Student Loan Deferrals

Impact on Consumer Credit Risk and Early Risk Indicators

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Overview: Background

- Student Loans are the largest source of U.S. household debt besides mortgages, totaling $1.75T
- Federal Student Loans have been deferred since March 2020, but payments will be due again starting in October of 2023
- However, there will be an "on-ramp" period for 12 months where interest accrues but no DQs are reported for non-payment
- An updated Federal income-driven repayment plan will cause monthly payments to be lower for many borrowers when deferral ends

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Overview: Impact on other loans

- There are reasons to believe the SL repayment will cause severe issues
  - Across credit-risk scores, Student Loan ("SL") borrowers have taken on significant additional debt over the last 3 years
  - SL borrowers' delinquencies have been rising on other assets
  - SL borrowers perform worse on their other loans than non-SL borrowers
  - Servicing confusion:
    - 3.5 years of payment suspension and change of payment plans will lead to borrower confusion and unknown payment behavior across asset classes
    - Reduction in servicer capacity and the switching of servicers for many borrowers will likely result in increased borrower confusion
- But we explore mitigating factors from Equifax Ignite data that have not been investigated thoroughly in other recent industry analyses
  - The data suggests SL and non-SL borrowers took on similar amounts of increased debt during the pandemic, which is mostly explained by being younger and newer to credit
  - Other borrowers also took on additional debt during the pandemic
  - The uptick in delinquencies is similar to non-SL borrowers with similar credit scores
- Student Loans are higher in the payment priority than credit cards, but lower than other loans, suggesting the biggest impact may be to card portfolios

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Overview: How can Lenders Prepare

- Lenders should carefully monitor SL borrowers in their portfolio so that they can read and react
  - Develop the ability to determine whether existing borrowers and loan applicants have Student Loans that have been in deferral.
  - Evaluate the performance of those customers, normalized for months on book and risk score (FICO and/or internally-built risk models).
  - Monitor for SL payment behavior (e.g., changes in balances on their federal loans, payment behavior on their existing loans) and adjust policies accordingly
  - Incorporate student debt into DTI calculations when making underwriting decisions, including CLI programs – **taking the new SAVE Plan into account**
  - Maintain strong lines of communication with credit bureaus to get frequent status updates on the reliability of Student Loan tradelines during this transition period
- Lenders should expect short term challenges caused by servicer confusion on Student Loans
  - Enhance Collections through increased digital communications to handle a short-term surge and develop additional agent talk-offs for these borrowers

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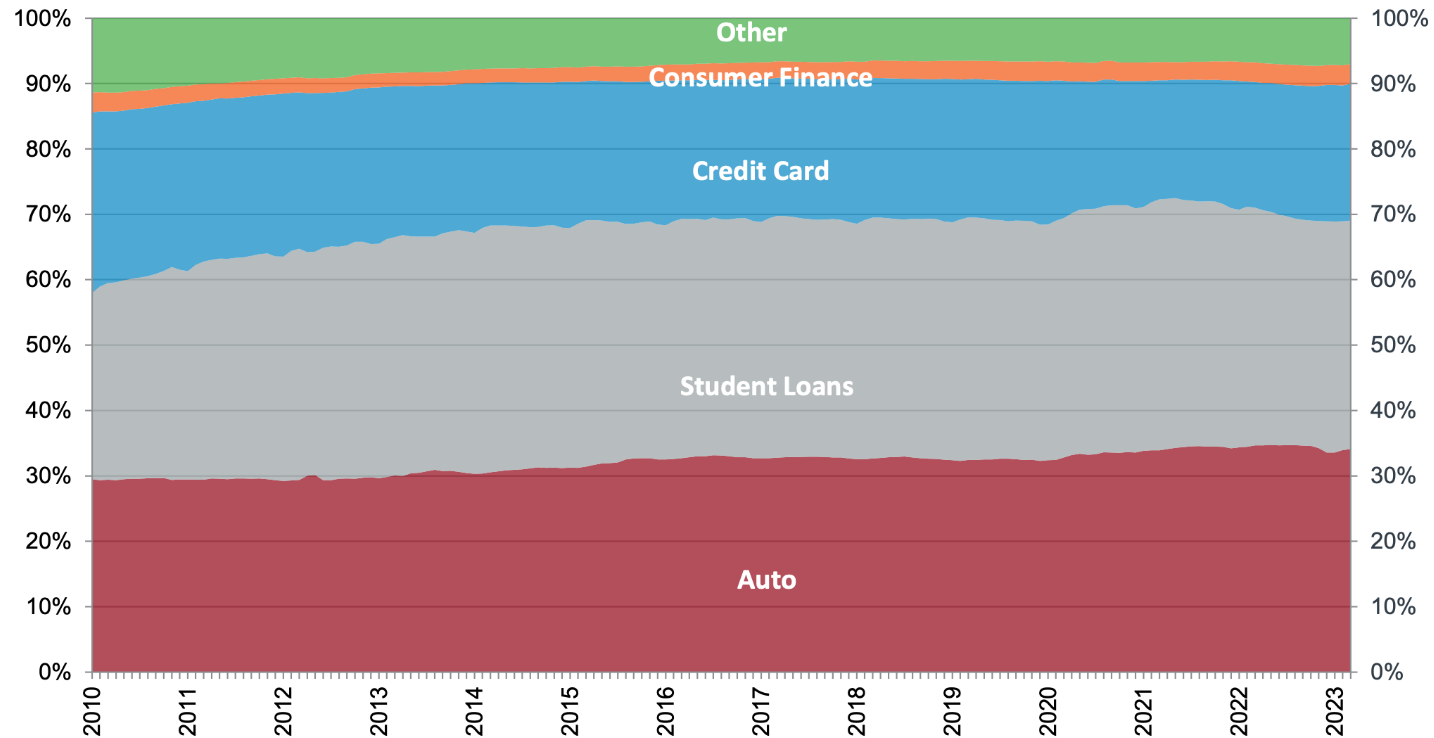
Student Loans are the largest source of U.S. household debt besides mortgages, totaling $1.75T

