



American Council on Education

Background Information for Presidents and Chancellors on the Recent Controversy Involving Student Loans¹

Recent controversies regarding student loan-related practices have attracted much institutional and public attention. Steps already taken by several state attorneys general, by the U.S. Department of Education (ED), and in Congress make plain that these issues will not soon be fully resolved. This document summarizes key issues, especially with respect to questioned practices and developing norms. This paper and the accompanying chart provide background, are not legal advice, and do not specify actions individual institutions should take. Legal counsel should be consulted on these legally sensitive issues.

1. What types of student loans are involved?

Two categories of student loan products are currently at issue: federal loans and private (or alternative) loans. The former are guaranteed by the federal government and are made available through campus aid offices. The latter are not federally guaranteed and may or may not involve campus aid administration.

Most federal student loans are provided through one of two programs: the Federal Family Education Loan Program (FFELP) and the William D. Ford Direct Loan Program (Direct Loan Program). Higher education institutions may participate in FFELP, the Direct Loan Program or both. Although the programs are structured differently, a significant common feature is that the government absorbs most of the risk. Through FFELP, eligible students or their parents receive loans from banks or other private lenders under terms specified by federal law. Borrowers repay the private-sector holders. The government guarantees the loans by ensuring that holders are reimbursed for unpaid principal if the borrower defaults. Through the Direct Loan Program, the government provides loans to borrowers using federal capital, and it owns the loans. Borrowers repay the federal government directly.

Increasingly, parents and students also finance education through private consumer loans from banks and other private lenders.² While federal regulations limit the terms of FFELP loans, private loan products can be tailored to a borrower's particular circumstances in terms of repayment options, risk level, rewards, and services. Often, however, the credit history of the borrower and/or the borrower's co-signer affects the terms of private loans, which carry more risk because they are not federally guaranteed.

2. Which institutional offices are most directly involved with student loans?

University and college financial aid offices function as the main interface between student borrowers and lenders. Financial aid offices provide students and their families information on financial assistance, assess levels of need, and develop and process aid packages that may include, for example, grants, work-study, and loans. Before a lender may disburse a federal education loan, the college or university must certify the student's eligibility and certain other matters.

Financial aid offices also manage relations with government and private lenders. At many colleges and universities, officials use a preferred lender list to recommend lenders to students. In developing a preferred lender list, financial aid administrators may evaluate interest rates, fees, quality of customer service, borrower benefits, collection and default management, and reputation. Proponents assert that preferred lender lists help students negotiate the vast array of loan products and, by simplifying the loan process, reduce the institution's administrative burdens. Critics contend that such lists limit borrower choice and may not lead borrowers to the best available product, in part because some borrowers select lenders from the list without additional research. Lenders often compete vigorously for placement on an institution's preferred lender list.

3. What legal framework applies to student loans and the relationships between universities and lenders?

The Higher Education Act of 1965, as amended (HEA), governs federal loan programs.³ ED has promulgated implementing regulations and has issued pertinent guidance to interpret federal requirements. Three HEA precepts are especially relevant to the current student loan controversies:

- **Preferred lender lists and borrower choice:** Colleges and universities can have preferred lender lists to help students choose a FFELP lender. However, an institution shall not insist that borrowers use only listed lenders. Nor can schools delay certification of a student's eligibility for a FFELP loan or otherwise engage in activities that impede a borrower's access to a FFELP loan simply because he or she selected a particular lender.⁴
- **Anti-inducement prohibition:** HEA forbids lenders and guaranty agencies from offering directly or indirectly payments or other incentives to institutions or individuals in order to secure FFELP loan applicants. To date, ED has not issued regulations that elaborate where the line should be drawn between prohibited inducements and permissible activities, but ED has issued guidance that does not have the effect of regulations⁵ and, as described below, is drafting new regulations.
- **School-as-lender program:** Under the school-as-lender program, colleges and universities can serve as FFELP lenders. As an FFELP lender, a school is subject to restrictions that do not apply to private lenders. For instance, it may provide FFELP loans to graduate and professional students but generally not to undergraduates, and revenue that an institution earns on FFELP loans may only be used for administrative expenses or to supplement, not supplant, institutional spending on need-based grants.⁶ An institution shall not insist that borrowers use only the school as lender.⁷ In 2006, Congress curtailed expansion of the school-as-lender program and limited further the ability of universities and colleges, and their affiliated organizations, to function as FFELP lenders.⁸

