United States Government Accountability Office

GAO

Report to Congressional Requesters

January 2005

FEDERAL FAMILY EDUCATION LOAN PROGRAM

More Oversight Is Needed for Schools That Are Lenders

Accountability * Integrity * Reliability

GAO-05-184

Highlights

Highlights of GAO-05-184, a report to congressional requesters

Why GAO Did This Study

In fiscal year 2004, lenders made about $65 billion in loans through the Federal Family Education Loan Program (FFELP) to assist students in paying for postsecondary education. The Higher Education Act (HEA), which authorizes FFELP, broadly defined eligible lenders—including schools. The Department of Education's (Education) Office of Federal Student Aid (FSA) is responsible for ensuring that lenders comply with FFELP laws and regulations. Recently, schools have become increasingly interested in becoming lenders, and this has raised concerns about whether it is appropriate for schools to become lenders given that they both determine students' eligibility for loans and in some cases set the price of attendance. In light of these concerns we determined (1) the extent to which schools have participated as FFELP lenders and their characteristics, (2) how schools have structured lending operations and benefits for borrowers and schools, and (3) statutory and regulatory safeguards designed to protect taxpayers' and borrowers' interests.

What GAO Recommends

GAO recommends that FSA take steps to ensure that all school lenders are consistently complying with applicable statutory and regulatory requirements. Education agreed with our recommendation.

www.gao.gov/cgi-bin/getrpt?GAO-05-184.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Cornelia Ashby at (202) 512-8403 or ashbyc@gao.gov.

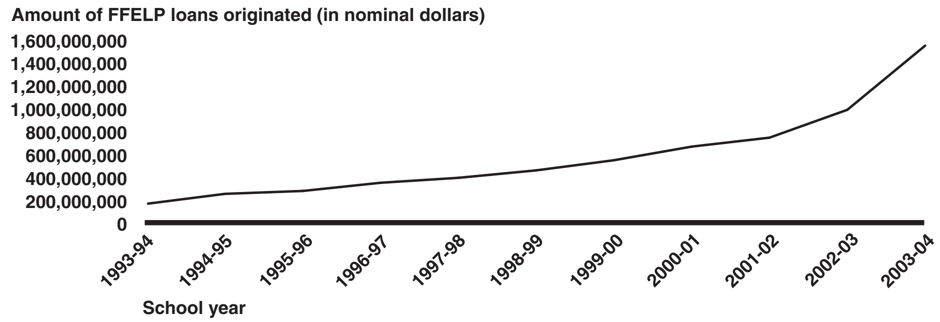
January 2005

FEDERAL FAMILY EDUCATION LOAN PROGRAM

More Oversight Is Needed for Schools That Are Lenders

What GAO Found

Between school years 1993–1994 and 2003–2004, lending by schools has increased significantly from 22 school lenders disbursing about $155 million to 64 schools disbursing $1.5 billion in FFELP loans, as shown below.



Source: GAO analysis of National Student Loan Data System data.

Several schools we interviewed reported that a primary reason to become a FFELP lender was to generate more revenue for the school. About 80 percent of school lenders in school year 2003–2004 were private nonprofit schools, and almost all of them had graduate and professional programs in medicine, law, or business.

Most school lenders have contracted with other FFELP organizations to administer their loan programs and subsequently have sold their loans to earn revenue, but school lenders differed in terms of how they financed the loans made and when they sold their loans. About a third of the school lenders we interviewed used their own money to finance the loans they made, while the others obtained lines of credit from a bank or secondary market lender, in some cases from the same organization that eventually purchased the loans disbursed by the school lender. Most schools we interviewed reported using or planning to use revenues earned from the sale of loans to lower student borrowing costs or provide need-based aid.

A number of statutory and regulatory provisions applicable to all lenders and schools, and some applicable only to school lenders, exist to safeguard the interests of taxpayers and borrowers. FSA, however, has little information about how school lenders' have complied with FFELP regulations. Under the HEA, FFELP lenders that originate or hold more than $5 million in FFELP loans must submit annually audited financial statements and compliance audits. In October 2004, FSA discovered that 10 of 29 school lenders required to submit an audit for fiscal year 2002 had not done so. Moreover, FSA has not conducted program reviews of school lenders. However, during the course of our review, three regional offices asked 31 school lenders about their compliance with the regulation pertaining to the use of interest income and special allowance payments for need-based grants.

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Abbreviations

ASEDS	Application, School Eligibility, and Delivery Services
FAFSA	Free Application for Federal Student Aid
FDLP	William D. Ford Direct Student
FFELP	Federal Family Education Loan Program
FPS	Financial Partners Services
FSA	Federal Student Aid
GDP	Gross Domestic Product
HEA	Higher Education Act
IPEDS	Integrated Postsecondary Education Data System
NSLDS	National Student Loan Data System
OIG	Office of Inspector General
PLUS	Parent Loans for Undergraduate Students

United States Government Accountability Office
Washington, DC 20548

January 24, 2005

The Honorable Dale E. Kildee.
Ranking Member, Subcommittee on 21st Century Competitiveness
Committee on Education and the Workforce
House of Representatives

The Honorable Chris Van Hollen
House of Representatives

The Higher Education Act (HEA) of 1965, as amended, established the Federal Family Education Loan Program (FFELP), which provided about $65 billion in student loans in fiscal year 2004 and is the largest source of federal financial aid for students and their families. A number of for-profit commercial, nonprofit, and public agencies are involved in the program, including originating lenders, secondary markets, postsecondary institutions (schools), and the Department of Education (Education). Commercial and nonprofit lenders—such as banks and state-designated agencies—provide loan capital, and the federal government guarantees these loans against substantially all loss through borrower default. Originating lenders often sell their loans to secondary markets, thereby obtaining additional capital to make new loans and receiving premium revenues—payments from loan buyers that are calculated as a percentage of the face value of the loans sold.[1] Lenders that hold loans receive interest income paid by borrowers and in some cases special allowance payments from the federal government for the loans they hold.[2] Schools assess students' levels of financial need, certify borrower eligibility for loans, and disburse loan proceeds to students. Education's Office of Federal Student Aid (FSA) is responsible for overall program administration and ensuring compliance with laws and regulations.

When FFELP was created, in 1965, Congress broadly defined eligible lenders—including schools—to ensure that students would be able to

[1] Secondary markets are lenders that include Sallie Mae, banks, and nonprofit state agencies.

[2] Lenders are guaranteed a statutorily specified rate of return—called lender yield—on the loans they hold. When the interest rate paid by borrowers is less than the lender yield, the government pays lenders the difference—a subsidy called special allowance payments.

locate a lender. Schools that are FFELP lenders primarily make loans to graduate students because of statutory limitations on lending to undergraduates.[3] As we and various news media have reported, schools, including those that have participated in the federal government's other major student loan program—the William D. Ford Direct Student Loan Program (FDLP), created in 1993—are becoming increasingly interested in entering the student loan business as lenders.[4] The possibility of an increasing number of schools becoming FFELP lenders and receiving revenues from the loans they make has raised concerns. Specifically, questions have been raised about whether it is appropriate for schools to become lenders, given that they both determine students' eligibility for loans and in some cases set the price of attendance. Additional concerns have been raised about the propriety of the schools' contractual relationships with other FFELP participants and whether these relationships create an incentive for schools to encourage student borrowing. In light of these issues and the pending reauthorization of the HEA, we are providing information and analysis on three issues:

1. To what extent have schools participated in FFELP as lenders and what are their characteristics?

2. How have schools structured their lending operations and what are the benefits for schools and borrowers?

3. What statutory and regulatory safeguards exist to protect the interests of taxpayers and borrowers?

To assess the extent to which schools have participated in FFELP as lenders, we analyzed data from Education's information systems on school lenders' loan volume in each school year from 1993–1994 to 2003–2004, which we converted to real 2003 dollars; the amount of loans made by other FFELP lenders for students attending these schools; and characteristics of school lenders, such as whether they are private or

[3]Under the HEA, a school lender may originate loans for undergraduates so long as it does not lend to more than 50 percent of its undergraduates and may only originate loans for students who have previously received a loan from the school or have been rejected by other lenders.

[4]GAO, *Direct Student Loan Program: Management Actions Could Enhance Customer Service*, GAO-04-107 (Washington D.C.: Nov. 20, 2003). Under FDLP, the federal government provides loans to students and their families, using federal capital, and owns the loans. Schools may serve as direct loan originators or the loans may be originated by contractors working for Education.

public schools. On the basis of our review of the documentation for these data and our discussions with Education officials about the steps they take to ensure the reliability and validity of these data, we determined that the data from these systems were sufficiently reliable for the purpose of our study. To assess school lending operations and benefits to schools and borrowers, we conducted site visits and interviews with 13 school lenders and reviewed their contracts with other lenders and servicers. We also interviewed 12 other lenders, including secondary markets; 2 state-designated guaranty agencies, which perform a variety of administrative functions on behalf of the federal government in the FFELP; and related higher education and financial aid associations. We also interviewed officials of all schools that were lenders in school year 2003–2004 or planning to lend in 2004–2005, to gather information on what type of lender purchased their loans. To assess existing safeguards for borrowers and taxpayers, we reviewed the HEA, related regulations, guidance issued by Education, and court decisions. We also interviewed officials in Education's FSA, Office of General Counsel, Office of Inspector General, and Office of Postsecondary Education. See appendix I for a more detailed discussion of our scope and methodology. We conducted our work from December 2003 to December 2004 in accordance with generally accepted government auditing standards.

