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Testimony of
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Before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

June 25, 2013

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Introduction

Chairman Johnson, Ranking Member Crapo, and members of the Committee, I appreciate this opportunity to discuss private student lending, and the OCC's supervisory approach for national banks and federal savings associations (hereafter, national banks and thrifts) engaged in this business. Promoting fair and equitable access to credit, including education financing, is a core OCC mission and one of our most important priorities. We work hard to ensure that national banks and thrifts offer and manage consumer credit portfolios in a safe and sound manner that promotes long-term access to credit across a spectrum of consumer products. National banks and thrifts have a long history of participation as lenders and servicers of federal and private student lending programs; however, they are not dominant players in this market, and their current portfolio holdings of private student loans represent just 3 percent of the total $966 billion in student loans outstanding.

We also have a longstanding policy of encouraging national banks and thrifts to work constructively with borrowers who may be facing hardship. As my testimony will describe, with respect to private student loans, we allow national banks and thrifts to offer additional flexibility when working with student borrowers in recognition of the unique challenges these borrowers face. This flexibility includes extended grace periods for loan repayments that go beyond what is permitted for other types of consumer credit. For long-term hardship cases, national banks and thrifts may also permanently reduce the interest rate or otherwise modify payments to assist the borrower.

As requested by the Committee's letter of invitation, my testimony provides an overview of trends in student lending and national bank and thrift participation in the private student loan market. I will describe applicable regulatory guidance as well as the

OCC's supervisory approach to private student loans. I will also address programs that national banks and thrifts may offer to assist borrowers who may be facing temporary hardship due to the current job market. My testimony concludes with a discussion of various recommendations that have been made to enhance the private student loan market and to help mitigate loan defaults, including a discussion of common workout programs for federal student loans and their applicability to private student loans.

Background

I want to begin by describing some of the unique challenges student loans can pose for lenders and borrowers and how the OCC has responded to those challenges. For most consumer loans, such as automobile loans, the underwriting, loan structure, and account management are straightforward. The use of funds is for a specific purpose, and the source of repayment is well defined, structured, and can be readily assessed at origination. In contrast, private student loans are unique for three main reasons: first, funding a post-secondary education often requires a substantial, multi-year-term commitment that extends from the time the student starts school until repayment begins once he or she has finished his or her education; second, advances made under private student loans are usually uncollateralized; and third, a substantial time period exists between the date when the lender advances funds and when that student reaches his or her anticipated earnings potential. Private student loans also differ from federal student loans in that the government does not guarantee repayment. For this reason, many lenders require that private student loans have co-signers.

Private student loans provide flexibility for deferment while borrowers are in school, and post-school grace periods to help borrowers transition from school to employment. Student loans are the only consumer product with such a transition period. This flexibility reflects both the unique circumstances of the student borrower and that these loans truly are an investment in the borrower's future. As my testimony will describe, the OCC believes this flexibility, if properly applied, supports student borrowers, and allows lenders to make private student loans and manage the resulting credit exposures in a safe and sound manner.

When borrowers experience financial difficulties, the OCC encourages national banks and thrifts to work with the borrower by offering prudent forbearance and modification programs. We recognize that well-designed and consistently applied workout programs can help borrowers resume structured, orderly repayment and minimize losses. Such work out programs are fundamental to effective lending, and ultimately, benefit both the borrower and the financial institution.

The interagency Uniform Retail Classification and Account Management Policy (Uniform Classification Policy) contains general guidance for consumer credit forbearance and modification programs.[1] This policy acknowledges that extensions, deferrals, renewals, and rewrites of consumer loans can help borrowers overcome temporary financial difficulties such as unemployment, medical emergency, or other life events. It further notes that prudent use of these loan modification measures is acceptable when based on the borrower's willingness and ability to repay the loan, and when the modification is structured in accordance with sound internal policies.

