Back to Main

Daily Lesson Plan
Lesson Plan Archive
News Snapshot
Issues in Depth
On This Day in History
Crossword Puzzle
Campus Weblines
Education News
Newspaper in Education (NIE)
Teacher Resources
Classroom Subscriptions

Student Connections

News Summaries
Daily News Quiz
Word of the Day
Test Prep Question of the Day
Science Q & A
Letters to the Editor
Ask a Reporter
Web Navigator

Parent Connections

Conversation Starters
Vacation Donation Plan
Discussion Topics

Site Guide
Feedback
Job Opportunities

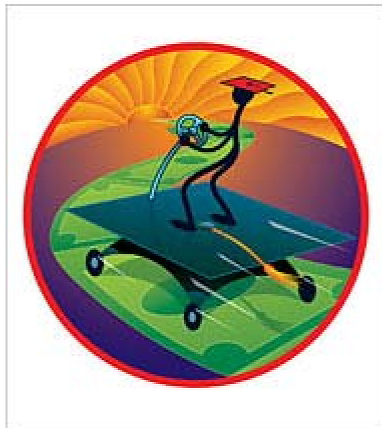
July 30, 2007

Lessons From the Loan Scandal

By LAURA PAPPANO

GO TO LESSON PLAN

Knowledge Tools
Turn Vocabulary On: Link words to the Merriam-Webster Collegiate® Dictionary.
Turn Geography On: Link countries and states to the Merriam-Webster Atlas®



Frank Frisari

ERIC SMOLITSKY, a senior at the University of Connecticut, is a sharp guy who is spending the summer doing stem cell research. But when it comes to student loans — he will graduate $30,000 in debt and plans to borrow $200,000 more for medical school — Mr. Smolitsky finds it annoyingly complicated. "I haven't spent much time looking into it," he acknowledges. "They say, 'Here is your financial aid package.' "

Students in general have not thought much about how it all comes together (as long as the dollars are covered somehow). After all, they had a trusted adviser in the financial aid office.

Such assumptions have been shaken by recent disclosures about financial aid officers receiving junkets, consulting fees and kickbacks courtesy of the loan industry, owning stock in loan companies and steering business through "preferred lender" lists. A report from Senator Edward M. Kennedy, released last month, details how a lender's place on the list at the University of Texas, Austin, had more to do with what "treats" were offered the financial aid director than what rates were offered students.

"Students and families had assumed that the advice they were getting on financial aid and loans from college officials was based on that person's experience and knowledge and on what would work best for that student," says Robert M. Shireman, president of the Institute for College Access and Success, in Berkeley, Calif. Mr. Shireman points out what is now obvious but was once unthinkable: colleges and financial aid officers can have "competing interests."

Legislation is pending in Congress, and the Department of Education has proposed rules governing the relationship between lender and college.

Now new concerns have surfaced about whether lenders use fair criteria to assess applicants for private, or “alternative,” loans. According to the College Board, such loans accounted for 20 percent of educational borrowing for the 2005-6 school year, up from 4 percent a decade earlier.

Ultimately, all this attention should benefit borrowers. But for now, students (and parents) scrambling to get loans for next year’s tuition bills must navigate this intimidating and labyrinthine industry.

“My wife and I are both college-educated, and we sit there and say, ‘How are kids supposed to do this?’ ” says David Robinson, who lives in Lexington, Mass. A project manager at I.B.M., he is helping his son apply for student loans, find part-time work and otherwise cover the $41,500 it will cost him to attend Merrimack College in September.

Despite money from a 529 college savings plan and scholarships for both academics and athletics (lacrosse), David Jr. will need $20,000 a year in loans. Mr. Robinson co-signed a private loan application at Sallie Mae but was stunned at the interest rate — 10.25 percent plus a 3 percent fee at repayment. “I think that’s too expensive,” says Mr. Robinson. “I find this an extremely daunting, nerve-racking process. You don’t know now what you are getting into.”

If the student loan scandal has made some wary, it has also provided a prod to get smart before borrowing.

Sam Is Your Best Rich Uncle.

“You should never get a private student loan unless you have exhausted your government student loans,” says Mark Kantrowitz, the publisher of FinAid

.org. Post-scandal, that fact is displayed prominently on lender home pages.