Results in Brief

In school year 2003–2004, 64 schools, chiefly private nonprofit institutions, made over $1.5 billion in FFELP loans, primarily to graduate and professional students. This represents a dramatic increase from school year 1993–1994, when only 22 schools participated in FFELP as lenders, making loans totaling about $155 million.[5] Several schools we interviewed reported that a primary reason to become a FFELP lender was to generate more revenue for the school. The amount of loans originated by school lenders will likely continue to increase because 17 schools are in the process of establishing an FFELP lending program. Despite the large increase in loans made by school lenders, such loans remain a small proportion (3 percent) of overall FFELP loan volume. Loans made by a school lender can, however, constitute a significant portion of all FFELP loans borrowed by graduate students at such schools. For example, at almost a third of the schools in 2003–2004, graduate students borrowed almost exclusively from the school lender rather than from other FFELP lenders. School lenders that originated loans in school year 2003–2004 had

[5]Loan volume in 1993–1994 was $184 million in 2003 dollars.

higher average tuition and larger enrollments and were more likely to be private nonprofit than schools that were not FFELP lenders. About 80 percent of school lenders in school year 2003–2004 were private nonprofit schools, and almost all of them had graduate and professional programs in law, business, medicine, or other health specialties.

By and large, school lenders contracted with other FFELP organizations to administer their loan programs and subsequently sold their loans to receive revenue, which some reported using to lower students' borrowing costs and provide need-based aid. The 13 school lenders we interviewed typically entered into contracts for loan origination, servicing, and sale by selecting one organization or multiple organizations to perform all three components. About a third of the school lenders we interviewed used their own money to finance the loans they made, while the others obtained a line of credit from a bank or secondary market, in some cases from the same organization that eventually purchased the loans originated by the school lender. Several school lenders emphasized that revenue received by selling loans was a significant factor in their decision to become a lender and outweighed the administrative burden and costs of becoming a lender. The premiums received by the school lenders we visited ranged from about 2 percent to 6 percent of the total face value of the loans. While some schools receive revenue only from selling loans, others hold on to the loans and also receive borrower interest payments and special allowance payments from Education as compensation for holding FFELP loans, which are required by the HEA to be used for need-based grant or reasonable direct administrative expenses. School lenders, however, have discretion in how they use revenues received from the premiums paid on loans sold. Officials from most of the schools we interviewed reported that they used or were planning to use their premium revenue for need-based aid. In addition, officials from some school lenders also reported that by becoming FFELP lenders, they were able to offer students reduced loan origination fees and better repayment terms upon graduation.

A number of statutory and regulatory provisions applicable to all lenders and schools, and some applicable only to school lenders, exist to safeguard the interests of taxpayers and borrowers. FSA, however, has little information about how school lenders have complied with these requirements. Under the HEA, FFELP lenders that originate or hold more than $5 million in FFELP loans must submit annually audited financial statements and independent compliance audits to assist Education in detecting fraud, waste, abuse, and mismanagement potentially contributing to borrower defaults. Another provision in the HEA, commonly called the "anti-inducement provision" is designed to protect borrowers' interests by prohibiting any lender from offering gifts or other incentives to schools or individuals to secure FFELP applicants. To address problems among school lenders in the 1970s, Congress added several provisions that apply only to them. For example, under the HEA, schools with high rates of borrower default are prohibited from participating in FFELP as lenders. FSA, which is responsible for ensuring compliance with laws and regulations, has not provided timely and adequate oversight of school lenders. For example, in October 2004, FSA discovered that 10 of 29 school lenders required to submit a compliance audit for fiscal year 2002 had not done so. Furthermore, until 2004 FSA had not used its authority to conduct program reviews of school lenders, which supplement the information contained in audits and are intended to improve the integrity of the program. During the course of our review, FSA asked 31 school lenders about their compliance with the regulation pertaining to the use of interest income and special allowance payments.

In this report, we are recommending that FSA's Chief Operating Officer take the steps necessary to ensure that all school lenders are consistently complying with FFELP statutory and regulatory provisions intended to protect the interests of taxpayers and borrowers.

We provided Education with a copy of our draft report for review and comment. In written comments on our draft report, Education generally agreed with our reported findings and recommendation. Education's written comments appear in appendix IV.

Background

In fiscal year 2004, students received over $84 billion in federal loans to finance postsecondary education. The major federal loans include

- Stafford subsidized and unsubsidized loans, which are available to both undergraduate and graduate students—the federal government pays the interest on behalf of subsidized loan borrowers while students are in school[6] and

- Parent Loans for Undergraduate Students (PLUS), which are made to parents on behalf of undergraduate students.

[6]Subsidized Stafford loans are made to students who are enrolled at least half-time and who have demonstrated financial need, while unsubsidized Stafford loans are made to any student enrolled at least half-time. Unsubsidized Stafford and PLUS loan borrowers must pay all loan interest costs.

Students can also receive consolidation loans, which allow them to combine multiple federal student loans into a single loan and to make one monthly payment.[7] In fiscal year 2004, about $65 billion was disbursed through FFELP and about $19 billion was disbursed through FDLP.

Since FFELP (originally called the guaranteed student loan program) was created in the HEA of 1965, the student loan market has changed significantly. First, there has been a dramatic growth in student loan volume, with more students relying on private loans, which are not part of FFELP, than at any point in the past. Combined with the recent increases in tuition rates and thus in the revenues generated by school tuition, this makes the student loan market an important economic concern. Second, a few very large lenders provide the capital for most of the loan volume. Specifically, in fiscal year 2003, 10 lenders originated 54 percent of all FFELP loans. Third, the creation of FDLP in 1993 and the significant growth of private alternative nonfederal loans have increased competition across loan programs. The primary result of this competition has been an improvement in benefits for borrowers and of loan management in both FFELP and FDLP, with most loans today being originated, disbursed, and serviced electronically, according to financial aid officials.

Disbursing Loans through FFELP

In order to receive a Stafford loan through FFELP, students must fill out and submit a Free Application for Federal Student Aid (FAFSA). Additionally, parents must have their credit checked to receive a PLUS loan. A school's financial aid office assesses a student's financial need and creates a package of financial aid of grants, loans—which may include Stafford loans—and work-study, a federal program in which students are provided on- or off-campus jobs. Lenders provide the capital for loans to both undergraduate and graduate students. Under the HEA, eligible FFELP lenders include banks, postsecondary schools, credit unions, and state nonprofit agencies. For a lender to originate a loan, the school must certify that a student is enrolled and therefore eligible to receive a loan, and the borrower must complete a promissory note.

After a loan is disbursed to a borrower, lenders may either service or sell their loans. Servicing includes sending bills to borrowers and collecting

[7] Borrowers may consolidate while in school if they are consolidating at least one direct loan but must wait until their grace period—the time period after a student graduates or leaves school but before any payments are due—or until they are in repayment if only consolidating FFELP loans.

loan payments after the loan has entered repayment. Lenders may contract with an outside organization for loan servicing. Lenders also have the option of selling loans to a secondary market, thereby freeing up capital to make additional student loans. To encourage lenders' participation in FFELP, the federal government guarantees FFELP lenders a minimum rate of return, called the lender yield. When the interest rate paid by borrowers is below the lender yield, the federal government makes special allowance payments. Lenders receive these special allowance payments for loans that they hold.

State-designated guaranty agencies, which are nonprofit organizations designated by the state to administer FFELP loans, perform a variety of administrative functions under the program. With federal funding, guaranty agencies generally provide insurance to the lenders for 98 percent of the unpaid principal of defaulted loans.[8] The guaranty agencies also work with lenders and borrowers to prevent loan defaults and to collect on the loans after default.

Borrower Fees, Benefits, and Payment Plans under FFELP

Students who borrow through FFELP may pay fees on their loans and have a variety of repayment options from which to choose. Specifically, students may pay a 3 percent loan origination fee and a 1 percent guarantor fee for each loan. Lenders may pay some or all of the origination fee to the federal government on behalf of the student, and guaranty agencies may waive the guarantor fee. While in repayment, borrowers in FFELP can choose from four repayment plans, including

- standard repayment—borrowers pay a fixed monthly amount of at least $50 up to 10 years,
- graduated repayment—borrowers pay smaller monthly amounts initially and larger amounts in later years,
- extended repayment—borrowers pay a fixed monthly amount that can be repaid over a time period as long as 25 years under FFELP, and

[8] For loans disbursed on or after October 1, 1998, the government pays 95 percent of the default costs plus certain administrative costs, and the guaranty agency pays the remaining amount. The percentage of default costs paid by the federal government decreases if the guaranty agency's default claims are high compared with the amount of loans in repayment.

- income-sensitive repayment—borrowers pay a monthly amount that varies according to the borrower's income.

In addition, while students are in repayment, lenders or loan servicers may offer interest rate reductions or cancel all or part of the loan.

