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## LEADING LADY:

Sallie Mae and the Origins of Today's Student Loan Controversy

By Erin Dillon

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## ABOUT THE AUTHOR

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## ABOUT EDUCATION SECTOR

Education Sector is an independent education think tank based in Washington, D.C. It is a nonprofit and nonpartisan organization devoted to developing innovative solutions to the nation's most pressing educational problems. The organization seeks to be a dependable source of sound thinking on education policy and an honest broker of evidence in key education debates in Washington and nationally.

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The \$85-billion-a-year student loan industry has been beset by scandal since New York Attorney General Andrew Cuomo announced on March 15, 2007, that his office was investigating “unholy alliances” between lending companies and college financial aid officers. Revelations of college officials accepting consulting fees from and holding stock in companies on their school’s preferred-lender lists, lenders staffing college’s financial information call centers, and close ties between U.S. Department of Education officials and lenders have been front-page news.

The largest and most influential player in the industry, SLM Corporation, better known as Sallie Mae, hasn’t escaped the controversy: In the wake of Cuomo’s investigation, the company agreed under the terms of a settlement with the New York prosecutor to abide by a new “code of conduct” and to put \$2 million into a fund to educate students about financial aid. Yet days after the Sallie Mae settlement, the publicly traded company announced that it was being sold to private investors for \$25 billion—a sum that suggests the enormity of the financial stakes in the student loan industry.

The story of Sallie Mae’s rise from a government-sponsored agency created to help needy students to a private corporation with a \$142 billion loan portfolio goes a long way toward explaining how and why the student loan industry has landed at the center of controversy.

Created by Congress in 1972 to increase the supply of lendable funds under the then-decade-old federal student loan program, Sallie Mae for many years played a relatively narrow role in the industry as a “secondary lender,” buying and managing loans from banks and other lenders that used their proceeds from Sallie Mae to make new loans.

But in the mid-1990s, skyrocketing demand for student loans prompted by escalating college tuitions, expanding eligibility for student loans, and a host of new types of lending combined to make the student loan industry infinitely more complex, larger, and more lucrative. And Sallie Mae emerged as the industry’s biggest player.

After shedding its government-sponsored status and becoming a fully private, for-profit corporation, Sallie Mae embarked on an aggressive expansion campaign. It bought, or formed partnerships with, companies working in every corner of the student lending industry, from lending and loan collection to enrollment management and even college-tuition savings plans for infants.

Sallie Mae has helped millions of students pay for college, students who would not have otherwise been able to cover the cost. But the relentless expansion of Sallie Mae and other lending giants into every part of the student-aid enterprise and into every region of the country combined with an outmatched and often unmotivated federal regulatory bureaucracy, industry political clout that reaches from the halls of Congress to college campuses, and lucrative regulatory loopholes that contribute to student lending’s immense profit potential have created a climate that’s ripe for the questionable marketing tactics and other industry wrongdoing that have emerged in recent months.

It is a climate that has empowered the lending industry to act aggressively at every turn, placing students at risk of paying inflated interest rates and fees on their federal loans and leaving taxpayers to pick up the tab for what members of Congress say are hundreds of millions of dollars in excessive subsidies for the student lending industry.

As the Sallie Mae story suggests, past is prologue in the student lending industry. Today’s problems are the result of conditions in the industry that have been building for years.

## Opening College Doors

The size, complexity, and immense profit potential of today's student loan industry isn't what Congress envisioned when it created the Guaranteed Student Loan Program (renamed the Federal Family Education Loan Program in 1992) as part of the Higher Education Act (HEA) of 1965. The program began as a relatively small, targeted effort to open college doors for financially needy students. The original program provided loans of up to \$1,000 per year to undergraduate students and \$1,500 a year to graduate students with family incomes of less than \$15,000 (see sidebar on federal student loans, page 7).<sup>1</sup>

Since the students in the program were, by design, higher-risk borrowers, the federal government created incentives for lenders to participate in the new federal initiative. It gave states funds to establish "guarantee agencies," which would insure lenders against losses from defaulted loans, thereby reducing lenders' risk. The feds also guaranteed lenders a 6 percent interest rate on their student loans—at the time, a rate slightly higher than rates for more secure home mortgage loans.

These incentives were insufficient to encourage states to take on the risk of establishing guarantee agencies without some federal insurance on loans, and the 6 percent interest rate was not high enough to attract private lenders. In response, the federal government pursued two strategies to boost participation by banks and states: shifting the risk to the federal government and increasing banks' profits on loans.

Congress in 1968 authorized the U.S. Department of Education (then called the Office of Education) to pay state guarantee agencies 80 percent of the amount of their losses. The year before, the Department of Education had established the Federal Insured Student Loan program to reimburse lenders in states without guarantee agencies. Under that program, the federal government reimbursed lenders 100 percent of their defaulted loans.

To increase profits to banks, Congress quickly raised the guaranteed interest rate on student loans to 7 percent.<sup>2</sup> But by mid-1969, interest rates charged to the most credit-worthy borrowers were 8.5 percent, making the 7 percent interest rate on more risky student loans unappealing to banks. In response, Congress established

in 1969 subsidies known as "Special Allowance Payments" to ensure lenders received market-rate profits on loans (see sidebar on special allowance payments, page 12). Special allowance payments were tied to

### Student Lending Glossary

**Government Sponsored Enterprise (GSE):** a for-profit, privately operated corporation chartered by the government to increase investments in a specific sector of the economy.

**Federal Family Education Loan Program (FFELP):** a federal student loan program authorized in the Higher Education Act. Loans are provided by private lenders and insured by the federal government. Loan programs include Stafford Subsidized and Unsubsidized loans, and PLUS loans.

**Federal Direct Loan Program (FDLP):** a federal student loan program authorized in the 1992 reauthorization of the Higher Education Act. Loans are provided by the Department of Education directly to students through their schools, without private lenders or guarantee agencies.

**Guarantee Agency:** organization in the Federal Family Education Loan Program that insures lenders against financial losses due to loan defaults. Guarantee agencies are also responsible for helping to administer the program and oversee lenders.

**Default:** Default occurs when a borrower fails to make the required monthly payments on his or her loan. In the Federal Family Education Loan Program and the Federal Direct Loan Program, a borrower is in default after 270 days of non-payment, assuming no alternative arrangements for payment were made with the lender.

**Loan Servicing:** activities performed to collect and process loan payments during the life of a loan. These include contacting and communicating with borrowers, collecting payments, filing paperwork with the Department of Education, and providing collection efforts on delinquent loans.

**Collection Agency:** agency hired by a lender or guarantee agency to locate defaulted borrowers and recover payments on defaulted loans.

**Loan Consolidation:** combining one or more loans into one loan with a single lender. Loan consolidation can allow borrowers to make one monthly loan payment, extend the payment period on their loans (thereby reducing monthly payments) and lock-in interest rates.

**Secondary Market:** an organization that buys existing loans from a bank or other lender. Lenders sell loans to the secondary market in order to raise money to make new loans.

**Enrollment Management:** the process of using past enrollment and financial aid data from a school to predict which students are likely to apply and enroll. Enrollment management often includes leveraging financial aid awards to recruit a desirable class of students.

