TG™

White Paper

An Industry Dialogue
with Student Loan Servicers and the Council for the Management of Educational Finance

Introduction

On June 13, 2002, Texas Guaranteed (TG) and its partner, the Council for the Management of Educational Finance (Council), hosted "An Industry Dialogue with Servicers" in Dallas, Texas. The event brought together members of the servicing, school, and lending communities to discuss policies, practices, and trends regarding deferments, forbearances, loan consolidations, and the future of loan servicing as they relate to default aversion. We offer this document to report on the dialogue and create a forum for continuing these discussions.

Participating lenders and servicers included Affiliated Computer Systems Inc, (formerly known as AFSA Data Corporation), Brazos Higher Education Authority, LoanStar Systems Inc., Nelnet, North Texas Higher Education Authority, Panhandle Plains Student Loan Center, Sallie Mae, SunTech Inc., Texas Higher Education Coordinating Board, Wells Fargo EFS, Student Loan Xpress, and First National Bank – Bryan/College Station. Participating Council schools included representatives from various sectors of higher education including Texas A&M University, Our Lady of the Lake University, Dallas Baptist University, Court Reporting Institute of Dallas, University of Houston, University of Texas at El Paso, and University of Texas at Brownsville. TG and the Council wish to express their most sincere gratitude to all of the meeting participants for their contributions to this important dialogue.

Today's historically low cohort default rates are the result of many individuals working continuously to develop innovative practices and policies. Many of the recent technological and process improvements in the student loan industry are due to the proactive alliance building of many committed organizations and industry stakeholders. It is this spirit in which this industry meeting was organized and conducted. As the loan industry continues to evolve, it will require the same level of commitment and innovation.

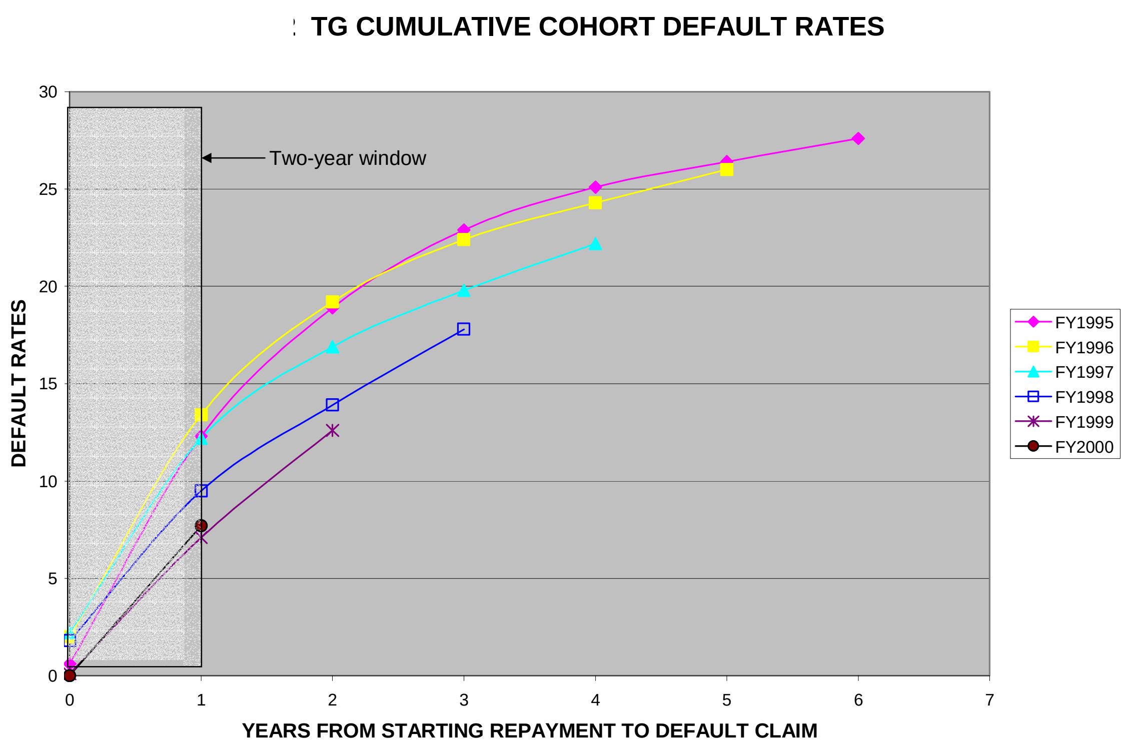
To that end, we begin by analyzing data that will help raise questions and explore existing practices for the purpose of continuing to strengthen the delivery of the student loan program.