FSA's Oversight Responsibilities

In response to concerns about fraud, waste, and abuse associated with the student aid programs and other management weaknesses, Congress established FSA as the government's first performance-based organization in October 1998. FSA's primary objectives are to improve the efficacy and efficiency of student aid delivery and to make it less expensive. FSA administers and provides oversight for all federal student aid programs, including FFELP. Currently, FSA oversees or directly manages approximately $320 billion in outstanding loans representing over 22 million borrowers.

FSA has 10 organizational units, 2 of which provide oversight and guidance for schools and lenders that participate in FFELP: Application, School Eligibility, and Delivery Services (ASEDS) and Financial Partners Services (FPS). The ASEDS office verifies the eligibility of schools to participate in FFELP and other federal aid programs. The FPS office provides oversight to all guaranty agencies, lenders, and servicers to ensure compliance with FFELP requirements.

FFELP Lending by Schools—Mostly Private Nonprofit Schools—Has Increased Significantly in the Last Five Years

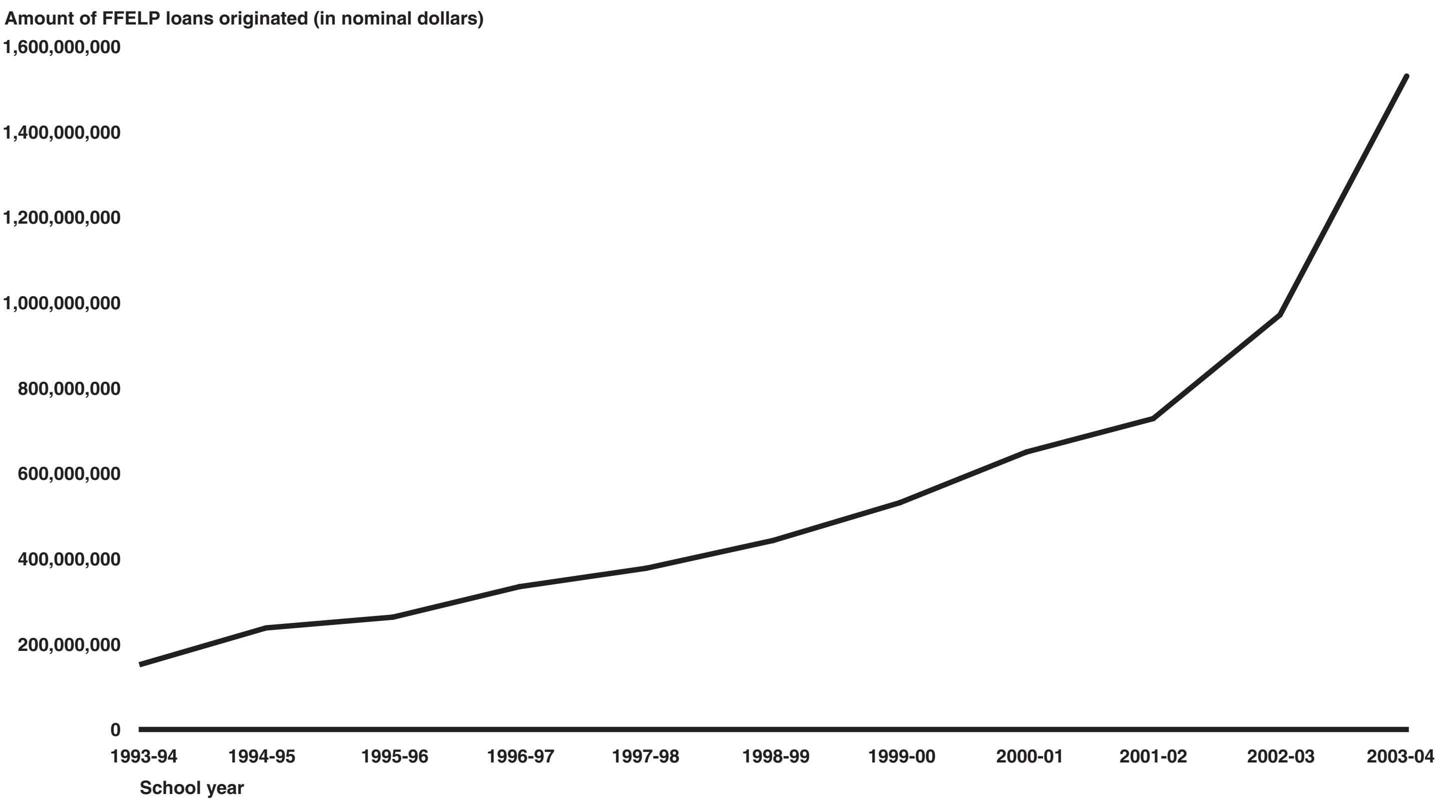
FFELP lending by schools—chiefly private nonprofit schools providing Stafford loans to their graduate and professional students—has increased significantly between school years 1993–1994 and 2003–2004 rising from $155 million to $1.5 billion.[9] The amount of loans originated by school lenders is likely to increase because 17 schools are in the process of establishing their lending programs. Despite the increases in school lending, it is still a small proportion of total FFELP loan volume. More than three-quarters of school lenders in school year 2003–2004 were private nonprofit schools, and all but one of them had graduate and professional programs in law, business, medicine, or other health specialties. Moreover, prior to becoming school lenders, several school lenders provided loans through FDLP. Some of these school lenders continue to participate in both FFELP and FDLP.

[9]Loan volume in 1993-1994 was $184 million in 2003 dollars.

Between School Years 1993–1994 and 2003–2004, the Amount of Stafford and PLUS Loans Originated by School Lenders Increased by Over a Billion Dollars

The amount of loans originated by school lenders has increased by over a billion dollars since school year 1993–1994, with the most significant increases occurring in the past 5 years. Between school year 1999–2000 and 2003–2004, the amount of loans originated by school lenders has almost tripled, from $535 million to over $1.5 billion.[10] As shown in figure 1, school lender loan volume has increased in each school year since 1993–1994.

Figure 1: Amount of FFELP Loans Originated by School Lenders, by School Year



Source: GAO analysis of National Student Loan Data System data.

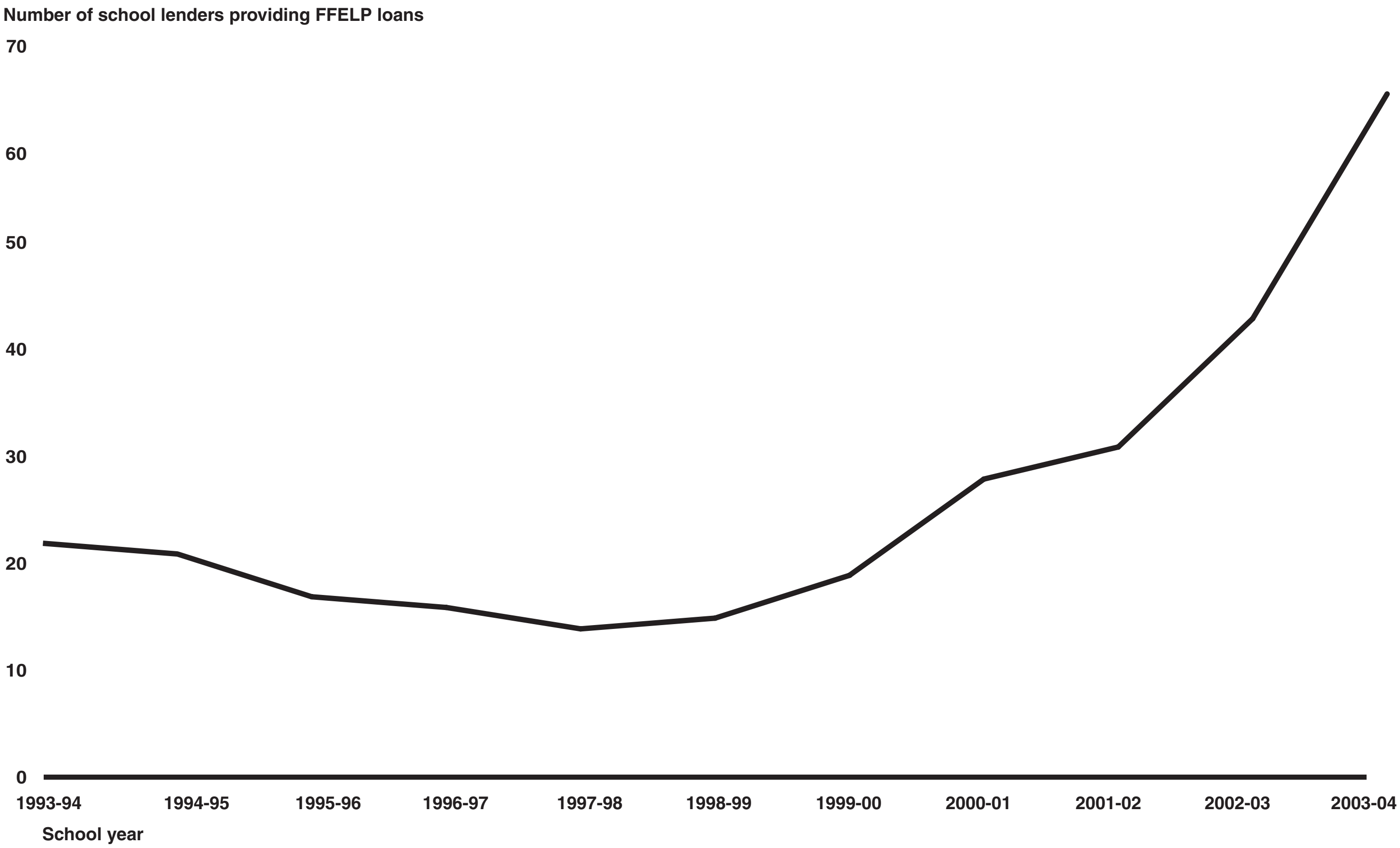
[10] Loan volume in 1999-2000 was $573 million in 2003 dollars.

