Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Securitized Student Loans: The Next Crisis?

By **Kevin O'Brien** (March 8, 2018, 4:45 PM EST)


Kevin O'Brien

When the housing bubble burst during the 2007-08 economic meltdown, the ripple effect on residential mortgage-backed securities was profound. Hundreds of billions of dollars of residential mortgages had been bundled into securities and sold to investors at a premium on the assumption that "housing prices will always go up." When the opposite occurred, and millions of Americans defaulted on their mortgages, the security holders were left with significantly impaired collateral. Myriad litigation ensued involving the banks that had extended the credit (in many cases, to borrowers who were not reasonable credit risks), financiers who had sold the loans, and insurers that had guaranteed repayment.

A similar scenario may be on the horizon with regard to securities backed by student loans (known as "SLABS" for student loan asset-backed securities). Unlike RMBS, there is no "asset" securing the student loan obligation, only the student's promise to repay. As a result, the SLABS investor's interest is even more precarious than that of the mortgage-backed securities holder. Now, with a variety of factors hampering the collection of student debt, some commentators are warning of a "looming collapse" in the SLABS market.[1] While investors have relied on the fact that a large segment of student loans are guaranteed by the government and are not dischargeable in bankruptcy, these protections do not extend to "private" student loans, often associated with the growing segment of "for-profit" colleges and universities. And even for the federally backed loans, delinquency rates have soared in recent years to over 11 percent, far in excess of the rates for credit card and mortgage debt.[2]

The rise in delinquency rates is only one warning sign relating to SLABS. Even to the extent that SLABS are perceived as less risky than other investments, there are concerns that the value of the debt has begun to outstrip the value of the asset — incomes for recent graduates have not kept up with rising costs of tuition, making it more difficult for them to keep current on their student loan obligations. As was the case with the RMBS crisis, investors are now dealing with the ramifications of what was an overextension of credit to borrowers where repayment ability was premised on an "assumption" that the value of a college degree would always justify the unsecured investment in the student's earning potential. As noted above, the position tends to be riskier with respect to "private" student loans made outside the federal student loan program. Not only do such loans typically carry higher interest rates, but they also are the vehicle typically associated with for-profit colleges, where statistics show that borrowers' default rates are higher in light of the lower graduation rates and more limited career prospects associated with those institutions. A Brookings Institute study[3] reveals that 40 percent of the 2004 borrower cohort may default on their student loans by 2023, with that number potentially being 70 percent with respect to for-profit college debtors. Thus, especially in the sector where federal guarantees do not back the loan, the value of the asset-backed security is trending downward. Yet even for the federally insured loans, about a third of all student borrowers are currently participating in some form of deferral or repayment program, slowing or halting altogether the cash flow for a student-loan-backed asset. One commentator has noted that investors might actually welcome defaults in larger numbers, “as that would trigger government guarantees and stabilize returns.”[4]

In light of the stress on the student loan market and the amount of money invested in SLABS, the likelihood of litigation regarding the marketing and securitizing of these assets is substantial. Issues surrounding the management and collectability of student loans have already spawned disputes in courts across the country, where creditors’ collection actions have failed because the underlying loan documents have either disappeared or do not demonstrate that the borrower actually received the financial aid at issue. As a result, in addition to the borrowers’ growing inability to repay as described above, billions in defaulted student loans may be uncollectible due to shoddy paperwork, adding a further level of peril for SLABS investors.

As individual borrower-lender disputes played out across the country, the federal agency assigned watchdog duties over the financial institutions managing the loans investigated the lenders’ questionable practices in attempting to collect the debts, and took action. The Consumer Financial Protection Bureau sued the National Collegiate Student Loan Trusts, or NCT — one of the nation’s largest owners of private student debt — in the U.S. District Court for the District of Delaware[5] charging violations of federal consumer financial laws in connection with the trusts’ servicing and collection of private student loan debt. Among other things, the complaint alleged that NCT had, through its debt servicers, submitted falsified and improperly notarized affidavits regarding possession of loan records, collected time-barred debt, and generally filed thousands of lawsuits without the intent or ability to provide documentary proof of the debt, all in violation of the Consumer Financial Protection Act of 2010.

The NCT entered into a proposed consent settlement with the CFPB contemporaneously with the filing of the complaint. The consent judgment called for a compliance audit of more than 800,000 loans and a compliance plan for future collection actions, in addition to restitution to affected borrowers, a “disgorgement” payment, and a civil monetary penalty, totaling in excess of $19 million. However, the settlement has been challenged by SLABS investors and companies that extended credit insurance on the bundled loans, arguing that their contractual interests would be impaired by the settlement and that the terms of the agreement violate the trust agreement under which the NCT services the loans.

In addition to the objections of these stakeholders, the settlement has also been challenged through an amicus filing by a trade organization known as the Structured Finance Industry Group. The SFIG asserts that the CFPB lacks authority to enforce the settlement because the named defendants — the NCT trusts — are not “covered persons” under the Consumer Financial Protection Act, and that entry of the consent judgment would destabilize market expectations in the trust agreements under which the loans are serviced. Obviously, this particular proposal to address issues with the servicing and collection of student loans has drawn the attention of investors, insurers and borrowers alike, and the court’s treatment of the settlement will be closely monitored.

Disputes over the management and collectability of the SLABS portfolio may only be the opening act. A scenario similar to the saga that played out in the residential mortgage-backed security field is on the horizon; SLABS investors who thought they were purchasing “can’t-miss” vehicles may assert that underwriters of the securities either concealed or ignored information regarding the creditworthiness of student borrowers and the prospects for repayment. Questions may be asked about the due diligence performed on the portfolio of loans, and offering materials connected with the securitizations may be scrutinized for evidence of fraud or material omission. Should the current trends in student loan performance continue, SLABS may generate significant financial litigation in the not-too-distant future.

Kevin J. O'Brien is a partner with Butler Rubin Saltarelli & Boyd LLP in Chicago. He is a litigator with experience in both trial and administrative hearings, including cases in insurance coverage, reinsurance, environmental law and other types of commercial litigation.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] See Austin Smith, "The Looming Collapse of Student Loan Asset Backed Securities," at www.bna.com/looming-collapse-student-n73014473186/.

[2] See "U.S. Student Debt — The Next Financial Crisis?" at www.bnrbeurs.nl/2018/02/14/u-s-student-debt-the-next-financial-crisis/ and "Should You Invest in Student Loan Asset-Backed Securities?" at www.thestreet.com/story/14142296/1/should-you-invest-in-student-loan-asset-backed-securities.html.

[3] Judith Scott-Clayton, "The Looming Student Loan Default Crisis is Worse than We Thought," at www.brookings.edu/research/the-looming-student-loan-default-crisis-is-worse-than-we-thought/, at 13.

[4] See "Should You Invest In Student Loan Asset-Backed Securities?" supra, at p.5.

[5] CFPB v. The Nat'l Collegiate Student Loan Trust et al., No. 17-cv 1323 (D. Del. 2017).