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The Latest Twist in Student Loans

As traditional sources such as banks and government agencies pull back, peer-to-peer lending is entering the student loan market

by Anne Tergesen

Because of the credit crunch, conventional lenders are making it tough for any but the most creditworthy borrowers to qualify for private college loans. Now, a new breed of student lender is trying to get students to return the snub—by writing off the Sallie Maes and Citibanks of the world in favor of relying on friends, family, and even perfect strangers to finance their college loans. "It's not a solution to the credit crisis in student loans by any means," says Mark Kantrowitz, publisher of financial aid Web site finaid.org. "But the idea of using peer networks to raise money is intriguing."

In recent months, peer-to-peer lending sites (*BusinessWeek*, 4/23/08) such as Prosper and Virgin Money USA have introduced student loans or started marketing existing offerings to families looking for college funds. Others, including startups GreenNote and Fynanz, are focused exclusively on making college loans. Analysts say the sites are benefiting from the confluence of trends—a growing acceptance of peer-to-peer lending and fallout from the credit crunch, which has caused lenders who account for more than 20% of the market for private student loans to stop lending.

The general idea is to facilitate loans between students, on the one hand, and either Good Samaritan friends and relatives, or strangers intent on investing in alternatives to stocks, bonds, and certificates of deposit. The sites take very different approaches, though. Some, such as Virgin and GreenNote, mainly seek to formalize loans between friends and family members. Others—Prosper among them—allow borrowers to publicize the amounts they wish to raise and the interest rates they're willing to pay. Then, lenders—friends or strangers—bid on funding even a small portion of these loans. As the competition among bidders intensifies for a piece of a loan, the interest rate a student will have to pay declines.

A WIN-WIN SETUP

It sounds like a great idea. For individual lenders, the loans are promoted as a way to earn a decent rate of return while helping a student in need. For borrowers, the allure is the prospect of securing an interest rate that's lower than the 6% to 16% that conventional lenders charge for private loans. (Interest rates on private loans depend mainly on credit scores.) "The idea that you can get people bidding down the interest rate on your student loan is certainly attractive," says Kantrowitz.

There are also plenty of potential drawbacks. For lenders, the risks are difficult to gauge. Indeed, many peer-to-peer sites say it's too soon to know what percentage of borrowers will ultimately default on their loans. While lenders can reduce the risk of a loss by carefully vetting borrowers, lending in small doses, and spreading their money among several borrowers, a loan portfolio with an average interest rate of 10% will net just 7.5% if 10% of borrowers default, says Kantrowitz. That's not unrealistic, given that 11.5% of Sallie Mae's private loans were delinquent in 2007. Some sites, including Fynanz and Zopa, offer lenders some degree of protection against losses. The trade-off, though, is lower returns.

For borrowers, the big question is whether the sites will help make loans more plentiful. Currently, most peer-to-peer lenders report low lending volumes. At Prosper, for example, only 2% of the $150 million in loans arranged so far are for education. Moreover, the terms on some of these loans may prove unattractive. Some lenders, for example, require students to repay loans over relatively short periods. Not all of them will grant postponements until after graduation. Moreover, the fees on these loans can be high. And because there's no guarantee of landing an attractive interest rate,

it's important, as always, to shop around.

Before borrowing from any of these sites, be sure to exhaust the amounts available under federally backed loan programs. With a maximum fixed interest rate of 6.8%, the Stafford Loan for students is almost always less expensive than a private loan. The downside: These loans limit undergraduates to a cumulative amount. But families can borrow more—up to the full cost of attendance—under the federal PLUS Loan program for parents. The current rate on a PLUS loan: a fixed 8.5%.

Here's a quick read on the various players in the market for peer-to-peer student lending:

Prosper:
The site (prosper.com) fits students into its one-size-fits-all loan program—a three-year loan that borrowers must start repaying immediately. The site models itself after eBay (EBAY). Borrowers allow Prosper to pull their credit reports, verify their enrollment status, and assign them a risk measure that alerts lenders to the potential risk of default. The lenders bid on slices of the loan, with those willing to earn less interest driving down the rate on the loan. The site makes money on fees. Borrowers pay 1% to 3% up front, depending on their credit score. Lenders pay a 1% servicing fee each year.