The vast majority of loans originated by school lenders are Stafford subsidized and unsubsidized loans to graduate students—over 99 percent of FFELP loans originated by school lenders in school year 2003–2004. Despite limitations on lending to undergraduates, Education officials reported that school lenders may originate PLUS loans so long as they do so to no more than 50 percent of their undergraduates. School lenders reported differing interpretations of the law regarding their authority to originate PLUS loans. Some reported that they interpreted the statute to allow school lenders to originate PLUS loans, while others—such as one large school lender and one large secondary market—believed that they could not. Because of this confusion, school lenders that may wish to originate PLUS loans and could legally do so have not done so. Moreover, school lenders currently originating PLUS loans may not be aware of the limitations in originating such loans. Education has responded to inquiries from school lenders that have asked for clarification on the issue but has not issued guidance available to all school lenders. More recently, a bill proposed by some members of Congress includes a provision that specifies school lenders may not originate PLUS loans, unless the school has already issued a loan to the student.[11]

Since school year 1996–1997, the increase in loans originated by school lenders has been due primarily to more schools participating as lenders rather than a stable number of schools originating more loans. Several schools we interviewed reported that a primary reason to become a FFELP lender was to generate more revenue for the school. As shown in figure 2, the number of school lenders increased dramatically from 19 in school year 1999–2000 to 64 in school year 2003–2004. (See app. II for the list of all school lenders in school year 2003–2004.) School lending likely will continue to grow in the coming years because another 17 schools are in the process of establishing their loan programs and preparing to originate FFELP loans in school year 2004–2005.

[11]College Access and Opportunity Act of 2004, H.R. 4283, 108th Cong. § 428.

Figure 2: Number of School Lenders Providing FFELP Loans, by School Year



Source: GAO analysis of National Student Loan Data System data.

Some school lenders are among the largest loan originators in FFELP. For example, in fiscal year 2003, 14 school lenders were among the top 100 FFELP loan originators. (See app. III for the top 100 FFELP originating lenders.) Despite the large increase in loans made by school lenders, the proportion of total FFELP loan volume from school lenders has remained small, rising from 2 percent in fiscal year 2000 to 3 percent in fiscal year 2003. Loans made by a school lender can, however, constitute a significant portion of all FFELP loans to graduate students at such schools. At several school lenders, graduate students borrowed almost exclusively from the school. At other school lenders, the proportion of graduate students that borrowed from the school was low—less than 10 percent.

School lenders have also made loans to not only students who attend their school but also students who do not attend their school. Specifically, four school lenders originated loans to students that did not attend their school in school year 2003–2004. Officials at an osteopathic medicine school that serves as a school lender reported that they lend to students at other osteopathic medicine schools as a way to meet the school's mission to promote osteopathic medicine nationally.

Most School Lenders Are Private Nonprofit Schools That Offer Graduate or Professional Programs, And a Few Once Provided Loans Through The FDLP

More than three-quarters of school lenders are private nonprofit schools representing a range of schools that offer graduate and professional programs in law, business, medicine, or other health specialties. Of the 64 school lenders in school year 2003–2004, 53 were private nonprofit schools, 1 was a private for-profit school, and 10 were public schools. Private nonprofit school lenders ranged from a university with a large student body (over 10,000 students) and graduate degree programs in law, business, medicine, and other academic disciplines to a small specialized school (just over 300 students) providing only a graduate degree in chiropractic medicine. Compared with schools that were not lenders in school year 2003–2004, school lenders were more likely to be private nonprofits; have higher tuition costs; larger student enrollments; and offer a law, business, or medical degree. (See table 1.)

Table 1: School Lenders Compared with Nonlending Schools in School Year 2003–2004

	School lenders	Nonlending schools[a]
Number of schools in 2003–2004	64	5,414
Percent private	84	65
Percent public	16	35
Average graduate in-state tuition	$ 13,534	$ 7,899
Average enrollment	7,669	2,070
Percent offering a law, business, medical, or other health degree	98	68
Percent offering a law degree	47	11
Percent offering a business degree	64	54
Percent offering a medical degree	39	7
Percent offering another health degree	89	45

Source: GAO analysis of National Student Loan Data System and Integrated Postsecondary Education Data System.

[a]Nonlending schools are schools eligible to participate in the federal financial aid programs but do not serve as FFELP lenders to their students.

Ten school lenders had once provided all student loans through FDLP. In school year 2003–2004, 7 of those school lenders only offered loans through FFELP. Another 3 school lenders have continued providing loans through both FFELP and FDLP—the schools lend to their graduate students, and undergraduates borrow through FDLP.

School Lenders Contract with Other FFELP Participants to Provide Student Loans and Later Sell Them to Receive Money, Which May Be Used to Lower Students' Borrowing Costs

Generally school lenders contracted with other FFELP organizations to administer their loan programs and subsequently sold their loans to receive revenue. School lenders typically entered into contracts with other organizations that participate in FFELP to perform key components of the FFELP program: financing, originating (i.e., ensure that borrowers complete promissory notes), servicing, and purchasing loans. Differences existed in how school lenders financed and when they chose to sell their loans. School lenders emphasized that the potential revenue received by selling loans, which ranged from 2 to 6 percent of the total value of the loans sold by these schools, was a significant factor in their decision to become a lender and outweighed the costs of the program. In addition to receiving revenue from selling loans, school lenders may also receive borrower interest payments and special allowance payments from Education as compensation for holding FFELP loans. Several school lenders reported using or planning to use premium revenue to provide borrower benefits such as reduced loan origination fees, better repayment terms upon graduation, and need-based aid.

Typically School Lenders Contracted with Other FFELP Organizations to Administer Their Loan Program, but Differences Existed in How They Financed Loans, When They Sold Loans, and the Costs Incurred in Selling Loans

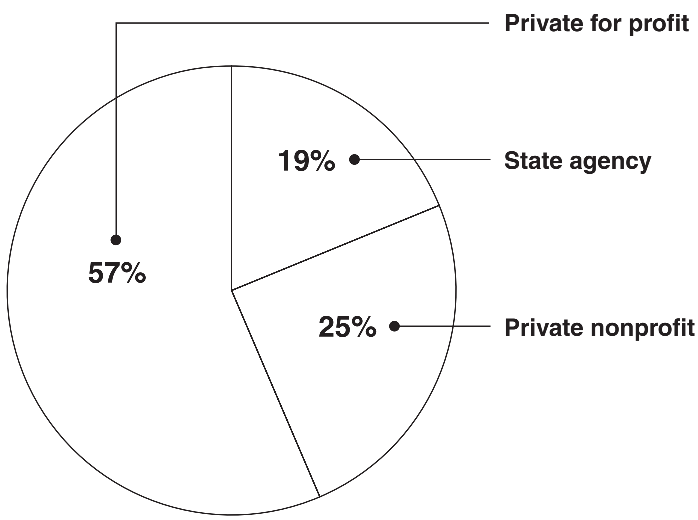
In order to provide FFELP loans, school lenders we interviewed generally entered into contracts with other organizations that participate in FFELP to perform key components of the FFELP program: financing, originating, servicing, and purchasing loans. To select the organizations that a school lender would use to finance, originate, service, and purchase its FFELP loans, some school lenders asked for organizations to submit contract proposals. For example, one school lender we interviewed specifically asked organizations to submit proposals that included

1. a line of credit to finance its loans with a below-market interest rate;
2. a fixed premium for loans sold rather than one that varied;
3. better financial benefits to borrowers, such as a 1.5 percent origination fee reduction; and
4. specifications for electronic loan processing.

These school lenders then would review the proposals and select the one that best met the school lenders' needs. While assessing submitted proposals, officials from two school lenders told us that they worked with a private company that assists schools in structuring loan programs and negotiating the prices paid for loans. For one public school lender, the process to review proposals was subject to the same requirements that state agencies must follow when selecting contractors, including having the proposals reviewed by a board that included the governor of the state

School lenders that originated loans in school year 2003–2004, or are in the process of establishing their FFELP lending programs, contracted with one of three types of organizations—private for-profit company, state agency, or private nonprofit company—to purchase their loans. As shown in figure 3, most school lenders sold their loans to private for-profit companies.