**529 Savings Plans:** state-sponsored investment options run by private investment groups and named after Section 529 of the tax code. In 2001, Congress exempted these savings plans, which can be used for higher education expenses, from federal income tax.

changing interest rates and paid lenders as much as 3 percentage points above the 7 percent interest charged to students. With special allowance payments, the federal subsidies rose along with interest rates, ensuring profits for banks regardless of interest rate changes.

As a result, lenders' guaranteed interest earnings on student loans jumped from 6 percent to 9 percent in 1969, while the associated risk dropped to nearly zero, making student lending a very attractive business.<sup>3</sup>

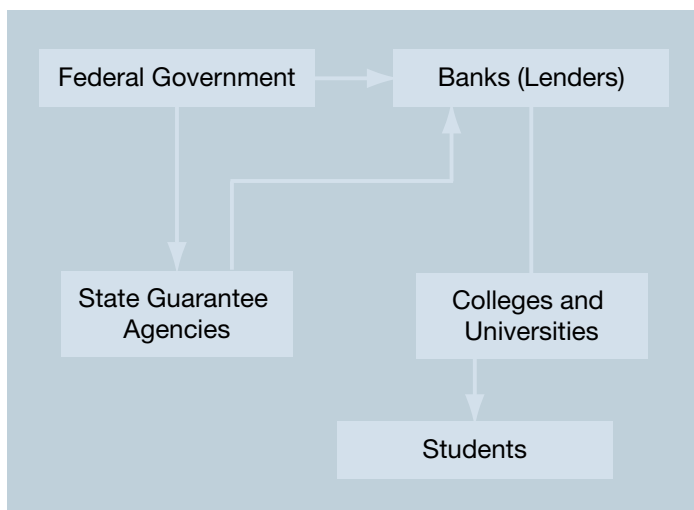
Still, the federal lending program was relatively simple in the 1960s. It involved lenders, the federal government, which provided subsidies and loan insurance to banks and state guarantee agencies, and colleges and students (see Figure 1).

## Increasing Cash Flow

But Congress soon expanded its efforts to encourage lending to students by making sure banks had ample lendable cash. In 1972, it created the Student Loan Marketing Association (SLMA), as Sallie Mae was originally called, to provide a "secondary market" for student loans. The new company bought student loans from banks to free up lender money for new loans.

Congress created Sallie Mae as a Government Sponsored Enterprise (GSE)—a for-profit, privately operated corporation chartered by the government to increase investments in a specific sector of the economy. Other

**Figure 1. Federal Student Loan Program, circa 1965**

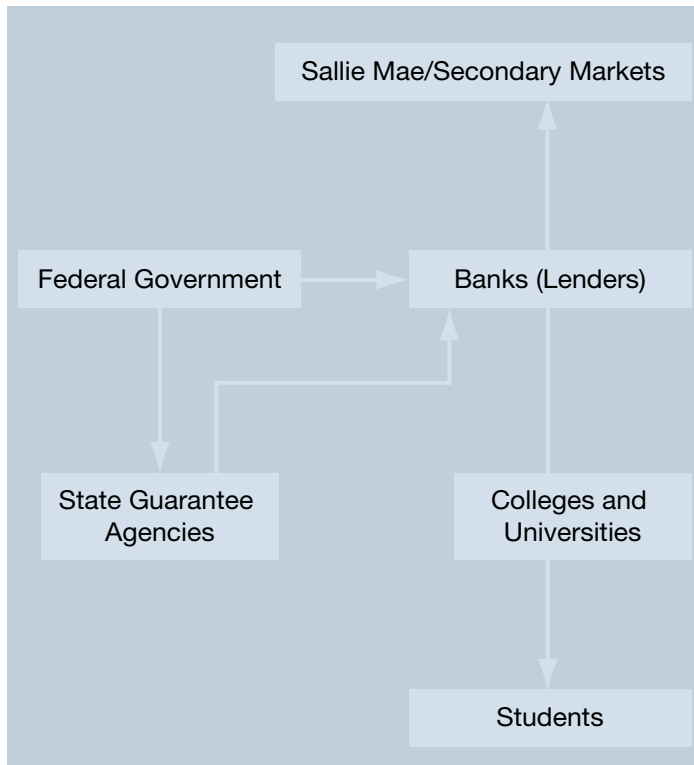


well-known GSEs include "Fannie Mae," for the housing industry, and "Farmer Mac," for the farming industry. Sallie Mae received valuable benefits as a GSE, including exemption from state and local taxes, and access to low-cost funds from the U.S. Department of the Treasury. Sallie Mae paid only a fraction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

Congress further sweetened the pot for states and lenders with the Tax Reform Act of 1976. This act authorized state agencies to issue tax-exempt bonds to purchase student loans in the secondary market. States quickly took advantage of this opportunity, which allowed them to use low-cost, tax-exempt money to buy loans while reaping in high federal interest subsidies on those loans. States established nonprofit corporations to act as secondary markets and purchase student loans from banks. Having both state secondary markets and Sallie Mae further ensured that there would be enough money available for banks to keep making loans, and it gave banks security, knowing they could sell their loans if needed. Congress also increased the federal "reinsurance" on defaulted student loans to 100 percent for state guarantee agencies. With the risk to state governments largely eliminated, the number of state guarantee agencies, which never exceeded 26 before 1976, grew to 50 by 1981.<sup>4</sup>

With the addition of Sallie Mae and other secondary markets, the federal loan program became more complex and more costly for taxpayers. The federal government was now guaranteeing all loans at 100 percent, and paying banks, Sallie Mae, and state secondary markets high interest subsidies on loans. In 1979, Alfred B. Fitt, the general counsel in the newly established Congressional Budget Office stated, "the [federal loan] program has gone through piecemeal alterations that have transformed it into a system much more costly than a direct federal loan program, with the higher costs not redounding to the benefit of student borrowers, but rather to the benefit of the financial institutions that make the loans" (see Figure 2).<sup>5</sup>

**Figure 2. Federal Student Loan Program, circa 1976**



## Selling Stock

Loosened loan eligibility requirements, together with two new federal loan programs, increased student borrowing from \$1.8 billion in 1977 to \$12 billion in 1989.<sup>6</sup> The 1978 Middle Income Student Assistance Act eliminated income restrictions and expanded federal loan eligibility to all students (In 1981, the Reagan administration re-instated financial need as a requirement for receiving subsidized student loans); the Auxiliary Loan to Assist Students program (ALAS), approved by Congress in 1981, extended eligibility to students with no parental financial support; and Congress created the Parent Loan for Undergraduate Students program (PLUS) in 1980, to allow parents to take out supplemental loans to help cover their children's college costs.

During the same period, Congress expanded Sallie Mae's role in the lending industry. In the 1980 reauthorization of HEA, Congress authorized Sallie Mae to offer "loan consolidation" to students with significant debt, permitting them to combine multiple federal loans into single loans with longer repayment terms and lower monthly payments. Lawmakers also granted Sallie Mae permission both to make loans directly to students in areas of the

country where students could not get loans from another lender and to act as a guarantor in states where demand for loans outpaced supply.<sup>7</sup>

These changes, along with the new loan programs and resulting boom in loan volume, meant rising profits for Sallie Mae and other lenders. Sallie Mae's assets grew from \$1.6 billion in 1979 to \$28.6 billion in 1988. In between, the company issued its first public stock offering in 1983, raising \$357 million in private capital.<sup>8</sup> With the influx of private capital, Sallie Mae was no longer reliant only on federal funds for expansion.

