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Student Loans for Higher Education

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Requested by Assemblymember Sally Lieber

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EXECUTIVE SUMMARY

Student loans are a rapidly growing \$85 billion a year industry fueled by the substantial higher economic returns associated with a college education, increased demand from students and their parents, and grant and scholarship funds that have not kept pace with rising school tuition and fees. This report describes federally subsidized and guaranteed loans, examines the private student loan industry, and discusses issues relating to student debt and financial counseling. We describe practices that have led to allegations and findings of fraud and abuse in the student loan system, and recent federal and state legislative and administrative responses. The report was requested by Assemblymember Sally Lieber in order to better understand the national student loan scandal and responses to it.

The focus of this report is on federally subsidized and guaranteed student loans and private student loans. California offers a number of grant programs but does not have a state-funded student loan program. However the state's guaranty agency, the Student Aid Commission, has an auxiliary nonprofit organization, EdFund, through which it administers the federal loan program. A wide range of federal financial aid programs -- from Pell Grants to student loans to work study -- provide billions of dollars in assistance to California students each year. Application procedures are complex and the diversity of federal grant, loan and work study products can be confusing for students and parents. One purpose of this report is to succinctly describe key elements of these programs.

Student loans are increasingly important to financing the escalating costs of higher education. Over time, there has been a significant shift from federal needs-based grants and subsidized loans to guaranteed (but not subsidized) loans and tax credits that assist middle class students. The recently enacted *College Cost Reduction and Access Act* increases funding for Pell Grants and limits interest rates and loan repayment terms for federally subsidized and guaranteed loans. Funding comes from reduced federal subsidies to lenders (\$19 billion) and state guaranty agencies (\$4.5 billion) of \$22.3 billion over the next five years.¹

The student loan industry is growing rapidly and is very profitable. Sallie Mae, the largest student loan lender, was created by the federal government in 1972, as a "government sponsored enterprise," and authorized by Congress in 1997, to privatize its operations. It has an estimated 12,000 employees in 19 states and manages \$142 billion in student loans.² According to an August 2007 article in the *Economist* magazine, Sallie Mae's recent five year average return on equity was an "astonishing 52% a year."³ However new federal legislation reducing federal lender subsidies, and the tightening credit market, have resulted in a decline in the company's stock price and the contested withdrawal of a \$25 billion purchase offer.

Private loans, which are increasingly made directly by lending institutions to borrowers, account for a quarter of all student loans. Private loans are more than twice as profitable for lenders as federally subsidized and guaranteed loans. The loans have higher and variable interest rates and can result in substantial student debt that cannot be discharged in bankruptcy. Sallie Mae is the largest lender, but many of the nation's largest banks are

also important lenders, including Citibank, the second largest lender of student loans, Bank of America, Wells Fargo, and others.

Recent investigations by Congress and the Attorney General of New York have found “...troubling, deceptive and often illegal practices... involving lenders, educational institutions and financial aid officials.”⁴ In addition, federal oversight of the student loan industry (by the U.S. Department of Education) has been deemed insufficient by the General Accountability Office (GAO).

The State of New York has enacted legislation that prohibits illegal inducements such as lender payments to schools in exchange for placement on preferred lender lists, forbids conflicts of interest among university and college student aid officials (through stock options, large gifts, etc.), and requires schools to disclose all financing options available under federal law as well as the criteria used to compile preferred lender lists. The U.S. Department of Education has also tightened up regulations. Both the University of California and the California State University system have instituted new policies regarding school relations with lenders and conflict of interest requirements for financial aid officials.

New York Attorney General Andrew Cuomo has called private lending “the Wild West of the student loan industry,” and noted that many graduates owe as much if not more than most homeowners owe on mortgages.⁵ He has suggested that the legislative reforms enacted for federal student loans should be applied to private student loans, and pointed out the similarities between subprime mortgage lending industry practices and some private student loan industry practices. These include a lack of clear consumer disclosure requirements, instant credit, variable interest rates that compound (making it difficult to pay off the principal), packaging and reselling of loans on the secondary market, and lender kickbacks to loan originators to steer business to them. Although the state’s scope of action is limited for federally regulated banks, the California Department of Corporations is responsible for enforcing regulations to protect the public from fraud at state-chartered financial institutions.

Misleading lending practices in the private student loan market are a particular concern. We give the example of a University of California graduate student who was marketed a private student loan by a bank when she signed up for a checking account. She understood she was receiving a loan with a much lower interest rate and favorable repayment options. When the first bill arrived, she found she had a loan with a 14.5 percent interest rate loan that compounds daily, leaving her with unmanageable debt.

California postsecondary students are less likely to receive needs-based Pell Grants and federally subsidized and guaranteed Stafford Loans, and may consequently be more reliant on expensive private student loans, suggesting the need for more aggressive financial aid counseling by colleges and universities, the Student Aid Commission and its auxiliary, EdFund.

The increasing level of debt is an important concern for students who find their career choices and life options constrained by debt. It is also a concern for policymakers because lower-paid public service occupations such as teaching do not offer salaries that

can support large loan repayment obligations. In 2006, the average debt of graduating seniors in California public four-year colleges was \$17,200, and 47 percent of the graduates were in debt.⁶ Borrowing was highest among students attending private four-year and for-profit schools.

A higher percentage of students attending for-profit proprietary postsecondary schools take out student loans: 80 percent took out a federal loan in 2003-04, and 15 percent took out a private loan (compared to 52 percent and five percent respectively of students at public four-year schools). These students are disproportionately from low income families, 26 percent of which earned less than \$20,000 in 2006.

The U.S. Department of Education reports that a disproportionate amount of school fraud and abuse in the student loan program involves proprietary schools. In California, 2,280 claims to the Student Tuition Recovery Fund have been generated since 2001, due to the closure of 49 proprietary schools. Students may be left with sizeable loans, above and beyond any tuition recovered from the state fund, when a school closes. The fees collected by the schools for originating those loans may be substantial.

Counseling and consumer protections, similar to those enacted in some jurisdictions to assist home buyers, might help protect students and their parents. Undergraduate and even graduate students are often not sophisticated borrowers and may agree to loan terms they do not fully understand. They may also not realize that they have the option of less expensive federally subsidized and guaranteed loans. Impartial information and personal counseling for students and their parents are critical to helping secure the most advantageous funding available. This is an important function of school financial aid offices.

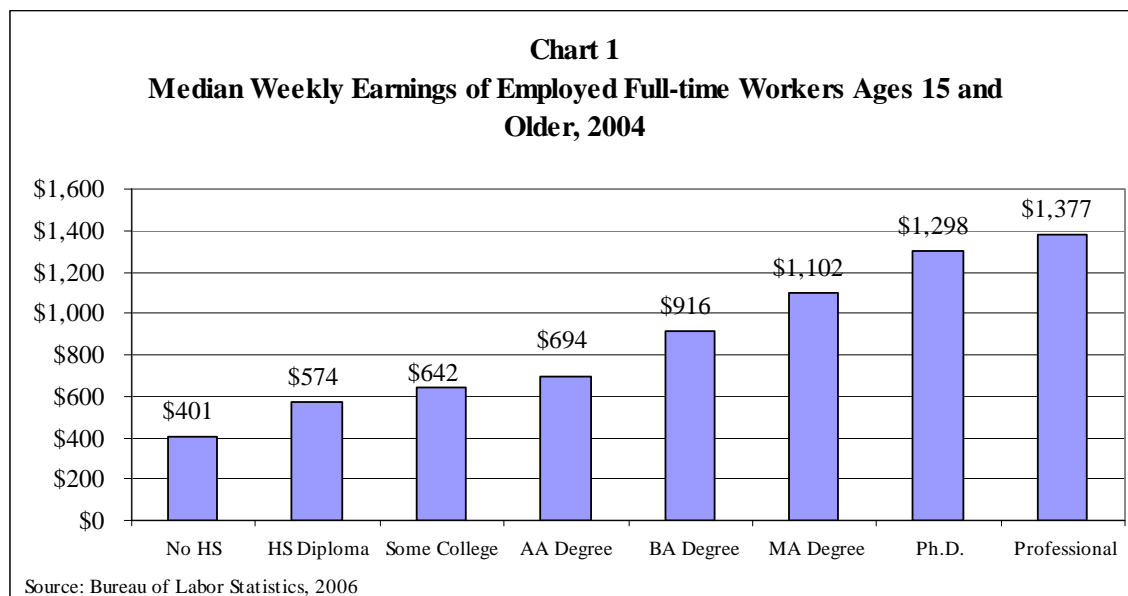
INTRODUCTION

A high school senior anywhere in this great land of ours can apply to any college or any university in any of the fifty states and not be turned away because his family is poor.

President Lyndon B. Johnson, at the signing of the *Higher Education Act* November 8, 1965.

President Johnson's aspirations for the federal student grant and loan programs created by the *Higher Education Act of 1965* are challenged to meet the greater needs and demands of students today. A college education has become a nearly essential component of the modern version of the American dream and a middle class lifestyle. Individual and societal economic well-being depends significantly on educational attainment.

In 2005, "...the typical full-time year-round worker in the United States with a four-year college degree earned \$50,900, 62 percent more than the \$31,500 earned by the typical full-time year-round worker with only a high school diploma."⁷ The significant differences in earnings between workers with less than a college degree and those with a college degree is shown in Chart 1.⁸



According to the California Postsecondary Education Commission, Californians experience greater income rewards for earning a bachelor's degree compared to people in similar states such as New York, Washington, Massachusetts and Florida. The Commission estimates that:⁹

- On average, just having some college adds 25 percent to earnings
- Compared to a high school level education, an associate degree increases income by 47 percent, a bachelor's degree by 108 percent, and a graduate or professional degree by 189 percent.

Society as a whole benefits when more individuals have college degrees. As estimated by the CollegeBoard:¹⁰

...a 1 percentage point increase in the proportion of the population holding a four-year college degree leads to a 1.9 percent increase in the wages of workers without a high school diploma and a 1.6 increase in the wages of high school graduates.

INCREASING DEMAND AND HIGHER COSTS

The financial rewards for earning a college degree have encouraged more people to apply for and attend postsecondary educational institutions. In 1990, 17 percent of Californians had earned a bachelor's degree; that number increased to 21 percent in 2005.¹¹

The cost of postsecondary education has increased faster than average incomes, making college less affordable for many students. Contributing factors include increased student demand, a relatively stable institutional supply, and declining state support. The national average cost for tuition at a public university has increased about 31 percent, after inflation, over the last 5 years.¹² However only about half the increased costs over the last decade nationally have been covered by grant aid.¹³

A recent poll by the Public Policy Institute of California (PPIC) found that 84 percent of California residents agreed that affording college is a problem for students, and two-thirds of adults agreed that the cost of college "...prevents qualified, motivated students from pursuing higher education." Housing costs, tuition, and fees were most often cited as the major problem.¹⁴

According to the CollegeBoard, the average cost of college (including books, travel, housing, etc.), based on 2007-08 academic year costs, is:¹⁵

- About \$54,000 for a four-year in-state degree at a public college
- \$122,000 for a four-year degree at a private college
- \$2,261 a year for community colleges (students live at home)
- \$12,089 a year at a for-profit proprietary school

California has the lowest costs nationally for public two-year postsecondary schools in its community college system: \$633 (tuition and fees) a year for the academic year 2007-08, a 13 percent decrease from 2006-07.¹⁶

The U.S. Department of Education compared average undergraduate college costs for public four-year institutions, by state, for 2002-03. Eleven states had higher average four-year undergraduate college costs than California, which averaged \$10,849 at that time. The highest was Vermont at \$14,016, followed by New Jersey at \$13,937, Pennsylvania (\$12,944), Maryland (\$12,332), Rhode Island (\$12,266), Ohio (\$12,260), Connecticut (\$11,805), Delaware (\$11,523), Michigan (\$11,408), Illinois (\$11,027), and New York (\$10,984).¹⁷

However over the last five years, costs at California's public four-year college and universities have increased sharply (tuition and fees did not rise between 1998 and 2002). Both of the state's four-year public university systems raised student fees above the national average for state-support campuses from the 2006-07 academic year to the 2007-08 academic year. The national average increase was 6.6 percent (an average of \$5,185), compared to the national inflation rate of 1.96 percent.¹⁸

The California State University (CSU) system raised fees over the last year by about ten percent to \$3,521 annually. According to CSU, campus costs of attendance for the 2006-07 academic year range from a high of \$12,162 at Sonoma State for students living with their parents (or \$17,674 with on-campus housing and \$18,930 with off-campus housing), to a low of \$10,189 at Fresno State for students living with their parents (or \$14,217 with housing).¹⁹

The University of California (UC) increased the cost for undergraduates by 9.7 percent over the last year to about \$7,500 (fees only). This does not include room, board, and books.²⁰ The UC estimates a cost of \$23,890 in 2007-08, for a student to attend and live on a UC campus.²¹

Student fees at 24 of UC's professional schools are increasing by seven percent in 2007-08, and another seven percent in each of the next three years. Fees at other graduate schools will rise as high as 15 percent a year. For example, in 2010-11, annual fees at UC Berkeley's Haas School of Business will be \$40,882 and a similar amount at the Boalt School of Law.²²

Stanford University, one of the most highly ranked private schools in the state and the nation, increased tuition by 5.46 percent to \$34,800 in the 2007-08 school year, an increase of about \$1,800. With room and board, undergraduate costs increased to \$45,608. Stanford calculates that full tuition covers only about 60 percent of the cost to educate an undergraduate; therefore, every student receives a subsidy of at least 40 percent.²³

In contrast, the median family income in California in 2006 was \$64,563, according to the U.S. Census Bureau's American Community Survey.²⁴

ACCESS

Students from low income families are significantly less likely to participate in postsecondary education. According to the U.S. Department of Education Advisory Committee on Student Financial Assistance, the percentage of low income students (family or personal income under \$25,000 a year) who earned a Bachelor's Degree by age 26 in 2004, was seven percent, compared to 60 percent of all upper-income students (family or personal income over \$75,000).²⁵ In summarizing its 2001 report, *Access Denied*, the Committee offered the following key findings:²⁶

- Large differences persist in enrollment rates by income.
- [There is a] Shift in priorities to merit aid and affordability for the middle class.