Figure 3. Percentage of School Lenders That Sold Loans to Either a Private For-Profit Company, State Agency, or Private Nonprofit Company



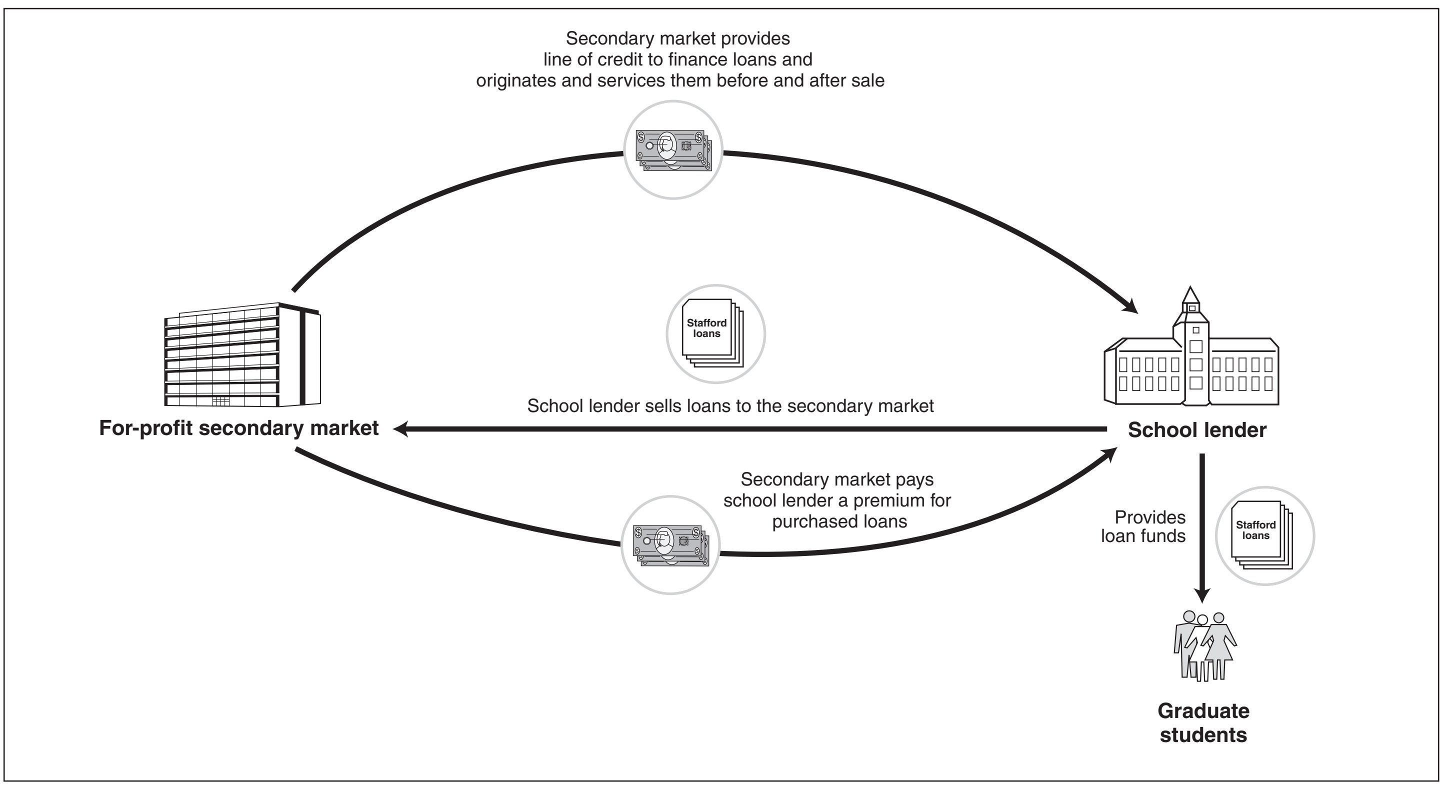
Source: GAO analysis.

Note: The figure shows the purchasers for all school lenders that originated loans in school year 2003–2004 or school lenders that are planning to provide loans for school year 2004–2005. The percentages add to more than 100 because of rounding.

While All School Lenders We Interviewed Contracted for the Sale of Loans, They Varied in the Extent to Which They Contracted for the Financing, Originating, and Servicing of Loans

The 13 school lenders we interviewed typically entered into contracts for loan origination, servicing, and sale by selecting one organization or multiple organizations to perform all three components. About a third of the school lenders we interviewed used their own money to finance the loans they made, while the others obtained a line of credit, in some cases from the same organization that eventually purchased the loans originated by the school lender. Some school lenders used the same organization to finance, originate, service, and purchase their loans. Officials with one school lender reported that contracting with one organization simplified the loan process and was operationally efficient. Figure 4 illustrates how one school lender we interviewed structured its program by contracting with one organization to finance, originate, service, and purchase its loans.

Figure 4: Structure of Lending Operation for One School Lender That Contracts with One Organization to Finance, Originate, Service, and Purchase Loans

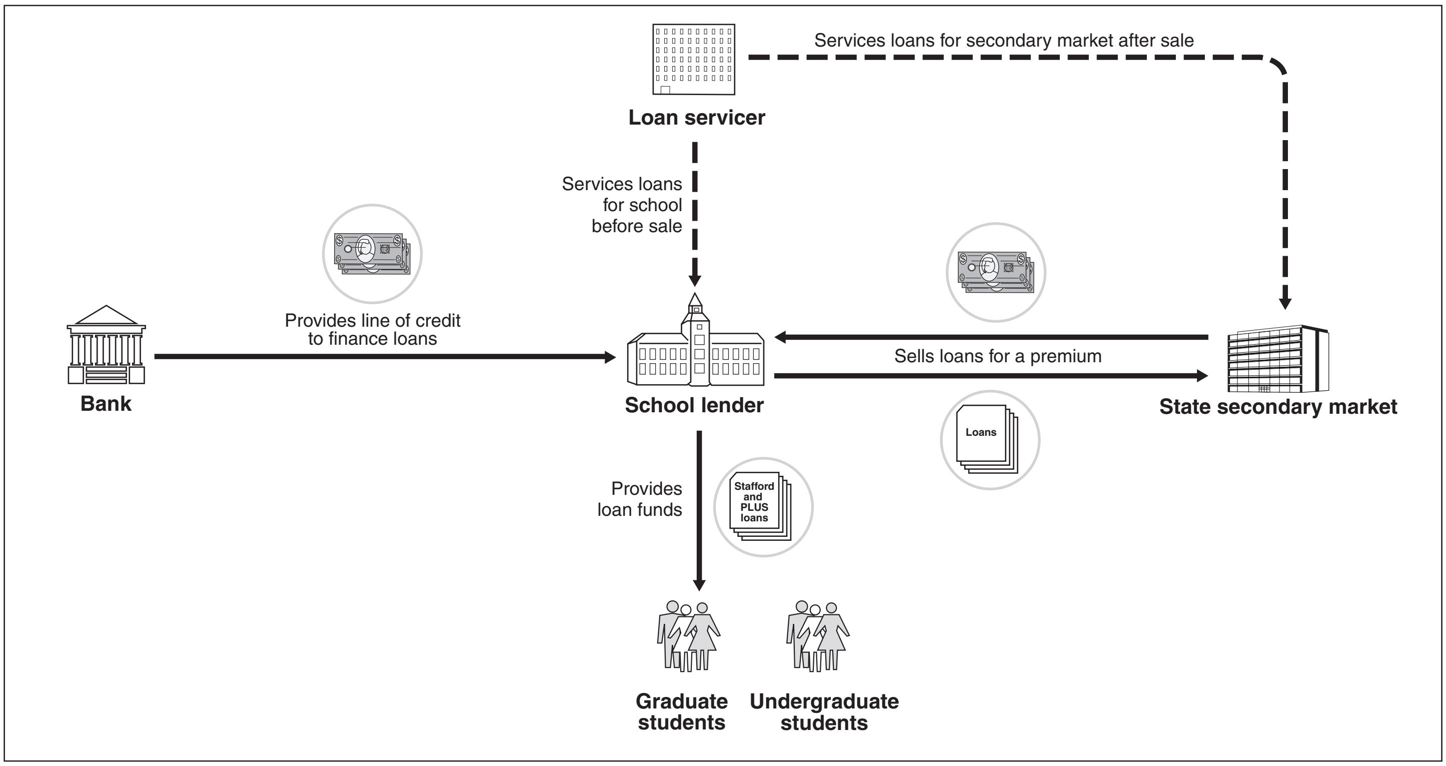


Source: GAO.

In contrast, five school lenders we interviewed contracted with two or more organizations to finance, originate, service, and purchase loans.

Figure 5 depicts how one school lender has structured its lending program by contracting with multiple organizations. In this example, the school received financing from a bank and loan servicing from a private nonprofit company and eventually sold the loans to a state secondary market.