Virgin Money USA:
This site (virginmoney.com) formalizes loan arrangements between friends and family. While some 11% of the $300 million in loans it has arranged have been used to fund education, it only recently launched a product, called Student Payback, that's specifically for students. President Asheesh Advani touts the loan's flexibility: Payments can be postponed until graduation, he says. And "every year, for no extra fee, borrowers and lenders can change the payment schedule." Negotiated between borrower and lender, the interest rates are typically about 4% or 5%—or far below the 6.8% rate on federally backed Stafford Loans. A lender can sign over up to $24,000 a year without triggering a federal gift tax.

While many parents dig into their pockets to make loans, some take out home equity or Federal PLUS loans—and use the site to formalize a student's pledge to repay those amounts. "Parents are more apprehensive about retirement now. This really provides them with peace of mind," says Advani. Still, peace of mind doesn't come cheap. Up-front fees on the loans range from $199 to $299, depending on whether a student borrows once or multiple times. When a student graduates and begins to repay a loan, Virgin pockets yet another $9 fee per payment to service the loan.

Fynanz:
Launched in March, the site (fynanz.com) makes students loans in seven states, including New York, New Jersey, and Massachusetts. By early 2009, CEO Chirag Chaman expects it to go nationwide.

For lenders, Fynanz takes some of the risk out of making loans. It guarantees repayment of anywhere from 50 cents to 100 cents on the dollar. The guarantees rise with a borrower's credit. It also requires borrowers to obtain co-signers, who become responsible for repaying loans that default. The site is picky about whom it selects: Currently, it turns away about 12 applicants for every borrower it accepts, Chaman says. "Our job is to reduce default rates."

The site offers some benefits to borrowers. By summer, it will launch a product that will exempt college juniors and seniors with credit scores of at least 640 from the co-signer requirement. And it shaves 1% off a borrower's interest rate once 10% of the loan is repaid. The site sets rates—which are variable and currently range from 5.6% to 10%—at auction. It charges lenders 1% a year to service the loans. Borrowers, who pay from 2.9% to 6.9% of the loan amount up front, max out at $120,000 as undergrads.

GreenNote:
Currently available to students at 12 colleges, this program will officially launch in early June. The site (greennote.com) doesn't plan to require students to line up a more creditworthy friend or relative to co-sign its promissory notes. Nor does it plan to check borrowers' credit scores. "It's a platform that allows students to tap into their social networks. This can be

friends, family, alumni of the same school, or friends of friends," says founder and CEO Akash Agarwal.

The site collects and transfers the amounts lenders contribute to schools. Students can postpone repaying these loans until after graduation. The interest rate is low—a fixed 6.8%, to conform to the maximum under the federal Stafford Loan program. "Lenders can choose to reduce or waive the interest at repayment, turning the loan into a gift," Agarwal says. GreenNote charges lenders a 1% documentation fee. Borrowers pay $49 or 2% of the loan, whichever is greater. The risk? If your network doesn't kick in all you need, you'll have to shop around for other loans.

Zopa:
When a student or parent applies for a loan, the site (zopa.com) runs a credit check. Zopa charges no fees but interest rates can be high—some 8.5% to 17%, depending on a borrower's credit score. Where's the peer-to-peer angle? Borrowers can ask friends and family to purchase one-year CDs from the site. Those who do are required to devote at least 0.10% of the current yield of 3.75% to helping a borrower meet his or her monthly payments. Because some CD holders are willing to part with far more than 0.10%, a borrower may see his or her monthly interest payments wiped out. A few even pocket enough to help pay down principal. As with other CDs, these are insured against losses. And when they mature, the principal is returned to the investor. The loans, which must be repaid over five years, are capped at $25,000. This summer, the company plans to launch a student loan product with a longer repayment term.

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U.S.News & WORLD REPORT

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Help, My Student-Loan Check Bounced!

Hundreds of students are being affected by a credit-crunch bankruptcy

By Kim Clark
Posted May 13, 2008

The credit crunch is starting to take its toll on college students: Several students who have turned to banks or private companies to borrow extra tuition cash in recent weeks have been shocked and penalized when the checks they received were refused. There haven't been any reports of problems with federally guaranteed Stafford student loans or PLUS parent loans.

