76%

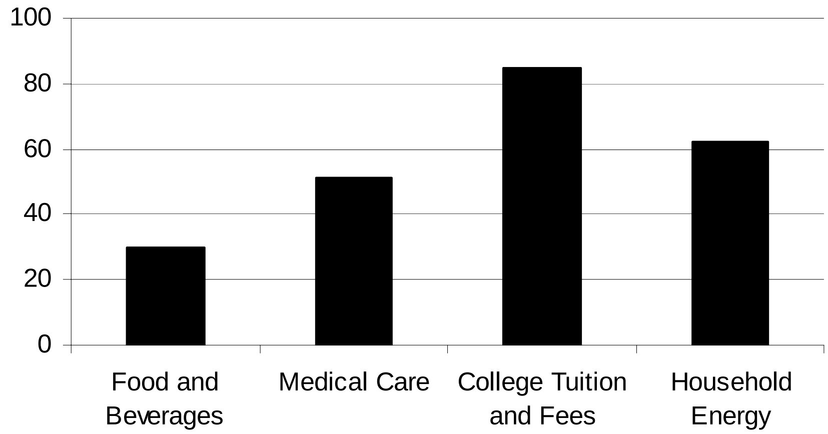
Source: *Digest of Education Statistics.*
Note: Tuition data are enrollment-weighted and are slightly different than the average across institutions. *Private school tuition data includes both for-profit and not- for-profit institutions*. Inflation calculated by author using the Consumer Price Index (CPI-U).

Nationwide, college tuition and fees increased 106 percent at public universities and 76 percent at private universities in inflation-adjusted dollars between 1997-98 and 2007-08.[3] According to the Consumer Price Index, a widely referenced measure of price inflation, the price of college tuition increased more than prices for other consumer goods and services including food, energy, and medical care during the same period.[4] (See Exhibit 2.)

Student Borrowing and Indebtedness

The proportion of Tennessee undergraduate students borrowing to pay for college increased between 1995-96 and 2007-08. This increased reliance on loans is consistent with national trends. Exhibit 3 shows by loan source the percentage of undergraduate students both in Tennessee and nationwide that took out loans.

Exhibit 2: Percent Growth in Cost of Select Consumer Products, 1998-2008



Source: Bureau of Labor Statistics, Consumer Price Index (CPI-U).

The percentage of Tennessee undergraduate students taking out federal loans rose from 25.8 percent in 1995-96 to 34.1 percent in 2007-08. While this figure grew during the 12-year period, the proportion of Tennessee students borrowing federal loans dropped over 10 percent between 2003-04 and 2007-08. Decreased reliance on federal student loans may have resulted from the introduction of the Tennessee Lottery Scholarship in 2004.[5] In 2003-04, just 7.4 percent of Tennessee students received state grants or scholarships, and the average grant award was about $1,900. In 2007-08, 27.1 percent of Tennessee students received state grants or scholarships with an average award of nearly $3,700.[6] Expanded state grant and scholarship programs have not produced a similar decrease in private loan borrowing. The percentage of students borrowing private loans showed a marked increase over this time period, growing from less than three percent in 1999-00 to 12.6 percent in 2007-08.

Exhibit 3: Percentage of Students Borrowing for Postsecondary Education by Loan Source

		1995-1996	1999-2000	2003-2004	2007-08
Federal Loans	**Tennessee**	25.8%	31.0 %	44.2%	34.1%
	National	25.7%	27.9%	33.7%	34.7%
Private Loans	**Tennessee**	0%[a]	3.0%	5.8%	12.6%
	National	0.2%	2.9%	5.1%	14.2%

Source: United States Department of Education, National Postsecondary Student Aid Study (NPSAS), 1996, 2000, 2004, 2008.
Note: Federal loans include both Stafford (subsidized and unsubsidized) and Perkins Loans.
a=Rounds to Zero

One of the effects of more students borrowing money to finance postsecondary education is that more students are leaving college with student loan debt. Nationwide, about two-thirds of students graduating from four-year institutions in 2004 had student loan debt, compared to less than half in 1993.[7] Among students graduating from four-year colleges in 2007:

- 59 percent of students nationwide graduated with loan debt, with an average debt load of over $20,000.[8]
- 44 percent of Tennessee graduates had loan debt, the third lowest percentage in the nation. The average debt load for Tennessee graduates was $19,304.[9]

Adjusted for inflation, student borrowing has more than doubled nationwide over the last ten years, rising from $41 billion in 1997-98 to $85 billion in 2007-08.
Source: College Board, "Trends in Student Aid 2008."

Student loan debt factors into borrowers' decisions about their future plans. Thirty-eight percent of respondents to a 2002 national survey of student loan borrowers indicated they delayed purchasing a home because of student loan debt, and another 21 percent stated that they put off having children. Almost one in five borrowers indicated that student loan debt significantly changed their career plans.[10]

Types of Loans Available to Student Borrowers

Students have several sources of loans available to them to help pay for higher education; however, most student loans are from federal and private sources. This section discusses the availability of and eligibility requirements for these loans.

Federal Student Loans

Federal loans are the largest source of student loans. They include:

- Federal Direct Student Loan Program (Direct) and Federal Family Education Loan Program (FFELP) Stafford Loans, both subsidized and unsubsidized;
- Direct and FFELP PLUS Loans; and
- Perkins Loans.

What is the difference between the Federal Family Education Loan Program and Federal Direct Loan Program?

Two federally-sponsored loan programs are available to students: the Federal Family Education Loan Program (FFELP) and William D. Ford Federal Direct Loan Program (Direct).[11] Both FFELP and Direct Loan Programs offer *Stafford* loans and *Parent Loans for Undergraduate Students (PLUS)*.[12] The most obvious difference between these two programs is the source of the loan capital. Together, FFELP and Direct Loan Programs distributed $66.8 billion in Stafford loans to 7.7 million recipients in FY 2007-08.[13] Most schools participate in either FFELP or the Direct Loan Program, or both.[14] Exhibit 4 illustrates specific differences in the two programs in terms of interest rates, award limits, payment details, and eligibility.

