

Loan Shark U.

How private banking gave student loans a bad name



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THE BIG MONEY

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When the president proposed his education budget, there was a lot for both the poor and the upper-middle class to like. For low-income students, the budget includes a substantial increase in Pell grants (government money for college). For the upper-middle class, it's even better, with a \$2,500-a-year tax credit for students or parents paying for college.

One thing, however, was conspicuously missing from the education plan: an increase in the amount of money students can borrow via federally subsidized loans.

Now, maybe students aren't in the mood to borrow more — aren't college graduates already terrifically overburdened with enormous loan payments? That's certainly what you might think from the public discussion of excessive **corporate profits** and crushing student debt.

The reality, though, of the federal loan program is more complicated. It's not the story of failure that many folks would imagine. It's a story of how neglect and the interests of private lenders — and to some extent, those of a small group of for-profit schools that

have abused the system — have smothered one of the government's most successful programs.

Stories about the travails of students who find themselves hopelessly in debt obscure a truly stunning fact: The amount that students can borrow in federally subsidized loans has remained almost unchanged for more than 15 years.

In 1993, the total that an undergraduate could borrow over four years in federally subsidized loans from the Stafford loan program was \$17,125. Since then it has risen to \$19,000 — a total of about 11 percent. Often in stories about college costs, you see numbers “adjusted for inflation.” So just to get this clear: Right now, most undergrads can borrow all of \$1,875 more in subsidized loans over their four years of college.

How much has the cost of college gone up since then? In the 1993-1994 academic year, according to the College Board, the average tuition at a four-year private college at the time was \$11,007. It is now \$26,273. Four-year public colleges? Same story: up from \$2,535 to \$7,020. You can do the precise math yourself, but here's the bottom line: The money that students have available from subsidized loans has stayed almost constant, while the cost of college has risen more than 150 percent.

We can add in another \$2,000 a year for some unsubsidized loans (which start accruing interest when students are still in school) that became available to most undergraduate students in 2008, but that doesn't seriously change the picture.

The bottom line remains that as college costs have skyrocketed, the money available to most students to pay for them has not come close to keeping pace.

And the effects of this are evident in rising college-dropout rates, as students find that after starting they simply don't have the money to finish.

So what happened to give “student loans” such a bad name? Two things.

The first is that public debate about student loans has focused on the profits that lenders have gained from participating in the federal program. Stafford loans guarantee that lenders get back 97 percent of their money if students default, and that they essentially have built-in profits.

The system dates to the beginnings of the loan program, when they were made through a specially chartered corporation, Sallie Mae. Sallie Mae is now SLM Corp., a fully private

company. It's still the dominant student loan lender, and together with others (Citi is the second biggest, though well behind Sallie) enjoys the fruits of a system in which the government takes all the risk and offers guaranteed returns.

Efforts to change this have long been stymied by Sallie Mae's Washington allies, including House Minority leader John Boehner, who has long had a particularly close relationship with the company and has been a top recipient of its campaign cash. Those guaranteed profits are a target of Obama's education plan, which would eliminate the role of Sallie and other private companies and have the government make loans directly, something it already does for about 30 percent of subsidized loans.

The second thing that has made Americans suspicious of student loans, though, is worse. Its private student loans, made at much higher **interest rates** than the government-guaranteed Stafford loans. Despite not having government guarantees, these loans have special status: Even a bankruptcy doesn't eliminate the debt.

Despite all the talk about lenders' excess profits on government loans, private loans are potentially much more profitable. Take Sallie Mae. Though it was created to make government-guaranteed loans, Sallie Mae has branched out into higher interest rate private loans as well. The rate on those runs about 5 percentage points higher than on federally guaranteed loans—in 2006 it averaged 11.9 percent, though in 2008 (the last year for which complete **data** is available) it was down to about 9 percent.

In 2008 — financial statements for 2009 will be filed soon — Sallie Mae collected about \$2.75 billion in interest on these private loans, substantially more than the \$2.16 billion in interest it got on Stafford and other federally guaranteed loans that Sallie originated, even though its **portfolio** of private loans is less than half as big. (Sallie Mae and other lenders also have a big business in consolidating and refinancing loans — that's not counted in these numbers.)

That's not even the whole story. One key way that lenders look at loans is the “spread” between what money costs them to borrow and what they can get lending it out. For government guaranteed loans, it's less than 1 percent. For private loans, it's about 5 percent — meaning that, dollar for dollar, private loans potentially can be as much as five times as profitable.

The very existence of this private loan market is the result of the government failing to raise the limits on guaranteed loans.

Private loans reached a high of 23 percent of the student-loan market in 2008. The number has fallen since the credit markets seized up but will probably go up again. These, not federally guaranteed loans, are the ones implicated in the worst stories of student debt. It's not just undergraduate programs but graduate and especially **professional schools** where this has become a huge issue. That's why the American Bar Association, worried that excessive private loan debt is keeping students out of public-interest fields, has pushed for an increase in the (professional school) subsidized-loan limits.

Yes, this might sound a little backwards. But one of the solutions to student loan debt is ... yes, more student loan debt. At lower, government-subsidized rates. One legitimate concern about this — expressed in this discussion from the New America Foundation — is that for-profit and **trade** schools will just raise their tuition levels to take advantage of this.

The answer to this is easy and obvious to anyone who has even the slightest familiarity with the nightmarish business practices of for-profit schools: It's to force them out of the program. That could be done either by limiting it to nonprofits (that's pretty much every real, non-diploma-mill college) or by tightening standards on the repayment rates schools need to achieve, which will also effectively knock out the diploma mills.

On this, too, House Republicans have a long record of opposing change; the rights of “proprietary schools,” the euphemism for “for-profit” preferred by the industry — was a particular pet issue of current House Republican leader Boehner when he chaired the House Education Committee. If you've been keeping count, you might want to add the abuse of government-subsidized loans by these kinds of schools as a third strike against the student loan program.

In the current reality, though, even the simplest change to the guaranteed loan program — the plan to switch to direct lending from the federal government — may be difficult to push through Congress. Keeping marginal for-profit schools out isn't something that's even on the table. Most important, though, what's happened with federal student-loan program is that it has been severely damaged by the perception that there is a crisis in student debt, a perception that's the result largely of lenders charging excessive rates on private loans.

So here is the irony: As states cut back on their **funding** for higher education, the federal government, if the Obama plan passes, steps into the breach to make up for the shortfall

with new grants. Those grants are substantial, and they should in fact cover a big group of folks — though there are likely to be some in the middle whose income is too high for Pell grants but also not high enough to take advantage of new federal tax credits.

The tax credit in particular is a remarkably roundabout way of solving the problems of states without money for their colleges and students without the money to pay for the higher tuitions this entails.

In a Tea Party world of public anger over **taxes** and government, the new education plan adds another middle-class entitlement — though one couched as a tax cut — to shore up the student financial-aid system. A new entitlement made necessary in large part because of the damage done to the student-loan system by the private enterprises of which the Tea Partiers and their Congressional allies often seem to think so highly.