- 92% of Student Loans are federally backed, and most federal Student Loans have been in interest-free deferral since 2020



Source: Forbes

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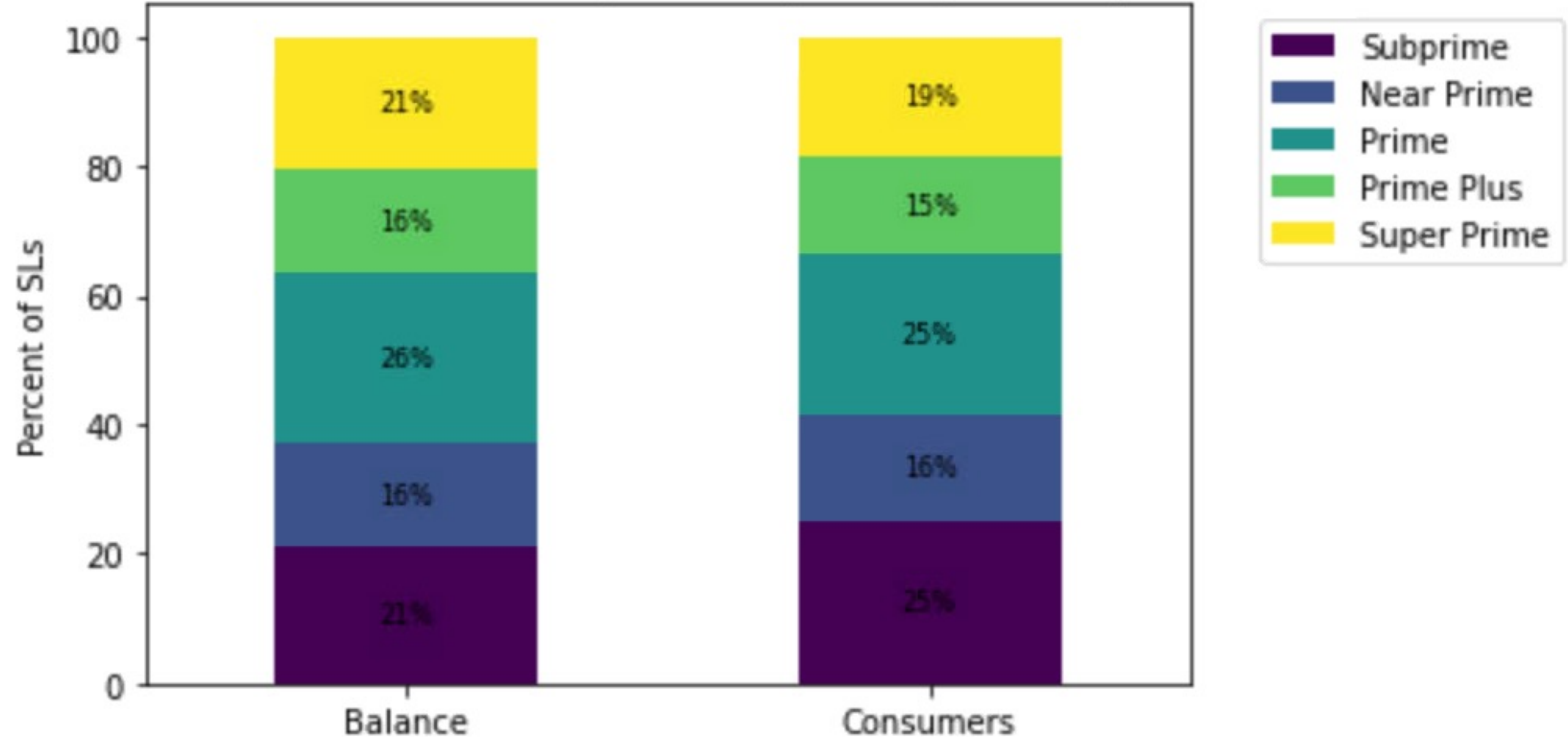
Approximately 43 million consumers have on average $37k in Student Loans. Borrowers with Student Loans skew subprime (25%)



Source: 2OS, Equifax Ignite

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Federal Student Loan payments were paused at the beginning of the pandemic

- Since the passing of the CARES Act in March 2020:
  - Federal SL borrowers have not been required to make payments towards their loan balances
    - This forbearance did not apply to ineligible loans: private Student Loans and Federal Student Loans which were originated prior to 2010 by private entities
  - Federal SL balances have not accrued interest
  - Collections activity on defaulted federal Student Loans has been paused

- 37 million federal SLs in interest-free deferral since March 2020 had DQ rates effectively at zero for 3 years

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When will payments on Federal Student Loans resume?

- Interest began accruing in September 2023
- Loan payments will be due in October 2023
  - Morgan Stanley Survey: 34% of SL borrowers say they will be unable to make payments when the deferral ends. 37% say they will need to cut spending in other areas.
- However, there will be a 12 month "on-ramp" to repayment

White House Fact Sheet

So that financially vulnerable borrowers who miss monthly payments during this period are not considered delinquent, reported to credit bureaus, placed in default, or referred to debt collection agencies

Source for MS information: Business Insider

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SAVE Plan: a new income-drive repayment plan will be phased in over the next year and will lower payments for many SL borrowers

2023

The amount of protected income will increase to 225% of the Federal Poverty Level (single borrower earning under $32,805 makes no payments)

Monthly interest that exceeds a borrower's new, lower payment under the SAVE plan will not be charged.