While the Uniform Classification Policy provides general guidance regarding extensions, deferrals, renewals, and rewrites, it does not specifically address private student loan workout and forbearance practices, nor does it directly address the unique

[1] Uniform Retail Classification and Account Management Policy, 65 Fed. Reg. 113 (June 12, 2000).

challenges that student lenders and borrowers may face. To address these issues, the OCC issued supplemental guidance to our examiners in 2010 that interprets the Uniform Classification Policy in the context of private student lending, and describes the OCC's minimum expectations for managing forbearance, workout, and modification programs (The Student Lending Guidance or Guidance).[2] The Student Lending Guidance explicitly permits national banks and thrifts to engage in the following actions to assist borrowers:

- *In-school deferments* – allows a lender to postpone a borrower's principal and interest payments as long as the borrower is enrolled in school at least as a half-time student.
- *Grace periods* – allows lenders to defer a borrower's payments for six months immediately following the borrower's departure from school, without conditions or hardship documentation.
- *Extended Grace periods* – allows lenders to defer a borrower's payments for an additional six months immediately following the initial grace period. This option is for those borrowers who are experiencing a financial hardship and is available to student loan borrowers who are unemployed or under-employed.
- *Short-term forbearance* – allows lenders to offer two-to-three month loan extensions to a borrower to address short-term hardships.
- *Loan Modifications* – allows lenders to provide interest rate and payment reductions to borrowers who are experiencing long-term hardships.

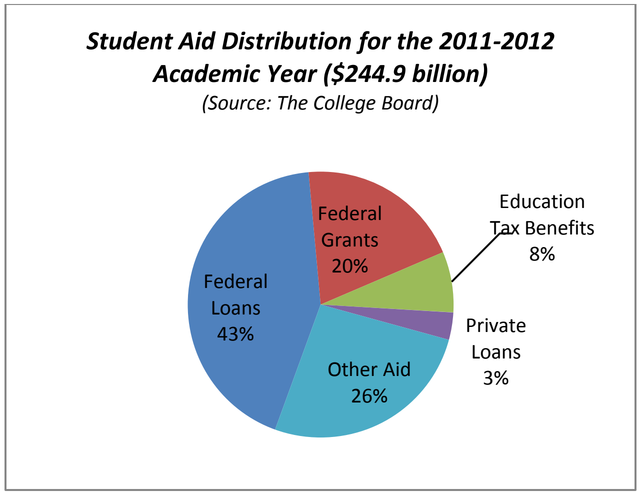
[2] CNBE Policy Guidance 2010-02, "Policy Interpretation: OCC Bulletin 2000-20 – Application to Private Student Lending."

The first three actions primarily help borrowers while they are in school and as they transition to full-time employment, and are unique to student loans. The extended grace period in particular is a direct response to the difficult employment conditions that many students are experiencing. Under our guidance, a national bank or thrift may allow a borrower facing difficulty in finding a job to not make any payment for up to 12 months after he or she leaves school. Upon completion of the extended grace period, the borrower is considered current and will remain in that status as long as scheduled payments are met. If the borrower is still experiencing hardship at the end of this extended grace period, we would expect the bank to work with the borrower and determine whether additional actions are warranted. Such actions may include the forbearance, workout, and modification programs allowed under the interagency Uniform Classification Policy. We also require banks to maintain appropriate loan loss allowances and regulatory capital levels, consistent with applicable accounting and regulatory requirements. Working constructively with troubled student borrowers, while adhering to prudent accounting principles, provides appropriate flexibility for both assisting troubled student borrowers and protecting the safety and soundness of the institution.

Trends in Private Student Lending

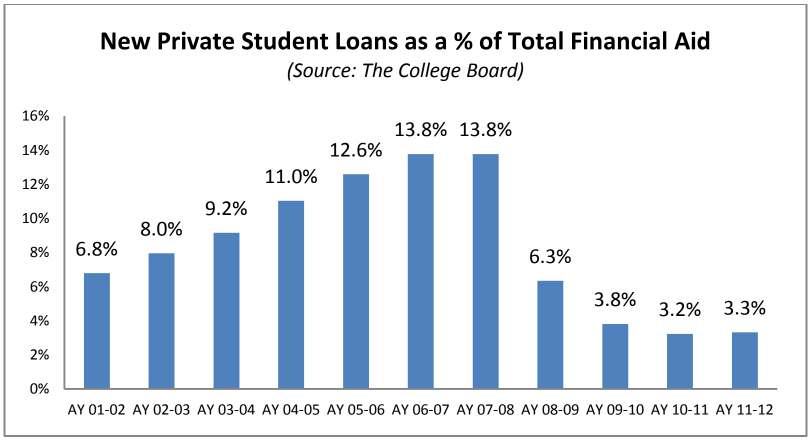
In 2012, The College Board released its most recent "Trends in Student Aid Report"[3] that included preliminary data for the academic year 2011-2012. Student aid includes loans (federal and private), grants, work-study, and education tax benefits.