Private loans, which carry variable rates, can come with double-digit interest (and no cap). Interest on federal loans, on the other hand, is set by Congress 5 percent for a Perkins (for the neediest students), a cap of 6.8 percent for a Stafford (for any income level) and 8.5 percent for a PLUS (for parents and graduate students).

“Why would anyone ever get a private loan?” wonders Mr. Kantrowitz, author of “FastWeb College Gold: The Step-by-Step Guide to Paying for College.”

The answer is that Perkins and Stafford loans have limits on how much can be borrowed, and despite plans in Congress to raise those limits, loan amounts can fall well short of college costs. As for undergraduate PLUS loans, parents might not qualify (unlike Stafford and Perkins loans, a PLUS requires a credit check, so a loan default, a credit card delinquency or a bankruptcy can sink an application). Or parents might not warm to decades paying off their child’s debt.

Mr. Robinson thought it would be good for his son to get a private loan as a way of investing in his own future. Also, he says, with three other children to raise and educate, “I didn’t want to totally be on the hook for it.”

For Rates, Expect the Worst.

Shopping for a mortgage? Flip to the newspaper’s business section for a chart comparing rates. But in the student loan industry, which has grown fast and unchecked, rates for private loans are all over the map. Lenders have developed their own criteria for assessing borrowers with unknown future income, no collateral (like that house to foreclose on) and brief (if any) credit histories.

In short, the greater the likelihood of default, the higher the interest rate.

Credit score is the biggest factor in determining the rate, but every lender judges differently the risk that you won’t pay back what you borrow.

Lenders advertise catchy interest rates, Mr. Kantrowitz says, but note with an asterisk that they are available only to customers with the best credit history. His research shows fewer than 10 percent of student borrowers qualify for the best rates, and more than 75 percent get the worst. “A good rule of thumb is to look at the worst rate and assume you will get a rate pretty close to that,” he says.

Lenders won’t reveal the cutoff scores that qualify for one rate or another. But in general, a borrower in the 500s (on a scale of 300 to 850) “could expect to get a fairly cool reception from any lender,” whereas someone in the 700s is appealing, says Craig Watts, spokesman for the Fair Isaac Corporation, whose FICO formula is widely used to calculate scores.

Mr. Watts says multiple lenders inquiring into a credit history can lower a score slightly, because it implies a propensity to seek credit. Borrowers with average to good scores aren’t likely to be affected by comparison shopping. But students with short credit histories may see their scores dip temporarily.

For students who lack a credit history, the lender MyRichUncle boasts on its Web site that it considers “their merits as a student, including G.P.A., school and program of study.” Raza Khan, the company president, says weighted formulas are used to assess borrowers.

Sallie Mae, the nation’s largest student lender, doesn’t take academic markers into account. “We don’t believe an A student should get dramatically better treatment than an A-minus or B student or C student,” says Tom Joyce, its spokesman. He says Sallie Mae “has standard pricing that is available at all schools,” though it will improve rates in “a competitive situation where a lender has come in and dropped prices.”

Al M. Davis, Nelnet’s managing director for private loans, says its underwriters consider a graduate student’s field of study but not an undergraduate’s except pre-med. They also “look at the school’s accreditation, at their historical performance related to job placement and their default history.”

Not All Colleges Are Equal in Lenders' Eyes.

Six students, including David Robinson Jr., agreed to shop online for their private loans last month and share the results for this article. Rates ranged widely: one student earning a master’s degree in public administration at New York University applied to four lenders and was offered rates varying by six percentage points. Some students came back empty-handed.

Cindy Grayson is halfway through an online master’s program in criminal justice at Florida Metropolitan University, a profit-making accredited career college. She applied for $8,000 to supplement her government loans but was rejected by Bank of America and Sallie Mae. The Sallie Mae rejection, says Ms. Grayson, “happened instantaneously.”

Ms. Grayson, 50, lives in a mobile home in a town of 3,200 in Arizona and has a foreclosure and bankruptcy in her past. She may not be an appealing private loan candidate but she is, in many ways, a typical one. She sees her online courses and her loans as a ticket to a better-paying job.

“I thought student loans were to help you,” says Ms. Grayson, a substitute teacher who just landed a second job as a clerk in a sheriff’s office. “If you don’t need it, you can have it. If you do need it, you can’t have it.”

Students are told they are free to borrow from any lender. In practice, lenders provide private money only for colleges with which they have a “relationship,” as customer service representatives put it. As a result, Ms. Grayson was not able to apply to three other lenders as a student at F.M.U., whose federal student loan default rate is 10 percent.