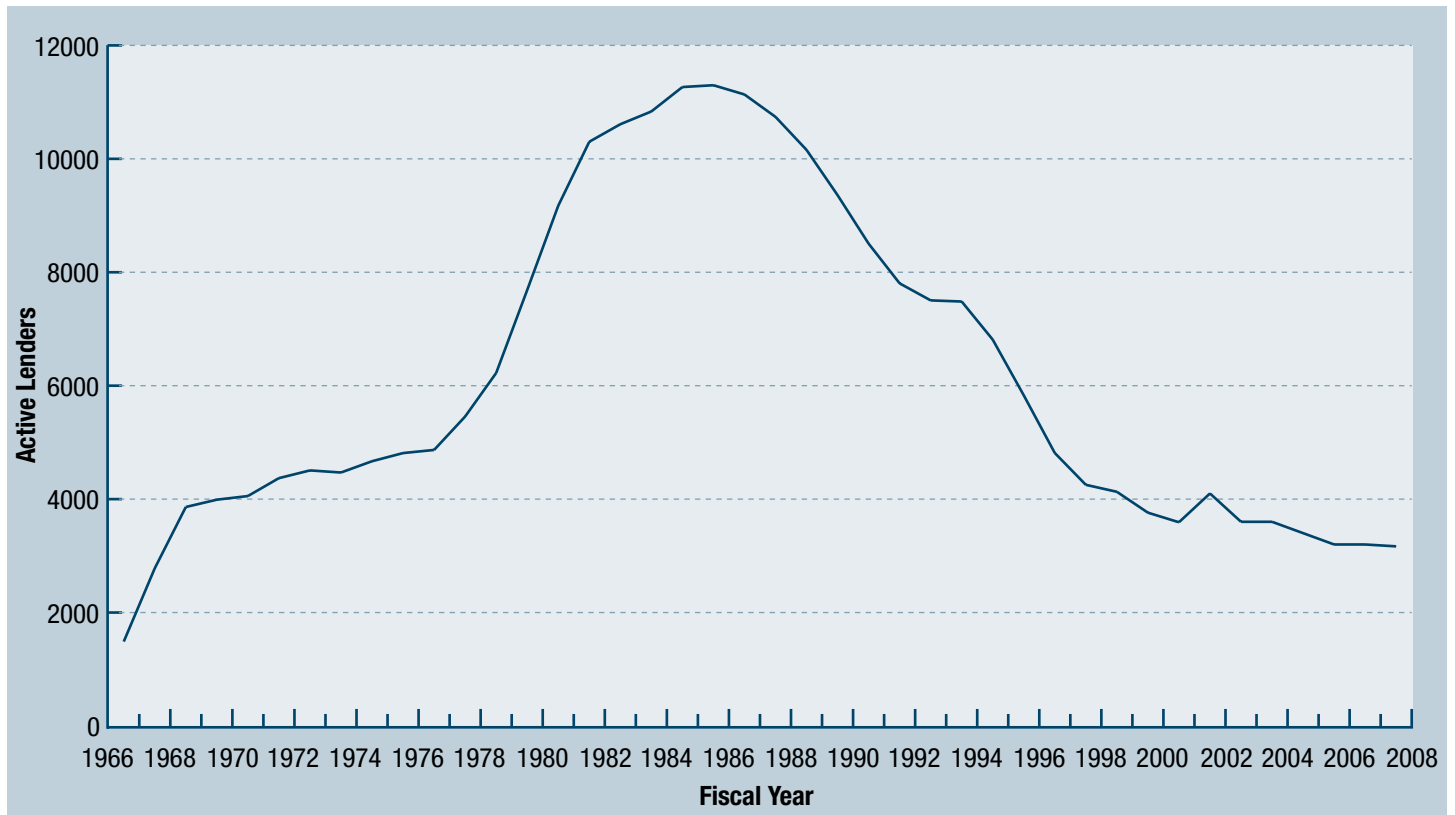
Rising lender profits meant higher administrative costs for the federal government. The price tag of the federal loan program, including loan subsidies to students and banks and federal payments for defaulted loans, grew from \$2.7 billion in 1981 to \$4.1 billion in 1985.<sup>9</sup> In 1986, payments to lenders for defaulted loans alone cost the federal government over \$1 billion.

In an effort to reduce high default rates, the U.S. Department of Education imposed new due-diligence requirements on the student lending industry when it reauthorized the Higher Education Act in 1986. The requirements dictated that lenders and guarantee agencies follow exacting procedures in making loans, processing payments, and collecting on defaulted loans—and risk losing reimbursements on defaulted loans if they failed to follow them. Inadvertently, the department's new regulations helped fuel the development of lending-industry giants like Sallie Mae by creating barriers to entry to smaller, newer companies wanting to enter the field.

Existing lenders, which were often state or regional banks, saw the new regulatory requirements as a threat to their bottom lines. To protect themselves, they began selling their loans to large lenders, or outsourcing loan servicing (processing payments and paperwork) and collection (locating and contacting defaulted borrowers). As a result, both lending and loan servicing became concentrated in fewer and fewer companies.<sup>10</sup> The number of active lenders in the federal loan program has dropped from a high of 11,298 in 1985 to 3,166 in 2007 (see Figure 3).

The outsourcing of loan servicing and collecting and the expansion of loan consolidation, which Congress originally only offered to Sallie Mae but soon extended

**Figure 3. Number of Active Lenders Participating in the FFEL Program, 1966–2007**



*Note:* Some lenders reported loans under multiple numbers. In these instances lenders were counted more than once. These counts do not include lenders who participated exclusively under the Federal Insured Student Loan Program which existed from FY68 through FY84.

*Source:* U.S. Department of Education, Office of Postsecondary Education, National Student Loan Data System.

to other companies, created an even more complicated student lending system (see Figure 4).

