Guidehouse

Surging Student Loan Debt and Growing Pains

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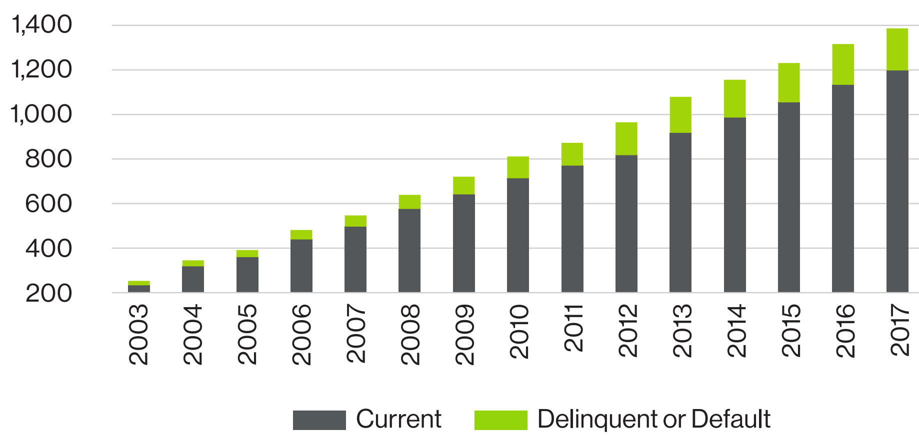
Introduction

The cost of education in the United States continues to outpace inflation, and outstanding student loan debt has grown to over $1.5 trillion, up over 600% since 2009. Student loan debt is currently the second-largest source of consumer debt in the country behind mortgages[1] Approximately 15% of student loan borrowers were in serious delinquency (90-plus days delinquent or in default) at the end of 2017, which is higher than the percentage of mortgage debt delinquency during the financial crisis.[2,3]

Unpaid Student Debt Balance (Bn. USD) and Delinquency



As the industry grows, the Department of Education's (ED) Office of Financial Student Aid announced plans for the Next Generation (next-gen) Financial Services Environment at the end of 2017. As a result of the increased outstanding student loan debt and related delinquency rates, as well as surging consumer complaints, regulators have sought to expand guidelines. In conjunction with the rollout of the next-gen servicing platform, the enhanced guidelines are intended to improve the servicing of student loans. However, questions also exist as to whether the ED or the Consumer Financial Protection Bureau is best-positioned to oversee and enforce federal student loan origination and servicing activities, as well as address consumer complaints. Additionally, multiple states, including Massachusetts, Maryland, and California, and the District of Columbia, have established licensing requirements for student loan servicers, which may increase the complexity of servicing. Furthermore, both federal regulators and state attorneys general have launched inquiries into or filed lawsuits against student loan servicers alleging unfair, deceptive, and abusive servicing practices, among other items.

"2018 was a turbulent year for the student lending industry with a series of high impact changes. As the industry landscape continues to transform, we foresee more disruption in 2019. Lenders and servicers that are able to embrace the challenges and opportunities will have a distinct advantage in this market."

Kathryn Rock
Director
Guidehouse

Challenges Facing Student Loan Servicers

Service Transfers — Large Volume and High Frequency of Transfers

As a result of servicing contract changes initiated by the ED, the past two decades have witnessed three industrywide service transfers of federal student loans, which make up 95% of the market.[4] Service transfers can have a long-lasting impact on both borrowers and servicers and can negatively impact the customer experience while also increasing operational costs. Due to the expiration of existing servicing contracts in 2019, it is anticipated that there will be another industrywide service transfer soon. While it depends on an organization's size, structure, and requirements, we have listed certain challenges along with detailed pain points and some of our related recommendations for consideration below:

<table>
<tr><th>Challenges</th><th>Key Scenarios and Root Causes</th><th>Top 5 Recommendations</th></tr>
<tr><td>High volume of service transfers</td><td>ED has been shifting loan portfolios among servicers every five years, resulting in three industrywide service transfers in the past two decades.
Another large service transfer is anticipated in 2019 when the ED's contracts with existing servicers expire.
A growing number of loans enrolled in rehabilitation will increase the volume of service transfers, as rehabilitation requires loan sale.[5]</td><td rowspan="2">Enhance communication with the previous servicer to reduce any payment-processing delays and assist with timely resolving any disputes and inquiries among other items.
Improve borrower communication to guide borrower through the service transfer process.
Upgrade the loan file transmission process to ensure available data, documentation, and previous communications are obtained from the prior servicer regarding servicing procedures, including any proprietary payment relief programs.
Strengthen pre- and post-service transfer testing and controls to validate data mapping; to effectively identify, organize, and label incoming loan document images; and identify service transfer exceptions.
Consider implications of the next-gen (the new federal aid servicing solution) deployment and the associated challenges of the platform change.</td></tr>
<tr><td>Inconsistent servicing practices and system of records</td><td>Variances in policies and procedures and system incompatibility between servicers necessitate reconciliation efforts and increase servicing cost.
New account setup post-service transfer can require additional borrower communication and cause delays in payment processing, among other items.
Missing information not transferred properly can be difficult to resolve and negatively impacts the customer experience, especially for delinquent and defaulted borrowers.</td></tr>
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Payment Allocation — Multiple Intake Channels and Borrower Instructions

Payment allocation is the methodology that a servicer uses to distribute a borrower's payment across multiple loans and has the ability to impact account status, interest charges, and assessed fees. Payment allocation has been one of the key servicing issues featured in multiple recent regulatory enforcement actions and has proved to be one of the more complex processes.

