Student Aid Policy Analysis

Improving Borrower Satisfaction and Compliance by Adopting a Better Communication Strategy

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EXECUTIVE SUMMARY

A review of lender correspondence and other communications with borrowers of federal and private student loans, including both the FFEL and Direct Loan federal education loan programs, demonstrates a variety of serious flaws in the timing, design, coordination, clarity and information content of letters from lenders to borrowers. Simple questions, such as how much the borrower currently owes on their loans or why the monthly payment changed, cannot be answered by most such correspondence. This contributes to borrower distrust and dissatisfaction with their education lenders. Few lenders appear to have developed or implemented any kind of a deliberate and carefully-crafted communications strategy. Lenders who adopt a better communications strategy will experience significant improvements in borrower satisfaction and significant reductions in delinquency and default rates. Even simple tweaks to the letter templates can have a big impact at little or no cost.

OPTIMIZING BORROWER COMMUNICATIONS

Borrowers do not trust lenders, especially when the loan statements are confusing and inconsistent. Many borrowers also do not understand how student loans work, such as the nature of loan amortization or interest capitalization, and often have no confidence in the accuracy of the amount owed or the monthly payment. A history of lender problems, such as errors in loan amortization calculations, a failure to approve mandatory deferments and incorrect or delayed crediting of payments, contributes to this distrust. When borrowers encounter financial difficulty, they are less likely to repay bills they don't understand. Optimizing the timing, content, coordination, clarity and design of borrower communications will help borrowers understand their loans and reduce opportunities for confusion. This will improve borrower satisfaction with their lenders. Few borrowers will ever love their lenders, but a better communication strategy will help build a non-negative relationship with borrowers. This, in turn, will improve borrower compliance with the terms of their loans, reducing delinquency and default rates.

Some students misunderstand the terms of their student loans. Variable interest rates, such as LIBOR + 6% or PRIME + 6%, are often misinterpreted as 6% fixed interest rates, causing confusion and anger when the interest rate increases. Interest rates are not tangible to borrowers in the same manner as monthly payments and total payments over the life of the loan.

Borrowers also do not understand interest capitalization. They do not understand that extended periods of nonpayment cause big increases in the loan balance and they are surprised when the loan balance at graduation is much higher than the amount they originally borrowed. For example, interest capitalization causes the loan balance at graduation to be about 18.5% to 23.0% higher than the amount originally disbursed for typical borrowers of federal education loans.[1] For typical borrowers of private student loans, interest capitalization causes the loan balance at graduation to be about 25% to 45% higher than the amount originally borrowed.[2] When the borrowers see such a big jump in the amount owed, they feel that the lender is deceiving and cheating them.

Most borrowers do not understand how interest and loan amortization works. The following quiz question from the CollegeGold.com web site has tested understanding of loan amortization for the past four years.[3]

What is the total amount repaid on a $10,000 loan with a 10-year term at 10% interest?

A. $1,000
B. $11,000
C. $15,858
D. $18,100
E. $20,000
F. $32,479

This is a multiple choice question, so guessing will pick the right answer about one sixth of the time (16.7%). But only 18.6% of respondents to date have chosen the right answer, barely better than a random guess. The correct answer isn't even the most popular answer. This result is not surprising, given that loan servicing staff, college financial aid administrators, CPAs and CFPs choose the right answer at about the same rate. Only mathematicians seem to choose the correct answer more often than a wrong answer.

Curiously, specious reasoning sometimes plays a role in a prospective borrower's evaluation of different loan options. For example, many students seem to become more cautious when the total interest paid over the life of the loan exceeds the amount borrowed. They explain that this is because they are paying back more than they borrowed. But any loan that charges interest involves paying back more than the amount borrowed.[4] Somehow the students don't draw this distinction, focusing in on the interest as opposed to the total payments. The total interest paid exceeds the original loan balance at a 15.9% interest rate for a level 10-year repayment term, a 10.6% interest rate for a 15-year term, an 8.0% interest rate for a 20-year term, a 6.4% interest rate for a 25-year term and a 5.3% interest rate for a 30-year term.

Confusion over loan terms contributes to an unwillingness of borrowers to evaluate loan tradeoffs. Many say that they will sign whatever is put before them if it enables them to pursue their dream of a college education. They figure that they'll worry about how to pay back the debt after they graduate. Since borrowers do not consider the consequences of incurring so much debt, they often treat loan limits as targets, borrowing more than they need to pay for the education, borrowing without restraint.

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[1] The 18.5% figure assumes that the student borrows to the limit on the unsubsidized Stafford loan at 6.8% interest with two disbursements per year. The 23.0% figure assumes that the student borrows an equal amount of PLUS loans each year at 7.9% interest with two disbursements per year.

[2] These figures assume that the student borrows an equal amount of private student loans each year with average interest rates of 8.5% to 14.0%.

[3] www.collegegold.com/quiz

[4] Careful dissection of the borrower's reasoning demonstrates that the focus really is on paying back more than what was borrowed, not having the cost of the loan exceed the amount borrowed.