Another comparison shopper, Katherine McBrayer, who just graduated from Monroe High School in North Carolina, was denied by Charter One Bank and Wachovia. Education Finance Partners, Citibank and

Nelnet would not accept an application for a private loan to attend the Utah College of Massage Therapy, a one-year accredited program with seven campuses (default rate: about 7 percent).

“I was irritated,” says Teresa McBrayer, Katherine’s mother. She says her daughter has a grade point average of 3.92 and excelled in calculus and chemistry but dreams of owning her own massage center.

“She didn’t choose the triple-A four-star college,” says Ms. McBrayer, who had wanted her daughter to be responsible for her own debt. She has since taken out a government PLUS loan.

Mr. Davis of Nelnet offers two possibilities when asked to explain why his company refused to lend money for the Utah massage college: “We don’t have a current relationship with that school or we have elected not to lend to that particular school.”

Justin S. Draeger, spokesman for the National Association of Student Financial Aid Administrators, says his organization is troubled by such exclusions.

“We are very concerned about students who are treated differently based on the school they attend,” he says. “There are definitely some questions that need to be raised about the underwriting of these loans.”

As part of his continuing investigation, Attorney General Andrew M. Cuomo of New York sent a letter to Congress last month complaining that “a significant number of lenders” weigh private loan applications and set rates depending on the college in question rather than the creditworthiness of the borrowers — an approach he compared with redlining in the mortgage industry.

You Will Be Confused.

Trying to figure out rates for a private loan is like the admissions process itself: you won’t know until you sit down and apply. Even then, the information comes in dizzyingly different forms.

Lenders talk in terms of margin, the number of percentage points above or below a selected index, which for student loans could be the prime rate, the 91-day Treasury bill or the London interbank offered rate. Some lenders do the calculations; others let you do the math.

The comparison shopper attending New York University applied for $8,000 from MyRichUncle. The lender offered $5,900 (through a partner, Doral Bank). The preapproval told her only that she would get prime plus 5 percentage points. She had to look up prime. The resulting rate, 13.25 percent, would be recalculated every quarter during the in-school deferral period and rounded up to the nearest .125 percent. There would also be an origination fee that would be “disclosed in the initial

Disclosure Statement for the first Advance.” (In fact, the fee was hidden on the promissory note. The loan amount was given as $6,413 — $5,900 plus a fee of $513.)

Confused yet?

True borrowing costs depend on the fine print: discounts, penalties, fees (which can counteract the benefit of a lower interest rate) and how often the loan is capitalized (when deferred interest is added to the principal — so in effect you pay interest on interest.)

Deanne Loonin, director of the Student Loan Borrower Assistance Project of the National Consumer Law Center, says private lenders are required to inform borrowers of interest rate, total number of payments and total cost of repayment key information for comparing deals. But, she says, there is no rule about how soon in the process lenders must divulge that information. (Proposed Senate legislation aims to compel lenders to disclose loan costs earlier.)

“The truth is, there is little substantive regulations of the loans themselves,” she says. “There is really no sugar-coating the problem that if someone really wants to shop around now, it’s not easy.”

The Preferred List Is (Still) Where to Start.

Comparison shopping usually begins and ends on a college’s preferred lender list. But what gets lenders top billing is still a mystery at many colleges: have they bought their way onto the list or do they represent a college’s assessment of which loans serve its students best?

Even with the credibility of financial aid offices damaged, experts say, don’t ignore the list. But do ask questions. New rules are expected to call for at least three lenders to be listed, and for some explanation of how they were selected.

A competition last year at the University of California shows the complexity of finding the best deal and how much influence a university can wield.

According to Nancy Coolidge, coordinator of student financial support for the system’s 10 campuses, administrators determined that students at some campuses were getting less desirable terms. At Santa Cruz, for example, students with the worst credit were paying up to 19.32 percent to Education Finance Partners and 14.25 percent to Sallie Mae with fees of up to 8 percent. The university decided to use the system’s volume some 2,000 undergraduates borrowed $20 million in private loans last school year to improve rates.

Six bidders vied for the coveted top spot on the lender list. Financial officers were seeking, among other criteria, lenders who would eliminate fees, would not demand default insurance and would capitalize loans just once. Administrators sorted through hundreds of pages of data. Citibank got the nod.