2024

Payments on undergraduate loans will be cut in half (from 10% to 5% of incomes above 225% of FPL)

Borrowers whose original principal balances were $12,000 or less will receive forgiveness after 120 payments (the equivalent of 10 years in repayment),
An additional 12 payments will be added for each additional $1,000 borrowed above that level, up to a maximum of 20 or 25 years.

Source: Department of Education

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Under the Save Plan, payments will be less than half of payments under previous income driven repayment plans

Estimated Monthly Payment Under the SAVE Plan

Income \ Family Size	1	2	3	4	5
$60k	$227	$130	$34	$0	$0
$50k	$143	$47	$0	$0	$0
$40k	$60	$0	$0	$0	$0
$30k	$0	$0	$0	$0	$0
$20k	$0	$0	$0	$0	$0
$10k	$0	$0	$0	$0	$0
$0	$0	$0	$0	$0	$0

Savings for a Sample Student Loan Borrower

ALEXANDER

ANNUAL INCOME: $38,000

LOAN BALANCE: $25,000

INTEREST RATE: 5%
on a Direct Subsidized Loan

Alexander is a borrower with no dependents and makes **$38,000** a year. He would save **$91** per month under the SAVE Plan.

$134
Previous Monthly Payment Under REPAYE

$43
New Monthly Payment Under SAVE

 Source: Department of Education

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Servicers have changed for a high percentage of Student Loan borrowers

- The CFPB estimates that 40% of Student Loan borrowers will have a new servicer when payments resume.
- While borrowers who are already on an income-driven repayment plan will be automatically switched to the SAVE Plan, many other borrowers will need to apply through their servicer.
- Servicers have had reduced work during forbearance, which suggests they have likely reduced staff, and that staff will have less experience with Student Loan plans
- Additionally, funding for Department of Education servicers has decreased
- These issues may cause confusion among borrowers around what payments on SL are due and what payment options are available, potentially causing borrowers to lower payments on other loans

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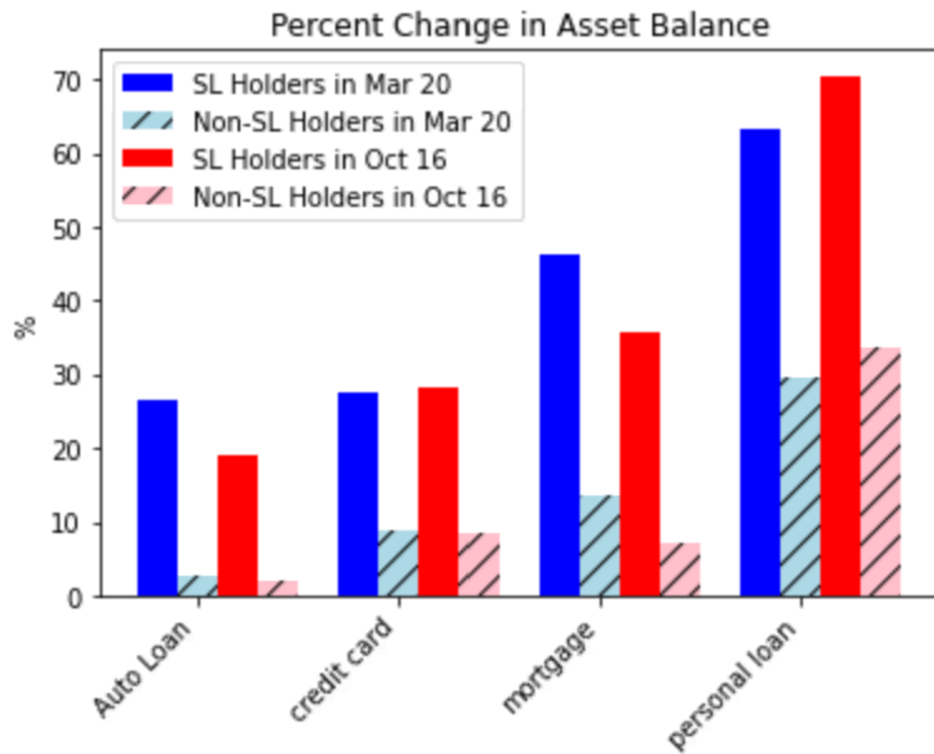
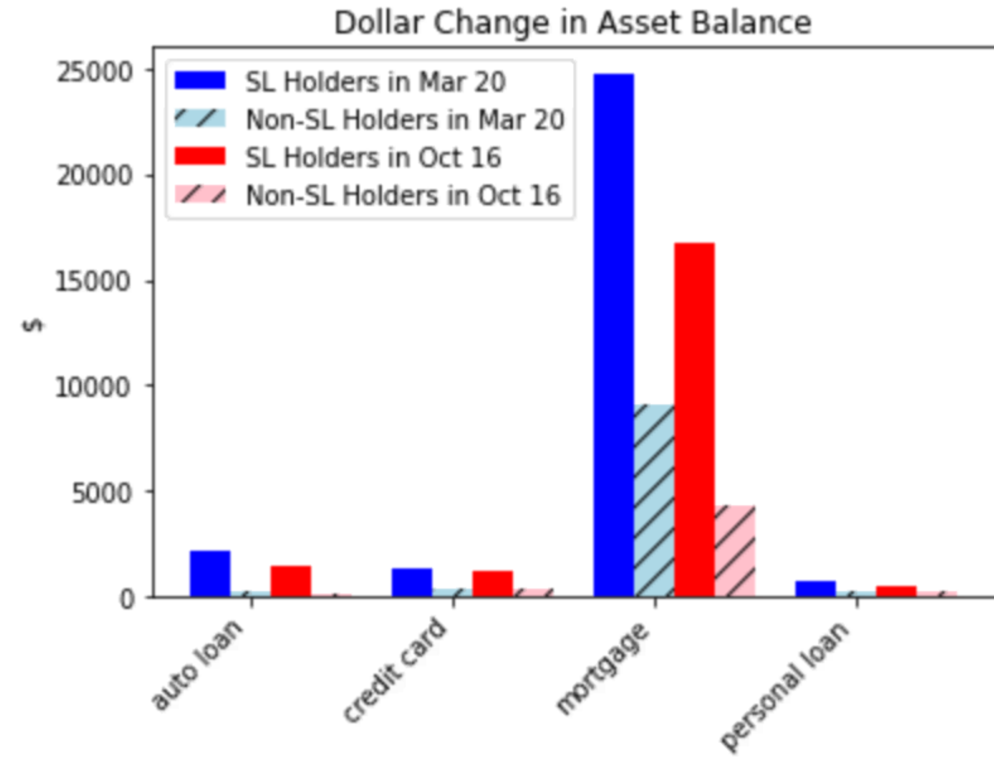
SL-borrowers took out more new debt than non-SL borrowers during the last 3 years, but the same is true of SL-cohorts from before the pandemic