Federal loans for undergraduate students are generally referred to as **Stafford** loans. **PLUS Loans** are fixed-rate loans available to credit-worthy parents of undergraduate students, regardless of financial need. Graduate and professional degree students may also obtain PLUS Loans.

Loan Capital

In the Direct Loan program, the capital comes from the federal government, with contractors or schools acting as loan originators on the government's behalf. The school assists in distributing the loan application, processing the loan, and disbursing the loan funds in the Direct Loan program.[15] Students pay Direct Loans back to the federal government through the U.S. Department of Education.[16]

Under FFELP, private lenders provide funds for loans that the federal government guarantees against losses resulting from borrower default.[17] The borrower therefore repays the lender, rather than the federal government. Guaranty agencies are the state or private nonprofit organizations that have agreements with the U.S. Department of Education to administer loan guarantee programs for the FFELP.[18] There is a guaranty agency available to every state; the Tennessee Student Assistance Corporation (TSAC) guarantees the majority of FFELP Loans borrowed by Tennessee students.

Tennessee Student Assistance Corporation (TSAC)

TSAC Rules state that:

The Corporation [TSAC] shall insure 100 percent of the unpaid principal balance plus accrued interest of educational loans made by eligible lenders to worthy and needy students who are bona fide residents of the State of Tennessee and who are enrolled or accepted for enrollment in eligible educational institutions…The Corporation shall also insure, under the same conditions, loans made to non-residents who attend eligible institutions located in Tennessee.[19]

A lender in the FFELP program is secure in lending to a college student because if the student borrower defaults, the guaranty agency will ensure the lender receives its money. Guaranty agencies also offer defaulted borrowers the opportunity to "rehabilitate" their loans and restore their credit ratings.[20] In cases where a student finds it difficult to secure a FFELP lender, TSAC has the federal authorization to become a Lender of Last Resort (LLR), itself lending money directly to the student. [21] TSAC has not taken this option, however, having been successful in locating lenders on students' behalf.

Fees

Both FFELP and Direct Loans have fees. These fees can be up to two percent of the principal amount for the Stafford and up to four percent for the PLUS loan. The fee is deducted before the student receives any loan money, so the loan amount received is actually less than the amount the student must repay.[22] The entire fee for the Direct Loan goes to the federal government, while the FFELP fee is split between the government and a guaranty agency.[23] The Higher Education Reconciliation Act of 2005 requires the guarantor (TSAC, in the case of Tennessee) to deposit one percent of the principal amount of federal student loans to the Federal Student Loan Reserve fund. Guarantors may collect this fee from borrowers; however, TSAC currently pays the entire one percent Federal Default Fee for the borrower.[24]

Direct Loans vs. FFELP Loans—Trends

The FFELP Loan depends upon the participation of private lenders. While the proportion of federal loans constituted by FFELP is much larger, many institutions have recently chosen to move into the Direct Loan Program to ensure uninterrupted access to federal loans. According to FinAid, as of May 6, 2009, 182 education lenders have exited or suspended their participation in all or part of the FFELP. In FY 2007, these lenders made up 12.6 percent of the market share, or $7.1 billion.[25] With private lenders pulling out of the student loan market, institutions may see a higher degree of security for their students, because the Direct Loan Program provides uninterrupted access to loan funds from the federal government.[26]

How are subsidized and unsubsidized federal loans different?

Undergraduate students who borrow subsidized Stafford loans must demonstrate financial need.[27] The U.S. Department of Education pays the interest on the subsidized Stafford while a student is in school at least half-time, and during grace and deferment periods. Students who borrow unsubsidized Stafford loans are responsible for the interest during the life of the loan, and all students, regardless of need, qualify.[28] Schools determine a student's unsubsidized loan amount after subtracting federal grant amounts, the subsidized loan amount, and any other financial aid received from the student's *cost of attendance*.[29] Subsidized loans made after July 1, 2009, will have a fixed interest rate of 5.6 percent, while the unsubsidized rate will remain at 6.8 percent.[30] Federal legislation passed in 2007 will gradually reduce the interest rate on the subsidized Stafford to 3.4 percent by 2011-12.[31]

> The ***cost of attendance*** is a school-determined yearly figure that includes tuition and fees; on-campus room and board; allowances for books, supplies, transportation, and loan fees.

What are Perkins Loans?

Perkins Loans are federal monies matched by institutional funds to make small, low-interest loans available to undergraduate, graduate, and professional degree students.[32] They are offered at a fixed five percent interest rate to full- and part-time students who demonstrate financial need. The school is responsible for administering the loans as the lender, and therefore borrowers pay back the Perkins Loans to the school. Schools participating in the Perkins program receive funds each year from the U.S. Department of Education. When all available funds for an award year have been distributed, no more awards can be made for that year. In academic year 2007-08, there were 504,000 Perkins Loan recipients in the U.S.[33]

What are the benefits of federal student loans?

Often student borrowers have limited credit histories and low credit scores. While these factors would influence interest rates and loan amounts in private lending, federal loans offer student borrowers the benefit of lower fixed interest rates. Award amounts are based on financial need, not credit histories or scores:

- For federal loans originating after July 2008, undergraduate borrowers have a fixed interest rate below seven percent.[34]
- Financial aid awards are calculated by deducting the *cost of attendance* from the student's financial resources and *Expected Family Contribution* (EFC).[35]

In addition, borrowers participating in federal loan programs receive benefits that are generally not available with private loans. Borrowers are afforded flexible repayment options, in-school and economic hardship *deferments*, and *forbearance* options.[36]

Direct student loans are also eligible for consolidation. Consolidation loans allow student and parent borrowers to combine multiple federal education loans with various repayment schedules into one loan with one monthly payment. [37] With a consolidation loan, a student may have a lower monthly payment with a fixed rate, and a student can take a longer time to repay (up to 30 years). However, consolidation can significantly increase the cost of loans over time, specifically because borrowers take longer periods of time to repay. In addition, students may lose borrower benefits, such as interest rate discounts or principal rebates, if they consolidate their federal loans. Prior to July 2006 when federal loans had variable interest rates, loan consolidation was a popular option because borrowers could obtain low, fixed rates. However, since federal legislation fixed federal loan interest rates, consolidation has declined.[38]