Statistics and General Trends

To prepare for the "Industry Dialogue with Loan Servicers," TG examined some of the issues, policies and practices that lenders and servicers employ to address student loan default – particularly those related to delinquency prevention and default aversion.

Long-term cohort default rates

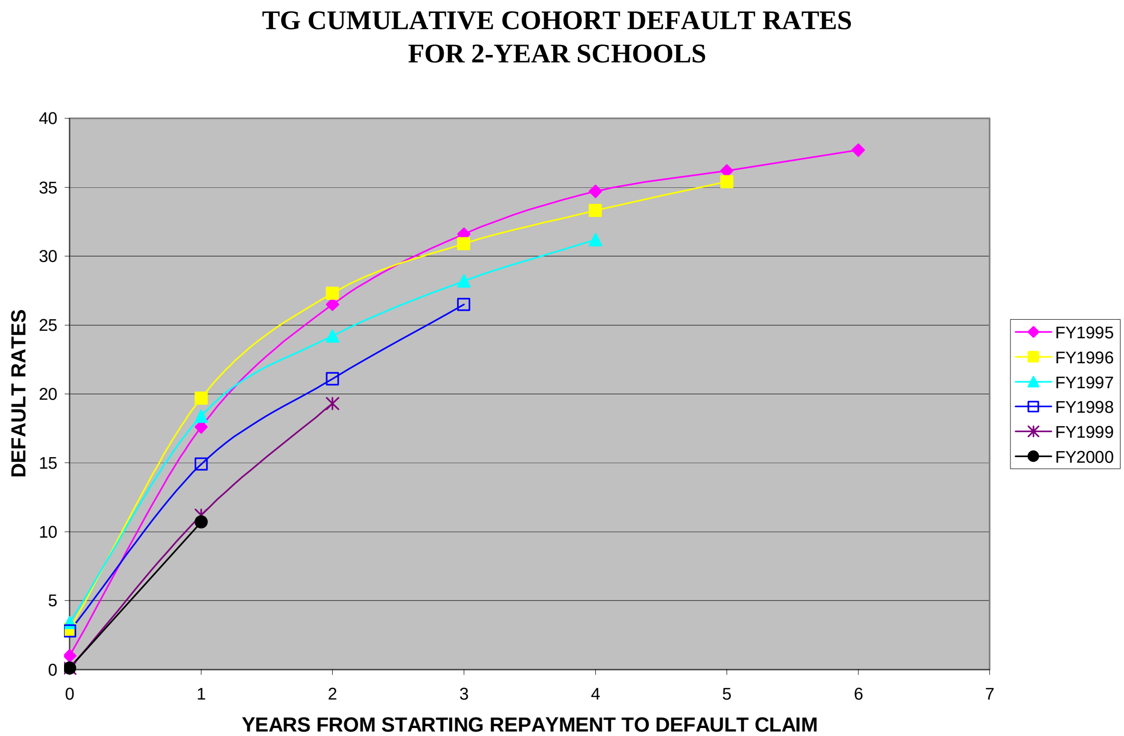
TG compiled statistical data on cumulative cohort default rates for TG-guaranteed loans. Nationally, cohort default rates as reported to the U.S. Department of Education for the two-year tracking period after a student leaves school have trended down significantly – from rates as high as 15-20 percent in the early 1990s to less than five percent for the 1999 cohort. This is a good indication of the effectiveness of the policies and practices that the student loan community has put in place to address default within the two years after a student leaves school. However, if the same cohorts are tracked over the life of the loan, the default rate continues to increase, reaching a cumulative cohort default rate in the mid-to-high 20 percent range.