Additional Debt Accumulated Over 3 Years: 2016-2020 and 2020-2023





Amongst asset classes, mortgage balances grew the most in both 3-year windows, likely reflecting inflation in the housing market rather than pandemic-particular trends.'

Source: 2OS, Equifax Ignite. Note: 39-month periods: October 2016-February 2020 and March 2020-June 2023

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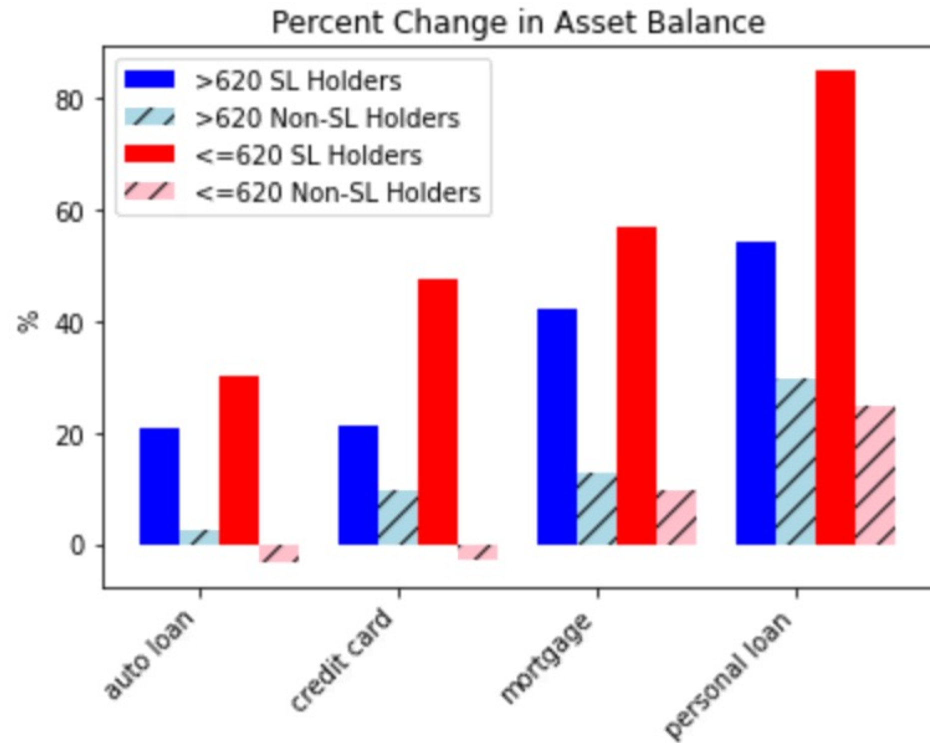
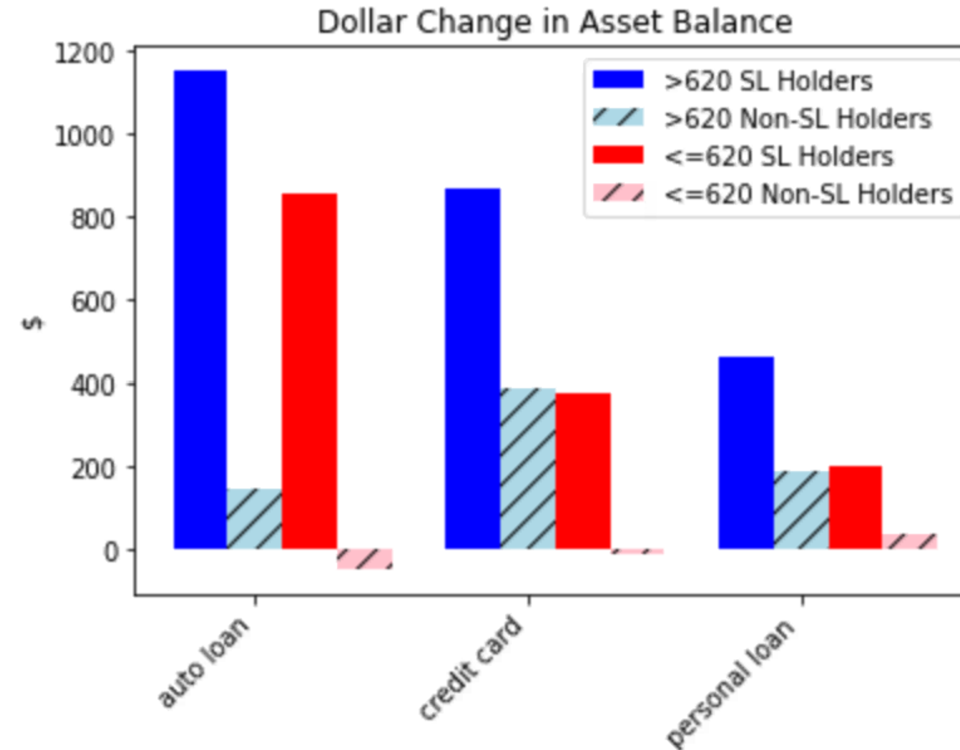
The riskiest SL-borrowers (Vantage <= 620) accumulated less dollars of debt than their higher-credit counterparts during the pandemic, but still more than non-SL holders