Federal loans currently comprise nearly 78 percent of student loans, but their share has declined since 1997-98, when they made up 93 percent of total student loan volume.[39] While federal student loan volume grew 70 percent in inflation-adjusted dollars over the decade from 1997-98 to 2007-08, nonfederal loan volume grew more than 500 percent during the same period.[40] This growth in private student loan volume may be attributed to tuition increases and limits on federal loan availability. Annual limits for Stafford loans, the largest federal student loan program, were unchanged between 1992 and 2007, while undergraduate tuition grew 166 percent at public universities and 127 percent at private universities during this period. [41,42] Students exhausting federal loan availability may turn to private loan products to meet educational expenses.

The ***Expected Family Contribution (EFC)*** is calculated by the federal government and indicates the portion of student and family resources that should be available to help pay for education. EFC is used to determine student financial aid eligibility.

A ***deferment*** is a time period during which no payments are required and interest does not accrue, unless the loan is an unsubsidized Stafford, in which case the interest must be paid. A student qualifies for deferment if he or she is in school at least half-time, cannot find full-time employment, or is experiencing economic hardship.

If a student can't meet the repayment schedule and is not eligible for deferment, a lender may grant ***forbearance***, which is a temporary reduction or postponement of student loan payments. However, the student is still responsible for paying the interest.

Private (Alternative) Student Loans

What are Private Loans?

Private loans, sometimes called alternative loans, are made outside the federal student loan program generally through banks or other commercial lending institutions. Some states offer private student loan programs operated by state agencies or contracted nonprofit lenders.[43] Tennessee does not currently operate a private student loan program. Private loan providers broadly offer loan products to undergraduate and graduate students and also target loans to specific populations, such as law students or students in health professional programs.[44] Lenders set various criteria for student enrollment and may restrict students' use of loan funds.[45]

Lending institutions generally do not publish private loan data, limiting the amount of publicly available private loan information.[46] Available data show that total private loan borrowing increased from $3 billion in 1997-98 to $19 billion in 2007-08, an increase of more than 500 percent in inflation-adjusted dollars. Private student loans comprised 23 percent of total student loan volume during the 2007-08 school year.[47]

How do private loans compare to federal loans?

Interest rates and fees for all federal student loan programs are determined by statute, and interest rates remain fixed for the life of the loan. By contrast, most private loans carry variable interest rates, and some loans have adjustable rate features such as different rates for in-school and repayment periods.[48] In April 2009, interest rates for private loans commonly listed on school financial aid websites ranged from just under four percent to nearly 15 percent, and borrower fees were as high as six percent of the loan amount.[49] Interest rates on private loans vary with the borrower's credit history and may be periodically adjusted based on banking indices (or *base rates*) such as the Prime Lending Rate. Traditional college-aged borrowers may pay a significant premium for private loans due to their limited credit histories.[50] Published banking indices change monthly or quarterly, which may alter the terms of *variable rate loan* products and change borrowers' repayment obligations.[51]

Base rate or index: the rate banks charge each other for interbank loans

Variable or adjustable rate loans: loans with interest rates that change according to market conditions

Private loans do not feature many of the borrower benefits and protections of the federal student loan programs. Among other benefits, federal student loan borrowers are entitled to deferments during economic hardship or active military service. Payments may be temporarily stopped for up to three years during deferment periods. Federal Stafford loan borrowers may also choose among several repayment options. In addition, federal loans are subject to discharge or forgiveness if the borrower dies, becomes disabled, or maintains employment in a qualified public service position.[52] A 2008 review of private student loan disclosure statements by the National Consumer Law Center, a consumer advocacy group, found that few lenders offered alternative repayment options and about half of the loans did not specify forbearance rights. Several of the loan disclosures examined stated that loans would not be cancelled in the event of disability or death of the borrower or co-signer.[53]

Why do some students borrow higher interest private loans?

Students are turning to private loans earlier in their educational careers. Recent data show that the proportion of undergraduate students borrowing private loans now exceeds the proportion of private loan borrowers among graduate students. In 2007-08, 14.2 percent of all undergraduate students borrowed private loans compared to just 5.2 percent in 2003-04.[54] The percentage of graduate students borrowing private loans grew more modestly, rising from 7.2 percent in 2003-04 to 10.7 percent in 2007-08.[55] The slower growth of private loan borrowing by graduate students may have resulted from an expansion of the PLUS loan program to include eligible graduate students.[56]

Research from 2003-04 data suggests undergraduate students borrow private loans to afford the cost of more expensive postsecondary institutions, and to attend more classes during the school year.[57] A majority of undergraduate private loan borrowers are financially dependent on their parents; in 2003-04, 67 percent of private loan borrowers were considered dependent students by the federal student loan program guidelines.[58] Annual Stafford loan limits for dependent students are lower than the limits for independent students, raising the possibility that Stafford loans alone will not meet a student's cost of attendance. Lower Stafford loan limits may explain why nearly seven out of 10 private loan borrowers are dependent students; borrowers with limited Stafford loan availability may turn to private loans to finance their education.

While most private loan borrowers (77 percent in 2004) also receive federal Stafford loans, some borrowers take out private loans before exhausting their options for federal aid or forgo federal student aid altogether.[59] A study of student borrowing patterns for the 2003-04 school year found:

- Over one-fifth (21 percent) of private loan borrowers did not take out the maximum Stafford loan amount available to them
- 21 percent of private loan borrowers did not take out any Stafford loans, and approximately half of these borrowers did not complete the Free Application for Federal Student Aid (FAFSA)[60]

One out of five undergraduate private loan borrowers—who appear to be eligible for a Stafford Loan—did not take advantage of this option.
- Who Borrows Private Loans? (American Council on Education, 2007, p.6)

Schools use FAFSA information when awarding other aid, including scholarships and state or federal grants.[61] Private loan borrowers not completing the FAFSA may forgo grant and scholarship awards, thereby increasing their need to borrow.