## Warning Signs

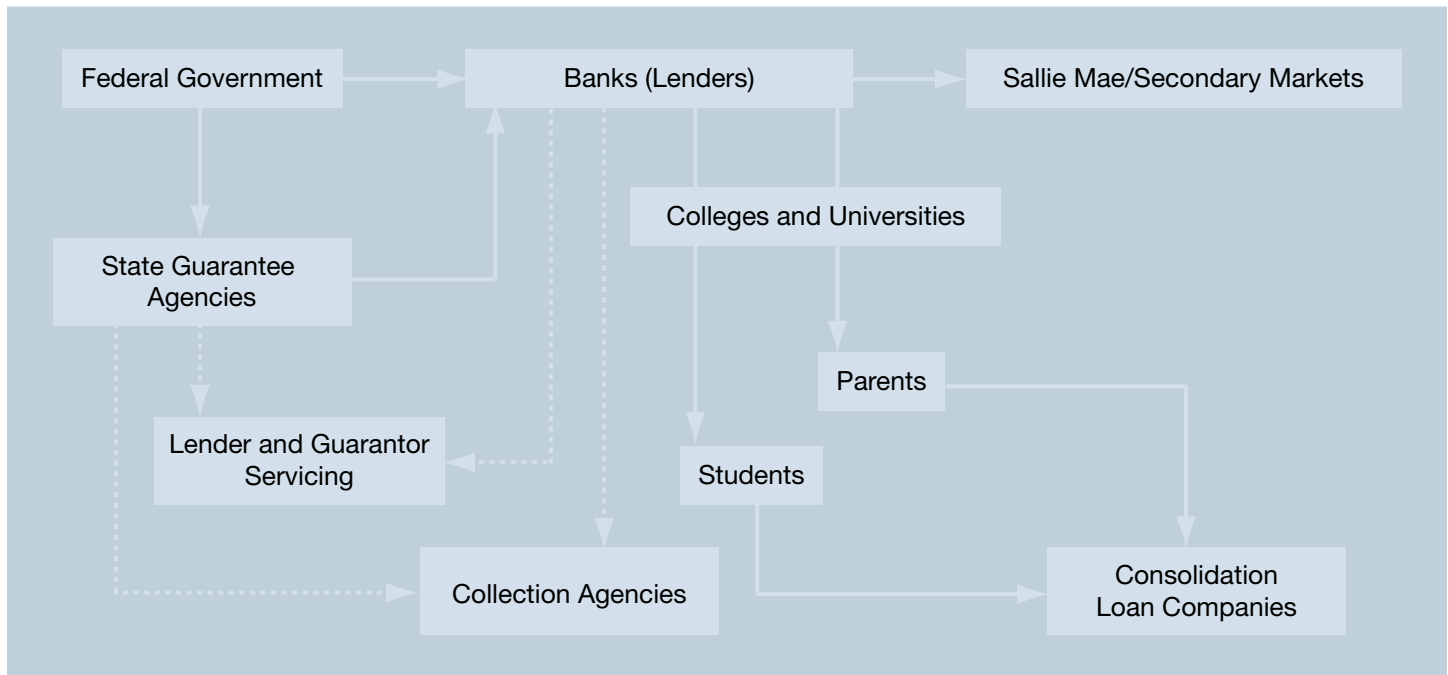
The 1990s saw more increases in both student lending volume (from \$14 billion in 1991 to \$30 billion in 1996) and industry profits. Rising tuitions and the 1992 reauthorization of the Higher Education Act, which increased federal loan limits and introduced unsubsidized loans (loans for which the government did not pay the interest while students were still in college) to students at all income levels,<sup>11</sup> fueled demand for student loans.

But this latest expansion of the student loan industry was accompanied by early signs of abuses and a lack of government oversight, much like the stories making headlines today. Hearings by the Senate Permanent Subcommittee on Investigations in 1990 revealed

instances of fraud and abuse among trade schools, lenders, and guarantee agencies. Charges included loan servicers falsifying documents to cover up mistakes, lenders not paying mandated fees to the Department of Education, and “diploma mill” for-profit schools using the loan program to make money without providing a worthwhile degree.<sup>12</sup> Congress “did not hear of even a single part of the guaranteed student loan program that is working efficiently or effectively,” declared committee Chairman Sam Nunn of Georgia.<sup>13</sup>

In response to the revelations of abuse in the program and the high profits of some lenders, Congress introduced a new Federal Direct Lending Program (FDLP) in 1992. The FDLP allowed the federal government to make loans directly to students through their schools, thereby creating a formidable competitor to banks and other Federal Family Education Loan Program lenders (FFELP). FDLP supporters argued that by eliminating the FFELP middlemen, the direct lending program would be a more efficient lending system and less prone to abuse.

Figure 4. Federal Student Loan Program, circa 1985



Note: Dashed lines indicate outsourced services.

In a move that significantly changed the role of guarantee agencies, Congress authorized lenders to appeal directly to the Department of Education for loan reimbursement, a step precipitated by the collapse of the Higher Education Assistance Foundation (HEAF), one of the largest guarantee agencies in the country. The move diminished the role of guarantee agencies as guarantors—they were no longer necessary for a lender to receive reimbursement on a loan, but did not change their oversight and administrative responsibilities in the loan industry. They must still verify loans, ensure that lenders have performed the required due-diligence on their loans, and verify that lenders’ default claims are valid.

HEAF collapsed in 1990 due to high default rates from the large number of loans it was making to for-profit colleges. To ensure lenders remained in the program and loans continued to be available to students, the Department of Education assumed responsibility for HEAF’s loans and, eventually, for all defaulted federal loans if a lender could prove a guarantee agency was insolvent.<sup>14</sup>

President Bill Clinton in 1993 expanded the direct lending program, with the goal of making all federal loans through the FDLP. The FDLP, because it got funds directly from

the Treasury and distributed them directly to students, eliminated the need for private banks, guarantee agencies, and Sallie Mae as a secondary market. Clinton also imposed a fee on Sallie Mae that essentially eliminated its funding advantage as a Government Sponsored Enterprise and mandated that Sallie Mae, because it was a government-chartered entity, act as a lender of last resort for students who could not obtain loans elsewhere.<sup>15</sup> Sallie Mae’s operations as a GSE were primarily limited to secondary market activities, making it difficult for Sallie Mae to respond to competitive threats like the FDLP. In light of these changes and increasing national-level competition for student loans, Sallie Mae sought and won congressional approval to abandon its GSE status and become a fully private company, free to expand its business operations and pursue profits more aggressively.<sup>16</sup>

Congress passed the Student Loan Marketing Association Reorganization Act (commonly referred to as the “Privatization Act”) in 1996. The law allowed the creation of a holding company—a company that owns multiple corporations—permitted to pursue business opportunities outside the limits of Sallie Mae’s GSE charter. SLM Holding Corporation became the parent company of both a GSE entity—known as the

“Student Loan Marketing Association”—and a non-GSE corporation—Sallie Mae. The GSE was allowed to continue serving as a secondary market for student loans, but was expected to end its operations by 2008. (The GSE entity actually ended its operations four years ahead of schedule, in late 2004.) Meanwhile, the non-

GSE arm of the holding company could pursue other business activities and build its operations into the company we now know as Sallie Mae. After two decades of operating under its GSE charter, Sallie Mae was free to expand its dominance of the student loan industry even further.

## Federal Student Loans

There are three types of loans offered through the federal student loan program: Stafford loans, which include subsidized loans, need-based loans for which the federal government pays the interest during school, and unsubsidized loans, non-need-based loans for which the government does not pay interest during school; Parent Loan for Undergraduate Students (PLUS) loans, which allow parents to supplement their children’s financial aid; and GradPLUS loans, a new loan for graduate students to supplement Stafford loans.

These loans are administered through two programs, the Federal Family Education Loan Program (FFELP) and the Federal Direct Loan Program (FDLP).

The difference between the two programs is that under FFELP, banks and other lenders provide federal loans to students via their college or university financial aid offices, while under FDLP, the federal government acts as the lender, with the U.S. Department of Education making loans to students through their campus aid offices. Seventy-seven percent of federal student loans are made through FFELP, 23 percent through FDLP.

While the interest rates and terms for all federal loans are the same, the private FFELP lenders often offer interest-rate reductions for on-time or automatic payments that come directly from the borrower’s bank account.

Students must complete the Free Application for Federal Student Aid (FAFSA) in order to apply for Stafford and GradPlus loans. The application calculates a student’s Expected Family Contribution—how much students and their families are expected to contribute to the cost of college—and a student’s eligibility for need-based federal financial aid.