- High unmet need for low-income students has a negative impact on their enrollment patterns.

The Advisory Committee estimated in 2002 that unmet financial need would prevent 4.4 million high school graduates from attending a four year college, and two million of those from attending any college.²⁷ A recent PPIC poll found that 58 percent of Californians agree that low-income students, regardless of their ethnic background, have less opportunity to go to college.²⁸

The U.S. House Education and Labor Committee recently examined the rising cost of a college education. According to Committee Chair Congressman George Miller, "...each year as many as 200,000 would-be students choose to delay or forego a college education because they simply can't afford it."²⁹

Although a detailed discussion of this important issue is beyond the scope of this paper, participation in postsecondary education is stratified by income and ethnicity. Students from poor families and minority students are less likely to attend and less likely to graduate. Nonetheless, postsecondary enrollment rates of recent high school graduates by family income and race/ethnicity have all increased over the last 20 years.

Student aid programs are critical in assisting students from low-and-low-middle income families to attend college. According to Chancellor Robert J. Bigeneau at UC Berkeley, a third of the campus's students come from families whose income is less than \$40,000 a year. Those students pay about \$8,000 from a combination of work-study and loans, and the campus provides \$17,000 from an elaborate system of financial aid.³⁰

The manner in which colleges and universities target student financial aid to attract higher-scoring students or higher revenues, or both, has become an important component of "enrollment management." Although not a focus of this paper, this is an issue of importance. According to an article in *Atlantic Monthly*, enrollment management at some colleges and universities has:

...changed financial aid—from a tool to help low-income students into a strategic weapon to entice wealthy and high-scoring students...Adopting data-mining and pricing techniques from the airline and marketing industries, they have developed a practice called financial-aid leveraging that allows a school to buy, within limits, whatever class it wants.³¹

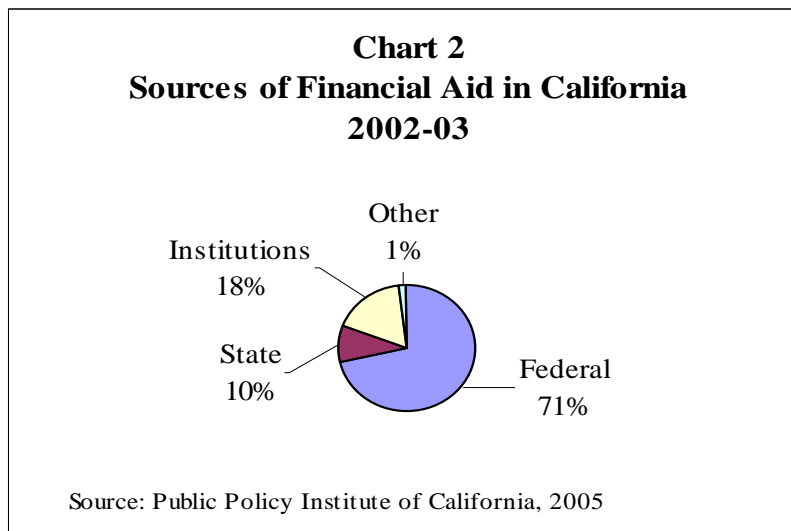
THE IMPORTANCE OF FEDERAL STUDENT AID TO CALIFORNIA STUDENTS

More than three and a half million students are enrolled in California's public colleges and universities. The state offers its students a number of grant programs including Cal Grants for undergraduates, vocational/occupational students, and teachers, Chafee Grants for foster youth, and special grants for law enforcement dependents and students committed to future careers in child care. The state has loan assumption programs for

* For the most recent data, see *Education Pays*, the CollegeBoard, October 2007.

future K-12 teachers, National Guard members, and nurses. The Student Aid Commission administers these and other programs. In addition, the state's public universities provide considerable financial assistance to students. For example, in 2007-08, the University of California has set aside 33 percent of all new fee revenue generated from undergraduate students for financial aid purposes.

Federal student aid programs are the predominant source of financial aid for California postsecondary students, providing about 71 percent of the financial aid available to students in California. The state provides less than ten percent.³² In 2006-07, three-quarters of full-time undergraduates nationally received some form of financial aid.



Although California provides its postsecondary students a number of grant programs, it does not have a state-funded student loan program. For that reason, the focus of this report is primarily on federal and private student loans. A wide range of federal financial aid programs—from Pell Grants to student loans to work study—provide billions of dollars in assistance to California students each year.

FEDERAL STUDENT FINANCIAL AID

A BRIEF HISTORY³³

Colleges were church-supported during the American colonial period. Students who obtained a degree were either wealthy or interested in becoming clergymen.

There was a rapid increase in the number of institutions of higher education in the United States in the 19th century, from 35 in 1800 to 977 in 1900. The *Morrill-Wade Land Grant College Act*, enacted in 1862, set the stage for the growth of state-supported higher education by granting public lands to states to support “land grant” colleges.

The financial situation of colleges and universities was precarious in the beginning of the 20th century. Yale, for example, did not increase its tuition for 30 years. However after World War I:

...people started to think of a college education as a vehicle for economic and social mobility rather than an activity reserved for the rich. Many colleges and universities took advantage of this increase in demand to increase prices.³⁴

College attendance increased 84 percent in the 1920s, primarily due to the growth of state-supported institutions that charged low, if any, tuition. By 1929, 69 state land grant colleges and universities had been established in the U.S., of which only two were privately supported (the Massachusetts Institute of Technology and Cornell). College attendance further increased during the 1930s and really took off after World War II as a result of the GI Bill (*The Serviceman’s Readjustment Act of 1944*), which supported about 4.4 million veterans going to college. Limited opportunities for work-study offered the primary means of financial aid for needy students at that time.

The concept of student financial need as a basis for the award of scholarships was endorsed by the President’s Commission on Higher Education in 1947, but it was not until 1958, with the launch of *Sputnik* by the Soviet Union, that Congress created the *National Defense Education Act* and the National Defense Student Loan Program, the first generally available student aid program. With the enactment of the landmark *Higher Education Act of 1965* (Title IV), the federal government became more involved in providing financial assistance to college students.

- Part A of Title IV established the Educational Opportunity Grant for high school students of “exceptional financial need” (Public Law 89-329 § 401). The grants were administered by institutions of higher education, which selected the students and determined the amount of the grant.
- Part B created the Guaranteed Student Loan Program. These needs-based loans were made by private lenders, but the federal government guaranteed the loans in case of default, paid interest while a student was in college, and after college paid the difference between the program’s low interest rates and market interest rates.

- Part C consisted of the work-study program previously administered by the Office of Economic Opportunity, and an expansion of the National Defense Student Loan Program.

In 1972, the *Higher Education Act* was reauthorized and Part A, the Educational Opportunity Grant, became the Basic Economic Opportunity Grant (which since 1980 has been known as the Pell Grant). A major difference was that the Pell grant was administered centrally in Washington (not by individual campuses), with a maximum grant amount of \$1,400 (\$6,977 in 2007 dollars). Also in 1972, a new State Student Incentive Grant Program was created to provide matching funds for state-operated needs-based financial aid programs. Notably, for-profit proprietary trade schools became eligible for all the Title IV programs, and the requirement that federal aid recipients had to be high school graduates was eliminated.

After 1972, the structure of the major federal student aid programs was in place. The Guaranteed Student Loan Program became the Stafford Loan and the National Defense Student Loan became the Perkins Loan.

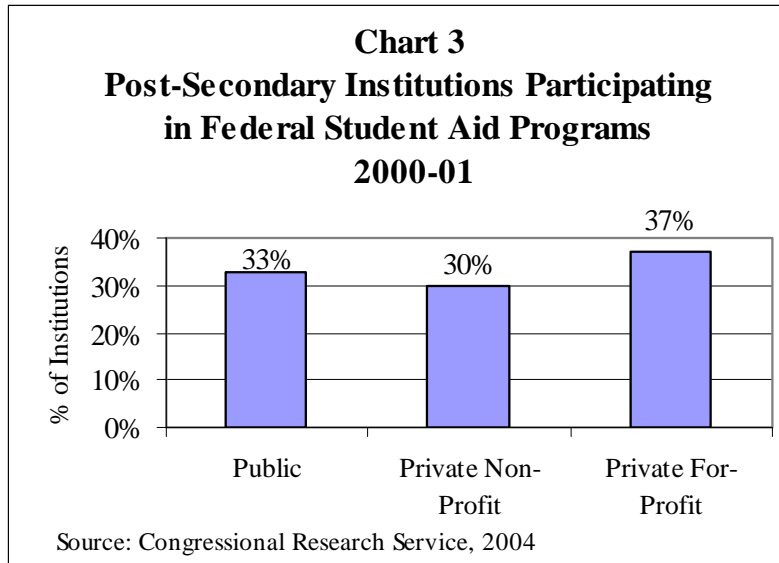
In 1992, legislation increased the amount that students could borrow, reduced family and student contributions (notably by eliminating a family's principal residence from the formula determining need), and created federally guaranteed but unsubsidized Stafford Loans. These changes opened the program up to middle-class students who did not qualify for needs-based loans. They were required to pay market rates, however, and the interest was not subsidized by the federal government. Increased demand for student loans was the result of these changes.

The 1992 legislation also created a demonstration program, the William D. Ford Direct Loan Program, in which the federal government directly made loans to qualified students, bypassing private lenders. Finally, the Parent Loan for Undergraduate Students (PLUS), which allows creditworthy parents to borrow up to the amount of a student's unmet financial need, was established. The interest on PLUS loans is variable but capped at nine percent as of 2007.

The complex array of federal loan products and application procedures has led the Secretary of Education to call the federal student financial aid system "redundant, ...Byzantine, and ...broken."³⁵

FEDERAL STUDENT FINANCIAL ASSISTANCE PROGRAMS

Higher education is a major enterprise in the United States. According to the Congressional Research Service, there were about 6,600 degree and non-degree granting postsecondary education institutions that participated in federal student aid programs in the academic year 2000-01, roughly balanced between public, private non-profit, and private for-profit or proprietary schools.³⁶



Most students attend public colleges and universities. Of the estimated 15.9 million students enrolled in undergraduate and graduate programs in 2000, three quarters were enrolled in public institutions, one fifth in private nonprofit institutions, and five percent in proprietary institutions.³⁷ Nonetheless, private for-profit schools are the largest group participating in federal student aid programs, as shown in Chart 3.

The U.S. Department of Education estimates that in 2007, its grant, loan, and work-study assistance programs provide financial assistance to more than 10 million postsecondary students.³⁸

The calculations that determine a student’s financial need begin with the lengthy and complex Free Application for Federal Student Aid, which uses a Congressionally-determined methodology to calculate the “expected family contribution.” The difference between the cost of attendance (fees, tuition, books, board and room, etc.) and a student’s resources (including scholarship awards) is the student’s unmet financial need. Over nine million students submitted the Free Application for Federal Student Aid for the academic year 2006-07.

Federal student financial aid programs are complex, and important provisions have recently been changed by the *College Cost Reduction and Access Act*, enacted in September 2007. The reader should consult qualified professionals for more complete information, as the following discussion is intended for descriptive purposes only.