[3] Trends in Student Aid 2012, The College Board, www.collegeboard.org.



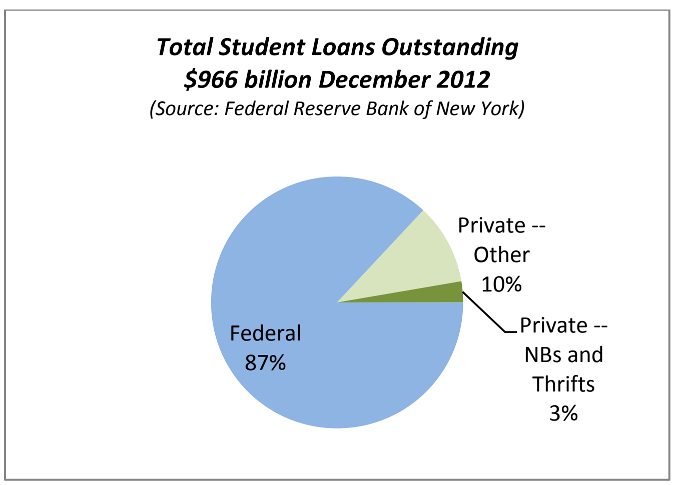
According to The College Board, total financial aid for academic year (AY) 2011-2012 was approximately $245 billion. Federal loans represented $105.3 billion for AY 2011-2012, or 43 percent of total aid. By comparison, private student loans for AY 2011-2012 were $8.1 billion, or 3 percent of total aid. This was similar to AY 2010-2011 and down substantially from the $25.6 billion in private student loans originated during the peak AY of 2007-2008.

The student aid distribution in AY 2011-2012 continued recent trends, where federal aid (loans and grants) are the principal source of student aid, while private student lending provides a supplement to help with shortfalls. Private student loan share peaked in AY 2007-2008 at just below 14 percent ($25.6 billion), but has been a much smaller share since then. After 2008, the financial crisis, high unemployment, weaker loan performance, and reduced securitization funding all contributed to lower market share in absolute and relative terms. We see little indication that private student lending volumes will increase or return to mid-2000 levels in the near term.



National Bank and Thrift Participation in the Private Student Loan Market

Total outstanding private student loans are difficult to estimate since volumes are not collected as part of call report or public financial statement reporting. Industry estimates place year-end 2012 totals somewhere between $126 and $150 billion. For this discussion, we use the Federal Reserve Bank of New York's estimates of $126 billion for private student loans and $996 billion for total student loans, both as of December 2012.[4]



As the chart above shows, federal loans dominate the student loan market, with 87 percent, or approximately $849 billion of the total $966 billion that was outstanding at the end of 2012. Within the private segment of the student loan market, national banks

[4] Quarterly Presentation on Household Debt and Credit, May 2013, Federal Reserve Bank of New York.

and thrifts hold approximately $27 billion of the remaining $126 billion in student loans, or roughly 21 percent of the private market and 3 percent of the total $966 billion outstanding. The "Private – Other" segment in this chart includes other non-OCC supervised financial institutions.

National bank and thrift participation in the private student lending market is highly concentrated, with only eight lenders holding portfolios of $500 million or more. Wells Fargo, JPMorgan Chase, Citibank, KeyBank, PNC, RBS Citizens, Bank of America, and U.S. Bank combined hold approximately $25.8 billion in private student loans, with Wells Fargo accounting for slightly more than 40 percent of the total. Of the eight banks, four have ceased making new private student loans since 2008 due primarily to concerns about portfolio performance and liquidity. The second largest, JPMorgan Chase, only offers new private student loans to existing bank customers.