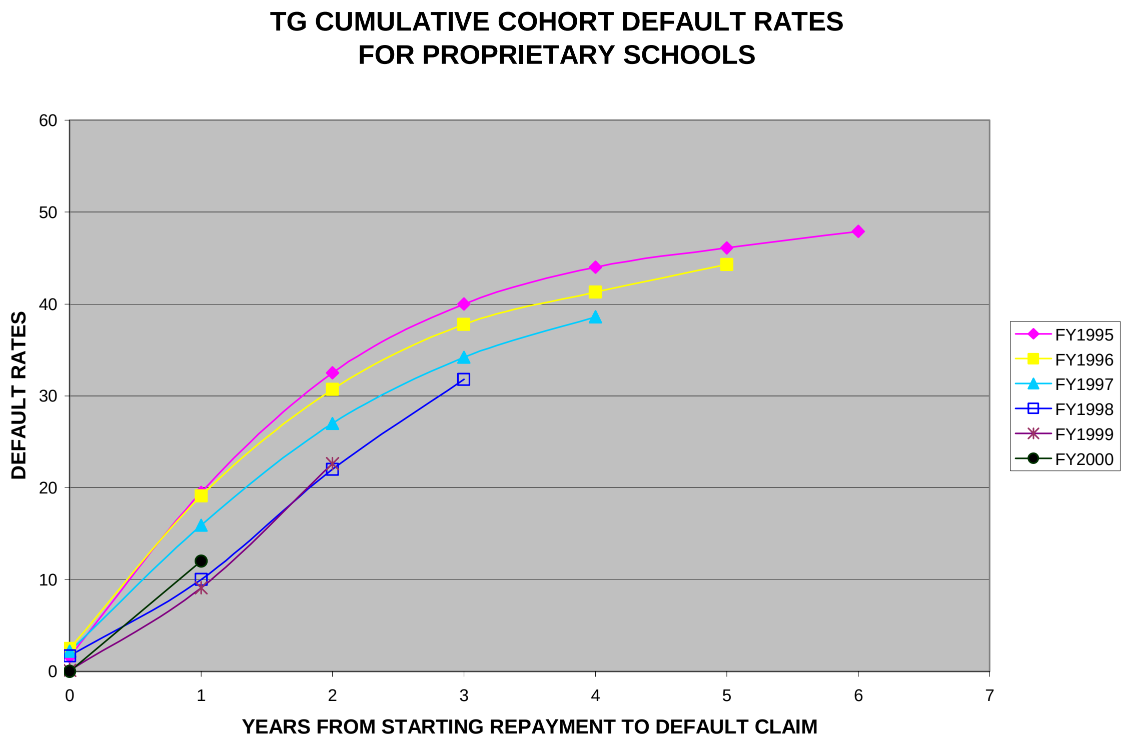


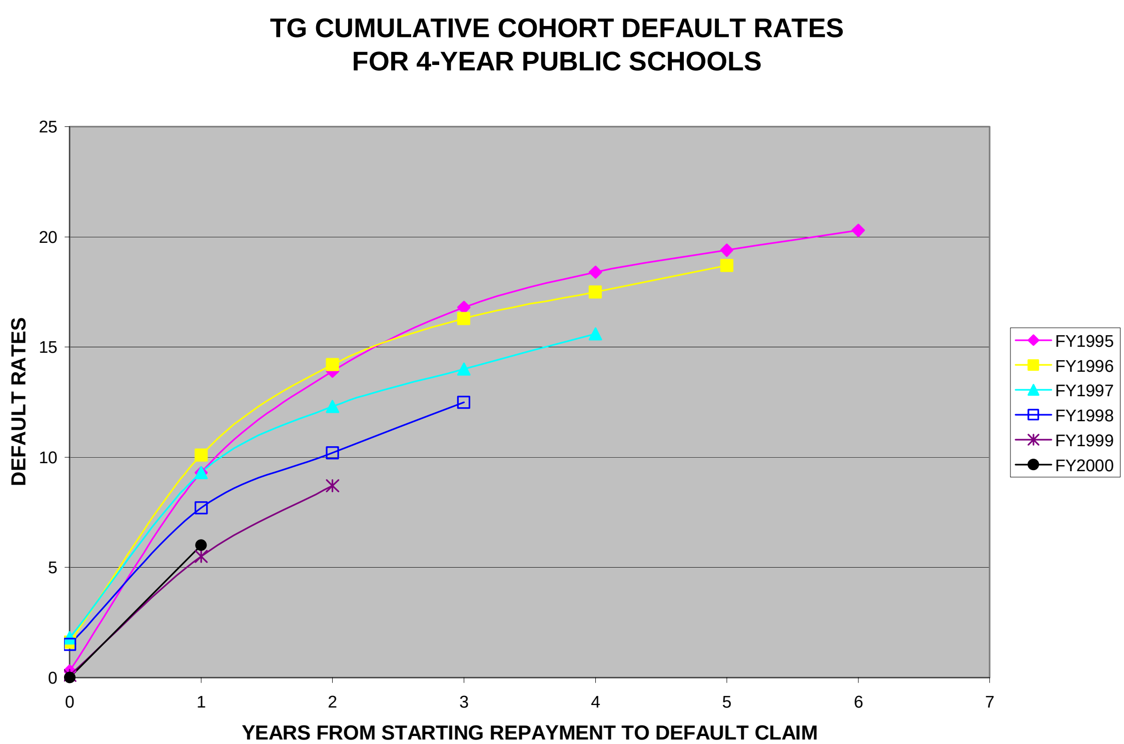
Note: For all cohort default rate calculations, Year 0 refers to the 0-12 month period that forms the cohort, while Year 1 refers to the year-long period (i.e. months 13-24) in which defaults are tracked for the cohort.