The HEA is generally inapplicable to private student loans except possibly to the extent that they are tied to federally guaranteed loans and thus raise anti-inducement issues. However, other state and federal laws, including consumer protection statutes, may apply to private loans.

4. How did the state attorneys general investigations begin?

In November 2006, New York Attorney General (NYAG) Eliot Spitzer opened an investigation into potential conflicts of interests within the higher education student lending industry. When Spitzer became Governor of New York, his successor, Andrew Cuomo, assumed control over the investigation. In February 2007, Cuomo expanded the investigation's scope and sent information requests to additional

lenders and to more than 60 public and private colleges and universities in New York and other states.⁹ The investigation has thus far reached at least six lenders¹⁰ and, according to the NYAG, more than 100 colleges and universities. At present, state attorneys general have announced inquiries into these issues in at least seven additional states—Arizona, California, Connecticut, Illinois, Massachusetts, Minnesota, and Missouri.

5. What substantive issues have been the focus of the NYAG’s investigation?

The NYAG’s information requests touch on a broad array of issues, but focus mainly on the following: (a) methods that colleges and universities use to assemble and manage preferred lender lists, and the role lenders play in that process; (b) lenders’ provision of items of value—including expense-paid trips, meals, gifts, entertainment, compensation, equipment, services, and staffing—to institutions or institutional employees; (c) lenders’ provision of “opportunity funds,” “opportunity loans,” or “override pools” to enable institutions to make available loans to borrowers whose risk profiles might otherwise make them ineligible for private loans; (d) interference with borrowers’ free choice among lenders and loan products; (e) revenue-sharing arrangements through which a lender pays an institution a percentage of revenue from loans originated at the institution; and (f) lenders’ use of institutional employees on advisory boards or panels. The information requests also cover the school-as-lender program, Direct Lending Program, and problems institutions or borrowers have experienced with lenders.

On March 15, 2007, the NYAG issued a press release detailing “deceptive practices” uncovered through his investigation to that point.¹¹ In conjunction with that release, the NYAG sent letters to presidents of more than 400 colleges and universities, including every institution in New York and institutions outside New York. The letters addressed certain student lending activities and recommended specific action to improve institutional practices.¹² In addition, the NYAG released a brochure to educate students and parents regarding the student lending industry.¹³ The attached chart describes certain practices that the press release and letter to colleges and universities stated or suggested are “problematic.”

6. What other types of conduct have been questioned?

In early April 2007, the New America Foundation reported that, according to Securities and Exchange Commission filings, financial aid directors at three universities and a senior ED official involved in FFELP lender oversight personally owned stock in the parent corporation of a student loan company that each institution had placed on its preferred lender list. The institutional officials reportedly received stock options from the company as compensation for service on an advisory board. The NYAG subsequently expanded his investigation to include these and related matters, such as consulting and other payments to institutional employees, at these three universities and other institutions. He is also looking into matters related to ED employees who previously worked for lenders. In addition, Sen. Edward Kennedy (D-MA), Chairman of the Senate Committee on Health, Education, Labor and Pensions, and Rep. George Miller (D-CA), Chairman of the House Committee on Education and Labor, recently announced that they have asked ED for information related to relationships between lenders and ED officials.

