Lending to students 'a gold mine' for creditors

by David Washburn

Get rich with no risk.

The classic business pitch is usually too good to be true - unless you're talking about the student loan business. Student loans, which banks and other lenders avoided in decades past, have become a creditor's dream.

Their product is desperately needed, the multibillion-dollar market is growing like gangbusters, and if things go south, lenders can turn to the government for a bailout.

The federal government estimates that college students and their families will take out $86 billion in loans this year, a 186 percent increase from 1995.

A sizable chunk of that money will flow to several companies in San Diego. Student Loan Corp., Goal Financial and Education Lending Group, which operates as Student Loan Xpress, held nearly $18 billion in student loans in 2005, according to Finaid.org, an informational Web site for borrowers.

Industry watchdogs have long alleged large profits, predatory lending practices and Draconian fees and penalties by these and other student loan companies. And recently, allegations of kickback schemes between lenders and college financial aid officers have surfaced.

Earlier in April, New York Attorney General Andrew Cuomo disclosed that the financial aid directors of three universities had held stock in Student Loan Xpress. Earlier, five other universities agreed to pay a $3.2 million settlement after an investigation by Cuomo's office revealed that the institutions were receiving payments from lenders.

Several recent calls to representatives of all three San Diego companies were not returned.

"It's very lucrative, a gold mine," said Deborah Fox, founder of Fox College Funding, a financial planning firm that specializes in helping families prepare for college.

So lucrative that Virginia-based student loan company SLM Corp., commonly known as Sallie Mae, is the third most profitable financial service firm in the world, said Finaid founder Mark Kantrowitz.

"They are the 2,000-pound gorilla of student loans," Kantrowitz said.

The growth of Sallie Mae is integral to the history of the student loan business.

Federally backed Perkins loans, which now have family income requirements, were first introduced in 1958. Stafford Loans, which do not factor in income, were introduced in the mid-1960s. But the government initially had a hard time persuading banks to lend money through the programs because students were considered bad credit risks.

So the government created Sallie Mae in 1972 as a government-sponsored enterprise. Its sole purpose was to buy existing student loans from banks, thereby limiting the banks' risk and freeing up capital for new loans.

Thus, a market was born. It picked up steam in the 1980s after the government introduced subsidized PLUS Loans for the parents of college students.

By the early 1990s, Sallie Mae and the private lenders were reaping huge profits, and drawing criticism from watchdog groups. So the Clinton administration pushed through a "direct lending" program that allowed the government to lend money directly through schools, thereby cutting out Sallie Mae and the private lenders.

Officials at Sallie Mae said the direct lending program was taking away its business, and that it would go under unless it was allowed to sever its government ties. Today, the direct lending program accounts for about 25 percent of all loans, Kantrowitz said.

Sallie Mae was given the right to go private in 1996 and completed the process in 2005. During that time, the company entered into every aspect of the student loan business, from loan origination to debt collection. The company now controls nearly half of the student loan market, and its net income went from $465 million in 2000 to more than $2 billion last year.

Much of the windfall to Sallie Mae and other lenders comes from soaring tuition costs and mushrooming college enrollment fueled by child-rearing baby boomers. College enrollment increased 21 percent from 1994 to 2004 and is expected to top out at 18 million students in 2012.

Following the enrollment boom has been a growth in companies specializing in student loans. Almost all of the major banks, including Citibank, Wells Fargo and Bank of America, have student loan divisions.

But beyond the fundamentals, student loan companies benefit from a confluence of government regulations that all but assure them hefty profits, say Fox and others.

To start, nearly $69 billion of the current $86 billion in student loans is backed by the U.S. Treasury, meaning that even if the loans go into default, the lenders are protected. These loans are subsidized by the government in order to keep interest rates low for borrowers and guarantee profits for lenders.

Between 1992 and 2004, the cumulative subsidy cost was $39 billion, according to U.S. PRIG, a federation of state public interest research groups.