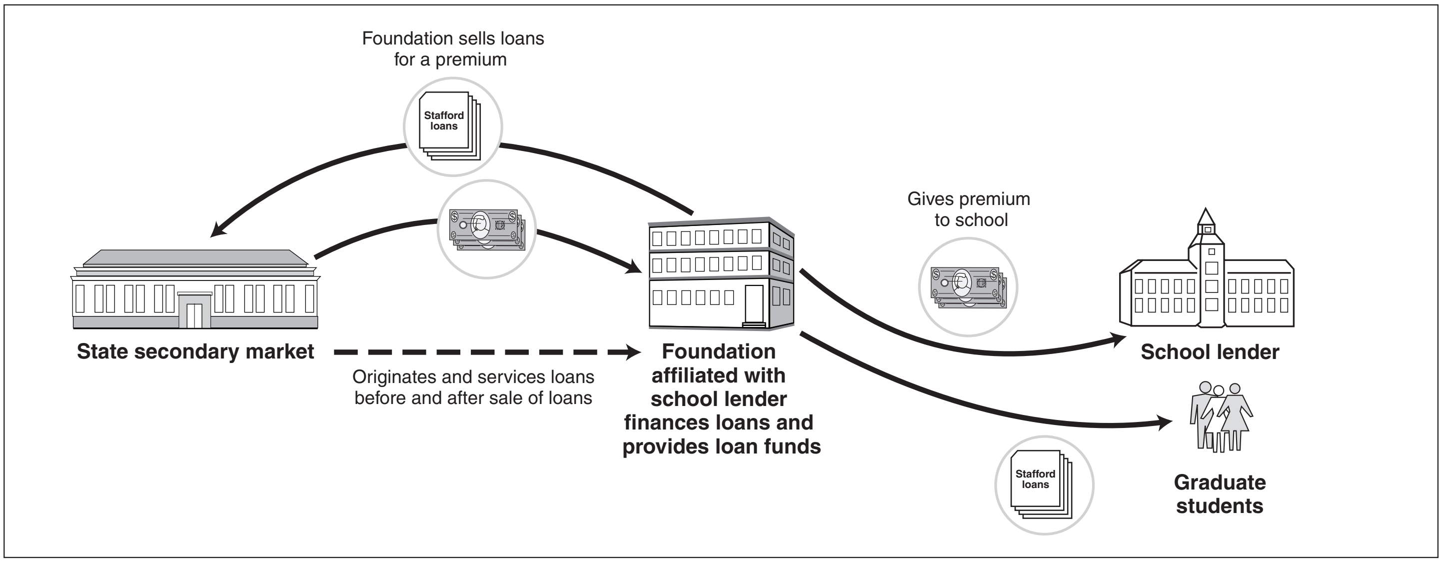
Figure 5: Structure of Lending Operation for One School Lender That Contracted with Three Organizations to Finance, Originate, Service, and Purchase Loans



Source: GAO.

Further, one school lender we interviewed had a unique approach in how it structured its lending program. The actual lender was a foundation affiliated with the school because state law prohibits public schools from incurring debt in that state. According to a school official, the foundation finances the loans, provides them to borrowers, collects interest payments from borrowers and special allowance payments from Education, and is responsible for having the loans serviced until they are later sold to the secondary market. After the foundation covers its administrative expenses, the official stated it gives the school any remaining money. As shown in figure 6, the foundation contracted with a secondary market, in this example a state agency, to originate, service, guarantee, and purchase the loans.

Figure 6: Structure of Lending Operation for One School Lender That Used an Affiliated Foundation and State Agency to Finance, Originate, Service, and Purchase Loans



Source: GAO.

By and large, school lenders contracted with others to operate their lending program, but some school lenders reported that it was beneficial to assume financing, origination, or servicing responsibilities themselves rather than contract with others. For example, four school lenders used endowment or other institutional funds to finance their loans, and one school lender's affiliated foundation issued a taxable bond to raise the funds needed to finance the loans. One school lender that used its own funds also performed its own loan origination. Moreover, this school lender performed its own servicing of the loans—monitoring student enrollment, billing borrowers, providing periodic reports to Education, and collecting payments for students no longer enrolled—before it sold the loans.

School Lenders Differed in Terms of When They Sold Loans and the Costs Incurred

School lenders we interviewed differed in terms of when they sold their loans, with most selling them 60 to 90 days after full disbursement, as shown in table 2.[12]

Table 2: Length of Time School Lenders Owned Loans before Selling to Another Lender to Receive a Premium

Number of school lenders	Number of days school lender owns the loans before selling them
1	7
9	60–90[a]
1	Up to 120
2	Until student graduates or leaves school[b]

Source: GAO analysis.

[a]One school lender receives a portion of the premium when it sells a legal interest in the loans the same day they are originated. Legal interest entitles the secondary market to all principal payments, accrued interest, government subsidies, and special allowance payments. The school lender transfers legal title within 60 days following full disbursement.

[b]Two school lenders sold PLUS loans 30 and 60 days after full disbursement but retain Stafford loans until time of graduation.

The decision to sell a loan can be motivated by a variety of factors. Typically, officials from school lenders that sold the loans before 90 days after they were fully disbursed reported doing so in part to minimize risk associated with potential default on loans and associated servicing costs. Moreover, some school lenders reported that they preferred to make and sell loans within the same fiscal year so that they could repay lines of credit to avoid having to record outstanding debt on the school's annual financial statements. For one school lender it was important not to record additional debt because of concerns about the impact of such debt on the school's bond rating. The school lender that sold the loans a week after first disbursement received the premium much sooner than those schools that sold the loans after full disbursement. Two school lenders that sold loans after the student had graduated or left the school were private schools with sufficient resources to finance the loans and were not as concerned about financial liability or receiving revenue quickly.

Several of the school lenders we interviewed reported that operating as a lender was only marginally more labor intensive and costly than the traditional processes for schools that are not FFELP lenders, and that the

[12]Under the HEA, loans are disbursed in multiple payments.

premium received when loans are sold makes being a lender worthwhile. Generally, school lenders incur initial start-up and ongoing costs when serving as a FFELP lender. Start-up costs can include staff time to research and sign contracts with other FFELP participants and training staff on new software to process loans. Ongoing costs include payment of a 0.5 percent fee to the federal government for each loan and staff to manage the loan process and originate and service loans. The extent of these costs borne by a school lender depended on how school lenders negotiated their contracts, with some negotiating contracts in which they did not have to pay for costs normally paid by FFELP lenders. For example, school lenders we interviewed that obtained a line of credit to finance their FFELP loans typically were charged market interest rates on the money borrowed. However, according to one contract, the secondary market that provided the line of credit for the school lender to finance its loans did not charge the school lender interest. In exchange, this school lender sold a legal interest in the loans on the day they are first disbursed, entitling this secondary market to all principal payments, accrued interest, government subsidies, and special allowance payments. Additionally, several of the school lenders did not pay for loan servicing, while most school lenders interviewed paid about $2 a month per loan for servicing. Moreover, one school lender also told us that it receives a special rate on private loans offered to students to supplement FFELP loans from the purchaser because of the volume of graduate loans it sells.

Many School Lenders Reported Using or Planning to Use the Money from Selling Loans to Lower Borrowing Costs or Provide Need-Based Aid, but They Are Not Required to Do So

Many school lenders interviewed reported using the premium received on the sale of the loans to lower borrowing costs and provide need-based aid to students, although current law does not specify how premiums should be used. The premiums that school lenders receive are based on several factors, such as the default rate of the students attending the school, the average amount borrowed by students, and the number of loans per borrower. Some school lenders received a fixed premium for their loan portfolio, while other schools were paid a variable premium that corresponded to the average amount borrowed. For example, one school lender's premium increased by 0.25 percentage points for nearly all increases of $1,000 in the average amount borrowed by students. The premiums received by school lenders we interviewed ranged from 1.85 percent to 6 percent of the total value of the loans sold, with an average premium of 4.4 percent.[13]

[13]This is based on premiums reported by 10 of the school lenders.

Unlike special allowance payments and interest income that under HEA must be used for need-based grants, school lenders may choose how they use premiums received when selling loans. Premiums are the primary source of revenue for many school lenders since most choose to quickly sell loans, thereby giving up the right to receive special allowance payments and interest income. Officials from several school lenders emphasized that as their financial budgets have been constrained, the revenue received from being a lender is a primary motivation for becoming a school lender. For example, one large public school lender estimated that it will receive about $7.5 million over a 3-year period. A smaller private school lender estimated it will receive less than $1 million over the next 3 years. Most of the school lenders interviewed reported that they used or plan to use premium money for student financial aid. However, they differed in how they allocated the money. For example, two school lenders reported using premium revenues to pay part of the origination fee for borrowers and generate revenue for need-based aid, while another school lender reported using premium revenue for only need-based aid. School lenders either used money to lower borrowing costs and/or provide need-based grants to its students. For some school lenders, the financial benefits offered to students who borrow through them are better than those offered prior to the school becoming a lender.

Although most of the school lenders reported using the premium revenues to provide financial benefits for students, under current law they could use the money to meet other institutional needs, such as student recruitment or facility improvement. One school lender told us that it does not plan to use premium revenue for need-based aid but instead will use it for initiatives that would improve students' educational environment, such as enhancing technological equipment. Legislation proposed in the House of Representatives in May 2004 would require school lenders to use the premium for need-based aid.[14] Generally, school officials told us that the requirement seems reasonable because most of the school lenders already use the revenue for that purpose. According to officials from two school lenders, they plan to use the premium for need-based aid but are still determining specifically how the money will be allocated. One school lender noted that the premium is applied to the school's general operating budget and that it is used in part for need-based aid.