Long-term cohort default rates by school type

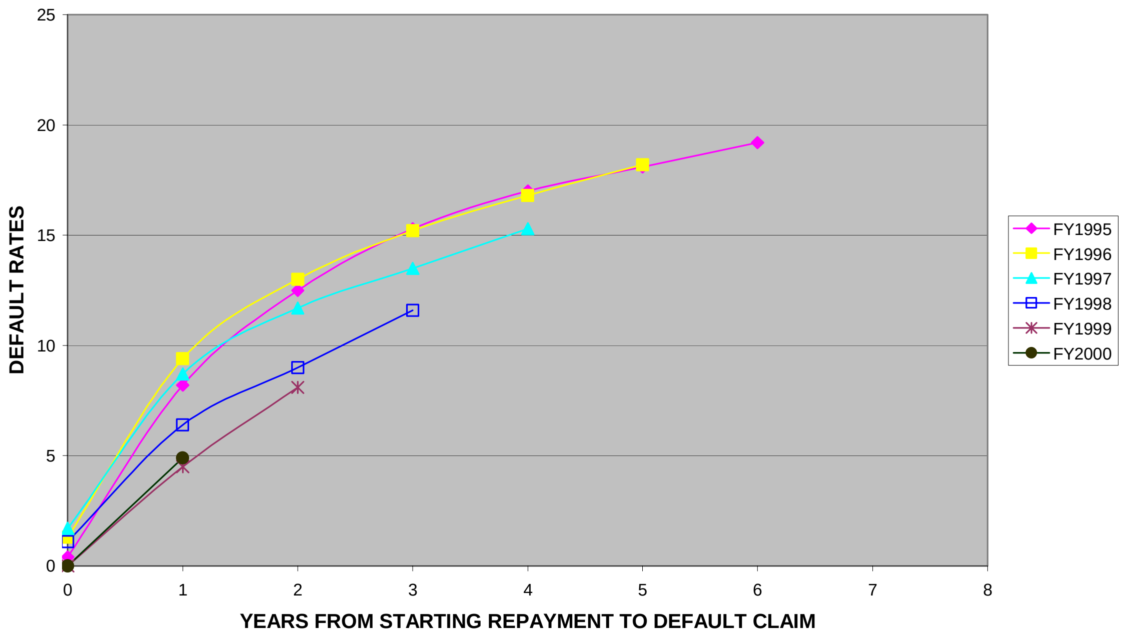
According to data supplied to TG by schools, the long-term default rates reach more than 35 percent six years after entering repayment for two-year schools and more than 40 percent for career colleges and schools. After six years, the long-term cohort default rate of four-year private and public schools increased to roughly 20 percent.




TG CUMULATIVE COHORT DEFAULT RATES
FOR PROPRIETARY SCHOOLS
DEFAULT RATES
YEARS FROM STARTING REPAYMENT TO DEFAULT CLAIM
0
10
20
30
40
50
60
0
1
2
3
4
5
6
7
FY1995
FY1996
FY1997
FY1998
FY1999
FY2000


TG CUMULATIVE COHORT DEFAULT RATES
FOR 4-YEAR PUBLIC SCHOOLS
DEFAULT RATES
YEARS FROM STARTING REPAYMENT TO DEFAULT CLAIM
0
5
10
15
20
25
0
1
2
3
4
5
6
7
FY1995
FY1996
FY1997
FY1998
FY1999
FY2000