Additional Loan Sources in Tennessee

Tennessee Student Loan Forgiveness Programs

Tennessee has three loan forgiveness programs specifically to support students wishing to become teachers and two for those wishing to become health professionals. After a determined period of service and adherence to loan program conditions, the state will cancel the loan. In all of the following programs, if a student does not complete the service terms, the student must repay the loan, or a portion of the loan, to the Tennessee Student Assistance Corporation (TSAC):

- Teacher Loan Program for Disadvantaged Areas of Tennessee[62]
- Tennessee Rural Health Loan Forgiveness Program[63]
- Minority Teaching Fellows Program[64]
- Graduate Nursing Loan Forgiveness Program[65]
- Tennessee Math and Science Teacher Loan Forgiveness Program[66]

Emergency Loans at Institutions

Many higher education institutions have emergency loan funds that they can make available to students in certain situations.[67] These are usually small loans that must be repaid quickly. Generally, they are used for items such as textbooks or as bridge loans if a student's federal financial aid is delayed.

Exhibit 4: Federal and Private Student Loan Terms and Conditions

STUDENT LOAN TYPE	INTEREST RATES & FEES	AWARD LIMITS	PAYMENT DETAILS	STUDENT ELIGIBILITY	LENDER
Federal Perkins Loan	**Interest rate**: 5%; tax deductible **Fees:** None	$5,500 for undergraduates, (max. of $27,500 as an undergraduate); $8,000 for graduate/ professional students	Borrowers entitled to forbearance and deferment; Payment is owed to the school that made the loan; up to 10 years to repay	Amount received depends on financial need, amount of other aid, and availability of funds at school	The school
Subsidized Direct or FFEL Stafford Loan	**Interest Rate:** Fixed rate of 5.6% for loans disbursed on or after July 1, 2009; tax deductible **Fees:** Up to 2%	$3,500-$8,500 depending on grade level	Borrowers entitled to forbearance and deferment; U.S. Dept. of Education pays interest while borrower is in school/during grace/deferment periods; 10-25 years to repay	Must be at least a half-time student and have financial need	Direct: U.S. Department of Education FFELP: Bank, credit union or other private lender
Unsubsidized Direct or FFEL Stafford Loan	**Interest Rate:** Fixed rate of 6.8% for loans disbursed on or after July 1, 2006; tax deductible **Fees:** Up to 2%	$5,500-$20,500 (less any subsidized amounts received for the same period), depending on grade level/dependency status	Borrowers entitled to forbearance and deferment; Borrower is responsible for interest during life of loan; 10-25 years to repay	Must be at least a half-time student; financial need is not a requirement	Direct: U.S. Department of Education FFELP: Bank, credit union or other private lender
Direct or FFEL PLUS Loan	**Interest Rates:** ***Direct***: Fixed 7.9% for loans disbursed on or after July 1, 2006; tax deductible ***FFEL***: Fixed 8.5% for loans disburse on or after July 1, 2006; tax deductible **Fees:** Up to 4%	Maximum amount is cost of attendance minus any other financial aid the student receives	Deferment provisions are generally the same as those under the Stafford loan program; forbearances granted at lender discretion; Borrower is responsible for interest during life of loan; 10-25 years to repay	Available to (1) parents of dependent undergraduates; (2)graduate and professional students; financial need is not a requirement, but acceptable credit history is	Direct: U.S. Department of Education FFELP: Bank, credit union or other private lender
Private Loans	**Interest Rate:** Variable; up to 14.625%. Based on Prime Lending Rate or other base rate plus a margin based on credit history or other factors **Fees:** 0% to 6%; may be based on credit history	Varies; determined by lender	Varies for each loan product; Deferment/ forbearance may be available at lender discretion; can be zero to 20 years to repay	Determined, in part, by borrowers' credit history	Bank, credit union, or other lender

Sources: U.S. Department of Education, Federal Student Aid, *Funding Education Beyond High School: The Guide to Federal Student Aid 2008-09*, pp. xi, 9; *2009-10*, pp. 2, 18-20. United States Department of Education, Federal Student Aid website: http://studentaid.ed.gov; United States Government Accountability Office; The Institute for Higher Education Policy, "Private Loans, Who is Borrowing and Why," December 2006; Student Lending Analytics, "Student Lending Analytics Alternative Loan Options," April 2009.

THE FEDERAL STUDENT LOAN PROCESS: THE STUDENT EXPERIENCE AND CONCURRENT INSTITUTIONAL PRACTICES

In order to obtain a federal loan, a student must attend a *Title IV* institution. The federal government requires Title IV schools to follow numerous regulations on all aspects of Federal Student Aid (FSA), including the FFELP and Direct student loan process. Schools are required to have institution-level policies on financial aid.[68] The federal government monitors schools' administrative and financial practices through institutional audits and school program reviews. The U.S. Department of Education can issue corrective actions and sanctions if a school violates regulations surrounding the practice and handling of federal aid funds.[69]

What is a Title IV institution?
Title IV of the Higher Education Act (1965) authorized federal student loan programs and outlined eligibility standards for participating schools and students. Schools are considered Title IV institutions after they apply to and receive approval from the U.S. Department of Education. Title IV schools may participate in Federal Student Aid (FSA) programs; students attending these institutions may receive both federal grants and federal loans. There are three federally-designated types of eligible institutions: nonprofit institutions of higher education; postsecondary vocational institutions; and private, for-profit proprietary institutions of higher education. In academic year 2008-09, Title IV institutions in Tennessee included all University of Tennessee and Tennessee Board of Regents institutions, 49 private nonprofit colleges, and 59 for-profit institutions—160 in total.

Who is eligible for federal student loans?