Michael Libman, a senior at San Diego State University, said he applied for an Astrive private loan of $10,000 in February so he could pay his last semester of fees and graduate this summer. He says Astrive took weeks to send him a check after approving his application, then, when he finally received the check, it bounced. He had to ask his parents to put his school fees on their credit card so that he could finish his last semester. Libman says he called Astrive repeatedly, but, despite the company's assurances that the problem was fixed, the check bounced again on his second attempt. Astrive hasn't yet sent him a good check, he says, and he needs the money to pay back his parents, who are saving up for the college costs of his two younger brothers. Libman is working six days a week to raise extra cash, and he's cutting costs. "Ramen is my friend," he says ruefully.

Chris Blawat, a prechiropractic student at Ivy Tech in Lafayette, Ind., was relieved when he got an $8,500 Astrive private loan check in April. He deposited it, saw that it was credited in his account, and started writing checks to cover rent, utility bills, and other expenses. Then, four days later, his account was suddenly overdrawn by $4,000, and he had racked up more than $600 in bad-check and insufficient-funds fees. "I had to live off my friends and my girlfriend" for several weeks, he says, until Astrive finally sent him a good check on April 24. He says he's still waiting for Astrive's promised check to cover the banking fees he had to pay when the first check bounced.

Astrive is a prominent marketer of private loans whose ads are familiar to watchers of late-night television and visitors to education-related websites. Company spokeswoman Janice Walker says the problem was a glitch that was quickly identified and fixed. Astrive has attempted to reach all affected students, has been sending out valid checks, and is covering bad-check fees and related expenses for affected borrowers.

Astrive is a brand of Boston-based First Marblehead, one of the nation's oldest and biggest packagers of private educational loans. Walker, First Marblehead's vice president for corporate communications, says the problem was caused by the bankruptcy of the nonprofit agency that guaranteed Astrive's student loans, the Education Resources Institute Inc. TERI, which guarantees private student loans for more than a dozen banks and marketers, filed for bankruptcy April 7. In the past year, TERI had been suffering from an increase in defaults on private education loans made years ago. Some Wall Streeters began to worry late last year that TERI hadn't set enough aside to pay off its guarantees. As worries mounted, Moody's downgraded TERI's rating to junk status, which made it very expensive for TERI to raise cash and pushed the company to seek court protection.

Because of TERI's financial and legal troubles, several hundred loan checks sent out in the names of some of its clients, including Astrive, bounced, TERI says. In a letter sent to colleges on May 7 and posted on TERI's website, TERI acknowledged that there were still delays in disbursing some student loans, but it said it hoped to resolve those problems soon.

TERI has set up a hotline for students affected by the bankruptcy: 888-563-7050.

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Borrowers' Uncertainty Has Colleges in Quandary

To keep enrollments up, institutions help families cope with the loan crisis

By BEN GOSE

The crunch in the student-loan market, a weak U.S. economy, and declining home values are all conspiring to make this an unpredictable year for college enrollment.

Most of the attention this spring has focused on fears that loan companies will depart from the federally guaranteed student-loan program. But students and parents have other worries. Some middle-income families have found it cheaper in recent years to borrow against their home equity to help pay for college, rather than take out private student loans.

That option may no longer be available for many families, as home values in many markets have plummeted and banks are tightening lending requirements.

To avert a crisis, some colleges are developing contingency plans to help students enroll even if bank loans fall through. And some financial-aid advisers are urging families to tap home-equity lines now, before it's too late.

Paula Bishop, an accountant in Bellevue, Wash., who advises families on how to pay for college, normally suggests that parents use home-equity lines of credit as the college bills come due. This year Ms. Bishop is changing her advice. She says families worried about paying fall-semester bills should consider immediately obtaining through a line of credit any money they will need. That's because banks have been eliminating or reducing home-equity lines of credit, even for homeowners with good credit.

"The funds could be cut off from them if they wait," Ms. Bishop says.

At Occidental College, a private institution in California, a handful of families have already contacted the student-aid office to say that they have lost lines of credit or have had home-equity loan applications rejected. Maureen McRae Levy, the director of financial aid, says she expects more such calls to come. In April, Occidental's trustees approved the use of $6.5-million in "quasi" endowment funds for emergency lending.

A survey by the National Center for Education Statistics in 2002 found that 10 percent of parents had already refinanced or taken out a second mortgage to help pay for college.