Pell Grants

In assisting a student, a financial aid officer employed by an institution of higher education first considers the Pell Grant. This needs-based grant does not have to be repaid. Pell Grants are generally for undergraduate students, and can either be paid directly to a qualified student or to the institution of higher education that the student attends, depending on the institution’s choice.

Pell Grants constitute about 65 percent of federal grants to postsecondary students, but only 31 percent of the total grant aid. The largest portion of student grant assistance comes from colleges and universities, which provide 41 percent of the total. The remainder is funded by states and private sources.³⁹

Pell Grants are designed to serve lower income students. In 2006-07, almost 60 percent of Pell Grant recipients were independent from their parents. Of recipients living with families, two-thirds came from families with incomes below \$30,000.

The amount awarded is based primarily on a student's financial need and the cost to attend school. The maximum Pell Grant award for the 2007-08 award year (July 1, 2007 to June 30, 2008) for a full-time student is \$4,310. This is less than the \$5,800 authorized by the *Higher Education Act* for the academic year 2003-04.⁴⁰ The maximum can change each award year and depends on program funding, which has been discretionary, meaning that Congress is not required to provide full funding.

The average Pell Grant in 2006-07 was \$2,494, which covered 32 percent of the cost of attendance at a public four-year university (tuition, fee, room and board) and 13 percent at a private college (compared to 52 percent and 21 percent respectively in 1986-87.)⁴¹

In 2005-06, over \$12 billion in Pell Grants was provided to more than five million undergraduate students, a decrease from \$13.6 billion in 2004-05. Pell Grants awarded that year constituted 26 percent of all grants received by undergraduates, 13 percent of all federal student aid, and nine percent of total student aid.⁴²

In 2005, Pell Grants provided California students \$1.5 billion (11.4 percent of the total U.S. spending for the program). One reason for California's smaller share of Pell Grants relative to its student population is the low tuition of the California Community College (CCC) system, "...the nation's lowest priced public higher education institutions."⁴³ The Pell Grant's "tuition sensitivity" rule reduces the maximum grant available to CCC students.

Funding for Pell Grants and the maximum award amount has not kept pace with the cost of attending a postsecondary institution. According a 2006 analysis by the College Board:⁴⁴

The proportion of the average published price of tuition, fees, and room and board at a public four-year college or university that could be met by a Pell Grant declined from 42 percent in 2001-02 to 33 percent in 2005-06.

Twenty years ago, maximum Pell Grants met nearly 60 percent of total charges in that sector.

One result is that Pell Grant recipients have much higher debt levels than other students. According to the Project on Student Debt, 88.5 percent of Pell Grant recipients who received a Bachelors degree in 2004 had student loans, compared to 52.7 percent of non-Pell recipients.

- Education debt was 12 percent higher for Pell recipients compared to non-Pell recipients (\$20,735 vs. \$18,420).
- One-fourth of Pell recipients had debt of at least \$27,623 (compared to \$21,500 for non-Pell recipients).
- Ten percent carried debt of \$38,000 or more (compared to \$32,000 for non-Pell recipients).⁴⁵

H.R. 2669, the *College Cost Reduction and Access Act*, September 2007, raises the maximum Pell Grant to \$5,400 over five years (\$4,800 in 2008-10, \$5,000 in 2009-10 and \$5,400 in 2011-12). The funding is classified as “mandatory spending,” which means the increases will be funded. The Act also increases the amount of income that students can keep for living expenses before reducing student aid, excludes the Earned Income Tax Credit from financial aid calculations, and increases excluded family income from \$20,000 to \$30,000, among other changes. New grants of \$4,000 are available for Teacher Candidates.*

A related federal student aid grant program, the Academic Competitiveness Grant (ACG), became available for students with Pell Grants meeting specified grade point average and course requirements in the academic year 2006-07. First-year full-time undergraduate students could receive up to \$750, as of 2007, and second-year undergraduate students could receive up to \$1,300 if they maintained a 3.0 grade average during their first year. In the first year of the program, 400,000 students received awards averaging \$850.⁴⁶

The National Science and Mathematics Access to Retain Talent Grant also became available for the first time in academic year 2006-07, for third and fourth year full-time undergraduate students with Pell Grants majoring in mathematics, science, technology, engineering, or a critical foreign language. They may receive up to \$4,000 per year. In its first year, the program awarded grants averaging \$3,875 to 80,000 students.⁴⁷

Federally Subsidized and Guaranteed Student Loans

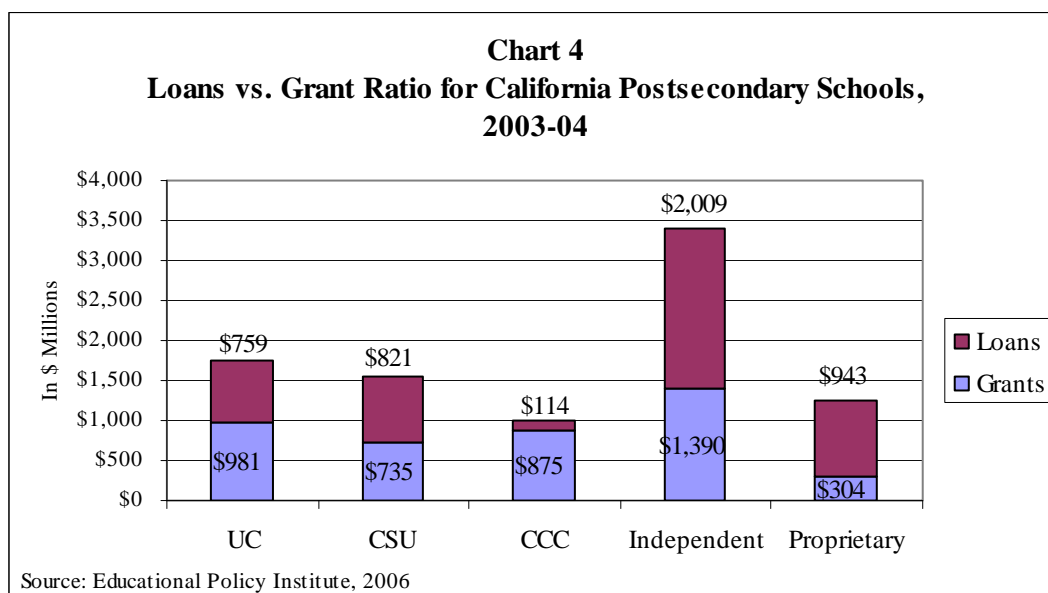
Federally subsidized and guaranteed student loans are an important source of student financial aid. In 2003-04, three-quarters of all student loans were federally subsidized and guaranteed loans, and one quarter were private loans.⁴⁸ In 2004, approximately \$52 billion was distributed nationally to 12 and one half million college students and their families through federal student loan programs.⁴⁹

A smaller proportion of California students received federal loans than students in other states in 2003, but the average loan size was larger. The state’s \$4.8 billion in new

* “The *College Cost Reduction and Access Act* (H.R.2669) lowers the cost of higher education by reducing lender subsidies by \$19 billion and then investing those funds in programs that increase grant amounts to students, improves access to student loans, cuts interest rates on student loans, provides for the repayment of parts of the loans through employment or service in areas of national need, and rewards colleges for lowering costs to students.” See <http://www.govtrack.us/congress/bill.xpd?bill=h110-2669>.

federal student loans comprised 8.4 percent of the nation’s \$57 billion total. In contrast, California was home to 12.4 percent of the nation’s college-age youth and 14.8 percent of the nation’s undergraduates.⁵⁰

In 2003-04, California for-profit proprietary school students received 75 percent of their financial aid as loans, compared to 46 percent of UC students, 52 percent of CSU students and 12 percent of community college students (see Chart 4). Students attending non-profit independent institutions (such as Stanford or Pomona) received the most aid, \$3.4 billion or 38 percent of all student aid in California. Students attending for-profit proprietary schools received \$1.3 billion (14 percent), UC students received \$1.8 billion (20 percent), CSU students received \$1.6 billion (17 percent) and California Community College students received \$1 billion (11 percent).⁵¹



Subsidized Stafford Loans

If a student’s resources and financial aid, including Pell Grants, are less than the cost of attending an institution of higher education, a student is eligible for a needs-based subsidized Stafford Loan. The federal government pays the interest while the student is in school and subsidizes the interest throughout the life of the loan. About 41 percent of federal education loans are subsidized Stafford Loans.⁵²

These loans are financed in one of two ways: the Federal Family Education Loan Program (FFEL), in which the loan is made by a private lending institution, or the William D. Ford Federal Direct Loan Program (Direct Loan), in which a loan is made by and repaid to the federal Department of Education and consequently costs the government less.

The two types of loan compete against each other in the postsecondary institution lending market, as institutions generally participate in one or the other. In 2005, for example,

The University of California offered the Direct Loan program on six campuses and the FFEL guaranteed loan program on four campuses. That year over 80,000 U.C. students received loans through federal programs.⁵³ Thirteen California State University campuses participate in the FFEL program, and ten in direct lending.

If a school participates in the FFEL, it generally has a list of preferred lenders that it provides to students. Students do not have to borrow from lenders on the list but they usually do because the college has often negotiated lower fees from those lenders (however preferred lender lists have led to some abuse, as discussed below). Over 3,000 lenders participate in the FFEL program.

Three quarters of postsecondary schools participated in the FFEL in 2005, compared to 25 percent in the Direct Loan Program. According to Congressional testimony by a representative of the University of California, "...borrowers and institutions in the Direct Loan program are not receiving enough of the federal subsidy to offer realistic level-playing-field competition to the FFEL program," for the following reasons:⁵⁴

- More generous federal subsidies to lenders and guarantors in the FFEL program mean that borrowers can get less costly loans.
- FFEL schools receive administrative assistance from private lenders that is not available through the Direct Loan program.
- Borrowers and schools receive an indirect subsidy through the "School as Lender" program, which is available in the FFEL but not the Direct Loan program, and allows "...a school to become a lender and share in the profits of doing so with a recognized lender/partner." Benefits to the school include low origination and guarantee fees and back end repayment discounts. This program has been involved in several scandals recently, with lenders providing kickbacks to school financial aid offices to steer students to them (see discussion below).
- Federal direct loan limits have not kept pace with the cost of attending postsecondary education, meaning that students have an increasing need to borrow additional funds. More advantageous private loan terms are available through schools that already have relationships with lenders through the FFEL.
- Under the FFEL program, some borrowers can receive lower cost loans because certain lenders share their federal subsidies with the schools. This flexibility is a central element in "enrollment management," in which financial aid becomes a key recruitment tool for universities and colleges.

The federal government guarantees subsidized Stafford Loans against default and pays interest while a student is in school. The amount a student may borrow depends on the student's financial need, but as of 2007 is limited to \$3,500 for the first year, \$4,500 for the second year, and \$5,500 for the last two years of study, or a total of \$13,500. The subsidized Stafford Loan has a grace period of six months after leaving school before the student must begin repaying the loan.

The newly enacted *College Cost Reduction and Access Act* reduces interest rates on new undergraduate subsidized Stafford FFEL and Federal Direct Loans from 6.8 percent to 6 percent starting July 2008, 5.6 percent starting July 2009, 4.5 percent starting July 2010, and 3.4 percent starting July 2011. In July 2012, the interest rate will revert back to 6.8 percent.

In addition to interest and principal, students must pay a fee of up to four percent of the loan to help defray the cost of a Stafford Loan. For a subsidized FFEL Stafford Loan, a portion of the fee payment goes to the federal government and a portion goes to the guaranty agency (the state agency that administers the program in each state). In California, the Student Aid Commission is the state's designated guaranty agency, and EdFund is its auxiliary. For Direct Stafford Loans, the entire fee goes to the federal government. In addition, there are lucrative collection costs and fees for late payments.⁵⁵

According to an analysis of 1999-2000 data, California undergraduate students were less likely to receive federally subsidized Stafford Loans—the state ranked 46th among states in the number of subsidized loan recipients, with only 16.3 percent of California students receiving the loans compared to 23.1 percent of the nation's undergraduates.⁵⁶ Why this is the case is not clear, given the large number of postsecondary students in California and their level of financial need.

Unsubsidized Stafford Loans

Since the subsidized Stafford Loan limit is less than the cost of attendance at most four year institutions of higher education, many students also take out unsubsidized Stafford Loans, which are not based on financial need. Unsubsidized Stafford Loans are made by private lending institutions. Repayment is guaranteed by the federal government, allowing for lower interest rates due to the decreased risk to the lender. Federal law sets the maximum interest rates and fees that lenders may charge.