A better communications strategy will address these issues by focusing on the content, organization, design, clarity and timing of communications with borrowers. It will address the following questions:

- What information should be included in the correspondence?
- How is this information presented to the borrower?
- When is each type of correspondence sent to the borrower, and with what frequency?
- How are the various communications coordinated?
- How can the clarity and effectiveness be improved?
- How is the clarity and effectiveness of the communication evaluated?

Testing Communications

A key part of any communications strategy is a method for evaluating the effectiveness of the strategy through measurable outcomes. This requires establishing an optimization framework, where incremental improvements are continually tested. One must run periodic experiments to test a variety of possible approaches. The experiments must be randomized and prospective to permit comparisons of effectiveness among test and control groups without the possibility of selection bias. The most effective solutions may then be scaled up to be applied to all borrowers. Small, ineffective programs should be eliminated.

The first step in developing a communications strategy is to solicit feedback and suggestions from a random sample of borrowers. This will help generate ideas for improving the quality of communications. Often within any problem lurks a creative solution. So a key aspect of surveying borrowers for ideas to improve communications is to ask them about the problems they've experienced.

Next, the proposed solutions should be evaluated internally against a set of test cases. For example, communication templates should be tested against every major type of borrower:

- Borrowers who have just one loan and borrowers who have multiple loans
- Borrowers with different loan statuses, such as borrowers who are in an in-school deferment, borrowers in the grace period, borrowers in repayment (both borrowers who are current and borrowers who are delinquent), and borrowers who are in various deferments and forbearances
- Borrowers with different repayment plans, such as standard, extended, graduated and income-based repayment
- Borrowers with different types of loans, such as Stafford loans (subsidized, unsubsidized), Parent PLUS, Grad PLUS, Consolidation, Private Student Loans, Perkins
- Borrowers with different repayment behavior, such as borrowers who are using auto-debit and borrowers who are not
- Borrowers who are making interest payments during the in-school and grace periods instead of capitalizing it
- Borrowers with different amounts of debt
- Married borrowers and single borrowers

Staff should put themselves in the mindset of the borrower and read the instantiated templates, seeing if there's anything that is confusing, anything that doesn't make sense. A variety of staff should read the communications, looking for inconsistencies and other problems.

Also ask whether the letter has enough information to answer a list of basic borrower questions. For example, try to calculate the original amount borrowed and the current amount owed from each letter. Identify a list of basic borrower questions based on call center and email statistics. Addressing these concerns in the communications can reduce the call volume and improve borrower satisfaction by helping them answer their questions on their own with less frustration. It also avoids the need for them to call during normal business hours; many students like to get instant answers on their own schedule.[5]

Next, use A/B testing with test and control groups of borrowers to evaluate the various communications strategies. Each strategy can be tested with a different independent set of borrowers. One should generally start off with a small set of strategies for comparison, to ensure that the results are statistically significant. If there are more strategies, one can use multivariate testing and similar approaches to evaluate them simultaneously. Before launching a full-scale evaluation, it is best to pre-test the strategies with a small group of borrowers to identify any flaws. Often one doesn't identify a problem with a proposal until after it is implemented, so pre-testing can help catch these problems before full-scale testing, avoiding the need to retest after a problem is discovered.

Evaluate communications according to effectiveness based on outcomes, such as the percentage of borrowers who are delinquent or in default and the distribution of borrowers according to repayment plans and other repayment options. Also evaluate the communications according to clarity, borrower satisfaction and compliance. Additional measures of borrower compliance include the number of days a payment is received before or after the due date and the use of auto-debit. One could also have a quarterly borrower satisfaction survey, to permit longitudinal tracking of general improvements in performance.

Content of Communications

Communications should be borrower-centric, not loan-centric. This requires coordinating (or combining) multiple loan-specific letters. Letters should be personalized and specific to the borrower's loans. For example, if the borrower's monthly loan payment has changed, the letter should explain why *this* borrower's payment changed, not just a generic list of reasons why payments sometimes change.

Math should add up, especially the breakdown of the current balance into its components. Extraneous figures should be omitted, as they can be a source of confusion. For example, listing the principal balance and accrued but unpaid interest separately, as opposed to a single figure for current balance owed, often leads to borrower complaints that the principal balance is not decreasing. The total debt is decreasing, but lenders usually apply payments first to accrued but unpaid interest before reducing the principal balance.[6] In such a situation the itemization of the principal balance makes it look like the borrower is not making any progress in paying off the debt, despite real progress in reducing the amount owed.

[5] It would be helpful to create a self-service trouble-shooting guide for solving problems that students can use to solve their own problems 24/7, especially during evening and weekend hours.

[6] Usually there is no difference between the principal balance and the accrued but unpaid interest in regards to the cost of the loan. So drawing a distinction between the two merely creates an opportunity for confusion. However, there are certain repayment plans like income-based repayment where the accrued but unpaid interest is not capitalized, meaning that there is no interest charged on the accrued interest. Likewise, if a borrower makes an extra payment on their loan, they usually want to have it applied to reduce the principal balance on unsubsidized loans, not the principal balance on subsidized loans. So sometimes the disaggregation of the debt outstanding into principal and interest figures is necessary. But usually it is just a source of confusion.