7. What enforcement action, if any, has the NYAG taken to date?

On March 22, 2007, the NYAG announced the first enforcement action to arise from his investigation through a press release,¹⁴ and notice of his intent to sue was issued to Education Finance Partners (EFP), a student loan company based in California.¹⁵ The target of the action is EFP’s revenue-sharing

arrangements with, according to the NYAG, more than 60 colleges and universities across the United States. Under such arrangements, institutions received payment from EFP based on loan volume, which they reportedly usually used for need-based student aid. The NYAG also asserts that EFP's use of school colors, logos, and mascots in promotional materials distributed at educational institutions amounts to deceptive marketing because it conveys implied institutional endorsement.

8. What did the NYAG settlement agreements entail?

On April 2, 2007, an NYAG press release announced the first settlements arising out of his investigation.¹⁶ Included in the settlements were at least eight universities or systems.¹⁷ At least six of the institutions agreed as part of settlement to make payments that collectively total more than \$3.2 million to their student borrowers who took out private loans during a period in which the institution participated in a revenue-sharing agreement with the students' lender. The NYAG disclosed the settlement agreements with New York University and the University of Pennsylvania.¹⁸ In identical sections titled "Industry-Wide Findings," those agreements set out what the NYAG characterizes as "common practices" in the student lending industry. These include asserted shortcomings in the substance of and disclosures surrounding preferred lender lists, interference with borrower choice, exclusive consolidation loan marketing agreements, undisclosed loan sales, and institutional conflicts of interest arising out of revenue-sharing arrangements, expense-paid travel, appointment of school officials to lender boards or panels, lenders' provision of staff and services to institutions, and lenders' provision of opportunity loans. Each disclosed settlement agreement also includes a Code of Conduct, which the institutions agreed to adopt.¹⁹ The attached chart summarizes Code of Conduct provisions contained in the disclosed settlement agreements. The NYAG has also announced settlements with Citibank and Sallie Mae.²⁰

9. What is Congress doing about these student lending issues?

On February 1, 2007, Sen. Kennedy and other senators introduced the "Student Loan Sunshine Act" (Sunshine Act). Several days later, Rep. Miller and other representatives introduced companion legislation in the U.S. House of Representatives.²¹ The Sunshine Act would regulate relationships between institutions and lenders with respect to federal and private loans through disclosure requirements and bans on such lender practices as provision of financial and other benefits to institutions or institutional personnel. The attached chart summarizes selected Sunshine Act provisions. To date there has been no action on the proposed legislation.

Shortly after the Sunshine Act was introduced, the Senate and House launched investigations of student lending practices. On March 21, 2007, Senator Kennedy sent information requests to 16 lenders, in part to determine whether they offered benefits to colleges and universities and/or their officials in exchange for preferential treatment. Seven days later, Representative Miller sent information requests to five student loan providers regarding their relationships with financial aid offices, including any efforts to encourage higher education institutions to participate in FFELP and not the Direct Loan Program.²² Recently, the House Committee announced an April hearing at which the NYAG is expected to testify.

10. What is the Department of Education doing about student lending?

In December 2006, ED began a "negotiated rulemaking" process that is still ongoing to amend regulations pertinent to federal student loan programs, including preferred lender lists and prohibited

inducements. The goal of negotiated rulemaking is to develop regulations acceptable to constituencies represented by the negotiators. The negotiating committee includes, in addition to federal negotiators, employees of lenders and schools, as well as consumer advocates and students. ED's draft regulations contain provisions similar but not identical to those in the proposed Sunshine Act and the NYAG Code of Conduct. The attached chart summarizes pertinent provisions in ED's most recent draft of the proposed regulations.²³ Those draft provisions will likely change before they are adopted.