Borrowers are charged interest from the time the loan is disbursed until it is paid in full. Students are responsible for all interest costs, and those interest costs are higher—6.8 percent—than on subsidized Stafford Loans. Once the student ends enrollment, any unpaid interest is added to the principal amount of the loan.* This means that loan obligations may balloon, as interest is due on the new principal. A borrower who chooses to pay the interest as it accumulates will repay less in the long run.

- Undergraduates may borrow \$4,000 to \$5,000 a year in unsubsidized loans, depending on the year in school, or \$13,000 in total in 2007.
- Graduate or professional students may borrow up to \$20,500 for the 2007-08 academic year, of which no more than \$8,500 may be in subsidized loans, with a maximum total debt of \$138,500. No more than \$65,500 of that total debt may be in subsidized loans, including for undergraduate study.

* Students may defer paying the interest by capitalizing it, which adds it to the principal of the loan, thereby increasing the size of the loan.

California undergraduates received a smaller share of unsubsidized Stafford Loans than their counterparts in other states in 1999-00—11.1 percent compared to 14.8 percent of all U.S. students.⁵⁷

Loans to Parents of Students

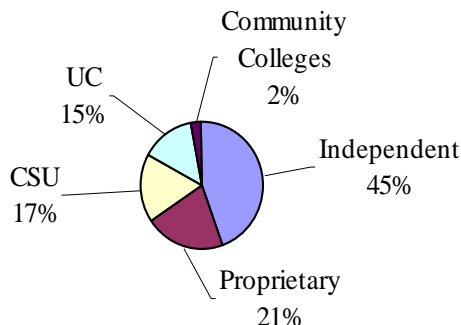
Creditworthy parents of dependent students may borrow up to the amount of the student’s unmet undergraduate financial need (the cost of attendance minus financial aid). These are not need-based loans. There are Direct PLUS Loans, in which the lender is the U.S. government, or FFEL PLUS Loans, in which the lender is a private institution. Loan payments are made to the school, which disburses the money. Parents are required to pay fees of up to four percent of the principal of the loan, which include an origination fee of three percent and a guarantee fee of up to one percent (the guarantee fee is often waived).

A Graduate PLUS Loan may be made to qualified graduate students to pay for the cost of attending graduate school minus any financial aid. Like the Parent PLUS Loan, eligibility for the Graduate PLUS Loan is largely dependent on the borrower’s credit rating and history. Borrowers must first have applied for their annual loan maximum eligibility under the subsidized and unsubsidized Stafford Loan Program.

The interest rate on the FFEL PLUS Loan was fixed at 8.5 percent as of July 1, 2006, and 7.9 percent on the Direct PLUS Loan, and may be tax deductible. Repayment begins after the end of the academic year.

Table 1 Parent Federal PLUS Loans for Graduating Seniors, 2004*		
	% of parents of graduating seniors with PLUS Loan	Average PLUS Debt
All Graduating Seniors	15.3%	\$17,709
Public 4-year institutions	12.3%	\$14,056
Private 4-year institutions	21%	\$21,984
*Excludes other forms of debt such as home equity loans. Source: <i>Quick Facts About Student Debt</i> , The Project on Student Debt.		

Chart 5
Federal Guaranteed Loans (Stafford and PLUS) Made in California, by Educational Sector, 2003-04



Source: Educational Policy Institute, 2006

Two thirds of all federally subsidized and guaranteed student loans (Stafford and PLUS) made in California in 2003-04, were for students attending private independent and for-profit proprietary institutions.⁵⁸

Under the terms of the *College Cost Reduction and Access Act* of 2007, the U.S. Department of Education will administer a competitive loan auction pilot program beginning in 2009, under which lenders in each state will compete to originate eligible federal PLUS loans at all institutions of higher education within the state (see H.R. 2669, Title VII). The purpose of the pilot is to see if the competition reduces the cost of the loans and federal subsidies.*

Consolidation Loans

Students sometimes take out more than one loan and from more than one lender. The law permits these loans to be consolidated into “consolidation loans” that allow a recipient (student or parents) to bring together several types of federal student loans, for example FFEL and Direct Loans, into a single payment that is used to pay off the balances on the other loans (similar to refinancing a mortgage). Depending on the type of loans, the consolidated loan is generally treated as a subsidized, unsubsidized, or PLUS loan. The interest rate is the weighted average of the interest rates on the loans being consolidated, rounded up to the nearest one-eighth of a percent and capped at 8.25 percent. There are also fees associated with consolidating a loan.

Consolidation loans often reduce the size of the monthly payment by extending the term of the loan beyond the ten-year repayment plan that is standard with federal loans. This makes the monthly payment easier for some borrowers but increases long term interest costs.

* Loan origination rights auctions are discussed in a GAO/U.S. Department of Education report, *Alternative Market Mechanisms for the Student Loan Program*, December 18, 2001 (GAO-02-84SP).

Campus-Based Programs

Three student financial aid programs in the *Higher Education Act*—the Federal Supplemental Educational Opportunity Grant, Federal Work-Study and Federal Perkins Program—are referred to as campus-based programs because federal funding is provided directly to postsecondary institutions, which in turn award the need-based financial aid to students. The institutions must provide a match of about one third of the federal funds they receive. The amount and type of aid provided to a student is determined by each institution's financial aid administrator.

The Perkins Loan program offers low-interest loans to needy undergraduate, graduate, and professional students and shares many of the characteristics of Stafford Loans, except that there are no fees and a longer grace period (nine months after leaving school) before a student must begin repaying the loan. Students can receive Perkins loans at any one of approximately 1,800 participating postsecondary institutions.

The Federal Supplemental Educational Opportunity Grant program provides grant aid to undergraduate students with exceptional need who are progressing satisfactorily toward a degree. By law, top priority is given to students who are Pell Grant recipients.

The Federal Work-Study program provides opportunities for paid employment to undergraduate, graduate, and professional students. Federal work-study funding assists a small number of students and constitutes about one percent of student aid. Nonetheless, three quarters of full-time college students had jobs and nearly half (46 percent) worked more than 25 hours a week in 2002.⁵⁹ (Student earnings are taxable for purposes of state and federal taxes, but exempt from FICA for full time students working less than half time.)

California received 10.4 percent of the nation's total spending on campus-based federal student aid programs in 2004-05, despite having 12.5 percent of the nation's college-age youth, primarily due to a campus-based federal funding formula that favors older and often wealthier private universities.⁶⁰ Funding to institutions takes into account their allocation in previous years and their "...proportionate share of eligible students' need that is in excess of their base guarantee (their fair share increase)."⁶¹

Table 2			
Campus-based Federal Student Aid Programs			
Federal Fiscal Year 2004			
Program	Federal Appropriation	Total Aid (with state match)	# Students Served
Federal Supplemental Educational Opportunity Grant	\$770.5 million	\$975 million	1.3 million
Federal Work-Study	\$998.5 million	\$1.2 billion	858,000
Federal Perkins Loan	\$165.4 million	\$1.3 billion	673,000
Source: James B. Stedman, <i>The Higher Education Act: Reauthorization Status and Issues</i> , Congressional Research Service, 2004.			

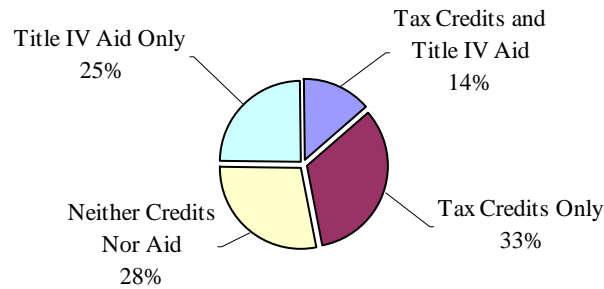
Tax Credits

The primary focus of the *Higher Education Act of 1965* was on assisting students from needy families, most of whom would not have benefited from a tax credit. Over the years, however, various proposals for tax credits were considered by Congress.

In 1997 Congress enacted the *Taxpayer Relief Act*, creating the Hope Scholarship Credit (\$1,500 tax credit) for each of the first two years of higher education and the Lifetime Learning Credit (\$1,000 tax credit) for the remaining years. In addition, interest payments on student loans were made tax deductible. These tax benefits primarily assist middle and upper-income class families. Students whose personal or family income exceeds \$100,000 are not eligible, and students or families whose income is under \$20,000 generally lack sufficient tax liability to take advantage of the credits.

Tax credits quickly became a significant component of federal financial assistance for postsecondary students, as Chart 6 indicates (Title IV Aid refers to the federal grant and loan programs authorized under Title IV of the Higher Education Act, as discussed above.)

Chart 6
Undergraduate Use of Federal Higher Education Tax Credits Compared to Grants and Loans (Title IV) 1999-2000



Source: GAO, *Student Aid and Tax Benefits*, 2002

In 2001, the *Economic Growth and Tax Relief Reconciliation Act* created a new deduction for tuition and other expenses. According to the GAO, federal tax credit assistance for postsecondary students in Fiscal Year (FY) 2002 totaled \$7.6 billion.

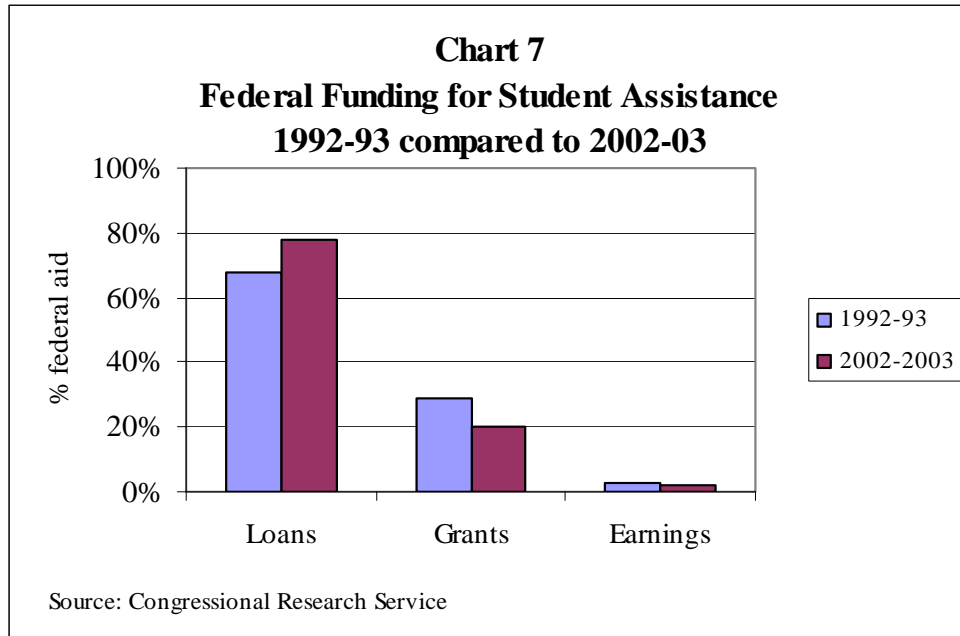
Federal Student Financial Aid Grants to States

The Leveraging Educational Assistance Partnership (LEAP) program provides matching funds to states to encourage them to offer need-based state grant programs. The FY 2006 federal appropriation was \$65 million, which supported an estimated \$165 million in total aid (including the state matches). Each state's allotment is based on its relative share of the total national population of "students eligible to participate" in the LEAP Program. Awards are made by states, and range from \$100 to \$5,000, with an average award of \$1,000.⁶²

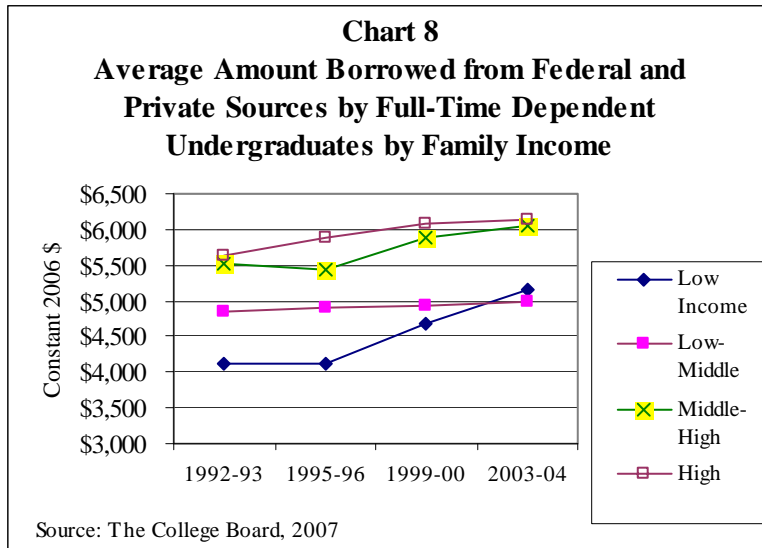
THE SHIFT FROM GRANTS TO LOANS

Over time, there has been a shift in federal student aid funding. Funding for needs-based grants (Pell Grants, Educational Opportunity Grants and LEAP Grants) and subsidized Stafford Loans targeted at low income students has declined relative to unsubsidized, guaranteed Stafford Loans and tax credits that are primarily available to middle income students. There has also been a gradual relative decrease in federal work-study support. The *College Cost Reduction and Access Act* of 2007, by increasing the size of Pell Grants and providing for mandatory funding, may somewhat ameliorate this trend.