[14] College Access and Opportunity Act of 2004, H.R. 4283, 108th Cong. § 428.

The school lenders we interviewed differed in the loan origination and guarantor fees charged to borrowers as well as repayment terms offered, and certain school lenders offered more financial benefits to borrowers than others. Four of the 13 school lenders we interviewed waived origination fees for their students. Additionally, several school lenders used guaranty agencies that did not charge or reduced the guarantor fee. Moreover, some school lenders sold their loans to secondary markets that offered better repayment terms than others, such as interest-rate reductions and principal rebates for timely payments. Table 3 shows the range of financial benefits offered to borrowers among selected school lenders.

Table 3: Comparison of Benefits for Stafford Borrowers among Selected School Lenders Interviewed

School lender	Origination fee	Guarantor fee	Repayment incentives
School lender A	0%	0%	0% interest rate charged if first 36 consecutive payments made on time 0.25 percentage point interest rate reduction for repaying electronically
School lender B	3%	0%	1.25 percentage point interest rate reduction at first payment 0.25 percentage point interest rate reduction for repaying electronically
School lender C	0%	0%	2 percentage point interest rate reduction after 48 on-time payments 0.25 percentage point interest rate reduction for repaying electronically
School lender D	1.5%	.5%	For loans disbursed 1/1/93-6/30/02: 2 percentage point reduction on interest rate for 48 consecutive on-time payments For loans disbursed 7/1/02-6/30/04: 3.3% of the original loan amount as either a credit or a check to the borrower 0.25 percentage point interest rate reduction for repaying electronically
School lender E	3%	1%	2 percentage point interest rate reduction after first 30 on-time payments 0.25 percentage point interest rate reduction for repaying electronically

Source: GAO analysis.

Officials from two school lenders stated that they contracted to sell their loans to the agencies in their states because of the benefit programs offered to borrowers. For example, one school lender contracted with a state agency for the sale of its loans because the state agency agreed to pay the origination fees for borrowers, reduce borrowers' interest rate to 0 percent if they made the first 36 payments on time, and reduce interest rates 0.25 percent for making payments electronically. Officials from two state agencies that purchase loans from school lenders said they were able to fund borrower benefits to residents of their state or students attending schools in the state in part with earnings from loans financed with tax-exempt bonds issued by their states prior to October 1, 1993. The federal government guarantees holders of loans financed with such bonds a minimum 9.5 percent yield, providing these agencies a source of relatively higher revenues in light of low current market interest rates.[15]

A Number of Statutory and Regulatory Provisions Exist to Safeguard the Interests of Taxpayers and Borrowers, but FSA Has Not Regularly Monitored School Lenders' Compliance with the Provisions

A number of statutory and regulatory provisions applicable to all lenders and schools, and some applicable only to school lenders, exist to safeguard the interests of taxpayers and borrowers. FSA however, has little information on school lenders' compliance because it has not provided timely and adequate oversight of school lenders. Under the HEA, lenders and schools must submit annual audits to demonstrate compliance with laws and financial stability. Another provision in the HEA, commonly called the anti-inducement provision, is designed to protect borrowers' interests by prohibiting any lender from offering gifts or other incentives to schools or individuals to secure applicants that may result in increased student borrowing. Not only must school lenders comply with audits and provisions of the HEA applicable to all lenders, but they must also comply with provisions specific to them. FSA has little information about how school lenders are complying with laws and regulations, and until this year, FSA had not used its authority to conduct program reviews of school lenders, which supplement the information contained in audits.

Several Statutory and Regulatory Provisions Applicable to All Lenders and Schools, and Some Applicable Only to School Lenders, Exist to Protect the Interests of Taxpayers and Borrowers

To protect the interests of taxpayers and borrowers, a number of statutory and regulatory provisions exist regarding, among other things, application processes and audit requirements for schools and lenders; these also provide FSA and guaranty agencies the authority to review lenders and schools. For example, in determining whether a lender will be granted a lender identification number and permitted to provide FFELP loans, according to HEA regulations, Education considers several factors. These include

- whether the applicant is capable of implementing adequate procedures for making, servicing, and collecting loans;
- the financial resources of the applicant; and

[15]Under the Internal Revenue Code (IRC), earnings on loans financed by tax-exempt bonds are limited. Lenders can reduce their earnings on loans financed with tax-exempt bonds, and avoid exceeding IRC limitations, by providing benefits to borrowers. For additional information see GAO, *Federal Family Education Loan Program: Statutory and Regulatory Changes Could Avert Billions in Unnecessary Federal Subsidy Payments*, GAO-04-1070 (Washington D.C.: September 20, 2004).

- in the case of a school that is seeking approval as a lender, its accreditation status.[16]

Additionally, under the HEA, all FFELP lenders that originate or hold more than $5 million in FFELP loans must have an independent annual compliance audit, which examines the lender's compliance with the HEA and relevant regulations as well as its financial management of FFELP activities. Lenders must then submit this audit to FSA. About 17 percent of the school lenders in school year 2003–2004 did not originate more than $5 million and therefore were not required to have a compliance audit. Schools that participate in federal financial aid programs must submit audited financial statements and compliance audits that attest to their compliance with laws and regulations governing federal financial aid programs, including FFELP.

FSA and guaranty agencies have the authority to conduct program reviews of lenders or schools, which are intended to assess, promote, and improve compliance with laws and regulations and to help ensure program integrity. Program reviews can supplement the information provided through the required annual compliance audits. According to FSA, program reviews of lenders tend to focus on lenders' billing of Education for interest and special allowance payments. FSA reviews schools that participate in federal financial aid programs and will target schools that have a cohort default rate in excess of 25 percent or have significant fluctuation in Stafford loan volume from year to year. Guaranty agencies also conduct program reviews of lenders and schools. Every 2 years guaranty agencies must review any lender that meets one of the following criteria:

- lender's loan volume represented 2 percent or more of the guarantor's volume of FFELP loans guaranteed during the preceding year,
- lender was one of the guarantor's top 10 lenders as measured by its loan volume for the preceding year, or

[16]The purpose of accreditation is to provide public assurance of educational quality. There are two types of accreditation: institutional and specialized. Institutional accrediting examines the school as a whole and includes an assessment of the formal educational activities of the institution, governance and administration, financial stability, admissions and student personnel services, institutional resources, student academic achievement, institutional effectiveness, and relationships with constituencies inside and outside the institution. Specialized accreditation examines programs within a school, such as medicine or teacher education.

- lender's loan volume during the most recent fiscal year equaled or exceeded $10 million.

Guaranty agencies also have the authority to review any lender that has more than $100,000 in defaulted loans and a cohort default rate above 20 percent. Guaranty agencies review schools to assess, among other things, how schools certify loan applications and maintain loan records.

Congress Adopted the Anti-Inducement Provision to Protect Borrowers' Interests

Another provision in the HEA, anti-inducement provision is designed to protect borrowers' interests by prohibiting any lender from offering gifts or other incentives to schools or individuals to secure applicants that may result in increased student borrowing. Education once attempted to enforce the anti-inducement provision with respect to school lenders. Specifically, Education proposed to limit the participation of a secondary market based on its financing and purchasing contracts with a school lender. Education contended that these contracts provided the school with an improper financial inducement to solicit more loan applications from students than it would have otherwise. The secondary market challenged Education's actions in federal district court, which found that the school lender's financing, servicing, and loan purchase contracts were not uncommon among traditional FFELP lenders. Moreover, the premium paid and other economic benefits received by the school lender were unremarkable and did not rise to the level of an improper inducement. The court found also that there was no evidence that borrowers were counseled improperly or encouraged to borrow more than they needed. Finally, while the court pointed out that under the anti-inducement provision, lenders are prohibited from offering "inducements" to educational institutions, including school lenders, it found that Congress' intent was unclear. Nevertheless, the court stated that Congress did not intend that all incentives be treated as inducements.[17]

Since the court's decision in this case, Education has not clarified its definition of inducements, and according to an Education official, the court's decision makes it much harder for Education to show that school lending arrangements violate the inducement provision. The lack of clarity surrounding the issue of inducements is not solely a problem for school lenders. In an August 2003 memo, Education's Office of Inspector General (OIG) noted that it had concerns about bargaining practices between schools and lenders for private loans that students may obtain to

[17] *Student Loan Marketing Assoc. v. Riley*, 112 F. Supp. 2d 38 (D.D.C. 2000).

supplement FFELP loans and preferred lender status that may violate the anti-inducement provision. OIG recommended that Education reevaluate the anti-inducement provision and determine if statutory revisions should be proposed during HEA reauthorization, but Education has not taken any action in response to OIG's memo. A work group representing FFELP lenders, guaranty agencies, and financial aid officers has developed guidelines for what constitutes an inducement, but these guidelines do not specifically address school lenders' contracts.