Within these portfolios, a greater number of borrowers have concluded the in-school deferment phase, and have started repayment. For the eight largest banks, more than 70 percent of the outstanding loans are in repayment, and overall delinquencies are relatively low, generally between three to four percent; only one of the eight largest lenders has a delinquency level in excess of four percent. In addition, all eight of these banks offer forbearance and extended grace programs. At the end of 2012, these banks had almost $750 million combined in active post-school deferment. Loss rates for loans in repayment are also relatively low, with the average for the eight largest private student lenders at 4.6 percent. These delinquency levels are manageable, and compare favorably to the overall student loan market and are considerably lower than the current delinquency rates for residential mortgages. The low levels associated with these private student loans reflect the quality of underwriting, including a greater prevalence of co-signers, and better risk selection than were evident after 2008.

How the OCC Supervises Consumer Credit Portfolios

Most lenders' consumer credit portfolios, including student loan portfolios, consist of a significant number of loans, with standardized underwriting, loan structures, and repayment terms. Because of the volumes involved, such standardized process-related decisions (credit score floors, credit line assignment, documentation of income, etc.) are critically important for consistent and timely credit decisions. Supervisory oversight generally focuses on the quality of the bank's or thrift's decision-making processes and on internal controls and audit. For safety and soundness purposes, the OCC focuses on whether management has established prudent risk tolerances, developed effective account management practices, and has a fundamental, disciplined understanding of portfolio quality.

Prudent risk tolerances generally involve establishing well-defined underwriting and repayment structures. The OCC expects national banks and thrifts to employ underwriting standards that consider both a borrower's willingness and capacity to repay any credit extended, based on reliable information prior to making the loan.

Effective account management and collection practices include active monitoring of loan performance and timely actions when issues arise. This includes the use of forbearance and modification programs that are designed to benefit both the borrower and the bank by improving the likelihood of repayment. As with risk tolerances, we expect lenders to consider and articulate accepted and prudent use of modification programs in advance, and then manage these activities within defined parameters.

Understanding portfolio quality generally involves robust, timely reporting that identifies loans or portfolio segments that are not performing as expected. A bank's portfolio monitoring should include new and existing loans, as well as the range of loss mitigation and collection activities that it uses. A comprehensive and accurate view of a loan portfolio's risk is critical for effective forbearance, workout, and modification programs.

The interagency Uniform Classification Policy establishes standard guidelines for loan classification and charge-off. Under that policy, consumer loans 90 days past due are classified "substandard,"[5] and amortizing loans that become 120 days past due are classified "loss,"[6] and charged-off. This is one aspect where the regulatory treatment for federal student loans and private student loans differs. While both types of loans are uncollateralized, generally banks are not required to charge-off loans that are federally guaranteed.[7]

Designating a loan as "loss" does not mean that a lender should stop the use of workout or modification programs, or that loss mitigation or collection efforts should cease. It simply means that for safety and soundness reasons and financial and investor transparency, the bank should follow appropriate accounting practices and reflect the increased credit risk in its financial statements.

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[5] Under the agencies' regulatory classification guidelines, "substandard" assets are defined as assets that are inadequately protected by the current sound worth and paying capacity of the obligor or collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

[6] An asset classified "loss" is considered uncollectable, and of such little value that its continuance on the books is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value; rather it is not practical or desirable to defer writing off an essentially worthless asset (or portion thereof), even though partial recovery may occur in the future.

[7] Under federal student loan program guidelines, federal student loans that are 270 days past due are considered to be in default.

The Uniform Classification Policy does not prohibit or discourage a bank from working with troubled borrowers nor does it dictate when a bank can begin to work with a borrower who may be facing hardship. We believe that full, objective analysis and timely identification of problem loans encourage lenders to work with troubled borrowers at an early stage when programs generally have a higher probability of improving repayment and reducing losses. To be effective, however, forbearance and modification programs need to be based on accurate assessments of risk and reliable information.

As previously noted, private student loans raise unique issues that are not explicitly addressed by the Uniform Classification Policy. In early 2010, OCC examiners noticed inconsistent practices regarding the use of grace and forbearance periods for borrowers who were transitioning from school to full-time employment. In response, the OCC issued the Student Lending Guidance to address the unique challenges associated with private student loan programs. As mentioned previously, that Guidance acknowledges the challenges that borrowers face shifting from school into the workforce, and recognizes the need to facilitate orderly transitions. To facilitate that transition, the Guidance allows a bank to defer a borrower's payments for up to a year.