Merit-based scholarships offered by state government and higher education institutions can also contribute to this trend unless the revenue brought in by the mostly well-to-do students who receive merit grants and scholarships is channeled back into needs-based grants.

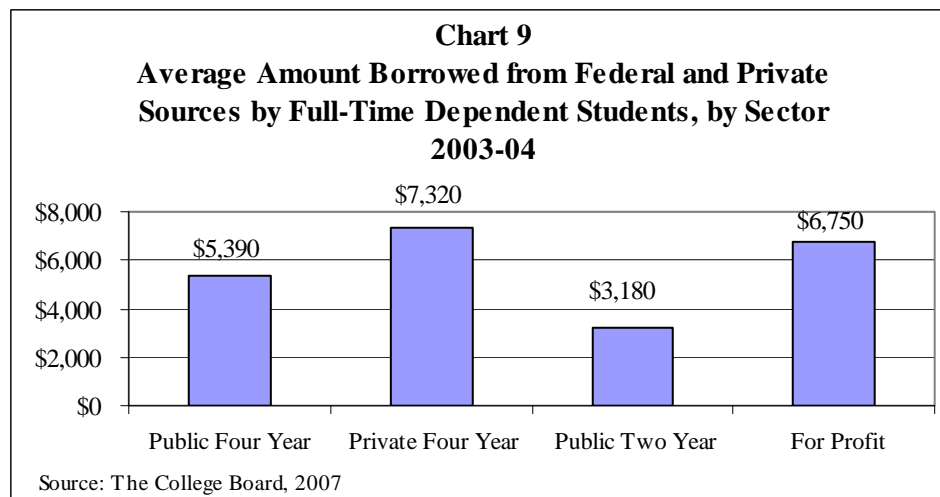


According to the CollegeBoard, nearly half (48 percent) of all students from families with incomes below \$40,000 in 2002, borrowed from federal and private sources, compared to 12 percent in 1992-93, and their average loan amount increased by \$1,500 (in constant 2006 dollars). Although students from high income families borrowed larger amounts, the increase was less.⁶³



The federal share of student loans is decreasing. In 1996-97, the federal government financed 93 percent of the \$30 billion in loans to graduate and undergraduate students; in 2006-07, the federal share was 75 percent of \$77 billion. Private loans accounted for 29 percent of all loans taken out by undergraduates.⁶⁴

Borrowing is highest among students attending private four-year and for-profit schools.



As a result of the rapidly increasing cost of higher education and relatively limited student aid in comparison to the demand for financial assistance, students and their families are increasing borrowing money directly from lending institutions, without the protection offered by federal loan guarantees (as is discussed in the next chapter).

Students are also working more while in school. The National Survey of Student Engagement in 2003 found that full time university and college students worked an average of ten hours a week and part-time students worked an average of 22 hours a week.⁶⁵

STUDENT DEBT

In 2003-04, two-thirds of four year undergraduate students nationally graduated with some debt, and about one in ten parents borrowed federal PLUS loans to finance their children's education. Nearly half (48 percent) of low-income students took out loans and borrowed an average of \$5,640 to help finance college, compared to 36 percent of the wealthiest undergraduates, who borrowed an average of \$6,140.⁶⁶

The average debt in academic year 2004-05 of undergraduates at the University of California was \$13,824. In 2005-06, the average debt for California State University graduates was about \$14,000. Half of the undergraduates at these public universities carried loan debt.⁶⁷ An analysis published by EdFund, California's student loan guarantee agency, in 2002 found that:⁶⁸

- California higher education students had significantly higher debt from all sources than in 1998.
- Students who attended half time were in a precarious financial position, with higher debts and lower incomes than former or current full time students.
- Students at two-year and proprietary schools had higher amounts past due and a higher proportion of delinquencies and defaults (leading to higher collection costs and fees).

In 2006, the average debt of graduating seniors in California public four-year colleges was \$17,200, and 47 percent of the graduates were in debt.⁶⁹ (This was very near the national average debt of \$17,277 for public university graduates.) For private school graduates, the average debt load was \$28,138.⁷⁰ About a quarter of this debt was privately-funded, while three quarters was federally subsidized or guaranteed.

According to a September 2007 analysis by *U.S. News & World Report*, Pepperdine University was the only California school whose students ranked among the top 15 universities and colleges nationally with the most debt: its average student debt ranked seventh (\$31,718, with 62 percent of graduates carrying student debt). Six California universities and colleges ranked among the universities and colleges with the least student debt:⁷¹

- Claremont McKenna College (\$10,518, 51 percent of graduates with debt)
- UC Irvine (\$12,074, 52 percent of graduates with debt)
- UC Davis (\$13,835, 46 percent of graduates with debt)
- Thomas Aquinas College (\$14,000, 65 percent of graduates with debt)
- UC Santa Cruz (\$14,381, 51 percent of graduates with debt)
- San Diego State University (\$14,700, 48 percent of graduates with debt).

Student loans can not be discharged in bankruptcy proceedings,* and wages and disability payments under Social Security can be garnished to pay overdue loans. The student loan default rate, which was as high as 50 percent in 1990, is now below five percent. Late repayment of federal loans incurs large fees.

For some students, private loans may be contributing to unmanageable debt burdens. A 2003 study found, for example, that almost two-thirds of law school students who had borrowed the maximum Stafford Loans for which they were eligible and had incurred financial need of \$10,000 or more, required private loans. The authors concluded that “Although high salaries in the future may cover the extra burden, such salaries are not guaranteed and some of these students may run into financial difficulties or be deterred from following certain careers.”⁷²

When asked in a recent PPIC poll, three in four California residents agreed that students have to take on too much debt in student loans to pay for their college education, an opinion shared by 92 percent of Blacks in the survey.⁷³

Congress has recently addressed concerns about the high level of student debt. H.R. 2669, the *College Cost Reduction and Access Act*, enacted in September 2007, contains an income-based repayment provision for undergraduate and graduate students (not parents) with federal loans (FFEL, Direct, and Perkins Loans if they are consolidated into a FFEL or Direct Loan). Under this provision, student loan payments are capped according to a sliding scale based on the borrower’s income, adjusted for family size (see Table 3). For most people, the cap is below ten percent of income, with a maximum of 15 percent of family income. No payments are required for students with a family income below 150 percent of the federal poverty level (about \$31,000 for a family of four). The caps apply to past, present and future federal student loans.

* Federal legislation in 1998 made student loans non-dischargeable in bankruptcy proceedings unless there is a finding of undue hardship. Legislation in 2005 specified that private student loans are non-dischargeable in bankruptcy. There is an exception if a school closes prior to the student completing his/her education.

Table 3				
Federal Student Loan Repayment Caps by Borrower's Income and Family Size (H.R. 2669)				
Family Size	Borrower Income			
	\$30,000	\$60,000	\$90,000	\$120,000
6	0%	4.6%	8.1%	9.8%
4	0%	7.3%	9.8%	11.1%
2	4.7%	9.9%	11.6%	12.4%
1	7.3%	11.2%	12.4%	13.1%

Source: The Project on Student Debt, *Key Provisions in H.R. 2669*.

If the capped payments specified by H.R. 2669 fail to cover interest charges on a subsidized Stafford loan, the program will cover interest for up to three years. After that, and for other loans, interest may only accrue on the principal amount and does not compound. After 25 years, the program cancels most remaining balances. For individuals working in public service careers including military service, first responders, law enforcement officers, firefighters, nurses, public defenders, prosecutors, early childhood educators, librarians, and others for more than ten years, and who have made loan repayments during that time, the remaining debt can be cancelled.* These new limitations on student debt provide important protections to student borrowers of federal student loans, but not borrowers of private loans.

Affect of student debt on life choices

Student debt is affecting student academic and career choices. Students are increasingly drawn to majors with clearly associated job titles such as business, parks and recreation, computer sciences, protective services, and health professions.⁷⁴ Public service jobs such as teaching and social work may be particularly impacted. A Higher Education Project of the State Public Interest Research Groups (PIRG) analysis, based on 2005 benchmark data,⁷⁵ found that 23 percent of graduates from public colleges and universities, and 38 percent of graduates from private colleges and universities, would have unmanageable debt as starting teachers.⁷⁶

* The GAO estimates that some 50,000 borrowers will qualify for loan forgiveness each year. The impact on public interest positions is particularly acute in law and medicine. According to the American Bar Association, public law school graduates owed \$54,509 on average in 2006, on top of an average \$20,000 in undergraduate debt. See Kelly Field, "Forgiving Loans of Those in Public Service Grows Popular, but Programs are Unproven," *The Chronicle of Higher Education*, Vol. 54, No. 12, November 16, 2007, p. 20.

Students despair over the impact that long term debt will have on their personal lives, as articulated in the following email from a UC student to the author:

I now have student loans that will set me back financially for at least 10 yrs. I owe more now in student loans than I make in income. At this rate, I'll never even have a chance to save for a house, let alone a family. All I hear about on the news, and in the papers, is about how people are suffering from home mortgage pressures. It doesn't even seem like anyone is concerned about education loans.

Since student loan default rates are extremely low, bankers are soliciting students like vultures. It ought to be illegal. It's no different from credit card companies sending college students pre-approved credit cards in the mail.

An article in the *New York Times* supports this student's story: "Many students out of dozens interviewed said it was not particularly clear what interest rate they had signed up for." In addition, the reporter found that students did not understand that interest would compound while they were in college, or that "...many private loan agreements make it impossible for students to reduce the principal by paying extra each month unless they are paying off the entire loan."⁷⁷

New York Attorney General Andrew Cuomo's office has compiled a short brochure on student lending which contains a Hotline number for students and their parents to call. The brochure advises that:⁷⁸

In many cases, the rates that are advertised to you do not appear in any of the actual loan documents that you sign. Therefore, it is important to keep the advertisements where these rates appear so that you will be able to document the promises made to you by your lender when it comes time to start repaying your loan years later.

Credit Cards

Nellie Mae, one of the nation's largest student loan companies and fully owned by SLM Corporation (Sallie Mae), reports that 92 percent of graduate students have a credit card, with an average balance of \$8,612 in 2006 (15 percent had an average balance of more than \$15,000). Undergraduate students averaged about \$2,169 in credit card debt.⁷⁹

An investigation in Iowa found that "...credit card contracts generated millions of dollars a year for the institutions' privately-run alumni organizations." Reportedly the Bank of America has marketing arrangements with about 700 U.S. campuses, mostly with alumni associations, athletics departments, and foundations, which typically collect 20 to 50 cents for every \$100 of credit card purchases.⁸⁰

Recently enacted California legislation (AB 262, Coto, Chapter 679, Statutes of 2007), the *Student Financial Responsibility Act*, requires the CSU and California Community Colleges, and requests the Regents of the University of California and governing bodies of private or independent colleges in the state, to adopt policies that regulate the

marketing practices used on campuses by credit card companies. Each campus is directed to annually disclose all exclusive arrangements with banks or other entities that engage in on-campus credit card marketing activities. Gifts to students who complete on-campus credit card applications for those lending entities are prohibited. Additionally, the bill urges the Regents to revise the *University of California Policy on the On-Campus Marketing of Credit Cards to Students*.

THE STUDENT LOAN INDUSTRY

The student loan industry is complex, in part due to the detailed statutory and regulatory framework of federal loan programs. Richard George, the President and CEO of the Great Lakes Higher Education Corporation offers the following list of industry players.⁸¹ Increasingly large providers like Sallie Mae provide a full range of activities. Fees and charges may be added at every point of service.

- Lenders (banks, credit unions, savings and loan associations, private lenders)
- Secondary markets (buy student loans from lenders, freeing up funds for additional lending)
- Bursars, registrars and financial aid officers (university/college employees who are key intermediaries between schools and lenders)
- Originators (assist borrowers to obtain their loans including schools, banks, private lenders, credit unions, and savings and loan associations)
- Servicers (collect payments from borrowers and pass them on to the investors who own the loans, and levy fees and other charges)
- Guaranty agencies (insure student loans against default and reimburse the lender for the balance of a defaulted loan)
- Collection agencies (engage in receivables management, helping lenders and guaranty agencies recover funds from borrowers who default on their loans)
- Securitization teams (issuer, bankers/underwriters, bond counsel, trustee, rating agencies, underwriter's counsel, and accountants)
- U.S. Department of Education⁸²

Although it is beyond the scope of this report to fully analyze the industry, the following discussion focuses on key players and the state's role.