Loan	Interest rate	Limits	Repayment
<b>Stafford Loans</b>	Fixed, 6.8 percent	Undergraduate limit: \$23,000  Combined undergraduate and graduate limit: \$65,500	Students may defer payments while in school and for 6 months after leaving school.  The repayment term is 10 years.
Subsidized Loans	The government pays the interest on these loans while the student is enrolled in school. While there is no income requirement to receive subsidized loans, students must demonstrate need, calculated as the cost of attendance, minus other aid and minus the Expected Family Contribution.		
Unsubsidized Loans	The government does not pay the interest on these loans while the student is enrolled. There are no income limits or need requirements to receive unsubsidized loans.		
<b>Parent Loan for Undergraduate Students (PLUS)</b>	Fixed, 8.5 percent	No cumulative limit.  Parents may borrow up to the cost of attendance, minus any loan, grant, or work-study aid received.	Repayment begins 60 days after funds are disbursed and the repayment term is 10 years.
There are no income or need requirements to receive PLUS loans. Parents must submit a loan application and pass a credit check. Parents with adverse credit histories may have their applications rejected, in which case the student is eligible for increased Stafford loan limits.			
<b>GradPLUS</b>	Fixed, 8.5 percent	No cumulative limit.  Students may borrow up to the cost of attendance, minus any aid received.	Students may defer payments while in school.  Repayment begins 60 days after funds are disbursed and the repayment term is 10 years.

There are no income or need requirements to receive GradPLUS loans, but students must submit a FAFSA and max-out Stafford loan limits first. Students, like parents for the PLUS loan, can be denied a loan if they have an adverse credit history, however they are not eligible for increased Stafford loan amounts if this happens. Students can consolidate these loans with the Stafford loans.

## Breaking Free

At the same time Sallie Mae was breaking free of its governmental shackles, two new lending trends were transforming student lending from primarily a local and regional business to a national industry, and making student lending a more competitive marketplace in the process.

In the early stages of the student loan industry, lenders and guarantee agencies primarily served their states. But as it became apparent that high loan volume could mean large profits, lenders and guarantee agencies moved across state lines and began to compete on a national scale. Sallie Mae, a large, national company with a well-known name, was in the perfect position to profit from this trend.

The second trend was the start, in the early 1990s, of direct-to-consumer loan marketing—whereby lenders went directly to students or parents to sell their loans, bypassing financial aid offices. This marked a significant shift in the relationship between schools, lenders, and borrowers.

As national-level competition and direct-marketing grew, both students and schools were faced with a variety of choices far beyond their local bank. To handle this new influx of loan information and to better compare and bargain for loan deals, schools relied on “preferred-lender lists.” And the lists of recommended lenders greatly influenced students’ borrowing decisions: The top lender on a preferred-lender list can garner upward of 95 percent of a school’s loan business.<sup>17</sup> This put financial aid offices in the powerful position of acting as gatekeepers to loan business. For lenders, it created a single location on every campus to market their products.

For Sallie Mae, the “preferred-lender list” arrangement has been a boon. In addition to marketing directly to students, Sallie Mae has a 400-member campus-based sales staff, which provides services to over 6,000 colleges and universities—in essence, nearly every college, university, and educational institution in the United States.<sup>18</sup>

Direct-to-consumer consolidation loan companies also sprung up in the 1990s. These companies, taking advantage of historic low interest rates, offered locked-in interest rates to graduates and did not require any financial aid office involvement.

The new consolidation-only loan companies threatened to take away traditional loan companies’ business entirely. With the low interest rates, students were consolidating their borrowing at record levels, even before they graduated from college, meaning that a company could lose a loan soon after making it. Family Federal Education Loan consolidations jumped from \$9 billion to almost \$54 billion between 2001 and 2005.<sup>19</sup> Originally, traditional lenders, including Sallie Mae, attempted to hold back the growth in consolidation loans by lobbying for Congress to implement regulations that limited the companies with which students could consolidate. Eventually, though, Sallie Mae and other private lenders joined the competition for consolidation loans, using their direct-marketing techniques to sell their loan consolidation services to recent graduates.

Sallie Mae also has been an aggressive player in the rise, since the mid-1990s, in private lending—lending outside of the federal student loan program at market rates and without subsidies to lenders or students.

The early reluctance of lenders to make loans to students, which led to the federal loan program, had largely vanished by the mid-1990s. After 30 years of experience managing federally backed student loans, banks saw private student loans as a profitable market. Rising tuitions opened up demand for private loans among middle- and upper-class families, and the higher interest rates banks could charge on these loans made them more profitable. As a result, private lending to college students has increased by an average of 27 percent a year since 2000, from almost \$4 billion to over \$16 billion in 2006.<sup>20</sup> Sallie Mae’s private lending increased from less than \$2 billion to over \$7 billion during the same period.<sup>21</sup>

With the advent of loan-consolidation companies, the Federal Direct Loan Program, direct marketing, and private education lending, the student loan landscape has become extraordinarily complex and lucrative, and increasingly difficult for regulators to track. According to Federal Student Aid, the U.S. Department of Education program that oversees the federal student aid programs, the department today works with 3,200 lenders, 35 guarantee agencies, secondary markets, 72 third-party loan-service organizations, and with many other industry entities.<sup>22</sup>

But it is Sallie Mae that dominates the industry. No longer held back by its status as a quasi-governmental agency, the company moved aggressively to establish a competitive

presence in every part of student lending, largely by acquiring a host of other companies (see Figure 5).

Sallie Mae's earliest purchases included Nellie Mae in 1999 and Student Loan Funding Resources in 2000, both nonprofit student lending corporations.<sup>23</sup> Nellie Mae originated over \$300 million in federal loans at the time Sallie Mae purchased it, making it the 17th largest loan originator. Since Nellie Mae was a nonprofit organization, Sallie Mae was required to compensate the public for its market value.<sup>24</sup> The result was the creation of the Nellie Mae Foundation, which had \$395 million in assets after the acquisition.<sup>25</sup> The acquisition of Student Loan Funding Resources received less attention, but involved the purchase of the eighth largest holder of federal student loans.

