Not All Student Loans are Created Equally

If you are getting ready to send your child to college, or if you have a child in college, you've probably spent a good deal of time thinking about the costs of a college education. There are tuition costs, dormitory fees, charges for books and the cost of a meal plan. But one cost that you may not have thought about is the interest on student loans. It may come as a surprise to you but the interest your child will pay on student loans could very well be determined by which college or university he or she decides to attend.

If you are going to Harvard and you need a student loan, the chances are that you will get a better interest rate than if you are going to your local community college. This may come as a surprise to you, but the reason for the difference is fairly simple. Lenders know that Harvard grads earn more money on average than graduates from community colleges. And history tells them that Harvard grads have a lower percentage of borrowers that default on their loans.

If this is news to you, then you are not alone. New York Attorney General Andrew Cuomo, who is involved in an ongoing investigation of the student loan industry, recently sent a letter about this matter to several members of Congress. In it, he accuses lenders of engaging in redlining and racial discrimination in student lending.

Cuomo's claim of racial discrimination appears to be somewhat flawed. It goes something like this. Many of the institutions with the lowest default rate, or that produce graduates with the highest income rates have fewer minorities than schools with high default rates or lower incomes. But there is little evidence to suggest that lenders have looked at the race of borrowers.

Instead some lenders have assigned a risk rating to various colleges and universities. The higher the risk (based past history for that particular school), the higher the interest rate; which may be a form of redlining of a different sort. This redlining may be based on the prestige associated with a degree from a particular university. As with any other form of redlining, the lender is taking into account an external factor that has nothing to do with the credit worthiness of an individual borrower when setting interest rates, and that is a real problem.

The difference in interest rates based on this form of redlining can be significant. One large lender that Cuomo investigated had a policy that broke borrowers into groups based on the university they attended. Universities with an overall default rate from 0% to 3% got interest rates that ran from 8% to 9.25%. Students at schools with a default rate from 3% to 5% would get interest rates from 9% to 12%. And those attending schools with a loan default rate of more than 5% would be charged interest rates of 11% to 14%.

The interest rates quoted above were not simply determined by the school attended but also based on FICO score. So a student with a high FICO score would receive an interest rate at the lower end of the range for the school they were attending. If they had a low FICO score, they would receive a loan with an interest rate at the higher end of the range.

To see how this type of system unfairly impacts students, you could for example look at someone with a credit score of 550 who was attending Harvard and then compare that person to another student with a credit score of 720 attending a local community college. The Harvard student would be likely to pay interest at a rate of 9.25%, while the community college student would likely be paying 11%.

Cuomo wants lawmakers to make this type of redlining illegal. At first, it appeared that some members of Congress agreed, but over the past two weeks some of their attitudes have changed. Why? Well, because many new students don't have any credit history at all. According to the logic that lenders are using, this means that these students would get the highest interest rates unless certain external factors can be included when considering them for a loan. This logic seems to have had an impact on some congressional votes.

There is only one problem. An aggregate history of repayment can not be applied fairly to any individual. In essence, lenders are attempting to assign a credit rating to each college and university nationwide. ACCESS has always maintained that credit scoring does not work and that scores can be manipulated. Lenders need to look at the borrower's entire credit report to make an intelligent lending decision.

Just as individual credit scoring is ineffective, so too is the idea that a lender can assign a score to a university. Such a score has little or no bearing on the ability of an individual student to repay a loan. Because of this, the institution should not be considered when setting interest rates.

Unfortunately, it is likely that lenders will be able to continue this practice. Therefore, it is important to students and parents to keep the "prestige" of a particular institution in mind when applying to colleges. Even if the tuition at one school is lower than at another, if the interest rate on student loans is different, the difference in tuition may be completely negated.

It is also important for parents and students to know that not all lenders set their interest rates this way. Because of this, you consider getting loan quotes from more than one source. And when applying for student loans, borrowers should ask if the lender sets the interest rate on the loan based on the school attended. If you are planning on attending Yale, this may help you. But if you are going to a community college or other less prestigious school, you should get quotes from several lenders.

by Jim Malmberg

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