Change in Average Balance for Other Asset Classes by Vantage Score: March 2020-June 2023





Increased debt of SL borrowers is true across Vantage scores and suggests that the increase in payment burden due to the end of Student Loan deferrals could have a meaningful impact

Source: 2OS, Equifax Ignite

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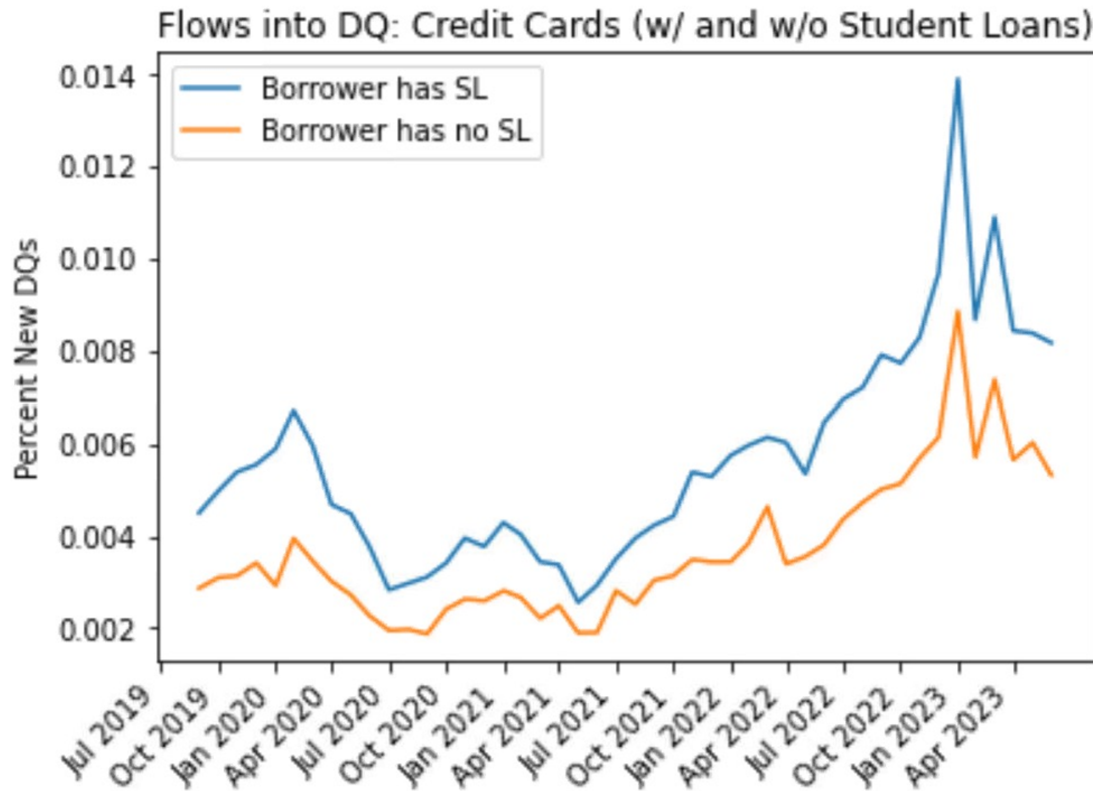
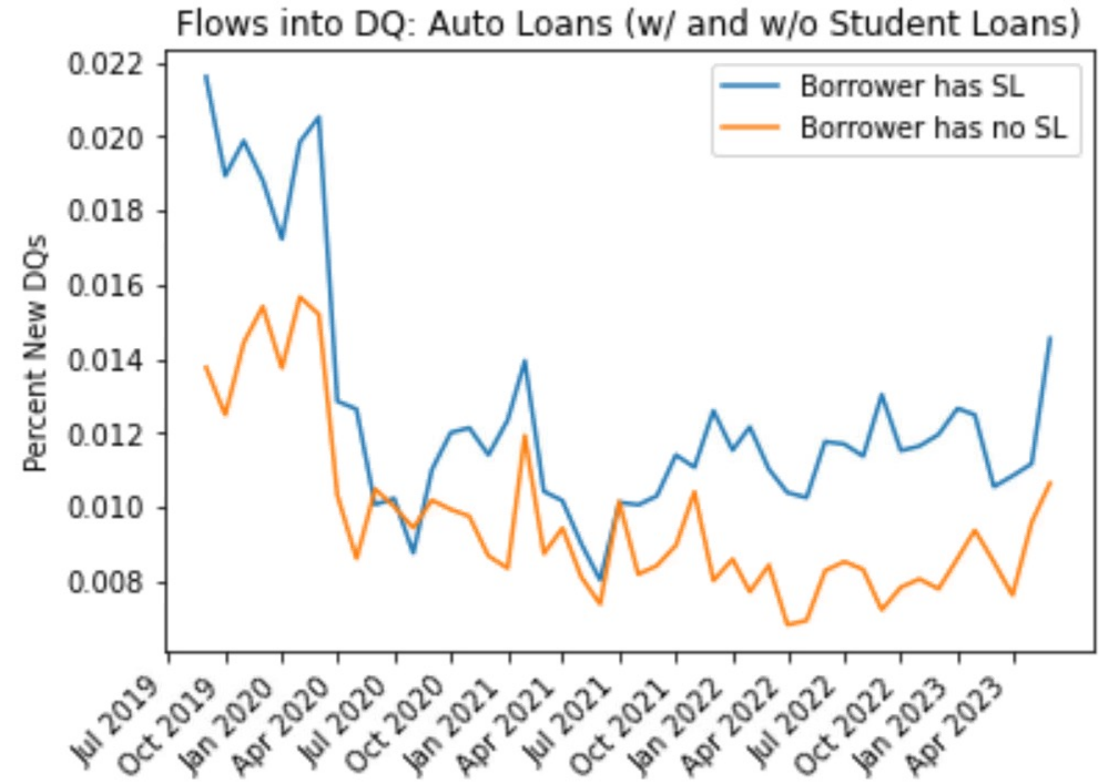
Pre- and Post-Covid Equifax data reveal an uptick in delinquencies across other asset types for Student Loan borrowers compared to non-Student Loan borrowers