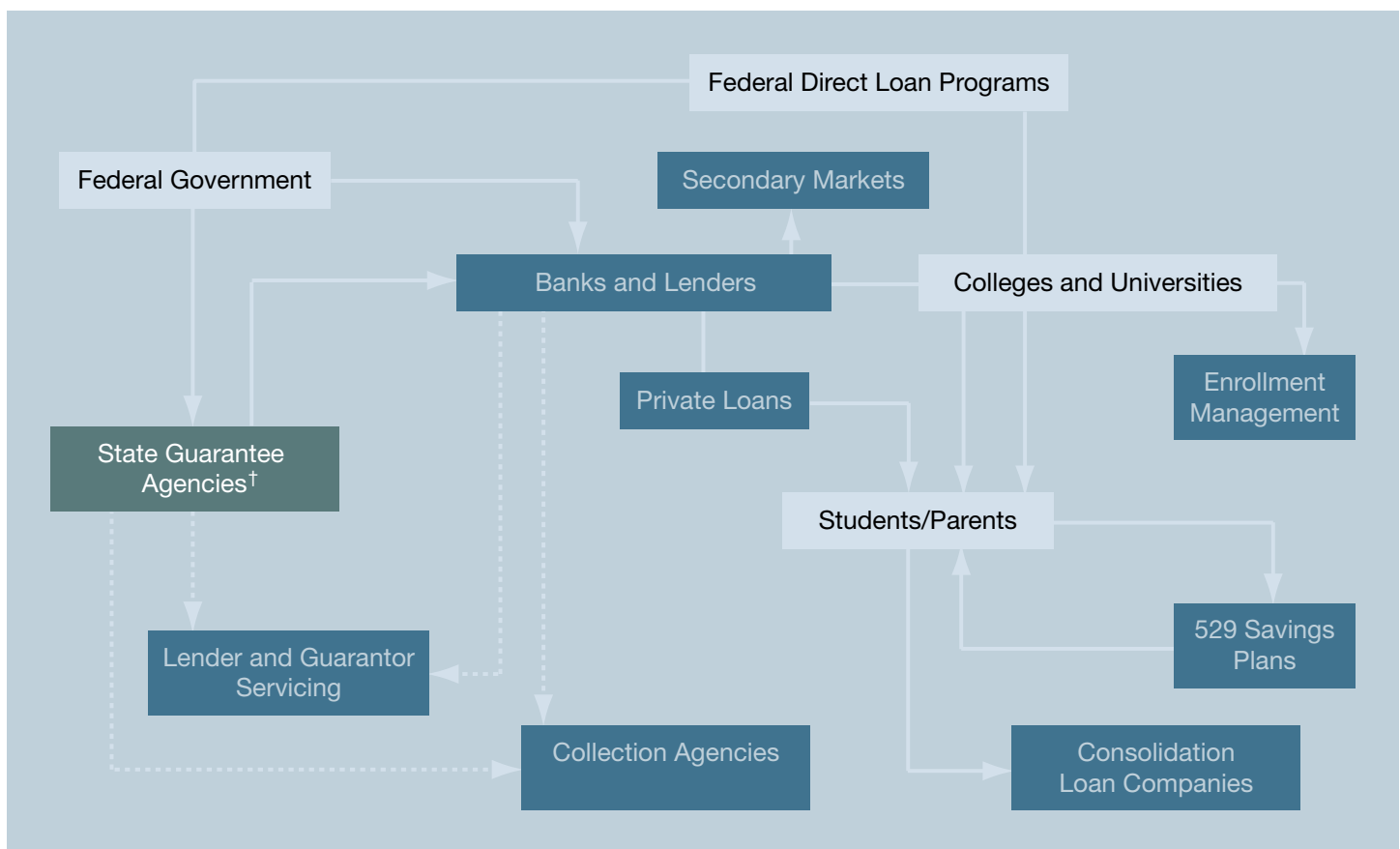
Three other lender acquisitions expanded Sallie Mae's geographic reach. In 2003, the company acquired the Massachusetts-based Academic Management Services

Corporation, which added \$1.4 billion in student loans. In 2004, Sallie Mae expanded to the Southwest with the acquisition of nonprofit Southwest Student Services Corporation, a top-30 loan originator, and then to the Northwest with the purchase of the nonprofit lender, Student Loan Finance Association.

In 2000, Sallie Mae purchased, for \$770 million, the USA Group, the largest guarantee agency in the country and a nonprofit lending conglomerate with services in loan origination, enrollment management, loan servicing, and debt collection.<sup>26</sup> With the USA Group purchase, Sallie Mae went from "being the 800-pound gorilla to being the 8,000-pound gorilla," in the student lending industry, said Henry B. Howard, president of U.S. Education Finance, a private loan company.<sup>27</sup>

Sallie Mae's purchase of USA Group did not include USA Funds, the guarantee agency arm of USA Group and

**Figure 5. Federal Student Loan Program, circa 2007, and Sallie Mae's Presence in the Market\***



Note: Dashed lines indicate outsourced services. \*Shaded boxes indicate areas in which Sallie Mae or a Sallie Mae subsidiary operate.

†Sallie Mae provides lending services to USA Funds along with eight other guarantee agencies. Sallie Mae does not own a guarantee agency.

its largest operation. Because guarantee agencies are required by law to be either state agencies or nonprofit agencies, Sallie Mae, as a for-profit company, could not own USA Funds. Instead, as part of the deal, Sallie Mae required USA Funds to contract all of its guarantee services to Sallie Mae. The exclusive relationship gave Sallie Mae control over the entire loan process, allowing it to offer schools more integrated services and giving it a sizeable competitive advantage.

The purchase also allowed Sallie Mae to dramatically expand its debt collection and default management services, now its second largest business segment behind student lending. The USA Group acquisition added \$6 billion in student loans to Sallie Mae’s portfolio and increased revenue nearly 40 percent with the new, fee-based services Sallie Mae was able to offer.<sup>28</sup>

Since the USA Group acquisition, Sallie Mae has purchased four other debt management and collection companies—General Revenue Corporation, Pioneer Credit Recovery, Arrow Financial Services, and GRP Financial Services Corporation—which have expanded its debt management operations beyond student loan collections into other types of consumer debt, including credit cards and mortgages.

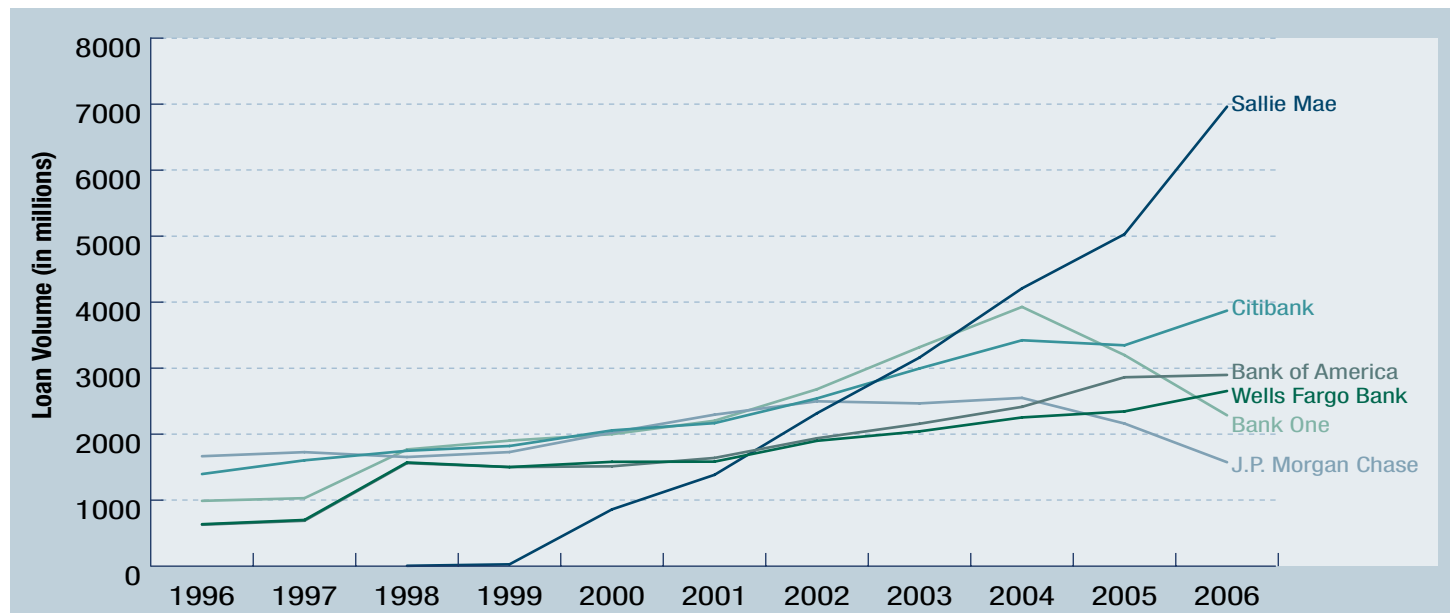
As a result of this shopping spree, Sallie Mae now owns a company, or partners with a company, in each of the critical areas of lending, from making loans to collecting loans. It is now the industry leader in loan origination, loan holdings, loan servicing, and loan collecting, and it contracts services to the largest guarantor in the country. In 2006, Sallie Mae originated, through its various lending brands, nearly \$7 billion in FFELP and PLUS loans, almost 80 percent more than the next competitor (see Figure 6). The company’s loans comprised 27 percent<sup>29</sup> of all federal student lending, 4 percent more than the Department of Education’s entire direct lending program, and 21 percent more than the next largest private student lender, Citibank.<sup>30</sup>

## March Toward Monopoly?

Sallie Mae’s dramatic expansion helped fuel extraordinary enthusiasm for the company by Wall Street investors. Sallie Mae’s stock has risen by 1,900 percent since 1995.