To be considered eligible to receive federal loans, students must meet the following criteria:[70]

- Complete the Free Application for Federal Student Aid (FAFSA)
- Demonstrate financial need
- Be a U.S. citizen or eligible non-citizen
- Prove completion of a high school education
- Be enrolled in an eligible (Title IV) program working toward a degree or certificate
- Certify that (1) he/she will use the federal aid for educational purposes only and (2) he/she is not in default on a federal student loan or does not owe a refund on a federal student grant
- Register for the Selective Service, if male and between the ages of 18 and 25
- Have not been convicted of possession or sale of illegal drugs while receiving federal student aid
- Maintain satisfactory academic progress, as determined by the institution

Exhibit 5 illustrates a traditional first-time undergraduate student's federal financial aid experience, from filling out the FAFSA to graduating and beginning loan repayment.

Applying for and Being Offered Financial Aid

In January of the high school senior year, a student submits financial and tax information to the federal government by completing the FAFSA. The U.S. Department of Education uses that information to estimate how much a family can pay each year in educational costs, called the Expected Family Contribution (EFC).[71] The Department then sends a summary of the information from the FAFSA, known as the Student Aid Report (SAR), to the student and schools to which the student is applying. The student

Exhibit 5: Student Federal Financial Aid Process, From FAFSA to Loan Repayment

1) Student completes the FAFSA and submits it to Federal Student Aid (FSA).

2) FSA sends student and schools a *Student Aid Report* (SAR).

3) Schools send award letters to students detailing the financial aid being offered.

4) Student accepts or declines financial aid, including federal loans. Student may consider private loans if financial aid offered doesn't cover college costs.

5) Schools provide student borrower access to entrance counseling; borrower signs the *Master Promissory Note* (MPN), and receives a copy of the *Borrower's Rights and Responsibilities.*

6) FSA sends funds to school and/or lender, which then applies them to student's account.

7) Student files FAFSA each year he/she is enrolled in school for federal loans.

8) Student completes exit counseling for federal loans before graduation.

9) Student begins loan repayment after a six month grace period.

reviews and corrects the information if necessary. The school uses the SAR to determine the student's financial need by subtracting the EFC from the cost of attendance.

Schools develop a process to determine student financial need and eligibility for financial aid.[72] When a school is reviewing a student's application for financial aid, it must verify student eligibility based on federal guidelines, and resolve conflicting information that would affect eligibility or the amount of federal aid the student might receive.[73] The school has discretion in determining the type and amount of assistance in each student's financial aid package. For example, a financial aid administrator may use professional judgment to account for special circumstances and to adjust the student's cost of attendance.[74]

After reviewing students' information, schools send award letters to students who have been accepted for admission and are eligible for financial aid. The letters detail the aid being offered, including federal, state, and institutional grants, and federal loan amounts available.[75] Students may accept or reject any aid being offered. If the combination of grant aid and federal loans does not meet the cost of attendance, many students apply for additional loans through private lenders.

Preferred Lender Lists

While students attending schools participating in the Direct Loan Program borrow money directly from the federal government, students with FFELP Loans must select a private lender that will provide funds guaranteed by the federal government. Often schools will recommend that a student borrower use a private lender that the school believes provides high-quality service.[76] The lenders that the school recommends are on the school's Preferred Lender List (PLL). In 2007, federal laws placed conditions on schools' PLLs for the purpose of avoiding conflicts of interest or favoring lenders who offered benefits to schools.[77]

Entrance Counseling and Distribution of Loan Monies

The U.S. Department of Education requires schools to ensure and document that a first-time student borrower receives entrance counseling before taking out a federal loan.[78] Before crediting a first-year student borrower's account with FFELP or Direct Loan monies, and before the student signs the *Master Promissory Note (MPN),* the school must provide the student access to entrance counseling and ensure that he or she receives a document outlining rights and responsibilities with regard to the loan.[79] Some schools require that the student sign the MPN only once, in the first year, while others ask students to sign one every year that they borrow federal funds. Perkins Loan recipients must sign an additional MPN and the bursar's office and financial aid office must determine that he or she is eligible, has completed entrance counseling, and has financial need.[80]

A ***Master Promissory Note (MPN)*** is the binding legal document listing borrowing conditions, deferment and cancellation provisions, and repayment terms.

The school, a consultant, servicer, lender, guarantor, or online service may provide students with loan counseling. The school is also responsible for providing knowledgeable staff to answer students' questions. Entrance counseling must include:[81]

- Reinforcement of the importance of repayment
- Description of the consequences of default, such as adverse credit reports, collection expenses, and litigation
- Explanation of the MPN
- Notice that repayment is required, regardless of educational outcome or employability
- Provision of sample monthly payment amounts

After the entrance counseling is completed, tuition funds are released into the student's school accounts.[82] Schools participating in the Direct Loan Program *originate* loans, meaning they submit award and disbursement data to the U.S. Department of Education, request the cash, and then disburse it to students. Schools participating in the FFELP program *certify* loans, meaning they submit identifying student data to the guaranty agency and the lender, request the date that lenders will send cash to the school, and then disburse it.[83]

Student and Institutional Responsibilities while a Student is Enrolled

Students must reapply for federal student aid every year they are enrolled in school by filling out the FAFSA annually.[84] In addition to reapplying, students must remain eligible by achieving Satisfactory Academic Progress as determined by their institution and remaining at least at half-time student status.[85] The Financial Aid office must verify these eligibility indicators before disbursing federal loan monies into a student's account. If a student falls below half-time status, drops out, or doesn't graduate, he or she is still responsible for paying back the student loans borrowed.[86]

The financial aid office sends annual reminders to student borrowers outlining their federal loan amounts and notifications before loan funds are credited to students' accounts.[87] Schools must segregate federal grant and loan funds to ensure that federal funds are used only for the benefit of eligible students. Excess funds must be returned to the U.S. Department of Education, the lender, or guaranty agency.[88]

Exit Counseling

Schools are required to ensure that student borrowers receive exit counseling before they graduate or drop below half-time enrollment. Exit counseling may be given in the same manner as entrance counseling. The emphasis for exit counseling shifts to more specific information about loan repayment and debt-management strategies, including the following elements:[89]