New 30+ DPD Delinquencies August 2019-June 2023





Source: 2OS using Equifax Ignite. Note: "Borrower has SL" refers to an open Student Loan account status in June 2023

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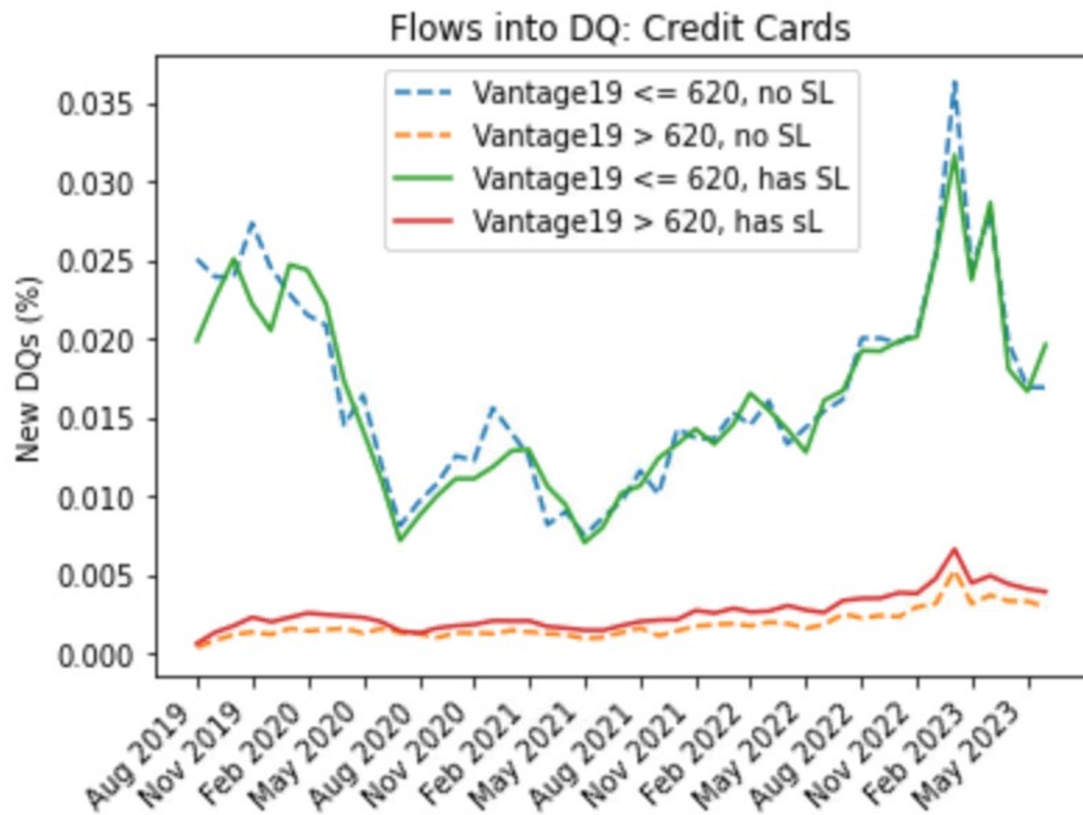
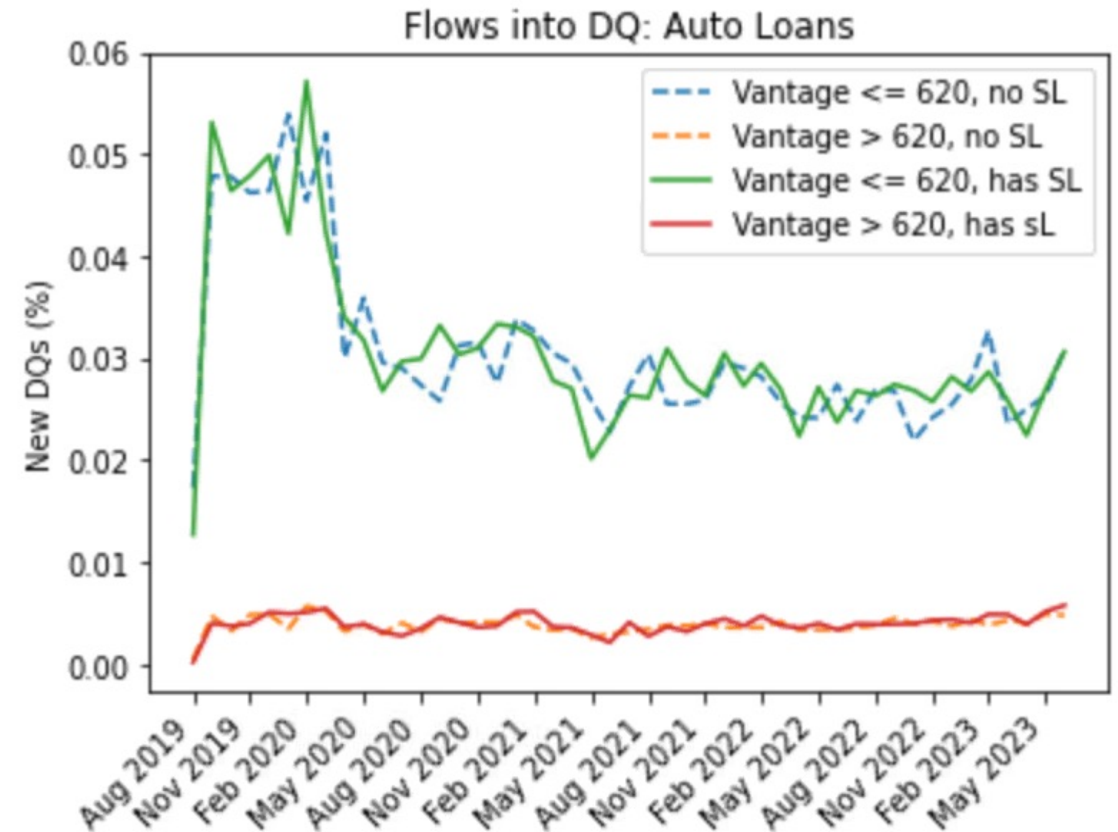
Controlling for risk score, Equifax data shows that high-risk borrowers have seen an uptick in DQ and that SL status has little additional impact