The content of the letters should be streamlined, eliminating unnecessary information. Educators often complain that students don't read their mail. But it is easy to miss an important communication when you are inundated with an avalanche of unimportant mail. Before sending any communication to a student, ask whether the mail is important to the student, not whether it is important to the sender. When in doubt, leave it out. Make every word count. Get to the point without wordiness.

Multiple disclosure requirements can add significantly to the length of a letter. These disclosures should be prioritized, so that the most important disclosures appear first. Disclosures regarding costs should appear before disclosures regarding privacy because costs matter more to most borrowers.

Letters should be narrowly targeted at only the borrowers who are affected. For example, annual letters concerning changes in variable interest rates on federal student loans should be sent only to borrowers with variable interest rates. Not only will this save a lot of money, since very few borrowers still have variable interest rates on their federal loans, but it avoids confusing current borrowers who wonder why they aren't eligible for the new interest rates.

<u>Standard Elements of Loan Letters</u>

There are certain basic pieces of information that should be included in every communication to a borrower. The bottom of every letter should include a summary of all of the borrower's loans, such as the loan id, the date disbursed, the loan status and repayment plan, the interest rate, whether the interest rate is fixed or variable, the loan term, and the current balance. The letter should also include the total amount originally borrowed, the loan balance at repayment and the current amount owed.

Including an indicator of the borrower's on-time payment status (the percentage of payments received by due date and the average number of days late) may encourage borrowers to make their payments on time. Since payments are credited on the date received, borrowers who are habitually late increase the cost of the loan by adding a few days extra interest. For example, a borrower who is a week late on every payment on a $10,000 loan with a 10-year term and 10% interest adds $52 in extra interest over the life of the loan, almost two-fifths of a payment.

Every borrower communication should include the phone number, email address and web sites for the servicer and for complaints (the ombudsman). The communications should also summarize the repayment plan, deferment, forbearance and discharge options, and other important borrower rights.

It would also be helpful if the loan statements included a progress bar showing the number of monthly payments remaining (expressed in years and months) until the debt is paid in full. This will give borrowers a sense of their progress in repaying the debt.

<u>Design of Communications</u>

Put the most important information up front and center in a monthly statement or other communications, perhaps in a box at the top right of the page, where borrowers look first. This includes action items, deadline dates and the amount due.

Use a standard layout for every letter. Consistency in the design helps borrowers know where to look for particular pieces of information.

Always include a date on the letter. It is helpful to include a letter identification number that can be used to retrieve the letter and related data. Thus, if a borrower calls about a letter, the call center staff will be able to look at the same letter as the borrower, supplemented with data to answer common questions.

Do not use cryptic abbreviations ("Sub Staf") or terminology ("LIBOR") without defining them somewhere on the letter, such as a footnote or glossary.

Use at least 9 point type to ensure that the letter is readable even if faxed or photocopied.

Timing of Communications

Create a master calendar of communications with borrowers, from the date of the borrower's first inquiry to the date the borrower's loans are paid in full. This should include the following:

- A welcome letter with basic contact information and loan details upon first disbursement
- Annual or once-a-semester statements during the in-school period will help avoid surprises at graduation (e.g., changes in variable interest rates, capitalization of interest) and minimize overborrowing (e.g., show the current total balance and the corresponding monthly payment)
- Letters should be sent at least a month in advance of important status changes, such as graduation, entering repayment and the end of deferment or forbearance
- Letters should be sent with any change in the monthly payment amount or repayment plan

Counseling that Works

Communications with borrowers should be personalized with their loan amounts and actual monthly loan payments. It is helpful to include the total interest paid and total payments over the life of the loan, especially if total interest exceeds the amount borrowed.

Use rules of thumb that involve simple comparisons, not calculations. Good rules of thumb include "Do not borrow more than your expected starting salary for your entire education", "Every $1 you spend in student loan money will cost you about $2 by the time you pay off the debt, so ask yourself if you'd still buy the item at twice the price" and "Do not borrow more than $10,000 for each year of college". These are simple, easy-to-remember rules that do not require any interpretation. Comparisons, not calculations. An example of a bad rule of thumb is "The debt-service-to-income ratio should be less than 8%." Not only does this require calculating the monthly payment, but it also requires calculating a percentage.

Another key problem is the lack of financial literacy training. Colleges should require every incoming student to undergo a financial literacy mini-course as part of orientation. Good textbooks include Beth Kobliner's *Get a Financial Life: Personal Finance In Your Twenties and Thirties* and Suze Orman's *The Money Book for the Young, Fabulous & Broke*.[7] These books present an introduction to basic money management and financial literacy for college graduates. They teach 20- and 30-somethings how to understand and manage their money, discussing how to set priorities, budgeting, credit cards, ATMs, getting out of debt, renting an apartment, buying a car, buying a house, insurance, saving money, investing, taxes and saving for retirement. This will lead to better borrowing decisions during college.

[7] Other good books are reviewed at www.fastweb.com/financial-aid/articles/2733-best-money-books-for-new-college-graduates.