- Review of the information from entrance counseling, including consequences of default, importance of repayment, use of the MPN, and obligation to repay loan
- Provision of the average anticipated monthly repayment amount, based on the student's indebtedness
- Review of repayment options
- Discussion of debt management strategies
- Review of forbearance, deferment, and cancellation options
- Collection and updating of students' personal and contact information

Repayment

Once a student graduates, withdraws from school, or drops below half-time status, he or she must begin to make monthly loan payments.[90] Borrowers have between 10 and 25 years to repay their student loans. Various repayment options are available, depending on economic circumstances.[91] Some borrowers may be eligible for in-school deferments, economic hardship deferments, or forbearance. All student borrowers who have graduated are afforded a grace period of six to nine months, depending on the loan.[92]

After a student graduates, a school can review student borrower information, such as repayment and default status, and must send repayment schedule reminders and options to the borrower at various points during grace periods. Such practices benefit schools as default prevention elements, because borrower default rates can affect schools' ability to participate in the Title IV federal student aid programs.[93]

In Brief: Default Rates

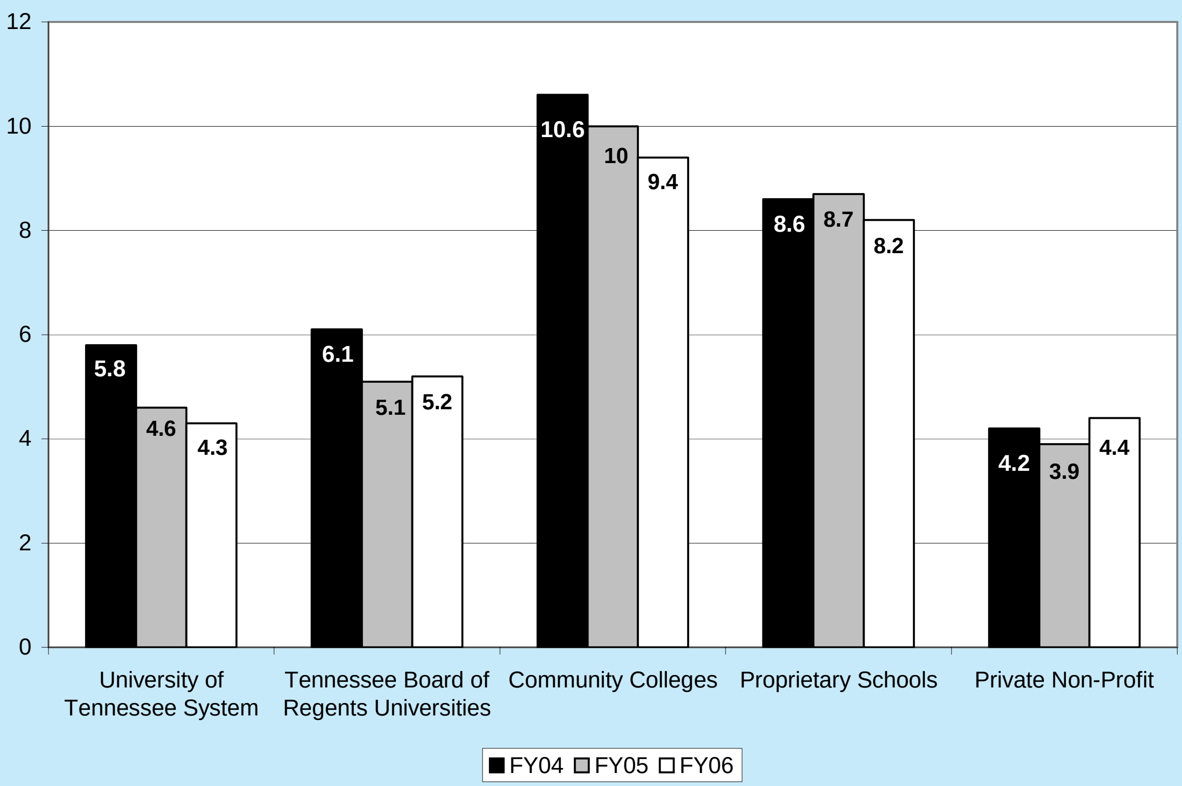
A student borrower defaults on a loan when he or she fails to make payments when due for a period of 270 days, not including the requisite grace period.[94] A school's *cohort default rate* is the percentage of a school's federal student loan borrowers who enter repayment during a federal fiscal year and default prior to the end of the next fiscal year.[95] The U.S. Department of Education calculates cohort default rates annually for all Title IV schools. Schools with high rates can be sanctioned and may in some cases lose their Title IV eligibility, while those with low rates can receive benefits, such as easier disbursement of funds.[96]

The current cohort default rate calculation includes two fiscal years, but beginning with FY 2009 a new formula will include a third fiscal year that may provide a more accurate picture of student loan default. Since the new calculation will include a longer repayment history, most schools will likely see increases in their cohort default rates. However, sanctions using the new calculation will not be applied until after October 1, 2013.[97]

In 2006, the U.S. average cohort default rate was 5.2 percent while Tennessee's was 6.1 percent, the 14th highest student default rate in the U.S. and its territories.[98] Of the 50 states, Wisconsin and North Dakota were the lowest at 2.3 percent and Kentucky was highest at 9.7 percent.

The chart illustrates average cohort default rates in Tennessee Title IV schools by system or institution type. Averages come from schools having 100 or more loans in repayment. In general, cohort default rates declined between 2004 and 2006. The community colleges had the highest average default rates. No technology center had enough incidents to constitute a calculation.

Tennessee Cohort Default Rates (%) by System, FY2004-FY2006



Sources: U.S. Department of Education, "Official Cohort Default Rates for Schools," https://www.ed.gov/offices/OSFAP/defaultmanagement/cdr.html; www.fafsa.ed.gov (Results of School Code Search).