New 30+ DPD Delinquencies August 2019-June 2023





Source: 2OS, Equifax Ignite. Note: “Borrower has SL” refers to an open Student Loan account status in June 2023. Vantage Score from July 2019. Newly DQ signifies current in previous month.

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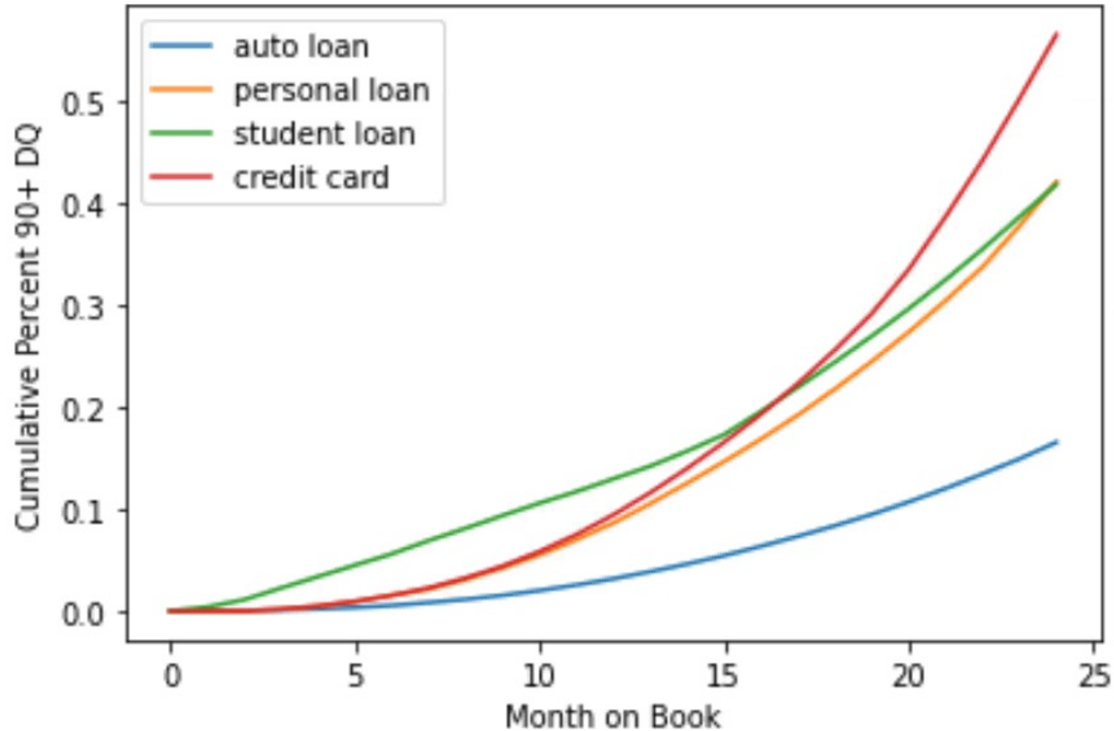
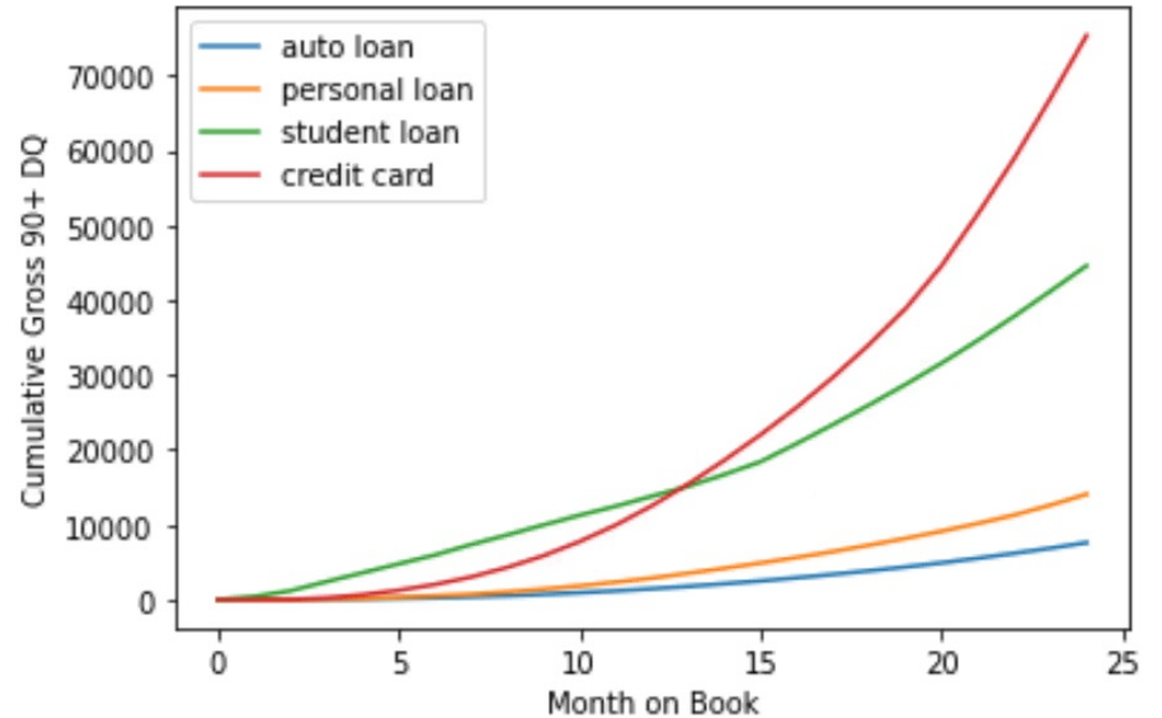
Equifax Data shows that Student Loans are ahead of credit cards in payment hierarchy, suggesting the end of Student Loan forbearance will most affect credit card repayment