SALLIE MAE

When the *Higher Education Act* was enacted in 1965, there was no private market for student loans. Students presented an unknown quantity to lenders because they did not have assets to secure a loan (like a house, for example), but rather an uncertain but likely increase in long term earnings potential. For this reason the federal government created and financed the Student Loan Marketing Association (SLMA or Sallie Mae) in 1972, as a "government sponsored enterprise" or GSE. GSEs are a hybrid form of a corporation that uses privately-provided capital to increase investment in a specific sector of the economy.* Congress also authorized the creation of state-chartered guaranty agencies,

* Other GSEs include "Fannie Mae" and "Freddie Mac," which own and/or securitize around 70 percent of the residential mortgage loans in the United States.

which are discussed below, to manage the student loan guarantee program under the supervision of the U.S. Department of Education.

Sallie Mae was created to encourage private banks to loan to students who were considered to be a credit risk; it did not make the loans itself. For many years, Sallie Mae functioned as a “secondary lender,” buying and managing loans from banks and other lenders, which used the proceeds to make new loans. This role, of freeing up more capital for private funding for student loans, was the reason that Congress created Sallie Mae.

Sallie Mae received valuable benefits as a GSE, including exemption from state and local taxes, and access to low-cost funds from the U.S. Department of the Treasury. Sallie Mae paid only a fraction of a percent in interest on the funds it borrowed from the U.S. Treasury...earnings—from interest payments made by students and subsidies paid by the federal government on student loans—were also tied to the Treasury bill rates. Therefore, if interest rates were up Sallie Mae paid more to the Treasury for its funds, but got even more back in subsidies...an easy path to profits.⁸³

In 1997, Sallie Mae began privatizing its operations. In 2004, Congress terminated its federal charter and it became a private company. In that time, its stock price increased by nearly 2,000 percent. The company is the country’s largest originator of federally-insured student loans and provides debt management services and technical and business products to colleges, universities and loan guarantors. Sallie Mae has the ability to control the entire loan process—making loans, guaranteeing them and collecting on them.

Sallie Mae has an estimated 12,000 employees in 19 states and manages \$142 billion in student loans. The company’s loans comprised 27 percent of all federal student lending in 2006, four percent more than the Department of Education’s direct lending program and 21 percent more than the next largest student lender, Citibank.⁸⁴ According to the *Economist* magazine, Sallie Mae’s recent five year average return on equity was an “astonishing 52% a year.”⁸⁵ Its profits in 2006 were \$1.3 billion.

In April 2007, Sallie Mae announced that an investor group including J.C. Flowers & Co, Bank of America, JP Morgan Chase and the private equity firm Friedman Fleischer & Lowe had agreed to purchase the company for \$25 billion. However the purchasers are attempting to withdraw, primarily because of “... changes in the legislative and economic environment,” due to a reduction in federal subsidies to for-profit lenders by 0.55 percent in the newly-enacted *College Cost Reduction and Access Act of 2007* (H.R. 2669).⁸⁶ Sallie Mae’s stock price has since fallen considerably and its operations have been affected by the tightening credit market.

FEDERAL SUBSIDIZES AND GUARANTEES

The federal government subsidizes federally-guaranteed student loans in several ways. It pays the interest on subsidized Stafford Loans while a student is in school, and assumes the lender’s risk by guaranteeing repayment of the loan.

Once a student borrower goes into default, the government pays all the principal and compounded interest that have accrued. The loan then passes into a collection phase, in which the collector gets to keep up to 25 percent of whatever is recovered. The same financial entities that make loans can also gain revenues from collecting on defaulted loans. For example, Sallie Mae earns nearly a fifth of its revenues from its collection business.*

The federal government also pays private lenders the difference between the interest rate that is actually charged to the student and a higher rate that is determined by Congress. This is the most profitable subsidy. The newly enacted College Cost Reduction and Access Act cut about \$18-\$19 billion in these lender subsidies over the next five years. Those savings were channeled into increased Pell Grants and capped loan repayments (as described above).

SECONDARY MARKETS

The original lender may sell its portfolio of student loans to a for-profit secondary-market organization such as Sallie Mae or Nelnet, or to a tax-exempt state-chartered institution such as the Pennsylvania Higher Education Assistance Authority. Much like home mortgages, student loans may be packaged into asset-based securities, a popular method for raising low cost capital. The loans are pooled, often by risk categories, into securities and sold. Some financial organizations specialize in securitization transactions, a profitable undertaking.

In general, securitizations of federal and private student loans have been marketed separately.

When student loans are sold to a new lender, future benefits (prepayment incentives, for example) promised by the original lender may be lost. The New York Attorney General recommends that:⁸⁷

It is important to make sure that if your loan is sold, the “back-end” benefits will travel with the loan. In some instances, the sale of the loan will terminate the very benefits that caused you to take out that particular loan in the first place! To preserve these benefits, have your lender commit to them in writing.

STATE GUARANTY AGENCIES

At the time the *Higher Education Act* was enacted, Congress authorized the creation of state-chartered guaranty agencies along with Sallie Mae to ensure sufficient capital for student loans. There are currently 35 state and non-profit federally-designated guaranty agencies. The Student Aid Commission is California’s guaranty agency.

* On defaulted Perkins Loans, the amount of collection costs that can be assessed to students is 30 percent of the total principal, interest, and late charges on first collection efforts, and 40 percent on second collection efforts or in cases of litigation.

Guaranty agencies perform an intermediary fiscal role in the federal student loan system. Students first apply to a participating lender through their school. The school verifies the student's eligibility and determines the loan amount the student is eligible to receive. The student then receives the loan from the lender. The guaranty agency guarantees the loan against default, thereby reducing lender risk and resulting in lower borrower interest rates and the increased availability of capital for student loans. If a student defaults on a loan, the lender files a claim with the guaranty agency for reimbursement of most of its loss. The U.S. Department of Education, which is the final guarantor, reimburses the guaranty agency for most of those claims and for some administrative costs.

Guaranty agencies also counsel students to keep them out of default, rehabilitate loans, and collect on defaulted loans, keeping up to 16 percent of the collected payments (as of October 1, 2007). They have their own underwriting criteria and separate credit ratings. They may guarantee private as well as federal student loans.

Guaranty agencies receive the majority of their revenues from student post-default loan rehabilitation and collection revenues. This reality creates an inherent conflict in their role as advocates for borrowers, since they receive less revenue for preventing defaults. A 2001 agreement between California's Student Aid Commission and the U.S. Department of Education was designed to reduce this conflict by providing incentive payments to lower the default rate of student borrowers (however this program will cease at the end of this year).*

Federal reimbursement policies and rates greatly impact the financial health of state guaranty agencies. In 2005, the federal *Higher Education Reconciliation Act* required guaranty agencies to collect and deposit a default fee on loans issued after July 1, 2006. The California State Auditor opined that as a result of this requirement, the Student Aid Commission's ability to generate sufficient revenues to sustain its status as a guarantor was at risk.⁸⁸ Recent changes in federal law further decrease payments to guaranty agencies by \$4.5 billion nationally.⁸⁹

THE STUDENT AID COMMISSION AND EDFUND

The California Student Aid Commission was established in 1955 and is the federally-designated guaranty agency for California. The Commission is governed by a 15-member board whose members serve four year terms. It guarantees the outstanding principal and interest due to lenders when student loan borrowers fail to repay as required, primarily by purchasing delinquent loans. In federal FY 2005-06, the Commission, through its auxiliary EdFund, guaranteed new federal student loans totaling

* The Student Aid Commission implemented a counseling program targeted at students who withdrew early from school and were thus at high-risk of defaulting on their loans. The state's student loan default rate did decrease to 2.6 percent, yielding federal incentive payments. According to the GAO, however, it is not clear if the early withdrawal counseling program influenced the improvement since default rates declined nationwide.

more than \$6.8 billion.⁹⁰ It is the second largest student loan guaranty agency in the country.

EdFund was created pursuant to state legislation in January 1997, and is a 501(c)(3) public benefit corporation. It serves the Student Aid Commission as the state's official guarantor for student loans, while operating under "... private sector employment and procurement standards."⁹¹ EdFund's President is a former Executive Director of the Student Aid Commission. According to the governor's 2004 Performance Revision Commission, EdFund spent \$89 million on operations.⁹²

EdFund Board members are appointed by and accountable to the Commission, which has oversight responsibilities over the fund. A 2006 report by the State Auditor found ongoing tension between the Student Aid Commission and EdFund that resulted in a lack of cooperation and hampered business operations.⁹³

EdFund administers an outstanding loan portfolio worth more than \$27 billion and has more than 600 employees.⁹⁴ Half of the loans it administers are made to students who live and go to school outside California. In federal FY 2006-07, 30 percent of all EdFund loan dollars were committed to students at nonprofit private institutions (\$2.058 billion). Four-year for-profit proprietary schools accounted for almost 28 percent of total loan dollars. The University of Phoenix is EdFund's largest school as measured by loan volume.⁹⁵

EdFund student loan default claims totaled \$703 million in FY 2006-07, a 35.5 percent increase from the previous year. Sixty-five percent of the defaults were from students at "high risk" segments, two-year public and private schools and all for-profit proprietary schools. The aggregate default rate for the year was 4.46 percent. EdFund is placing more emphasis on loan rehabilitations (regular payments on defaulted loans) and wage garnishments than direct loan consolidations, prompted in part by changes in federal reimbursement policies.⁹⁶

State legislation that became operative in August 2007, (SB 89, Chapter 182, Statutes of 2007) authorizes the Director of the Department of Finance, in consultation with the State Treasurer, to act as the state's agent in the sale and transfer of EdFund's student loan guarantee portfolio. The transaction is to be completed by January 2009. The legislation also requires the Director of the Department of Finance to approve all Student Aid Commission activity relating to the federal student loan program.

In his May Budget Revision, Governor Schwarzenegger estimated that the sale of EdFund would realize one-time revenues of \$980 million for the General Fund. The actual sale price would likely be less given recently-enacted decreased federal lender subsidies that also have resulted in the withdrawal of a \$25 billion offer to buy Sallie Mae (as discussed above). The Legislative Analyst Office estimates a potential sale price of \$500 million.⁹⁷

Potential buyers of EdFund are to be assessed on a variety of criteria, as provided in SB 89, including:

- borrower transparency or disclosure policies for products and/or services offered to students outside of the federal student loan program
- the quality of student services offered, including borrower training in budgeting and financial management, debt management and other financial literacy skills

The State of Missouri considered selling its state-chartered student loan guarantee agency, the Missouri Higher Education Loan Authority, but instead has directed the Authority to transfer \$350 million in assets to a special fund. Money in the fund can be appropriated to finance capital projects at public colleges and universities, and to fund the Missouri Technology Corporation to commercialize technologies developed by academic researchers. In return, the Authority was granted the power to issue a specified amount of private activity bonds.

PRIVATE STUDENT LOANS

Rapid Growth

Fueled by higher demand for postsecondary education due to changes in the economy, and diminishing public financial aid relative to rising fees, the private student loan industry has been growing rapidly. Private student loans:

“...make up a large and fast-growing asset class, with a demand fueled by student enrollment growth, college tuition costs that are rising faster than the rate of inflation, and aggressive marketing efforts by loan companies and financial aid offices.”⁹⁸

Market forces similar to those in the subprime mortgage market have also contributed to the explosive growth of private student loans. Demand for bundled student loans sold to institutional investors worldwide has fueled lending to students. The market for private student loan-backed securities leapt 76 percent in 2006, to \$16.6 billion, from \$9.4 billion in 2005, according to Moody’s Investors Service.⁹⁹

These loans may be certified by a financial aid office at an institution of higher education, but increasingly many are direct-to-consumer loans. They usually require students to show a positive credit history or have a co-borrower (generally a parent).