TG CUMULATIVE COHORT DEFAULT RATES
FOR 4-YEAR PRIVATE SCHOOLS



Deferments and forbearances and their impact on curing delinquencies

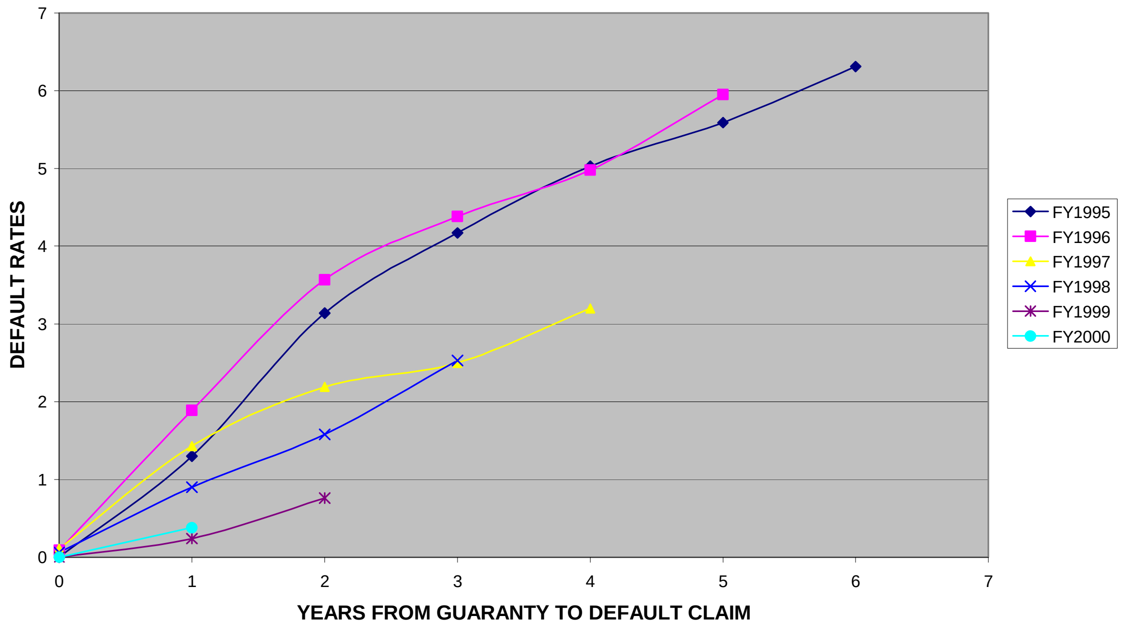
TG examined the use of deferments and forbearance in curing delinquencies prior to default. Nine schools supplied data to serve as a sample for this analysis: Huston-Tillotson College, Our Lady of the Lake University, Texas A&M University, University of Houston, The University of Texas at Austin, University of Texas at El Paso, Austin Community College, Court Reporting Institute of Dallas, and University of Texas at Brownsville. Beginning with 1998, the general trend for all of these schools indicates an increase in the use of deferments and forbearances to cure delinquencies, while the use of payment or payment options to cure delinquencies is decreasing. Specifically,

- Seven out of nine schools reported an increase in deferments as a cure mechanism – ranging from an increase of .9 percentage points to 5.4 percentage points for delinquencies being cured through deferment;
- All nine schools had an increase in forbearances to cure delinquencies – ranging from a 4.9 percentage to a 15.2 percentage increase in use of this method;
- All nine schools had a decrease in payment as a method for curing delinquencies – ranging from a four percent decrease to a 14.1 percent decrease, reaching their lowest levels in 2000. Each showed an increase from 2001 to 2002 by an average of 18.7 percent.
- When delinquencies were examined across all TG-guaranteed loans for two-year, four-year, and career colleges and schools, the same observations hold true, with the most significant increase in cure methods evident in the use of forbearance and the only decrease found in the use of payment. This data does not specify the type of forbearance being utilized.