Serious Delinquency for Borrowers with Many Asset Types: February 2018-2020





Source: 2OS, Equifax Ignite. Cohort includes a random sample of borrowers who had all 4 displayed loan types open in February 2018 and were current on their payments.

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The VCA & 2nd Order Solutions Value Proposition

Upcoming student lending developments may pose a threat to issuer profitability if loan repayments impact borrowers’ ability to pay other debts.

VCA and 2nd Order Solutions have a multi-year strategic partnership established to navigate our clients through ever-changing economic conditions, including the impact of resumption of Student Loan payments. VCA and 2OS bring a unique combination of data breadth, economic insights, and deep advisory expertise to drive better business decisions.”

Kate Manfred, SVP - Visa Consulting & Analytics, North America

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Credit Risk Models may be blind to the risk signal from Student Loan delinquencies once the deferrals end

Impact of Student Loan deferrals on credit risk models

- Given the Student Loan deferrals, risk models trained on the post Feb-2020 data are blind to the repayment risk signal of Student Loans.
- When training models, 2OS has seen Student Loan delinquencies and trades not show up in the top model features.
- In fact, several 2OS models picked up on credit bureau features that specifically excluded Student Loans. For example: 'Percent of trades excluding Student Loan trades 30+ DPD Delinquency in 6 months'.
- One such model had 4 out of the top 10 features with an 'excluding Student Loan' feature.
- Once the deferrals end and Student Loan delinquencies begin to rise, models trained on data from the last few years may be missing important risk signals of Student Loans or associated features.

What can lenders do

- Monitor performance and volumes of cohorts with Student Loans.
- Short-term: Add model overlays for blind spots.
- Long-term: Retrain models with updated data once the Student Loan delinquencies start to flow through so the model captures the risk.
- Stress test models with synthetic data to ensure the model captures the risk signal of increased Student Loan delinquencies.

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What should lenders for other asset classes expect?

- While there are some mitigating factors, lenders should still expect new payments to have significant impact on the portion of their portfolios that also have Federal SL, at least during the initial confusion period
- The upcoming payment shock is likely to cause Student Loan borrowers stress making their payments on other loans, but the reduction in payments due to Save Plan and other forgiveness should lessen the overall impact over time
- Lenders should expect, due to payment hierarchy, that delinquencies will be most likely to increase, especially for credit card, when repayments resume
- Student Loan borrowers may prioritize their other loans during the “on-ramp” period, ending in October 2024, minimizing the short-term impact

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What should lenders for other asset classes do?

- Develop the ability to determine whether existing borrowers and loan applicants have Student Loans that have been in deferral.
- Lenders should monitor Student Loan bureau balances, if still available, once forbearance ends to determine which borrowers are not making payments and should ensure credit policy considers the increased risk
- Evaluate the performance of those customers, normalized for months on book and risk score (FICO and/or internally built risk models).
- Incorporate student debt into DTI calculations when making underwriting decisions, including CLI programs – **taking the new SAVE Plan into account**
- Maintain strong lines of communication with credit bureaus to get frequent status updates on the reliability of Student Loan tradelines during this transition period

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- Our data scientists are experts in statistics, advanced analytics, and machine learning, with exclusive access to insights from VisaNet, one of the largest payment networks in the world.
- Our economists understand economic conditions impacting consumer spending and provide unique and timely insights into global spending trends.

The combination of our deep payments consulting expertise, our economic intelligence and our breadth of data allows us to identify actionable insights and recommendations that drive better business decisions.

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