The Guidance also specifically allows national banks and thrifts to offer loan modifications, but we expect such modifications will reflect three key concepts: i) eligibility and payment terms that are based on a credible analysis of the borrower's hardship and reasonable ability to repay; ii) sustainable payment schedules that avoid unnecessary payment shock; and iii) revised loan structures that promote orderly repayment and do not include elements such as interest-only payments, balloon payments, and negative amortization.

A credible analysis of the borrower's difficulties and the use of payment terms that are sustainable ensure that a modified student loan is likely to be successful over the long term. Moreover, modification programs should address hardship and payment issues directly, with the objective of improving the borrower's ability to repay. The Guidance discourages the use of payment terms such as interest-only and negative-amortization. Such payment structures delay problem recognition in the hope economic or other market conditions might quickly improve and resolve the issue, but often will leave the borrower exposed to uncertain market conditions, and ultimately, higher costs as a result of the payment deferrals or increases in principal balance.

Finally, while the OCC encourages national banks and thrifts to work with troubled borrowers, offering prudent forbearance, workout, and modification programs does not relieve these institutions of their fiduciary responsibility to ensure that regulatory reports and financial statements are accurate and fairly represent the financial condition of the institution. This tends to be a point of confusion, as some mistake the expectation of full and accurate reporting as limiting available forbearance, workout, and modification programs. To be clear, the Student Lending Guidance allows options and flexibility to lenders in offering forbearance and modification programs to private student loan borrowers, but requires banks to ensure the integrity of their books and records by reporting the volume and nature of transactions accurately. These options and responsibilities are not mutually exclusive, and together promote a safe and sound banking system.

Consistent with Section 121 of the FDIC Improvement Act of 1991, national banks and thrifts offering workout and modification programs are expected to follow generally accepted accounting principles (GAAP) to ensure transactions are accurately reflected in the institution's regulatory reports and financial statements.[8] In general, under GAAP a bank must recognize a loan modification for a financially troubled borrower that includes concessions as a troubled debt restructuring (TDR), with appropriate loan loss provisions if impairment exists.[9] The designation of a loan as TDR does not prohibit or impede a bank's ability to continue to work with the borrower.

Potential Enhancements to the Private Student Loan Market and Mitigation Efforts

A number of thoughtful studies have highlighted policy recommendations to strengthen student lending programs, including the Consumer Financial Protection Bureau's July 2012 and March 2013 reports. Some of these recommendations are aimed at improving the transparency and clarity of student loan programs and loan terms to help ensure that students and their families can make informed decisions. The OCC supports proposals that would enhance borrowers' ability to understand and compare various financial products and options that may be available. Likewise, we support loan documents and billing statements that allow a borrower to fully and readily comprehend his or her financial obligation.

Other recommendations have focused on exploring permissible mitigation efforts for student borrowers who are facing difficulties and whether plans permitted under current federal loan repayment programs can be used for private student loans. As previously discussed, the OCC believes its guidance provides national banks and thrifts with appropriate flexibility in providing loan modifications to troubled borrowers. This

[8] See 12 U.S.C. 1831n.

[9] The Glossary section of the Call Report Instructions provides regulatory guidance for the identification of TDRs and associated allowance methodologies under the topics Troubled Debt Restructures and Loan Impairment.

flexibility includes the ability to adapt features of repayment programs used for federally guaranteed student loans to private student loans, as described below.

Graduated Repayment Plans – Most federal student loans allow a lender to establish a payment schedule where the borrower's payment obligation starts low and then increases over time. Initially, payments can be interest only, and no required payment plan can be more than three times any other payment. Loan terms are generally 10 years (excluding in-school, grace, deferment, or forbearance periods) or 25 years for borrowers with an extended repayment term.