But, not everyone is as enthusiastic as Wall Street about Sallie Mae’s rapid growth. Industry observers worry that if Sallie Mae continues to expand, it could eliminate competition in the student loan industry and, most importantly, the benefits students see from competition, including reduced fees and discounted interest rates.

**Figure 6. Loan Origination Volume Among Top Student Lenders, 1996–2006**



Source: U.S. Department of Education, Office of Federal Student Aid, Financial Partners “Top 100 Originators of FFELP Loans Historical Reports.”

“Sallie Mae is on the march toward monopoly here,” charged Barmak Nassirian, associate executive director of the American Association of Collegiate Registrars and Admissions Officers, in a 2006 *Chronicle of Higher Education* article on Sallie Mae’s purchase of state nonprofit loan agencies.<sup>31</sup>

Nassirian’s concerns are illustrated by Sallie Mae’s purchase of the lending giant USA Group, which not only added billions in student loans, but also allowed Sallie Mae to expand its operations into each point of the student lending cycle, and by a \$1 billion unsolicited bid that Sallie Mae made in 2005 to buy the Pennsylvania Higher Education Assistance Association, the nation’s largest nonprofit state loan agency.

Yet the biggest potential for monopoly may lie in the decline of the Federal Direct Lending Program, Sallie Mae’s biggest competitor. The federal government’s share of new student loans through its direct lending program dropped 9 percent—from 32 percent to 23 percent—between 1999 and 2006, while Sallie Mae’s market share has increased by 12 percent—from 15 percent to 27 percent—during the same period.<sup>35</sup>

When the direct lending program was introduced, it offered a number of benefits to students not available among private lenders: faster, online loan application and processing; reduced loan fees; a variety of repayment plans; and no confusion about where to send their checks because the federal government wouldn’t sell their loans. In response, private lenders improved their services, including offering more flexible payment plans and reduced, or zero, loan fees.

Sallie Mae contends that despite its expansion, the student loan industry remains a healthy, competitive marketplace, and that competition has benefited borrowers through reduced interest rates for on-time payments, zero origination fees, improved services to schools and students, and lower default rates from improved collection practices. The company also argues that its scale has allowed it to invest heavily in improved technology and services that have also helped borrowers.<sup>36</sup>

Yet the decline in the direct lending program’s market share, which is partly due to Sallie Mae’s aggressive marketing to schools to switch from the direct lending

program to the private lending program, may effectively eliminate Sallie Mae’s only real competitor.

## Relationship Building

The most significant purchase during Sallie Mae’s expansion was the company’s acquisition of USA Group and the resulting deal with USA Funds. In the deal, USA Funds agreed to outsource the default-management and loan-servicing functions on its then-\$9 billion loan portfolio to Sallie Mae, making USA Funds one of Sallie Mae’s biggest customers. In 2006, 32 percent of Sallie Mae’s fee-based, debt-management revenue came from servicing USA Funds’ \$27 billion loan portfolio.<sup>37</sup>

While this is a good deal for Sallie Mae, it might not be a good deal for taxpayers. Relationships between lenders and guarantee agencies—like Sallie Mae’s relationship with USA Funds—may compromise the oversight role of guarantee agencies and ultimately hurt students and taxpayers.

Guarantee agencies, in addition to being the primary insurer of federal loans, are responsible for ensuring that lenders perform due diligence on loans—fulfill their legal obligations to locate and collect delinquent loans—before filing a claim for repayment. This helps prevent fraud in the FFEL program by ensuring that lenders do not file false default-reimbursement claims.

Title IV of the Higher Education Act prohibits guarantee agencies from contracting with outside entities to perform default aversion or collection services on loans, if those entities hold or service the loan.<sup>38</sup> In the Sallie Mae/USA Funds arrangement, Sallie Mae’s guarantor servicing division services USA Funds’ loans. Because this division is technically separate from Sallie Mae’s lending entities, it does not violate the Title IV prohibition. But this does not eliminate the potential for conflict of interest.

The U.S. Department of Education Inspector General issued a report in 2002 stating that this exact arrangement between USA Funds and Sallie Mae did, in fact, violate the Title IV regulation.<sup>39</sup> But, USA Funds successfully argued in 2004 that Sallie Mae’s guarantee servicing arm and its lending arm constituted two separate entities, and the U.S. Department of Education decided to let the USA Funds/Sallie Mae arrangement continue. This decision deviates

## Special Allowances and the '9.5 Percent Loan' Controversy

Special Allowance Payments are intended to ensure that lenders make enough profits on student loans to continue participating in the federal loan program. These payments make up a significant amount of the program's administrative budget, costing the federal government \$4.6 billion in fiscal 2007.<sup>32</sup>

Congress is responsible for establishing the "Special Allowance Margin,"—in effect, the profit—that's guaranteed to lenders. But, to reduce program costs, Congress has, since 1986, gradually reduced the special allowance margin from a high of 3.5 percent. Currently, for a Stafford loan in repayment, the special allowance margin is 2.3 percent.

This "profit" is added to a reference interest rate. The reference interest rate is meant to reflect current market rates, which, in turn, reflect the cost to lenders of making student loans. Prior to 2000, this reference rate was the 90-day Treasury bill rate. For loans made after January 2000, the U.S. Department of Education uses the rate for 30-day commercial paper.

In the current formula, the special allowance margin is added to the cost of 30-day commercial paper, and if this total (commercial paper + special allowance margin) exceeds the interest rate paid by the borrower, the U.S. Department of Education pays lenders the difference. Lenders bill the Department of Education quarterly for these special allowance payments.

The special allowance margin on loans has declined steadily over the past 10-years, except on so-called 9.5 percent loans, which have provided a financial windfall to some lenders.

During the difficult economic times of the 1980s, the federal government allowed nonprofit lenders, generally state-sponsored agencies such as the Pennsylvania Higher Education Assistance Association, which financed their loans with tax-exempt bonds, to collect a higher rate of return on student loans—9.5 percent. This was intended to encourage

nonprofit lenders to continue making loans to students and to protect their financial stability. In 1993, when the economy had improved, Congress took away the special 9.5 percent return for any new loans—or so it thought.