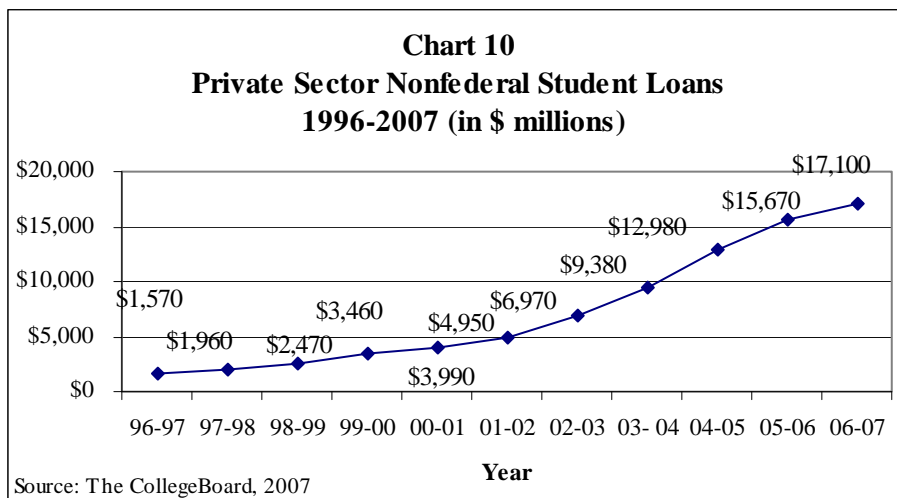
Since private loans are not subsidized or guaranteed by the federal government, they have higher, variable market-based interest rates (that can reach 20 percent) and charge guarantee fees, making them more expensive. Applications are generally shorter, easier to understand, and require less personal information than for federal student loans.

Many private student loans, like home mortgages, carry adjustable rates and are resetting to higher levels, thereby increasing student repayment obligations and creating the potential for problems in the student loan credit market. Under provisions of the federal bankruptcy law enacted in 2005, private student loans may not be discharged in bankruptcy.

Federal oversight responsibility for private student lending activities falls under the jurisdiction of banking regulatory agencies including the Comptroller of the Currency, the Securities and Exchange Commission, the Federal Deposit Insurance Corporation and the Federal Trade Commission.

According to Sallie Mae, profit on private loans exceeds five percent, compared to less than two percent for federally subsidized loans. In its quarterly earning report, the company projected growth in private loans in 2008 of up to 20 percent.¹⁰⁰

Private student loan volume grew from \$1.57 billion in 1996-97 to \$17.1 billion in 2006-07, including student and parent loans for undergraduate and graduate education. These loans now comprise one fourth of all student and parent postsecondary education loans, compared to six percent ten years ago.¹⁰¹



Undergraduate students at for-profit proprietary higher education institutions took out the most private student loans in 2003-04, as shown in Table 4. These students are disproportionately from low income families: 26 percent of the private loans made to students attending for-profit schools in 2003-04, were to students whose family incomes were under \$20,000, compared to between ten and 12 percent of private loans to the students from low income families that attended public and private four-year institutions.¹⁰²

Table 4
Undergraduate Student Loans, 2003-2004

Institution type	% who took out a federal student loan	% who took out a private student loan
Public 4 year	42.8%	5.1%
Private non-profit 4 year	54.4%	11.5%
Public 2 year	11.3%	1.4%
For-Profit 2 and 4 year	80.2%	14.9%
For-Profit less than 2 year	54.7%	8.3%
Source: The Project on Student Debt, <i>Public Loans, Private Loans</i> .		

FRAUD AND ABUSE

PREFERENTIAL LENDING INDUCEMENTS

Investigation by New York Attorney General Andrew Cuomo

In February 2007, New York Attorney General Andrew Cuomo began an investigation of deceptive lending practices by student loan providers, including illegal payments and inducements to universities, colleges, and financial aid officers. Schools and financial aid officers control borrower counseling and loan certification (verifying enrollment) processes, and their agreements with lenders have long shaped lenders' market share. Many institutions of higher education have created lists of recommended lenders. Lenders on these lists typically receive up to 90 percent of the loans borrowed by the institutions' students and parents.¹⁰³

Two main allegations are involved in the investigation and findings of abuse: (1) paying for "shelf space" or a place on a school's recommended lender list; and (2) payments to influence the service provider-selection process in order to limit borrower choice of lenders. The investigation found financial arrangements and relationships between lenders and schools, such as revenue sharing and referral fees, to be "...burdened with a strong potential for conflicts of interest."¹⁰⁴

The alleged payment activities are illegal under federal law to prevent students and parents from paying unnecessarily high interest rates and fees.

The *Higher Education Act of 1965*...prohibits lenders from offering 'points, premiums, payments, or other inducements 'to individuals or institutions 'in order to secure [student loan] applicants,' and prohibits schools from engaging 'in any pattern or practice that results in a denial of the borrower's access to FFEL loans...because of ..selection of a particular lender.'¹⁰⁵

The CollegeBoard, NelNet, Citibank, JPMorgan Chase & Company, Bank of America, Wells Fargo, Student Loan Xpress, and Sallie Mae, among others, were targets of Attorney General Cuomo's investigation. They reached negotiated settlements over their student loan practices and agreed to change lending standards, follow a new code of conduct and donate to a fund to educate college-bound students about loan options.

The CollegeBoard, which is a nonprofit membership organization of schools and colleges, announced that it will leave the student loan business. It originated about \$400 million in student loans in federal FY 2007, less than one percent of the total volume of federally guaranteed loans.¹⁰⁶

The Code of Conduct negotiated by the Attorney General:¹⁰⁷

...prohibits revenue sharing and kickbacks in other forms, including printing services. It prohibits lenders from funding gifts and trips for institutions' financial aid employees. The Code prohibits lender staffed call

centers...[and] lays out strong but fair guidelines concerning, among other things, preferred lender lists, advisory board compensation, and loan resale.

Settlements with universities and lenders total nearly \$10 million, including with the following universities:

- Columbia University - \$1.1 million
- New York University – \$1,394,563.75 covering students who received loans issued over a five-year period.
- St. John’s University – \$80,553.00 for loans issued over a one-year period.
- Syracuse University – \$164,084.74 for loans issued over a two-year period.
- Fordham University – \$13,840.00 for loans issued over a one-year period.
- University of Pennsylvania – \$1,617,580.00 for loans issued over a two-year period.
- Long Island University – \$2,435.41 for loans issued over a one-year period

The investigation also probed alumni associations, including those at UC Riverside and UC Santa Cruz that received cash for directing members to consolidate their student loans with Nelnet. As part of its settlement with Attorney General Cuomo, Nelnet agreed to cancel its “affinity” contracts with 120 alumni associations and pay \$2 million into a consumer education fund.

The Connecticut Attorney General also reached settlements with three institutions over preferred-lender issues and issued a model conflict-of-interest policy.

The New York Attorney General is continuing his investigation, most recently issuing 33 subpoenas to companies suspected of using misleading marketing practices, such as offering false gift cards and rebate offers and creating solicitation letters designed to look like official government notices. He is also investigating whether more than three dozen college athletics departments received payments for arranging loans for students with University Financial Services.¹⁰⁸

The U.S. Department of Education is investigating illegal inducements and has contacted 55 colleges (which have not been identified) that have a high proportion of student loans with a single lender. Of those, 48 colleges held more than 95 percent of their loan volume with a single lender and seven had at least 80 percent of their volume with a single lender. The Department is concerned that this level of concentration may be a sign of violations of federal law, such as having financial-aid websites that automatically direct students to a particular lender.¹⁰⁹

Congressional Investigations

In June 2007, the U.S. Senate Health, Education, Labor and Pensions Committee issued a *Report on Marketing Practices in the Federal Family Education Loan Program*. The Committee made the following findings:¹¹⁰

- Some lenders provided compensation to the schools with the expectation, and in some cases explicit agreement, that the lenders would be given preferential treatment on the school's preferred lender list.
- Some lenders spent large sums on travel and accommodation expenses for school officials, with the expectation of increased loan volume or other preferential treatment.
- School officials held financial interests, including stock and options to purchase stock in lenders on the preferred lender list (including the then-Director of Financial Aid at the University of Southern California*).
- School officials received payments for consulting and serving on advisory boards from lenders on the preferred lender list.

The Committee found that financial aid officers had solicited benefits from lenders, creating an appearance of conflict of interest, undermining student trust in the process and risking illegal quid pro quo deals (for example, between Citibank and the University of Texas). Lender marketing and promotional incentive expenditures directed at schools were widespread, including \$21,242 from the Bank of America to sponsor two UC Los Angeles "Regents Scholarship Receptions."¹¹¹ The Committee found that the questionable expenditures could have been directed at reducing the cost of student loans.

In its second report, the Senate Committee found that some lenders and a (New Jersey) guaranty agency provided donations, services, private loan funds, improper payments based on loan volume, and other benefits in exchange for preferential treatment with student loans. In addition, some schools and alumni associations entered into agreements that improperly constrained financial aid officers from providing unbiased and neutral financial advice to students.¹¹²

An investigation by the Government Accountability Office found that "... some student loan lenders were paying schools to promote their loans, and some schools were limiting students' choice of lenders."¹¹³ The GAO and the Inspector General of the U.S. Department of Education have each found that the Department's oversight of the federal student loan program has been inadequate.

On November 1, 2007, the U.S. Department issued regulations on federal student loans that require colleges to include at least three lenders on a preferred lender list, restrict lender gifts to colleges in exchange for business, prohibit payments to college financial aid employees, and encourage loan counseling.¹¹⁴ The Department's regulations are definitive on eligibility for federal aid, but do not supersede state consumer protection laws.¹¹⁵

* She retired effective June 1, 2007. The University found that her actions in connection with the student loan company Student Loan Xpress were inconsistent with USC's conflict of interest policy.

State Legislative Responses

New York has enacted AB 7950, the *Student Lending Accountability, Transparency and Enforcement Act*. The Act establishes consumer protections for students and parents by mandating new standards for schools, and creates the “Student Lending Education Account” to educate borrowers concerning student loans processes and to reimburse victims of inflated student loans. Key provisions include:

- Lenders are prohibited from making gifts to colleges and universities and their employees in exchange for any consideration relating to education loans, and revenue sharing is prohibited.
- Colleges and universities and their employees may not solicit or receive gifts from lenders, and employees may not receive payments for services on advisory boards or for travel expenses.
- Lenders’ employees and agents are prohibited from staffing school financial aid offices or identifying themselves as school employees.
- Schools must discuss all available financing options available under federal law with potential borrowers.
- Preferred lender lists must disclose the criteria used in compiling the list, advise students they may select lenders not on the list, be based on the best interest of the students and not on the basis of benefits provided to the school or its students, and be reviewed annually.
- Lenders may not be placed on a preferred lender list unless they provide assurance that the advertised benefits will continue regardless of whether the loan is sold, and the sale must be disclosed.
- Lenders must disclose to schools, when asked, default rates, rates of interest charged to borrowers, and the number of borrowers receiving those rates.
- Violations by a lender or institution may result in civil penalties not to exceed \$50,000, or \$7,500 if the violation is by an employee of a covered institution. Lenders found to be in violation will be barred from a preferred list.

Attorney General Cuomo has recommended that the same consumer standards be enacted to apply to the private loan sector.

Iowa college students graduate with one of the nation’s highest debt loads (second to New Hampshire). Legislative hearings have focused on practices at public universities and at the Iowa Student Loan Corporation, the state-affiliated nonprofit guarantee agency. “Much of the controversy stems from the lending corporation’s practice of taking advantage of its reputation as a state-affiliated entity to help sell ‘private’ loans.”¹¹⁶

- Three bills have been introduced relating to student loan practices: SB 605, HSB 322 and SSB 1360. HSB 322 and SSB 1360 are study bills relating to student loans. SB 605 is modeled on the New York legislation, and proposes protections

for students and parents from lender and school conflicts of interest, and establishes a student lending education fund.

New Jersey Senate Bill 2729 would prohibit specified arrangements and interactions between student lending institutions and institutions of higher education. Like the New York legislation, lenders would be prohibited from offering gifts or other inducements to schools in exchange for preferred lender status, and schools could not receive any benefit, including revenue sharing, in exchange for placing a lender on a preferred lender list. Preferred lender lists would have to disclose selection criteria, clarify that other lenders could be selected, contain at least three different lenders, and be updated at least once a year. Lenders and schools could face fines of up to \$50,000 per violation, and employees could face fines of \$10,000 for the first offense and \$20,000 for each subsequent offense.

California Public Colleges and Universities

In response to the investigations and findings made by Attorney General Cuomo and Congress, the UC and CSU reviewed their student loan programs and tightened controls.