Borrowers are now classed in four groups: credit worthy (scores of 671 or higher), credit ready (670 to 610), low credit (609 to 570) and poor credit (569 or less), and their rates range from 7.75 to 14.25 percent. Students in the two middle categories get 9.25 and 11.25 percent, respectively, if they have co-signers.

Consolidation Is No Longer a No-Brainer.

It used to be that you got federal loans at variable interest rates; once you graduated, you consolidated them into one neat, low-interest, fixed-rate loan.

The value of consolidation has waned since federal rates became fixed last year. But the pressure to consolidate has heated up, with lenders urging students, “Lower your monthly payments,” which simply means stretching out the loan for more years and increasing the total interest.

It makes sense to consolidate private loans if you can improve terms or better manage payments, Mr. Kantrowitz says. But consolidating is not automatically a better deal, and you may lose rebates or pay penalties. Never consolidate federal and private loans together, because that wipes out some benefits of a government loan (such as loan forgiveness for certain types of public service).

The Department of Education ombudsman for student aid, Debra Wiley, says her office is fielding more complaints this year — about 300, compared with 125 last year and 50 the year before from students who say they were tricked or who were uncertain about consolidation forms they had signed. “I know people are confused,” she says. “They think they are signing something to get more information when they are signing a consolidation application.”

Steven E. Brooks, the executive director of North Carolina’s State Education Assistance Authority, a state agency that makes, services and guarantees government loans, says he has received 150 forms at once instructing the agency to transfer student loans to a commercial lender — and then heard from upset students who hadn’t intended to consolidate.

In April, the University of Idaho allowed On Campus Student Loans of Helena, Mont., to hold a consolidation workshop at the same time and in the same campus building where university officials were offering exit loan-counseling for seniors.

Elaine Ruscilli, a senior in psychology, dropped into the workshop to figure out how to structure repayment of her $40,000 in federal loans (and eat some free pizza). Mistaking the seals on documents and signs for Department of Education insignia, she signed forms, she says. Later she “got that sinking feeling” and demanded the company not consolidate her loans. It didn’t. But other lenders are still trying. She got a check in the mail for $473.43 from Academic Loan Group hers if she consolidated. “If you were desperate for money, you might be tempted to cash that,” she says.

Dan Davenport, director of admissions and financial aid at the University of Idaho, which lends government money directly to students, says students face a 1.5 percent charge for consolidating federally guaranteed loans with private lenders.

“Students are confused about what to do,” says Mr. Davenport, who is pessimistic about proposed legislation. “I am totally convinced that all of this will continue — the false advertising, the illegal incentives, the misinformation — until we redesign the loan programs. It’s such big money and such easy money that everybody wants to get it.”

Pick a College (and Major) You Can Afford.

Everyone knows college is expensive. But with so much energy focused on getting in, discussion about whether it’s worth the cost is pushed to the background.

Lewis Mandell, professor of finance and managerial economics at the University at Buffalo (of the State University of New York), says students who need loans should ask themselves if running into debt at a private college makes sense. “If I could get the same education at a state institution, I need to ask, ‘What is the differential? What am I paying for?’ ” he says. “It is one thing if Mom and Dad will send you to college; that’s fine. But if you have to pay back $100,000 to $200,000, you should say to yourself, ‘Is this degree really going to prepare me for the types of jobs that will be there for much of my career?’ ”

Robert D. Manning, director of the Center for Consumer Financial Services at the Rochester Institute of Technology, has students compare their expected earnings with expected payments on student loans and credit card debt — he worries when more than 50 percent of starting salary is needed to repay debts. Mr. Manning says students often have an unrealistic expectation of starting income. “We’ve actually had students decide they can’t do their major,” he says.

Dawn Wooters followed her passion at the University of Tennessee, graduating in 1998 with a fine arts degree. “I was thinking, ‘This is what I would really love to do and the money wouldn’t matter.’ It’s hard to admit that now,” says Ms. Wooters, who couldn’t live on painting watercolors. At 34, she is getting a second undergraduate degree, in nursing, at Kennesaw State University in Atlanta.

Ms. Wooters graduated the first time without debt. She now works full time at a Hampton Inn and has already borrowed $13,000 in Stafford and $3,500 in private loans (which she got with her boyfriend co-signing, after she applied alone and was turned down). “You never want to tell someone, ‘Don’t do what you love,’ ” she says. “But you need to have a realistic concept and a backup plan.”