Graduated payment terms that are part of the payment structure at origination are permissible and consistent with existing regulatory guidance. In the case of student loans, programs that include such payment terms recognize that borrowers are likely to have significantly lower income with entry-level jobs at the beginning of the payment period, and that their income may increase significantly over the next few years. Under GAAP and regulatory reporting guidelines, a bank offering a graduated payment plan as a workout concession to a financially distressed borrower generally would have to report the loan as a TDR and take an appropriate impairment charge to earnings.

Income-Based Repayment Plans – These are payment plans for federal student loans where monthly payments are based on a borrower's expected total monthly gross income and family size. Such plans require the borrower to show a hardship, and payments are generally limited to 15 percent of eligible income. Any remaining loan balance is forgiven after 25 years.

For private student loans, income-based loan modifications are consistent with regulatory expectations and typically form the basis for prudent modification programs.

Given that payment and principal concessions are due to the borrower's financial hardship, these modified loans likely would require TDR designation under GAAP, and would require appropriate recognition, carrying values, and impairment allowances. As a modification, we would expect that approved payment terms would not reflect interest-only or negative amortization provisions. In addition, any balances forgiven would likely require full loan loss allowance coverage, or be charged-off.

Consolidation Loans – Federal programs allow borrowers to combine multiple student loans into one consolidated loan, simplifying the repayment obligation. The consolidated loan's repayment term is determined by the total loan balance, and can extend from 10 years to 30 years. Borrowers pay a fixed interest rate equal to the weighted average interest rate of the underlying loans.

Consolidating loan balances is also permitted under existing regulatory policies. Since consolidated loans generally do not include concessions to troubled borrowers, extending their use to private student loans likely would not require TDR designation. As with any consumer loan, a lender should have reasonable underwriting criteria that considered a borrower's reasonable willingness and ability to repay the full amount of the consolidated loan.

Loan Rehabilitation Programs – A federal student loan that has defaulted (*i.e.*, more than 270 days delinquent) can be returned to performing status if the borrower makes at least nine on-time payments in a 10-month period. This rehabilitated loan must retain the same interest rate, repayment terms, and other benefits that were applicable when the loan was first disbursed, and collection costs and accrued interest are capitalized and built into the principal balance of the loan. After a federal student loan has been rehabilitated, the loan's default status is deleted from the borrower's national credit bureau reports, and, pursuant to the loan's original terms, any benefits that were available before the borrower defaulted (such as deferment, forbearance, or consolidation) are reinstated.

Rehabilitation programs for federal student loans are late-stage actions that occur well after normal collection activities for private student loans are exhausted. As previously noted, once a private student loan becomes 120 days past due, the Uniform Classification Policy indicates that the institution is expected to record the exposure as a loan loss and charge-off any remaining loan balance. Work out activities may continue post-charge-off, including payment plans for financially troubled borrowers, but any amounts received from the borrower are treated as recoveries. Charged-off loans are rarely re-booked as performing assets. This discipline is an important part of financial statement transparency, and ensures that lenders accurately report their balance sheets and capital.

The OCC believes that full and accurate reporting to credit bureaus that includes updated default status for loans that subsequently perform as well as their prior history, is important for both lenders and borrowers. Much of the depth and breadth of the $11 trillion consumer credit market is tied directly to objective and accurate bureau transaction data that supports credit decisions and other account management practices.

Conclusion

We recognize that access to higher education remains an important public policy objective, and that cost-effective funding for an education can be a challenge for students and their families. Private student lending is a relatively small but important part of the student aid package, but still can contribute to the substantial debt burden that some students have once they leave school.

The OCC encourages national banks and thrifts to work constructively with troubled borrowers, and expects banks and thrifts to make informed, objective decisions in workout situations. For troubled loans, most often this means active loss mitigation practices that include forbearance, workout, and loan modification programs. We believe that our guidelines provide lenders with the flexibility necessary to work with troubled private student loan borrowers, including permitting the lenders to take advantage of a number of the options currently used in connection with federal student loans. In particular, we recognize the challenges that student borrowers can have finding employment during difficult economic conditions, and in response, we have allowed grace periods to extend up to a full year to help these borrowers as they transition into the work force.

These and other forbearance and modification programs are consistent with safety and soundness principles and complement prudent underwriting practices. Both help borrowers handle debt responsibly, and avoid default during periods of hardship, and both are important for vibrant and sustainable loan markets.