Lenders face a little more risk with the $17 billion in private "alternative" loans that are not backed by the government, but not much. They can charge interest rates that approach those of credit cards, and federal regulations, strengthened with bankruptcy laws enacted in 2005, make it almost impossible for student loans to be discharged through bankruptcy.

If that is not enough help, the Supreme Court ruled in 2005 that lenders have the right to garnish even Social Security income from those who are delinquent on their student loans.

Finally, student borrowers are only allowed to consolidate, or refinance, their debt once after graduating. So when a borrower consolidates with a lender, he or she is committed to that lender for the life of the loan.

The Stafford and PLUS loans, which fall under the Federal Family Education Loan Program, now have fixed interest rate limits of 6.8 percent and 8.5 percent, respectively. Loans that are not federally backed can have initial rates above 12 percent, depending on a borrower's credit score, Kantrowitz said.

The terms of the federally backed loans always start at 10 years, but they can be extended for as long as 30 years if a borrower consolidates his or her loans after graduating.

If a student borrows $50,000 for college and makes prompt payments from graduation through the end of the 10-year term, he or she will pay approximately $20,000 in interest and fees.

But, consumer advocates say, if the borrower misses payments or allows the loan to go into default, the companies pounce. Late payment penalties that equal 25 percent of the loan's value are common, said Alan Collinge, founder of StudentLoanJustice.org, an advocacy group for borrowers.

"Who wouldn't want to be in that business? You can't lose. There is no bankruptcy protection, and you have the borrowers for life," Collinge said. "It has led to some really abusive situations."

And, as Cuomo's investigation revealed, some companies can gain an unfair advantage by cultivating relationships with financial aid officers at colleges and universities.

When students seek the advice of a financial aid office, they are often led to a list of "preferred lenders" that financial aid offices have presumably determined to be the best deals in terms of cost and service.

Landing a good spot on such lists is the student lender equivalent of finding the golden goose. As much as 90 percent of all student loans go to lenders high on the list.

At many colleges, 99 percent of loans go to the first company on the preferred list, according to Stephan Burd, a fellow at the Washington, D.C.-based New America Foundation who has reported on the industry for 15 years.

"The name of the game is to get as much loan volume as quickly as you can," Kantrowitz said. "And it causes some people to cross the line."

To be sure, Fox, who has been counseling families since 1998, said the majority of lenders operate above board.

"I know that certain lenders overstep their bounds," Fox said. "(But) it is important that the public know that it is a relatively small percentage."

Collinge says that this may be the year that Congress takes steps to protect borrowers. Sen. Hillary Clinton, D-N.Y., has reintroduced the Borrower's Bill of Rights, which, among other things, would bring back some bankruptcy protection for student loan borrowers and allow them to refinance more than once.

And Cuomo's investigation in New York has put tremendous pressure on the companies and financial aid directors to be more transparent in their handling of the "preferred lender" lists.

Cuomo's office disclosed that financial aid directors at Columbia University, the University of Texas and the University of Southern California held stock in Student Loan Xpress, a "preferred" lender at all three schools.

New Jersey-based CIT Group, which bought Student Loan Xpress in 2005, suspended three of the company's top executives, pending the outcome of the investigation.

Some colleges and universities have changed their policies recently regarding their preferred lender lists. And Sallie Mae and Citibank have agreed to $2 million settlements, and pledged to end some practices that Cuomo said were deceptive and unlawful.

Regardless of regulatory changes, Kantrowitz said, the business will remain hugely profitable. He points to investments in student loan companies made by investment banking titans Merrill Lynch and Goldman Sachs.

And a $25 billion offer for Sallie Mae was made recently by a consortium of J.C. Flowers and Friedman Fleischer & Lowe, two private equity firms, along with Bank of America and JPMorgan Chase.

"But," Kantrowitz said, "I do think all this will make consumers more wary, and there will be a more level playing field."

CNS writer Eleanor Yang Su contributed to this report.