It is not unusual for borrowers to take out more than one loan. When a borrower holds more than one loan, servicers generally put those loans in one billing group. When submitting payments, borrowers can take advantage of a variety of channels, including online payment portals, call centers, and mail, and can specify which loans to allocate their payment(s) toward. As borrowers can submit instructions, servicers should have the ability to obtain and implement these instructions. This becomes even more relevant when a borrower makes a partial payment, overpayment, payoff payment, or when a payment is made by a third party. These features make payment allocation a challenging process for servicers and increase the complexity of required payment processing activities.[6] While it depends on an organization's size, structure, and requirements, we have listed certain challenges along with detailed pain points and some of our related recommendations for consideration below:

<table>
<tr><th>Challenges</th><th>Key Scenarios and Root Causes</th><th>Top 5 Recommendations</th></tr>
<tr><td>Lack of federal or state regulation governing payment allocation</td><td>• Servicers often service multiple loans for one borrower in one billing group, driving the need for a payment allocation methodology.
• The variety of loan types, rates, and repayment terms creates multiple options for allocating payments across multiple loans.</td><td rowspan="3">1. Establish a baseline methodology for payment allocation.
2. Develop additional payment allocation options and hierarchy (e.g., prioritizing by annual percentage rate and distribute internally.
3. Promote the use of a digital portal, lessening use of inefficient intake channels.
4. Disclose the default payment allocation methodology in use as well as additional options to borrowers.
5. Enhance payment processing system functionality and diversify payment allocation options.</td></tr>
<tr><td>Obtaining borrower instructions on payment allocation</td><td>• Multiple borrowers may have distinct payment allocation preferences.
• Mailing channel generally requires additional effort and time because of the need for interpretation and data entry.</td></tr>
<tr><td>Implementing borrower instructions</td><td>• Borrowers' instructions may deviate from a servicer's standard payment allocation methodology.
• Borrowers' preferences can change often.
• Servicers' payment processing system functionalities may have limitations.</td></tr>
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Payment Relief Programs: Program Offerings and Income-Driven Repayment Plans

As previously stated, outstanding student loan debt has grown rapidly and approximately 7 million student loan borrowers are severely past due. When a loan is nonperforming, typically defined as over 90-days past due or defaulted, a servicer must perform additional activities, including guiding borrowers through the payment relief program options. As there can be a large number of payment relief program options and each one can differ based on eligibility criteria and benefits, payment relief program selection can be complex and difficult for all parties. Making an appropriate selection requires a deep understanding of each borrower's unique circumstance and a cost-benefit analysis of all eligible options at a particular point in time. Certain servicers develop sophisticated job aids for their customer service representatives that contain numerous combinations of loan types and payment relief program options in order for them to sufficiently guide borrowers. The multitude of payment relief program options requires comprehensive training, also increasing servicing costs for nonperforming loans.

Additionally, recent enforcement actions demonstrate regulators' increasing focus on payment relief programs, especially for some of the more complex programs, including Income-Driven Repayment (IDR) plans. For example, after the initial IDR enrollment, annual recertification is required for borrowers to maintain participation in their IDR plans and retain the benefits. However, the existing rules around the IDR recertification process, in combination with enforcement actions and litigation, have placed mounting pressure on servicers to re-examine IDR plan servicing. While it depends on an organization's size, structure, and requirements, we have listed certain challenges along with detailed pain points and some of our related recommendations for consideration below:

<table>
<tr><th>Challenges</th><th>Key Scenarios and Root Causes</th><th>Top 5 Recommendations</th></tr>
<tr><td>Guiding borrowers in payment relief programs selection</td><td>• A large number of payment relief program options are available, each with distinct eligibly criteria and benefits.
• An assessment of a borrower's unique circumstance and an evaluation of eligible payment relief program options are necessary for making the optimal selection.
• Job aids detailing loan types and characteristics of all payment relief programs</td><td rowspan="2">1. Develop a standard guide, including all payment-relief program options, and provide it to customer service representatives.
2. Provide scenario-based training and detailed job aids to prepare customer service representatives to guide borrowers.
3. Conduct outreach of borrowers in existing IDR plans before the expiration deadline and develop/strengthen controls around recertification notification process, including content and timeline.
4. Work closely with borrowers to resolve incomplete information issues in submitted recertification packages. Develop assumptions (e.g., for family size) and apply to IDR income calculations as necessary.
5. Develop control points and reporting to monitor key milestones of the default management and collections processes.</td></tr>
<tr><td>Complying with granular rules around IDR recertification</td><td>• IDR is strongly advocated by regulators due to its income-based nature and the benefit of debt forgiveness.
• IDR recertification rules are stringent regarding notification time frame, deadline, disclosure of consequences, and payment-calculation method.
• Failure to recertify can negatively impact servicers' performance metrics and result in large-payment shock for borrowers.</td></tr>
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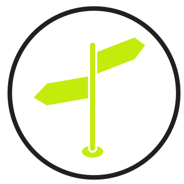
Credit Reporting — Lack of Consistent Guidance