THE PRIVATE STUDENT LOAN PROCESS: LENDER REGULATIONS, SCHOOL PRACTICES, AND THE STUDENT BORROWING EXPERIENCE

The Higher Education Act of 1965, as amended, contains specific requirements for postsecondary institutions administering federal student loan programs.[99] By contrast, private student loan regulations affect lenders and do not include specific provisions affecting school financial aid operations. Private student loans are subject to the same consumer lending regulations as other types of consumer credit, such as credit cards or auto loans. Applicable regulations include the federal Truth in Lending Act (TILA), requiring that private loan lenders disclose interest rates and fees to student borrowers, and the Equal Credit Opportunity Act, prohibiting lender discrimination based on race, religion, gender, and other protected classes.[100,101] Banks and nonprofit lenders that provide private student loans are overseen by several federal banking regulators, including the Federal Deposit Insurance Corporation, the United States Comptroller of the Treasury, and the United States Federal Trade Commission.[102]

Applying for Private Student Loans

Private loan borrowers follow a different process than that used to apply for federal student loans. Some private loan borrowers receive private loans without filling out the FAFSA. Instead, these students complete private loan applications received directly from the lender or from materials distributed through school financial aid offices.[103] Students completing the FAFSA may also receive private loan offers *packaged* with federal aid in school financial aid award letters.[104] School-originated student financial aid award letters and other loan materials distributed on school campuses are not necessarily endorsed or evaluated by school personnel.

Packaging: a process used by school financial aid officers to assemble grant, loan, and other scholarship aid into a student financial aid award offer

Private Loan Disclosures

The federal Truth in Lending Act (TILA) encourages the informed use of credit by requiring uniform disclosures about a loan's terms and conditions. TILA requires private loan lenders to make certain disclosures to student borrowers; however, entrance counseling is not required.[105] Under current regulations, student borrowers receive partial disclosure information before they sign and return the promissory note. This disclosure must include the interest rate of the loan during the in-school and repayment periods, the amount financed, and the conditions under which the interest rate will increase.[106] Current TILA language exempts lenders from full disclosure requirements until borrowers enter repayment.[107] If borrowers are not fully informed of repayment obligations they may have difficulty comparing loan products prior to loan approval. Lenders must provide complete loan disclosures including finance charge information, payment schedules, and the total sale price of the loan before the borrower begins repayment.[108]

It is very difficult for even the most sophisticated and motivated consumers to compare the actual terms and conditions of private student loans….many lenders do not provide complete information about what a private loan will really cost until the borrower signs a promissory note.
- Improving Consumer Protections for Private Loans (Project on Student Debt, 2007, p.2)

Borrowers evaluating private loan disclosures may be confronted with other complex loan terms. Most private loans carry variable interest rates, and many have adjustable rate features such as different rates for in-school and repayment periods.[109] While lenders must disclose this information before loan funds are received, evidence suggests that some borrowers may not fully understand the terms of adjustable rate loan products.[110] A 2001 survey of adjustable rate home mortgage customers found that 41 percent of respondents did not know the maximum interest rate that could be charged over the life of their loan.[111]

Dispersing Private Loan Funds

While postsecondary institutions must observe specific practices when administering federal loans, school involvement in private student loans is less uniform. After borrowers accept loan terms, lenders may certify loans with school financial aid personnel but are not required to do so.[112] Lenders distribute loans upon receipt of a signed promissory note from the borrower and other documents the lender requires for verification of application materials. School-certified loans are distributed through financial aid offices, while funds from direct-to-consumer loans are sent directly to the borrower from the lender.[113] The school is responsible for ensuring that the amount of the loan, in combination with other aid, will not exceed the student's financial need or loan limit.[114] If a student's total financial assistance, including private loans, exceeds the cost of attendance, it can result in an overaward of federal aid that, if discovered by school personnel, may result in the redistribution of excess federal loan funds to other students.[115]

Student Responsibilities while Enrolled and during Repayment

Student financial responsibilities for federal loans while enrolled in school and during repayment are governed by federal law and regulation. In contrast, student responsibilities for private loans vary according to individual loan contracts. Loan contracts detail terms and conditions for in-school deferment periods and specify whether flexible repayment options are available. Private loan contracts also contain additional repayment terms including default stipulations and conditions for assessing penalties or fees.[116] Borrowers in default may lose loan benefits or discounts, and defaulted loans may carry a higher interest rate.

New Regulations Addressing Private Student Loan Practices

The U.S. Department of Education does not regulate private student loans; however, the Higher Education Opportunity Act of 2008 addresses the role of postsecondary institutions in private loan marketing and restricts potential conflicts of interest with lenders. The law also requires Title IV institutions who provide private loan information to inform students of the availability of federal aid, prohibits private lenders from offering inducements (e.g., payments to the school for each completed loan application) to higher education officials, and restricts private loan marketing activities.[117]

Title X of the Higher Education Opportunity Act (HEOA) of 2008 amends the Truth in Lending Act by requiring lenders to provide additional consumer disclosures to student borrowers. Beginning in February 2010, lenders must provide borrowers with additional interest rate and fee information during the application and approval process, which may allow borrowers to better estimate the cost of borrowing before assuming a loan. Loan applications or solicitations must include the potential range of interest rates and fees and an example of the total cost of the loan using the maximum interest rate currently offered by the lender.[118] This is intended to end the practice of lender advertisements featuring only the lowest interest rates, which are typically reserved for students with the best credit.[119]

Exhibit 6: Private Student Loan Origination Process with Higher Education Opportunity Act (HEOA) Required Disclosures

1) Borrower applies; lender provides initial disclosure with application.

2) Loan application approved.

3) Lender provides approval disclosure containing actual loan terms including interest rates, fees, limitations on interest rate adjustments, finance charges, and estimated loan repayment amounts.

4) Post approval acceptance period. Lender must provide borrower with 30 days to accept loan terms. Loan Terms cannot change during this period.*

5) Borrower accepts terms.

6) Borrower completes self-certification form.

7) Borrower provides any outstanding documentation and signs promissory note or other loan contract.

8) Lender provides loan consummation disclosure, contents similar to approval disclosure.