The home-equity problem is being compounded by the student-loan crisis, says Ms. McRae Levy. Before, if parents of undergraduates were denied a home-equity loan, they could always qualify for a federal PLUS loan. Now, she says, "we're not so sure everyone will get a PLUS loan."

James H. Day, a consultant who works for private colleges on financial aid and other matters, says colleges seem to be underestimating the risks that a prolonged crisis in student lending could pose to their operations.

"A conservative estimate is that 40 percent of private-college revenue arrives in the form of loan capital," Mr. Day says. "This whole question of credit availability is huge."

More Cost-Conscious

Many financial-aid officials say they are working to find money to help students enroll. Tom Willoughby, vice chancellor for enrollment at the University of Denver, says the institution "is trying to be more conscious of students' needs this year." The university had been running behind last year's pace on deposits until late April, even though the number of high-school graduates nationwide is expect to reach an all-time high this year.

"If we see a family with unusual or special circumstances because of a lost job or something like that, we're going to try and respond and help them to the greatest extent that we can," Mr. Willoughby says.

But some aid experts doubt such generous policies will survive if the United States slips into a deep recession and colleges begin to see their endowments wither.

"This situation is bad enough even if the financial-aid system works perfectly, but it doesn't," says Paul Wrubel, co-founder of TuitionCoach, a Web site that helps students and families determine how to pay for college. "Colleges are victims of the bad economy as well. Their endowments and cash-cow programs are not performing as well, so there may not be enough campus-based aid to entirely fill the need."

Other institutions are also taking steps to ensure that students will have money to pay for college. Michigan State University is rejoining the federal direct-loan program, which it left in 2003, after spending five years in a guaranteed-student-loan program run by a state agency. The state agency pulled out of the guaranteed-student-loan program in April.

Richard Eddington Shipman, the university's director of financial aid, says Michigan State is rejoining the direct-loan program to reassure students and their families. "When you're in a situation where you have 25,000 people depending on you for a loan," he says, "you can't point them to a set of lenders who may or may not be in business next year."

Some public colleges may benefit from anxiety about the worsening economy. Dave Schindel, a college counselor at Sandia Preparatory School, a private school in Albuquerque, works with 35 seniors, about a third of the senior class. More than half of those students are going to the University of New Mexico next fall. Typically, well over half of Sandia Prep's graduates would attend out-of-state private colleges, he says.

"I've never seen numbers like that before," Mr. Schindel says. "Almost without exception they give economics as the reason."

Middle-Class Burden

Officials at Whitworth University, a private institution in Spokane, Wash., anticipated during the winter that economic woes would lead a higher number of admitted students this year to enroll at less-expensive colleges instead. So the university offered admission to 2,400 students — 8 percent more than a year ago — even though its strategic plan called for slightly shrinking the size of this year's freshman class.

"Many of our top students are very cost conscious, and if push comes to shove and they feel like they just can't afford it, the University of Washington and other publics will get a good number of those students," says Fred Pfursich, Whitworth's dean of enrollment services.

The prediction proved accurate. The percentage of admitted students who choose to enroll is at 22 percent this year, down from 24 percent a year ago.

But patterns are still hard to discern. The University of the Pacific is in Stockton, Calif., which has been called the "epicenter" of the subprime crisis because of the large number of foreclosures in the area. The full cost of attendance is nearly $41,000, and about 20 percent of the private university's students come from local counties. Yet as of the end of April it was running ahead of last year's tally on freshman deposits. "We're happily surprised," says Tom Rajala, associate provost for enrollment services.

Most experts agree that any lending crisis will fall most heavily on middle-class students, since low-income students typically qualify for more grant aid. However, Patricia McGuire, president of Trinity Washington University, in Washington, D.C., where the median family income of students is just $30,000, worries that the news media's coverage of the loan mess will dissuade students from modest backgrounds from even considering going to college.

"Lower-income families who already struggle with how to figure out the alphabet soup of the loan market may become more discouraged and walk away," she says.

If the loan crisis worsens, Ms. McGuire says, she will ask university fund raisers to seek donations for an emergency fund to help affected students cover costs.

"We raise money for scholarships all the time," Ms. McGuire says. "We would put that effort into overdrive."

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