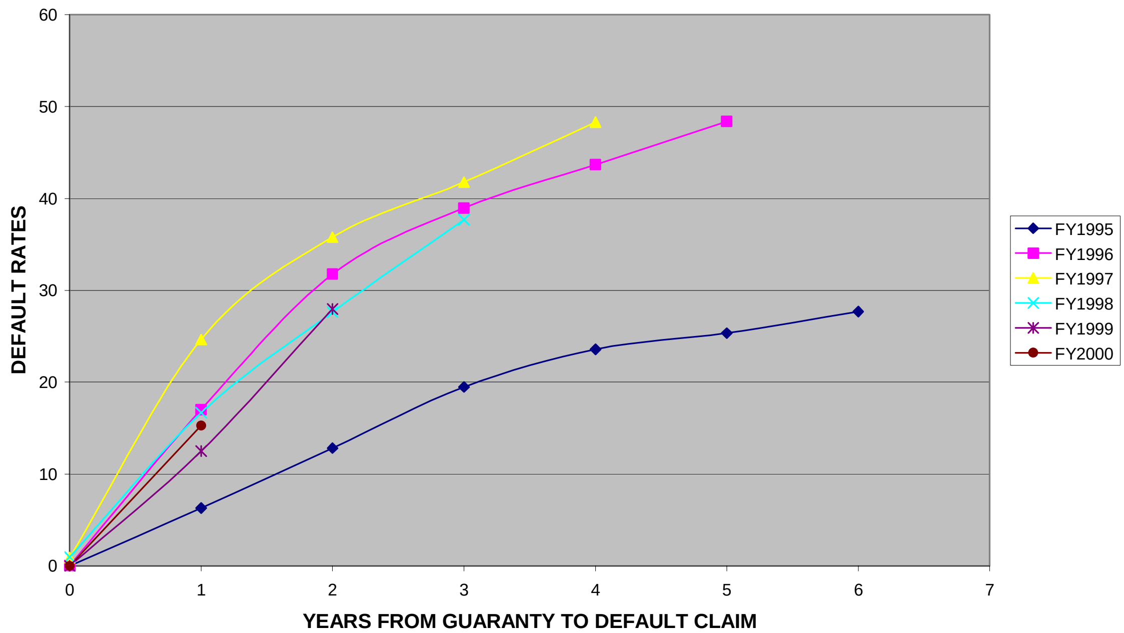
Default rates and the impact of consolidation

TG also examined the default rates of Consolidation loans in its portfolio. When borrowers consolidate their loans without having any previous loan(s) in default, the default rate is under 10 percent over the life of the Consolidation loans. However, when one or more of a borrower's underlying loans has been in default prior to the consolidation, 50 percent of borrowers default on their Consolidation loans.

TG CUMULATIVE DEFAULT RATES FOR CONSOLIDATION LOAN BORROWERS WITH NO UNDERLYING DEFAULTED LOANS



TG CUMULATIVE RE-DEFAULT RATES FOR CONSOLIDATION LOAN BORROWERS WITH PRIOR DEFAULTED LOANS



It bears mentioning that median borrower indebtedness continues to increase for student loan borrowers. Consequently, consolidation dollar amounts are rising, as are the dollar amounts of claims on Consolidation loans. With the current borrower-friendly interest rates, the number of Consolidation loans is also rising.

The implications of the trend analysis indicate a need for the student loan community to continue to be proactive in preventing defaults over the life of the loan – in addition to continuing to work with borrowers during the two-year cohort default rate tracking period. The discussion that follows explores some of the reasons for the increasing use of forbearance to cure loans along with other trends and issues affecting student loan servicing.

Deferments and Forbearances

As indicated by the data provided above, the use of forbearance in curing delinquencies has steadily increased over the past several years. Representatives of the student loan servicing community stated that although they do not begin by counseling borrowers about forbearance, it often becomes the simplest path for borrowers mainly due to the following factors:

- Applications for economic hardship deferments are often rejected (some indicated as many as 45 percent) on first and second submission, frustrating and complicating the borrower's already tenuous situation.

- For borrowers of unsubsidized loans there is no difference in the monetary benefit between an economic hardship deferment and a forbearance.
- Applications for forbearance are readily available from various sources online and are sometimes included in mass mailings from entities other than loan servicers.
- Borrowers may request a forbearance without receiving counseling about other repayment options.
- The extension of the date of default from 180 days to 270 days may have had an impact on the increase in use of forbearances. Any cure under the new timeline could require more payments than previously as the delinquency progresses. Also, the ability of a borrower to make additional payments to cure the delinquency lowers the probability that a loan will be cured by payment.

Several servicers have established processes for counseling borrowers who become delinquent. In most cases, the first step in the process is to try to collect payment from the borrower – including looking at alternative payment plans. If the borrower cannot make any payments, the servicer's counseling staff proceeds with possible qualifiers for available deferment options. Generally, forbearance is granted only as a last resort.

The following suggestions were offered by individual meeting participants regarding the use of deferments and forbearances:

- Simplify the process for applying for an economic hardship deferment. Consider a two-step analysis of poverty level and debt-to-income ratio.
- If forbearance is appropriate, consider granting it for a shorter period of time, commensurate with actual borrower need. This will help keep the servicer and borrower in frequent contact.
- Require loan counseling each year or each semester that a student borrows while he or she is in school.
- Consider more personal counseling along with any online entrance and exit counseling offered by schools.
- Offer exit and budget counseling whenever possible for those who stop out or drop out.
- Work with other members of the student loan community (schools, guarantors, etc.) to collect e-mail addresses to be able to communicate quickly and efficiently with borrowers.
- Assess appropriateness of mass mailing or e-mailing unsolicited forbearance forms.
- Make counseling available when providing forbearance forms online.
- Ensure that other call centers and counselors (financial aid officers, guarantors, lenders, etc.) do not promise forbearance to borrowers without information from the servicer.