9) Three day “cooling off” period: Lender may not disperse funds, borrower may cancel loan.

10) Lender disperses loan.

* Lender may adjust interest rates in conjunction with changes in the prime rate or other index.

The new law requires that lenders collect a self-certification form from borrowers prior to dispersing loans. Borrowers complete the self-certification form with financial aid information compiled by the school, including cost of attendance, expected family contribution, and information on other aid received. The self-certification requirement ensures that borrowers understand their potential eligibility for federal student aid before borrowing private loans. This process provides financial aid officers consistent notification when students apply for private loans and may help prevent overawards of federal aid. The HEOA also gives borrowers a three-day “cooling off period” after signing a promissory note during which they may cancel their loan agreements without penalty.[120]

CONCLUSION

The percentage of Tennesseans borrowing to pay for postsecondary education continues to increase as college becomes more expensive. The proportion of Tennessee undergraduate students borrowing to pay for college increased between 1995-96 and 2007-08. Tuition and fees at Tennessee public postsecondary institutions more than doubled between 1997-98 and 2007-08.

Most of the money borrowed for education costs is through federal loans, which offer benefits and provide the same rates for the same categories of student based on need, not credit history, all through a highly regulated process. However, an increasing share of student borrowers rely on private loans to finance their education. Most private loans carry higher interest rates and fees than federal student loans, and lenders are not required to offer the same benefits as the federal student loan programs.

Tennessee higher education institutions that are qualified as Title IV schools must follow the same regulations and rules as any Title IV school in the U.S. The federal government outlines rules, regulations, and procedures that Title IV schools must follow when handling all aspects of the federal student loan process. These schools are also audited annually. However, federal law does not dictate specific procedures for institutions — Title IV or not — in terms of how they handle private loans, except in the case of preventing conflicts of interest with regard to a school's preferred lender list.

On the Horizon

President Obama's 2010 budget blueprint proposes significant changes to federal student loan programs, primarily by eliminating the government-backed, private lender-based Federal Family Education Loan Program (FFELP) by June 30, 2010. Under this proposal, all Stafford, PLUS, and consolidation loans made after July 1, 2010, would be Direct Loans, making the federal government the sole lender for all federal student loan programs.[121] The change to Direct Lending would also alter the role of student loan guaranty agencies such as the Tennessee Student Assistance Corporation. According to the Congressional Budget Office, the move to Direct Loans would save an estimated $94 billion over the next 10 years.[122] The savings would be reinvested in student aid through the expanded Pell Grant program.[123]

Pell Grants: need based awards administered by the Department of Education to promote access to postsecondary education. Students may use funds at any of the approximately 5,400 eligible institutions.

President Obama's budget proposal makes significant improvements to the Pell Grant program, increasing Pell Grant funding from $19.4 billion in FY 2009 to $28.7 billion by FY 2010. According to White House estimates, the budget improvements will provide Pell Grants for an additional 1.5 million students over the next two years.[124] If enacted, Tennessee students would receive $576 million in Pell Grant awards by FY 2010, an increase of almost $215 million in total Pell Grant aid over FY 2008 levels.[125]

The President also proposes changes to the Perkins Loan Program, increasing funding from around $1 billion a year in FY 2009 to nearly $6 billion by FY 2010. Under the President's budget proposal, the number of schools participating in the Perkins program would increase from 1,800 to 4,400. The U.S.

Department of Education would administer Perkins Loans by using its existing loan distribution and origination system, relieving schools of their current responsibility of making, servicing, and collecting the loans. Loans made under the new Perkins Loan Program would no longer feature an in-school interest subsidy for borrowers.[126]

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Appendix 1: Persons Contacted

Peter Abernathy, Staff Attorney, Tennessee Student Assistance Corporation

Dr. Stephanie Bellard-Chase, Director of the School Approval Division, Tennessee Higher Education Commission.

Mandie Aubrey, Attorney with the Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System (FDIC).

Richard Bayer, System Provost for Enrollment Services, University of Tennessee - Knoxville

Ron Gambill, Chairman and CEO, Educational Funding of the South Inc.

Jeff Gerkin, Financial Aid Director, University of Tennessee - Knoxville

James Griffith, Statistician, U.S. Department of Education, Institute of Education Sciences, National Center for Education Statistics

Marea Harrington, Client Representative, Tennessee Student Assistance Corporation

Levis Hughes, former Associate Director of Loan Programs, Tennessee Student Assistance Corporation

David Hutton, Director, Office of Student Financial Aid and Scholarships, Middle Tennessee State University

Donna Jewell, Audit Manager, Division of State Audit, Tennessee Comptroller of the Treasury

Joseph Marks, Director of Education Technology, Southern Regional Education Board

Chris Miller, Federal Student Aid Program Compliance, School Eligibility Channel, U. S. Department of Education

Claude Pressnell, President, Tennessee Independent Colleges and Universities Association

Renee Stewart, Assistant Vice Chancellor Business and Finance, Tennessee Board of Regents

Jason Seay, Director of Outreach, Tennessee Student Assistance Corporation

Bernard Tadley, Regional Inspector General for Audit, U.S. Department of Education Office of Inspector General

Tod Trulove, Assistant Commissioner, Tennessee Department of Financial Institutions

APPENDIX 2: EXCERPT FROM PUBLIC CHAPTER 1103 (2008)

PUBLIC CHAPTER NO. 1103
SENATE BILL NO. 3789
By Kurita, Woodson, Marrero
Substituted for: House Bill No. 3857
By Odom, McCord

SECTION 4. Tennessee Code Annotated, Title 49, Chapter 7, Part 1, is amended by adding the following language as a new, appropriately designated section:

§ 49-7-1__.

The comptroller of the treasury shall study and report to the general assembly by February 1, 2009, concerning the following:

Current practices and sources of student loans at all institutions of higher education operating in the state. The Tennessee Student Assistance Corporation shall develop a student disclosure form to provide notice of the specifics of loans consistent with state and federal law on the subject.

PASSED: May 15, 2008

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