An internal audit of financial aid offices on UC campuses did not find personal financial relationships between lenders and financial aid officers, and the University was not one of the institutions alleged to have conflicts of interest. Nonetheless the University has adopted a new policy that:

- prohibits any payment or other benefit from a lender in exchange for inclusion on a preferred lender list.
- forbids lender employees from identifying themselves as UC employees.
- requires annual training for UC financial aid employees on conflict of interest rules.¹¹⁷

According to UC officials, the new UC loan policy also applies to alumni associations. Under certain specified conditions, agreements between alumni associations and lenders to offer education loan products to alumni are permitted, but must be reviewed by the campus financial aid office and approved by the Chancellor. In addition, disclosures to potential borrowers are required. The policy applies to every University department, including campus athletic departments but does not explicitly include unaffiliated “booster clubs.”¹¹⁸

The California State University system has also adopted new rules for campuses and financial aid officers, including listing loan companies randomly on lender lists and tightening conflict of interest regulations. Prohibited practices include financial aid officers serving as paid consultants to any lender or advisory board, accepting equipment or supplies at below-market costs, or accepting reimbursement from lenders for transportation, meals, or lodging to financial aid events. In addition, loan companies now may not make presentations to students on behalf of university financial aid offices.¹¹⁹ The policy does not currently cover alumni associations, affiliated foundations, or athletic booster groups. The CSU is “...in the process of developing additional advice to CSU campuses” to clarify how the new policies affect campus-affiliated organizations.¹²⁰

PREDATORY LENDING

There are parallels between abuses in the subprime mortgage lending market and practices in the private student loan market. New York Attorney General Andrew Cuomo has called private lending “the Wild West of the student loan industry,” because many graduates owe as much if not more than most homeowners owe on mortgages.¹²¹ Other similarities include a lack of clear consumer disclosure requirements, instant credit, adjustable interest rates that compound (making it difficult to pay off the principal), and lender kickbacks to loan originators (including financial aid officers at schools) to steer student loan business to them. In both cases, the ability of lenders to package and sell loans to secondary markets has added an additional profit motive for aggressively pursuing potential borrowers.

Critics contend that what has happened in the subprime mortgage market could happen in the student loan market. The key elements are similar: high costs to borrowers with imperfect credit who have borrowed more than they could otherwise afford.¹²²

Several states have passed bills prohibiting predatory lending practices in the home mortgage market, and some of these prohibitions could be applicable to the student loan market. For example, Maine recently enacted L.S. 1869 (Chapter 273, signed by the Governor on June 11, 2007), which contains the following provisions, among others, intended to protect consumers:

- Lowers the threshold for fees that can be charged from eight percent of the total loan to five or six percent, based on the loan amount, restricts the imposition of late payment fees or penalties, and prohibits the inclusion of payments for credit insurance as part of the loan.
- Prohibits creditors from refinancing a loan with no tangible net benefit to the borrower, and prohibits fees in connection with the modification of the loan or deferral of payments.
- Requires creditors to receive certification that a borrower has received counseling on the advisability of a loan from a third-party. Creditors must have a reasonable belief at the time of closing that the borrower has the financial ability to make the scheduled payments on the loan.
- Requires certain disclosures regarding interest rates and fees.

The California Department of Corporations regulates 4,339 consumer and commercial financial lenders, and perhaps could be given additional responsibilities to regulate private student loans made by state-regulated lenders. According to the Department’s website, it is “...the last line of defense for many of the most significant financial transactions that Californians make, from mortgages to retirement plans.”¹²³

- Since 2001, the Department has compelled finance lenders and mortgage bankers to make over \$61,363,000 in refunds to consumers.

- The Department has authority over finance lenders and brokers who, in 2005, made or assisted in the making of about \$315.5 billion in consumer and commercial finance loans.
- Since 2001, the Department has brought approximately 3,968 enforcement actions, including but not limited to, against people or companies perpetrating frauds, making misrepresentations, and pursuing predatory lenders.

Student Loan Industry Marketing Practices

Lenders have an incentive to market private loans and not the federally subsidized and guaranteed loans that cost students and their parents less. As a result of federal subsidy cuts enacted by HR 2669, the *College Cost Reduction and Access Act* (described above), lenders will likely depend even more on their ability to write more profitable private loans that are marketed directly to students, bypassing college and university student aid offices.

Aside from extensive lender marketing over the Internet, MTV, and through direct mail, students are vulnerable when they go to open checking accounts at local banks, as the following communication to the author from a graduate student at UC Irvine indicates:¹²⁴

When X bank learned I was a graduate student, while opening a checking account, the bank solicited me with what they called a student loan. I was promised a fixed simple interest rate of 5.5% and was told payments were deferred until my date of graduation. However, recently I received a statement and saw that the interest was 14.75% and that the interest was compounded continuously...I would have been better off borrowing school funds on my credit card (which has an interest rate of 9.9%)...I cannot afford the loan and it scares me to death that I am going to be in debt up to my ears when I graduate this summer...In only four months, the interest accrued on my loan was over \$700.

The student did not receive clear information about the loan that might have assisted her to make a more informed consumer choice.

X bank contacted me regarding the loan on the phone. I did not receive official paperwork regarding the interest and payoff, etc., until after I completed my application. Everything was done via fax until the check came in the mail.

The loan statement... reads like an unsubsidized Stafford Loan in that payments are deferred until my graduation but the way in which interest accrues is much more like a personal loan.

Lender requests for student information to target potential borrowers are a source of controversy. High school seniors regularly receive solicitations. Recently Sallie Mae requested that state universities and community colleges in three states provide it with student names, telephone numbers, and mailing and email addresses for marketing purposes. In New York, the request was made as a *Freedom of Information Law* request. According to the U.S. Department of Education, schools can refuse requests for student

contact data that are made under federal or state Freedom of Information laws. Federal law also prohibits a college from releasing information about students' financial-aid status.¹²⁵

Financial Literacy—Counseling Students

Counseling by school financial aid officials is an important source of information for students, who often lack financial literacy. Entry and exit counseling by school financial aid officers is required for students who receive federally subsidized and guaranteed student loans, but not private loans. Federal student loans are generally a less costly alternative for students and their parents. However since they may borrow directly from private lenders, they may not receive the more disinterested counseling that school financial aid officials can offer.

New York's Attorney General has published a two-page brochure on *Student Lending* that advises students to, "Ask tough questions of potential lenders and your school financial aid office." The questions include:¹²⁶

- how lenders are placed on a school's preferred lender list
- how the interest rates for federal and private loans compare
- whether the university's 'signature' loans are likely to be resold
- what the repayment benefits are and if they continue once the loan is sold.

Financial planning workshops at college orientation for new students can be helpful. For example, a large public university on the East Coast requires extensive counseling for students choosing to obtain private loans, including participation in a separate on-line entrance interview. Students must complete a budget that shows their total costs and expected sources of financial support, expected income after graduation, expected monthly loan payments, and other relevant facts.¹²⁷

Given the importance of financial counseling to relatively unsophisticated new student borrowers, a particularly troubling finding made by the recent U.S. Senate Labor and Education Committee investigation is that "... schools often 'contract out' to FFEL lenders their duties...to provide exit counseling to student borrowers, and lenders frequently use this opportunity to market loan products to students rather than offering unbiased financial advice...such services violate the inducement prohibition."¹²⁸

For example, Rhode Island's state-chartered student loan agency allowed the lender Nelnet to operate a telephone call center that purported to offer students unbiased advice on their loans and encouraged them to take out Nelnet loans. Pace University in New York had a similar arrangement with Sallie Mae, which operated its financial aid call center. These arrangements were recently terminated.¹²⁹

Congressman George Miller, Chairman of the House Committee on Education, recently asked the Federal Trade Commission to investigate this type of deceptive marketing.

FEDERAL OVERPAYMENTS TO LENDERS

According to the *Washington Post*, a group of ten lenders may have collected as much as \$330 million in improper overpayments from the U.S. Department of Education by taking advantage of a loophole in the federal student-loan program.¹³⁰ The loophole involves billing at a 9.5 percent interest rate that was allowed in the high-interest rate 1980's, but was ended by Congress in 1993. Lenders took payments from pre-1993 student loans and used that money to make new loans by refinancing bonds before the cutoff date, claiming the old 9.5 percent interest rate guarantee, which the Department of Education paid. This has been a very profitable subsidy, given the lower interest rates otherwise available. In 2006, in a settlement with the Department, Nelnet agreed to repay \$278 million in 9.5 percent interest rate subsidies. However the Department has subsequently decided to forgive the subsidy overpayments to Nelnet.¹³¹

Although a full discussion of this issue is beyond the scope of this report, it demonstrates the amount of money involved in federal student loan subsidies, as well as the programmatic complexities that can lead to abuse.

SCHOOL FRAUD AND ABUSE—PROPRIETARY SCHOOLS*

Between 1983 and 1989, loan defaults from student loans increased by 338 percent to nearly two billion dollars. By 1990, the cost of defaults, as a percent of all guaranteed student loan program costs, was more than 50 percent. The U.S. General Accounting Office (GAO) identified student loan programs as being at “high risk” in terms of their vulnerability to waste, fraud, and abuse.¹³²

An investigation by the Permanent Subcommittee on Investigations of the Committee on Government Affairs of the U.S. Senate in 1990 found that a “disproportionate amount of problems” were attributable to proprietary school student borrowers. Proprietary school borrowers comprised 22 percent of all federal student loan borrowers but 44 percent of defaulters (as of September 1987), with a default rate of 39 percent compared to ten percent for students at four-year public and private schools.

One of the several egregious examples of fraud and abuse investigated by the U.S. Senate Permanent Subcommittee involved First Independent Trust Company of Carmichael, California (FITCO). At the time of its collapse, FITCO was the nation's second leading lender of guaranteed student loans, originating about \$1.5 billion in loans over a nine year period, primarily to proprietary school students. These loans were guaranteed by the California Student Aid Commission and the New Hampshire Higher Education

* Proprietary schools are “for-profit” institutions run by private individuals or institutions. They offer vocational training, and Bachelors, Master's, and even Ph.D. degrees.

Assistance Foundation. California's State Banking Department closed FITCO in May 1989.*

School fraud and abuse in the federal student loan program continues to primarily involve proprietary schools. According to the U.S. Department of Education, from 1998 to 2004, 74 percent of the schools involved in fraud and abuse cases were proprietary schools.¹³³

Proprietary schools include two types of institutions: privately held schools and schools that are part of much larger publicly traded corporations. According to the Department's Inspector General, the rapid growth of schools owned by publicly traded corporations presents a risk factor due to impaired administrative capabilities. In other instances, the fraud is intentional.¹³⁴ Refund violations, caused when a student drops out of an institution, are a particular problem. The institution must determine if a refund is owed, calculate the amount and return those funds to the loan holder. Sometimes the schools do not repay the refunds in a timely manner, or make insufficient or no payment, keeping the money (a federal crime under the *Higher Education Act*). The student may be left owing money for classes that he/she never attended.

Distance education via the Internet, combined with the nearly paperless delivery of student financial assistance funds, creates another risk in ensuring that students are actually enrolled and complete the courses.

Fraud can also occur when a program does not meet the minimum requirements for participation in federal student loan programs (such as accreditation), or when an eligible institution establishes additional locations that do not meet the requirements. In a Michigan example cited by the Inspector General, a private college eligible for participation in federal student loan programs purchased a closed computer learning school, renamed it the "Northstar Institute of Technology," enrolled students, and fraudulently used the eligible school's status to award nearly \$1 million in student financial assistance funds in six months.

California Proprietary Schools

According to staff at the Bureau for Private Postsecondary and Vocational Education[†], there are approximately 1,500 state-approved private postsecondary institutions in California, of which about 1,200 are non-degree granting schools (generally leading to licenses) and 300 of which offer degrees. The list of institutions can be found on the

* A review by GAO found that FITCO had problems keeping current its loan origination fee payments to the United States Department of Education. Twenty-one audits and reviews of FITCO activities were identified, each of which found minor or major deficiencies in FITCO's operations. See GAO, Student Loan Lenders: Information on the Activities of the First Independent Trust Company, 1990, GAO Report 09-00.

[†] The Bureau for Private Postsecondary and Vocational Education went out of existence on June 30, 2007. However the Department of Consumer Affairs may enter into voluntary agreements with for-profit schools to abide by state rules through January 31, 2008. SB 823 (Perata), which will be under consideration in the Assembly after it reconvenes in 2008, proposes to reconstitute the Commission and associated activities.

website of the California Postsecondary Education Commission, and include computer schools, beauty schools, culinary institutes, law, theology, trucking, and liberal arts schools, among others.

Students who attend these institutions and their parents may apply for and receive federally subsidized and guaranteed student loans, as well as private loans. As noted in Table 4, over 80 percent of students nationally who attended for-profit two-and-four-year postsecondary institutions in 2006 took out federal loans, and nearly 15 percent took out private loans. These students were disproportionately from low income families: 26 percent of the loans were made to students whose family incomes were under \$20,000.¹³⁵

Since 2001, 49 for-profit proprietary schools have closed in California, generating 2,280 claims to the state's Student Tuition Recovery Fund.¹³⁶ Unaccredited computer schools have generated the biggest losses. Students may be left with sizable loans, above and beyond any tuition recovered from the state fund, when a school closes. Fees collected by the schools for originating those loans may be substantial, a motive that has generated some fraud and abuse at the national level, as discussed above.

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