Loan Consolidation

With record low interest rates in effect July 1, 2002 to June 30, 2003, the issue of Federal Consolidation loans has particular salience for the loan servicing community. Because of the increasing requests for Consolidation loans and the fixed rates applicable to these loans over a period of up to 30 years, servicers and others will experience not only short-term workload increases, but also long-term implications for their portfolios.

Representatives from several servicing organizations expressed concern about current legislation to eliminate the single-holder rule. This single-holder rule requires a borrower whose underlying FFELP loans are held by a single lender to apply for a Consolidation loan with that lender. This legislation may have long term implications for some schools. A school's default management strategies, which sometimes include established relationships with lenders and servicers, may be adversely impacted. This legislation could hamper a lender's ability to reinvest in students if Consolidation loans are being made externally upon conversion to repayment no longer an earning asset on the lender's balance sheet.

With regard to the current interest rates, several servicers indicated that they are looking at "cannibalization" of their own portfolios, or they may risk losing them to other companies.

The servicers agreed that, in general, consolidation is a good option for borrowers – especially with interest rates as low as they are currently. In the course of talking with borrowers about consolidation, they have had the opportunity to counsel them about all their options.

The U.S. Department of Education Financial Partners Channel has received many requests for lender eligibility from organizations wishing to be Consolidation loan providers without prior servicing experience or affiliation with the student loan industry. There do not appear to be any new servicing entities in FFELP origination and administration, so these new entities are either consolidating and servicing themselves or parceling out delivery and/or administration to existing third-party servicers. As a result, schools may have less influence and certainty as to who will be providing loan servicing to their students in repayment and the quality of that servicing.

The following suggestions were offered by individual meeting participants regarding Federal Consolidation loans.

- Consider supporting a variable interest rate on Consolidation loans.
- Consider establishing a shorter term repayment schedule when it is in the best interest of the borrower.
- Require new eligible lenders to partner with an established servicer, who can provide servicer audits with no significant exceptions from the audits.

The servicing community acknowledged that, realistically, the nature of these types of changes within a federal loan program can only be made within the process of

Reauthorization of the Higher Education Act. The servicing community needs to define a position on these issues in order to effectively pursue enactment of any necessary change.

The Future of Loan Servicing

Participants discussed the future of loan servicing in the context of describing an "ideal servicing model." Suggestions included:

- Actively communicate with borrowers who stop out or drop out prior to completing a program or degree.
- Provide in-grace counseling to help borrowers make their first payment successfully.
- Collect e-mail addresses through cooperative efforts between schools, guarantors, and servicers.
- Communicate borrower benefits more clearly.
- Conduct exit counseling in person.
- Require students to complete loan counseling each semester or year.
- Simplify the deferment process.
- Simplify the Department of Education's "Exceptional Performer" program, or consider a type of VFA for servicers. (If delinquencies and defaults are below a certain rate, the servicer would claim 100 percent reinsurance on any defaulted loans.)
- Apply the same standards of service to online customers as those offered to other customers.
- Improve enrollment reporting and verification – tap into a single source (NSLDS or NSC) for direct verification – to develop a more streamlined process.
- Provide incentives for exceptional performance rather than punishments for poor performance.
- Assist schools in setting up a predictive modeling program to identify potential default problems that would adapt to varying economic conditions.
- Conduct credit scoring on all FFELP accounts to determine the credit risk for students in early repayment.

Servicer representatives also discussed the impact that alternative or private loans have had on their operations. Most of the servicers indicated that borrowers who have private loans with corresponding FFELP loans have lower delinquency rates than borrowers with only FFELP loans. This lower delinquency rate is largely due to the fact that customers with private loans have gone through a credit check process to determine eligibility.

TG's Delinquency Prevention Program

To conclude the meeting, TG shared information about the initiatives in place to complement servicers' efforts in delinquency and default aversion. In particular, TG outlined its newly-launched pre-delinquency call center, which extends TG's repayment counseling to full life-of-the-loan support. The Center, intended to strengthen the results of TG's Voluntary Flexible Agreement (VFA), began operations on June 10, 2002.

The new effort includes a counseling team that supports borrowers who have separated, withdrawn, or graduated from school. In addition, a pilot program delivers withdrawal information to the team much earlier than it is customarily available, enabling counselors to work closely with those borrowers at greater risk for delinquency and default. The goal of the Center is to present borrowers with repayment information as soon as they leave school — "just-in-time" contact.