In addition, on March 29, 2007, ED issued written guidance in response to complaints that some colleges and universities have refused to certify loans because borrowers have selected particular lenders.²⁴ The guidance stresses that such practices violate the HEA. It also reminds institutions that failure to comply with the HEA could trigger fines or other administrative action. ED also recently announced creation of a team to conduct targeted program reviews and investigate complaints about student loan practices, including preferred lender lists.²⁵

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¹ This paper was written by Stephanie Gold, Martin Michaelson, Joshua Civin, and Matthew Ballenger of the Washington, D.C. law firm Hogan & Hartson L.L.P.

² College Board, [Trends in Student Aid](#) at 5 (2006).

³ See 20 U.S.C. § 1070 *et seq.*

⁴ See 34 C.F.R. § 682.603(e); U.S. Department of Education, Dear Colleague Letter GEN-07-01, FP-07-04 (Mar. 29, 2007); see also 20 U.S.C. §§ 1082(m)(1)(B)(ii), 1087tt(c).

⁵ See U.S. Department of Education, Dear Colleague Letter 95-G-278, 95-L-178, 95-S-73 (Mar. 1, 1995); U.S. Department of Education, Dear Colleague Letter 89-L-129, 89-S-55, 89-G-157 (Feb. 1989).

⁶ See 20 U.S.C. § 1085(d)(7).

⁷ See U.S. Department of Education, Dear Colleague Letter GEN-07-01, FP-07-04 (Mar. 29, 2007).

⁸ See Higher Education Reconciliation Act, Pub. L. 109-171, § 8011, 120 Stat 4, 165-66 (2006); Third Higher Education Extension Act, Pub. L. 109-292, § 3, 120 Stat 1340, 1340-41 (2006).

⁹ According to the NYAG, each of the institutions that received the information requests enrolls students from New York. The [press release](#) that announces expansion of the investigation can be found on the NYAG web site.

¹⁰ The six lenders identified publicly are Education Finance Partners ("EFP"), Sallie Mae, Nelnet, EduCap, the College Board, and Citibank.

¹¹ The [press release](#) can be found on the NYAG web site.

¹² The NYAG's [letter](#) can be found on its web site.

¹³ The [brochure](#) can be found on the NYAG web site.

¹⁴ The [press release](#) can be found on the NYAG web site.

¹⁵ Pursuant to N.Y. Gen. Bus. Law §§ 349 and 350, the NYAG is required to provide the target of any proposed enforcement action with five days advance written notice of its intent to file suit and an opportunity to respond. The [notice letter](#) can be found on the New York state web site.

¹⁶ The [press release](#) can be found on the NYAG web site.

¹⁷ The institutions publicly identified by the NYAG included the State University of New York, Fordham University, Long Island University, New York University, St. Lawrence University, Syracuse University, St. John's University, and University of Pennsylvania.

¹⁸ Those agreements can be found [here](#) and [here](#).

¹⁹ The Code of Conduct can be found within the text of the settlement agreements at the sites identified above. The NYAG has also prepared a [one-page summary](#) of the Code of Conduct.

²⁰ Citibank and Sallie Mae each agreed to pay \$2 million into a fund administered by the NYAG to educate students and parents about the student lending industry. Citibank reportedly also agreed to adhere to the principles set forth in the institutional Code of Conduct. Sallie Mae agreed to adopt a lender Code of Conduct. See the NYAG [press release](#) regarding the Sallie Mae settlement, which includes a copy of the agreement.

²¹ Press releases that announce introduction of this legislation can be found [here](#) and [here](#). Other legislation pertinent to student lending issues includes a bipartisan bill to encourage higher education institutions to participate in the Direct Loan Program rather than FFELP. See [Press Release](#) (Feb. 15, 2007).

²² The press releases that announce these investigations can be found [here](#) and [here](#).

²³ See ED's most recent [draft regulatory language](#).

²⁴ See U.S. Department of Education, Dear Colleague Letter GEN-07-01, FP-07-04 (Mar. 29, 2007).

²⁵ See Kelly Field, U.S. Officials Scrutinize Colleges' Deals with Lenders, CHRON. OF HIGHER EDUC., Apr. 6, 2007.