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California Department of Business Oversight Sues Student Loan Servicer PHEAA/FedLoan

SACRAMENTO – Challenging industry claims that federal student loan servicers are largely exempt from state regulation, the California Department of Business Oversight (DBO) has filed a lawsuit to force the nation's second largest student loan servicer to comply with California's law to protect the state's 4 million student loan borrowers.

The lawsuit, submitted April 1 to the San Francisco Superior Court, requests an order requiring student loan servicer Pennsylvania Higher Education Assistance Agency (PHEAA), better known as FedLoan Servicing, to produce documents that detail the company's administration of a mismanaged grant program for teachers.

"There can be no serious dispute that California has a compelling interest in protecting its student borrowers from poor servicing practices. These students comprise California's future and we cannot sit idly as struggling, well-meaning students fall further into default because of shoddy servicing," DBO Commissioner Manuel P. Alvarez said. "In the absence of any meaningful federal oversight, state regulation of student loan servicers is essential."

The grant program, known as the Teacher Education Assistance for College and Higher Education or TEACH program, has been the subject of servicer abuse since its inception in 2008. Federal audits found that student loan servicers given exclusive franchises to run the grant program were improperly converting thousands of the grants to student loans, which are much more profitable to service.

The TEACH grants have been administered since 2012 by PHEAA, which services more than $35 billion in student loans for more than 900,000 Californians. Californian's 4 million student loan borrowers owe more than $141 billion, or an average of $37,500 each.

Under California's 2016 Student Loan Servicing Act, the DBO began an examination of PHEAA in January. As part of the exam, the DBO repeatedly requested student and other records that would allow the DBO to determine whether PHEAA improperly converted TEACH grants of California teachers to loans. Improper conversions of the grants have in some cases added tens of thousands of dollars to individuals' student debt.

PHEAA has refused to provide the records, contending California's law is pre-empted by the federal Higher Education Act. PHEAA also contends the records are owned by the U.S. Department of Education (DOE) and cannot be released under the federal Privacy Act of 1974.

In 2012, the DOE granted PHEAA an exclusive contract to administer the TEACH grant program. Grant recipients are required to satisfy a specific set of eligibility criteria that includes teaching a minimum number of years in a low-income community. If recipients are later found to have failed to meet all the criteria, the grants are converted to federal loans.

Severe mismanagement of the TEACH program by PHEAA and an earlier servicer caused more than 10,000 teachers who had otherwise satisfied the obligations to have their grants erroneously converted to loans with back interest, a U.S. Government Accounting Office report found.

Notably, PHEAA had a significant financial incentive to convert the grants to loans. The servicer earned more than two times as much to service student loans as it did to service the grants. And when a grant recipient fulfilled all the requirements, PHEAA would no longer be paid anything for that person.

In December 2018, amid pressure from the media, advocacy groups, and federal lawmakers, the DOE announced a TEACH Grant reconsideration program for those who had grants erroneously converted into loans. But, in a bewildering move, the DOE left PHEAA in charge to administer the reconsideration process with no other checks or oversight, the lawsuit states.

"The federal government's lack of accountability and oversight in … the TEACH Grant program is not anomalous," the DBO lawsuit argues. "It has been regularly documented that there is lax oversight and no consistent or market-wide federal standards for student loan servicing, and servicers have had wide discretion to determine and implement their own policies, much to the detriment of student loan borrowers."

Nationwide, student loan debt exceeds $1.5 trillion and is the fastest-growing category of consumer debt. PHEAA services some 25 percent of federal student loans.

The DBO licenses and regulates financial services, including state-chartered banks and credit unions, student loan servicers, money transmitters, securities broker-dealers, investment advisers, non-bank installment lenders, payday lenders, mortgage lenders and servicers, escrow companies, franchisors and more.

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