One option for withdrawn borrowers is to return to school. TG's pre-delinquency counselors are prepared to help borrowers who have fallen below half time or who are no longer enrolled find ways to return to school at least half-time.

As part of the team's efforts to identify separated borrowers, TG has entered into a unique pilot program with 12 schools. This program offers potential benefits for everyone involved. The 12 schools, which include several Historically Black Colleges and Universities in Texas and other schools represented on the Council for the Management of Educational Finance, have agreed to share withdrawal information with TG much earlier than it is traditionally available.

As soon as the schools identify a borrower who has withdrawn, the schools update their information so that TG has access to the latest enrollment data. The pre-delinquency team can then contact the borrower as soon as possible, early in grace, and provide him or her with the information needed to begin repayment on time, delay repayment if appropriate, or return to school before the borrower's grace period ends.

Considering Economic Factors in Planning Effective Default Aversion Policies and Practices

As we engage in discussions about forward-thinking default aversion policies and practices, we cannot underestimate the U.S. economy's impact on our industry. We must continue to remain proactive and flexible, so that we may adapt to varying economic conditions. Most forecasters, including the Congressional Budget Office (CBO), believe that the current recession, which we entered in 2001, will prove to be mild compared to previous economic downturns. Unlike in previous years, however, this recession brings with it unprecedented patterns.

The current recession ended the longest economic expansion in the history of the U.S., lasting 10 years, from March 1991 to March 2001. Several factors contributed to this expansion, but most important was a historically high level of business investments spurred on by advances in information technology. Expansions typically end after imbalances build up in the economy resulting from a supply and demand disparity. Unlike the previous nine recessions that have occurred since World War II, today's recession arose not from an excess of demand over supply, but from overly optimistic expectations of the future profitability of new investments. Moreover, in 2001, the Federal Reserve cut the federal funds rate 11 times, from 6.5 percent to 1.75 percent. These cuts may have kept the stock market from sinking further and bolstered the housing and automobile markets.

CBO forecasters predict that the current recession will push unemployment higher in 2002 than it was in 2001. The unemployment rate is expected to rise to an average of 6.1 percent in 2002, up from 4.8 percent in 2001. The stronger growth that CBO forecasts for the economy in 2003 trims unemployment to 5.9 percent.

CBO further estimates that the Federal Reserve will raise short-term interest rates gradually as the economy recovers, in an attempt to prevent it from overheating and to keep inflation from rising. Nevertheless, short-term interest rates are likely to remain relatively low over most of the next two years. CBO expects that the rate on three-month Treasury bills will average just 2.2 percent in 2002, roughly 1 percentage point less than in 2001 and much lower than in 2000. As the growth of the GDP quickens its pace in 2003, the short-term rate will rebound to 4.5 percent.

Moreover, long-term rates typically fluctuate less than short-term rates do, and this is likely to be true again during the forecast period. CBO expects the rate on 10-year Treasury notes to average 5.0 percent in 2002, as it did in 2001. In 2003, CBO forecasts the rate will rise by 0.5 percentage points, compared to a rise of 2.3 percentage points in short-term rates.

According to the CBO the unusual economic patterns of the current recession make it difficult for forecasters to predict with increasing certainty a mild recession and/or a strong recovery. There are fewer precedents on which to predict the results of the economic patterns of recent years. As we continue to work together to strengthen our default aversion efforts, we must remain cognizant of the current economic conditions. Historically, economic recessions bring with them a spike in college enrollment, and any increases in unemployment are likely to impact a borrower's ability to repay. Our industry strategies and practices in default aversion must remain flexible to accommodate changes resulting from these unsteady economic conditions.

In closing, TG and the Council are eager to continue working in concert with all of our industry partners. We know that only by collaborating will we be able to refine our collective efforts in default aversion. Together the possibilities to create innovative policies and practices are endless. The results will help ensure the viability of the student loan industry and the success of students and families across the country. Moreover, these discussions will surely benefit the many debates to come as our industry prepares for the reauthorization of the Higher Education Act. We look forward to future discussion and involvement with our business partners across the student financial aid community.

For additional information on the "Industry Dialogue with Servicers" or for more information about TG's VFA or other delinquency and default prevention efforts, contact Sue McMillin, TG Senior Vice President, Customer Relations & Business Operations, at (800) 252-9743 ext. 4949 or sue.mcmillin@tgslc.org.