While Congress allowed lenders to continue collecting the 9.5 percent margin on existing loans, a loophole in the law allowed both nonprofit lenders and for-profit lenders who had purchased a nonprofit student loan company, to make new 9.5 percent loans, through a process lenders termed "recycling." By making new 9.5 percent loans, these companies could dramatically increase their revenues—while interest rates on most loans in 2003–04 were around 3 percent, banks were collecting 9.5 percent interest on "recycled" loans. The federal government made up the difference, paying banks a huge amount in subsidies and giving them huge profits—profits that came from taxpayer money via the Department of Education.

A September 2006 Inspector General audit of special allowance payments on 9.5 percent loans to one large, for-profit student loan company, National Education Loan Network (Nelnet), found that Nelnet received approximately \$278 million in improper payments from the Department of Education. By "recycling" existing 9.5 percent loans in a program that Nelnet termed "Project 950," the company increased the amount of these loans from \$551 million in March 2003 to \$3.66 billion in June 2004.<sup>33</sup>

In January 2007, Nelnet settled with the Department of Education. The settlement agreement allowed Nelnet to keep the \$278 million in improper payments; however, it prohibited future payments to Nelnet on those loans. The Department of Education also stopped all future payments to lenders until it could verify that the loans were eligible for the 9.5 percent subsidy. To many, the settlement was insufficient. Declared Senator Edward Kennedy: "The [Bush] administration should have settled for nothing less than the full recovery of Nelnet's ill-gotten proceeds from these loans."<sup>34</sup>

from the findings of two earlier reports on relationships between guarantee agencies and loan companies.

A 1993 report by the Government Accountability Office, the investigative arm of Congress, highlighted the problem of conflicts of interest between guarantee agencies and lenders: "An environment in which a guaranty agency's financial transactions with lenders are 'less than arms-length' ... may result in reduced attention by guaranty agencies to their oversight responsibilities."<sup>40</sup> Another 1993 report, from the U.S. Department of Education Inspector General, concluded that "billions of dollars" of FFELP loans were at risk of "mismanagement, waste, and abuse," because of guarantee agencies' affiliations with lenders.<sup>41</sup> Currently, however, only nine of the 35 guarantee agencies nationally are *not* associated with a lender or secondary market.<sup>42</sup>

Along with USA Funds, eight other guarantors also contracted with Sallie Mae to do the same type of work in 2006 and in all, Sallie Mae processed guarantees for 29 percent of the federally guaranteed student loans that year.<sup>43</sup>

Through its purchases of companies at each stage of the loan cycle, Sallie Mae has sought to create a "seamless" system for customers, and to profit from the fees and services at each point. Sallie Mae has also used its acquisitions to build relationships with college financial aid officers and to cross-promote its services to potential customers—more signs of its aggressive and successful business strategies.

The USA Group purchase marked Sallie Mae's entry into enrollment-management consulting through the

acquisition of USA Group subsidiary Noel-Levitz, the nation's largest enrollment-management consulting firm. Enrollment management uses past enrollment and financial data from a school to predict which students are likely to apply and enroll, and how financial aid awards can be leveraged to enroll the most desirable class of students. Noel-Levitz has advised 1,800 colleges and universities over its 30-year history, working with schools on marketing campaigns, recruiting methods, financial aid awards, and student retention and graduation strategies.

This relationship allows Sallie Mae to consult with colleges on their financial aid strategies, and thus potentially increase the amount of Sallie Mae-provided loans the college offers.<sup>44</sup> It is unlikely that Noel-Levitz's consulting services directly drive much of Sallie Mae's lending business. But it does give Sallie Mae an important relationship-building tool. Even with increases in direct-to-student marketing, colleges and universities remain gatekeepers to student loan business, and Noel-Levitz gives Sallie Mae an opportunity to build relationships with financial aid offices.

Sallie Mae's most recent acquisition has created another opportunity for the company to cross-promote its businesses. In 2006, Sallie Mae entered into the business of college savings plans. To encourage college savings, Congress exempted so-called 529 Savings Plans contributions (named after Section 529 of the federal tax code) from federal income tax. The plans are state-sponsored investment options run by private investment companies. These savings plans have grown rapidly since the income tax exemption began in 2001, and, in 2006, Sallie Mae purchased UPromise, one of the top 529 savings plan companies.

The purchase, which stock market analysts hailed as a coup for Sallie Mae, not only further diversified Sallie Mae's operations, it gave Sallie Mae early access to potential customers.<sup>45</sup> Parents who open 529 savings plans for their children are likely also parents that will be helping their children decide which loans to take out for college, and co-signing private loans. UPromise's 7.2 million members provide Sallie Mae with many such potential borrowers.

## An Opportunity for Change

While revelations of questionable marketing practices and other potential wrongdoing by Sallie Mae and other

lending industry companies continue to unfold, Sallie Mae's recent sale for \$25 billion to a private investor group that includes Bank of America, J.P. Morgan Chase, and two private equity firms, is likely to reduce public scrutiny of the company because privately held companies are not subject to the same levels of public disclosure of financial information that the federal Securities and Exchange Commission requires of publicly traded companies.

This puts even more pressure on the U.S. Department of Education to oversee the activities of Sallie Mae, as well as the entire student lending industry—something it has not done well in recent years. “Financial Partners had not implemented an acceptable level of internal control over its monitoring and oversight of Federal Family Education Loan program participants,” the U.S. Department of Education inspector general said in a September 2006 report on Financial Partners, the arm of the department's Office of Federal Student Aid responsible for monitoring guarantee agencies, lenders, and servicers. The report also stated that Financial Partners “emphasized partnership over compliance in dealing with guarantee agencies, lenders, and servicers.”<sup>46</sup>

Recent news reports have revealed ties between the Department of Education and the lending industry that may further compromise the department's oversight abilities. *The Washington Post* has reported, for example, that “at least 20 former Sallie Mae employees had moved into the department under the Bush administration.”<sup>47</sup> The student loan industry also spends a lot of money on campaign contributions and lobbying. According to *The New York Times*, Nelnet, a large lender found to have improperly billed the Department of Education for millions of dollars, was the “nation's most generous corporate donor to the National Republican Congressional Committee in 2006.”<sup>48</sup>

The inspector general's 2006 report noted that high turnover in the general manager position at Financial Partners contributed to the “weak control environment for monitoring and oversight.” Since 1999, Financial Partners has seen four different general managers. Of these, three have come from the lending industry (and two returned to it following their time at Financial Partners) and one from the National Council of Higher Education Loan Programs, a loan industry trade group. This list includes the current general manager, Matteo Fontana, who worked at Sallie Mae prior to taking the top job at Financial Partners, and

who has recently been suspended by the U.S. Department of Education after disclosure of his ownership of stock in a student loan company.

When it launched the federal student loan program four decades ago, Congress was forced to offer significant financial incentives to banks and other lenders in order to get them to participate in the student lending program. Since then, the program has grown steadily larger and vastly more lucrative for lenders and other players in the industry. Yet the program has continued to favor the industry through lending rate structures and generous,

taxpayer-funded financial perks that all but guarantee immense profits, and through a sympathetic regulatory environment. Not surprisingly, the lending industry has recognized these opportunities for what they are and has moved aggressively to capitalize on them—often at significant costs to students and taxpayers.

But in the upcoming reauthorization of the Higher Education Act, Congress has an opportunity to strike a new balance in student lending, one that serves the interests of students, taxpayers, and the industry in more equal measures.

## Endnotes

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