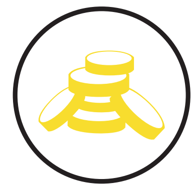
Student loan data furnishing has been a challenge for servicers because current regulations offer conflicting guidance, provide little clarity, or are silent on how servicers should furnish certain borrowers' payment behaviors. As of February 2019, the Credit Reporting Resource Guide (CRRG) still does not include a student loan section and no date for publishing has been announced.[7] A few challenging scenarios are listed below:

How to report when bankruptcy account is rehabilitated?



How to report when two loan sequences are in distinct statuses?

How to report when retroactive forbearance is granted?



How to report when co-signer filed bankruptcy and borrower keeps paying?

As an example, the CRRG provides potentially conflicting guidance in the scenario when a bankruptcy account enters rehabilitation. Per the bankruptcy section of the CRRG, an account status freeze is required, while the rehabilitation section indicates that an account status change may be required. Deciding which guidance to follow can be confusing to servicers and increase the risk related to reporting a borrower's status. In similar cases where the guidance is ambiguous or nuanced, servicers should determine whether to: (a) follow the reporting guidance; (b) report in a meaningful way; or (c) suppress reporting altogether. The industry continues to struggle with identifying one option that is compliant, feasible, and favorable to the borrower.

Certain data-furnishing practices can trigger consumer complaints, credit bureau reporting rejection, regulatory risk, and/or litigation. Therefore, servicers should consider industry standard practices, instructions from the ED as well as the credit bureau, and legal advice when determining the best reporting approach. Moreover, the selection and approach rationale should be documented to show that reasonable thought and consideration were taken for furnishing data accurately.

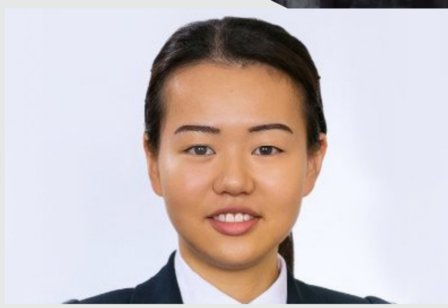
Final Thoughts — Manage the Persistent Challenges

The student loan industry has experienced growing pains, and it appears that these problems will only persist based on current trends. Additionally, servicers will face new operational and compliance challenges with the rollout of the new licensing requirements by multiple states. In today's changing landscape, it is prudent for servicers to re-examine their key servicing processes, update their compliance frameworks for new laws and regulations, as well as manage regulatory expectations resulting from enforcement actions. This exercise has the benefit of not only reducing regulatory risks, but also helping position the servicer to better assist delinquent and defaulted borrowers, improve performance scores, and grow its servicing portfolio.

Endnotes

1. Federal Reserve System, Consumer Credit — G.19, March 7, 2019, https://www.federalreserve.gov/releases/g19/current/default.htm.
2. Center for Microeconomic Data, "2018 STUDENT LOAN DATA UPDATE," Federal Reserve Bank of New York, https://www.newyorkfed.org/microeconomics/databank.html.
3. Federal Reserve Bank of New York press release, "Total Household Debt Increases, Delinquency Rates of Several Debt Types Continue Rising," Nov. 14, 2017, https://www.newyorkfed.org/newsevents/news/research/2017/rp171114.
4. Federal Student Aid, "Federal Student Loan Portfolio," https://studentaid.ed.gov/sa/about/data-center/student/portfolio.
5. Rehabilitation: A student loan rehabilitation is typically a 9-10-month payment program where the borrower will make agreed-upon payments to rehabilitate the student loan and remove the default status. And Federal Family Education Loans must be sold for the rehabilitation process to complete and the defaulted loan to re-enter repayment. As a result, loan sale is oftentimes a byproduct of rehabilitation.
6. Sallie Mae, "How we allocate and apply your student loan payments," https://www.salliemae.com/student-loans/manage-your-private-student-loan/understand-student-loan-payments/apply-and-allocate-your-student-loan-payments.
7. METRO 2® FORMAT FOR CREDIT REPORTING, Consumer Data Industry Association: https://www.cdiaonline.org/resources/furnishers-of-data-overview/metro2-information/.

Contacts



Kathryn Rock
Director
M +1-202-973-6541
E krock@guidehouse.com

Savannah Xiao
Managing Consultant
M +1-202-481-8697
E savannah.xiao@guidehouse.com

linkedin.com/company/guidehouse

twitter.com/guidehouse

guidehouse.com

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