School Lenders Are Subject to a Number of Regulations

Not only must school lenders comply with audits and provisions applicable to all lenders, but Congress has added provisions that apply only to school lenders—in part to address past problems among school lenders. In the early to mid-1970s, certain school lenders—particularly vocational schools—did little to ensure that students paid back loans, such as informing and counseling borrowers about repayment obligations and options, which contributed to high default rates. Congress was also concerned that schools were determining the cost of attendance and also awarding students financial aid while investing few resources in preventing loan default. While there was pressure from some groups for Congress to eliminate the school lender provision in the 1976 reauthorization of the HEA, there were still concerns about students' access to loans and school lenders' roles in helping meet students' need. Rather than eliminating school lenders, Congress enacted and revised several provisions designed to reduce the number of school lenders with abusive practices that contributed to high default rates. In 1992, Congress added another requirement specific to school lenders that they use interest income and special allowance payments for need-based grants. Since 1992, Congress has not added any statutory provisions regarding school lenders. Figure 7 shows the primary statutory provisions applicable to school lenders today that were, for the most part, enacted in the mid-1970s.

Figure 7: Statutory and Regulatory Provisions Specific to School Lenders

School lenders:

- shall employ full-time at least one person whose responsibilities are limited to the administration of financial aid programs for students attending the school;
- may not be a correspondence school;
- may not make or originate loans that would be outstanding to or on behalf of more than 50 percent of the undergraduates in attendance at that school on at least a half-time basis unless the secretary waives this rule because of extreme hardship to the school;
- shall inform any undergraduate student who has not previously obtained a loan that was made or originated by the school and who seeks to obtain such a loan that he or she must first make a good faith effort to obtain a loan from a commercial lender;
- may not make or originate a loan for an academic period to an undergraduate student unless the student provides the school with evidence of denial of a loan by a commercial lender for the same academic period;
- may not have a default rate exceeding 15 percent; and
- except for reasonable administrative expenses directly related to FFELP, school must use interest and special allowance payments for need-based grant programs for its students.

Source: HEA and 34 CFR 682.201.

FSA Has Little Information about How School Lenders Are Complying with Laws and Regulations because It Has Not Provided Timely and Adequate Oversight of School Lenders

FSA has minimal information about how school lenders are complying with laws and regulations, and until this year, FSA had not used its authority to conduct program reviews of school lenders to assess compliance with regulations specific to them. For example, FSA does not check a school's accreditation status when the school applies to be a lender, as specified in HEA regulations. FSA was unaware that in fiscal year 2004, one school lender who received a lender identification number, which is needed to originate loans, had been placed on probation by its accrediting agency. According to the accrediting agency, the school lender was on probation because of concerns about the school's financial stability. In general, the lack of financial stability at a school can have a serious impact on the funding of instructional programs, the quality of learning resources available to students, and the number of faculty and staff employed.

FSA is also responsible for ensuring that lenders submit required annual compliance audits that attest to the lender's financial stability and compliance with laws and regulations. Compliance audits are but one source of information about a lender's compliance with laws and regulations and are a mechanism to assess an organization's internal controls. Without these audits, Education's ability to monitor and detect significant fraud or other illegal acts is compromised. Compliance audits are generally due 6 to 9 months after the end of the lender's fiscal year.[18] If a lender does not submit the compliance audit, then Education may suspend the lender's participation in the FFELP program. For fiscal year 2002, FSA did not verify, on a timely basis, that all school lenders required to submit compliance audits, which were due between June and August 2003, had done so. As a result, FSA did not realize, until September 2004, that 10 of 29 school lenders had failed to submit required compliance audits for fiscal year 2002. Moreover, while FSA had previously notified 6 of these 10 school lenders that FSA had not received the required compliance audits, it had not yet notified the remaining 4 schools of their failure to submit such audits. FSA subsequently reminded the 4 school lenders to submit their required compliance audits and suspended the remaining 6 school lenders from receiving interest and special allowance payments for their failure to submit compliance audits. After FSA contacted or suspended the school lenders in September 2004, 3 school lenders subsequently submitted their fiscal year 2002 compliance audits. FSA officials told us that school lenders required to submit compliance audits for fiscal year 2003 had done so.

According to FSA officials, the Financial Partners office is responsible for monitoring school lenders and may conduct program reviews to determine compliance with regulations. FSA has not conducted such reviews of school lenders. However, during the course of our review, three regional offices asked 31 school lenders about their compliance with the regulation pertaining to the use of interest income and special allowance payments for need-based grants. The school lenders told FSA that they were in compliance with this regulation and provided information on their servicing costs and interest rates paid for lines of credit. FSA is planning to conduct a more thorough review of 10 school lenders to gain a further understanding of how school lenders are structuring their lending

[18]Lenders or servicers that are nonprofit or governmental organizations have the option of obtaining an audit in accordance with Office of Management and Budget Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions.* Such audits are due 9 months following the end of the lender's fiscal year. Audits submitted by other lenders are due 6 months following the end of the lender's fiscal year.

programs. FSA officials reported that school lenders will be selected based on several risk factors, such as a large increase in loan volume or an increase in default rates. As part of these reviews, FSA will follow the review guide used for traditional lenders, and it will also review contracts to ensure there are no violations of the anti-inducement provision and that fee arrangements are appropriate. However, FSA officials told us that they had not determined the criteria for what would constitute an improper inducement.

Conclusions

When FFELP was created, in 1965, Congress was concerned about lenders' capacity and willingness to make loans to students who had little credit history and when the economic returns on such loans were uncertain. Postsecondary schools were included in the definition of eligible FFELP lenders as one way to help ensure that all students would have access to student loans. In recent years, an increasing number of schools are becoming FFELP lenders as a way to generate more revenue for the school, rather than ensure students' access to loans. As the number of schools becoming lenders continues to increase, it is critical for FSA to ensure school lenders' compliance with laws and regulations designed to ensure program integrity, thereby protecting taxpayer dollars and student interests. For one such requirement—annual submission of compliance audits—FSA has not ensured that school lenders have submitted them in a timely manner. Without this information, FSA is unaware of, among other things, whether school lenders disburse loans only to eligible students in accordance with the law and are financially stable. A school's financial stability is important because if a school is unable to meet its financial obligations, it may place into jeopardy students' completion of their educational programs and, in turn, their ability to repay their student loans. Future FSA plans to review selected school lenders should provide useful information about how school lenders operate, but without consistent oversight, FSA may be unaware of practices that could place taxpayer dollars at risk.

Recommendation for Executive Action

To ensure program integrity, we recommend that FSA's Chief Operating Officer take the steps necessary to ensure that school lenders are consistently complying with statutory and regulatory provisions. As a first step, FSA should ensure that school lenders consistently submit audited financial statements and compliance audits in a timely manner.

Agency Comments

We provided Education with a copy of our draft report for review and comment. In written comments on our draft report, Education generally agreed with our reported findings and recommendation. Education agreed that increased oversight is necessary given “the very substantial growth in the number of school lenders and the loan volume associated with these lenders.” Education stated that it believed the efforts it undertook to verify that lenders submitted required annual compliance audits for fiscal year 2002 were instrumental in ensuring compliance and further noted that all school lenders that were required to submit such audits for fiscal year 2003 had done so. As a result, Education noted that it believed our “criticism that FSA has little information about how school lenders are complying with laws and regulations is misplaced.” As we describe in our report, compliance audits are but one source of information concerning the extent to which school lenders comply with laws and regulations. FSA staff could also learn about school lender compliance issues by collecting information themselves, such as—as described in our report—determining a school’s accreditation status when the school applies to be a lender and by conducting program reviews. Finally, Education noted in its comments that FSA is planning to conduct a more thorough review of 10 school lenders. Education’s written comments appear in appendix IV.

We are sending copies of this report to the Secretary of Education, appropriate congressional committees, and other interested parties. In addition, the report will be available at no charge on GAO’s Web site at http://www.gao.gov.

If you or your staff have any questions about this report, please call me on (202) 512-8403 or Jeff Appel on (202) 512-9915. Other contacts and staff acknowledgments are listed in appendix IV.

Cornelia M. Ashby

Cornelia M. Ashby
Director, Education, Workforce,
and Income Security Issues

Appendix I: Scope and Methodology

To address our research objectives we analyzed data from the Department of Education (Education); interviewed officials with school lenders, Education, lenders, and others; and reviewed relevant laws and regulations. To assess the extent to which schools have participated in the Federal Family Education Loan Program (FFELP) as lenders, we obtained a list from Education of schools approved to be FFELP lenders and then, using data in the National Student Loan Data System (NSLDS), we analyzed the dollar amount of FFELP loans made by each school lender in each school year from 1993–1994 to 2003–2004.[1] We converted loan volume to real 2003 dollars using the Department of Commerce's Gross Domestic Product (GDP) Deflator and the Congressional Budget Office's GDP Deflator projections. We also analyzed the amount of loans made by other FFELP lenders for students attending these schools. We used the Integrated Postsecondary Education Data System (IPEDS) to determine the characteristics of schools that were lenders, including whether they were private or public schools, whether they provided graduate or professional programs, average tuition, and average enrollment.[2] To identify school lenders that once provided or still participate in the FDLP, we analyzed data on the amount of FDLP loans provided at a school between school years 1994–1995 and 2003–2004.[3] On the basis of our review of the documentation for these data and our discussions with Education officials about the steps they take to ensure the reliability and validity of these data, we determined that the data from these systems were sufficiently reliable for the purpose of our study.

To assess school lending operations and benefits to schools and borrowers, we conducted site visits and interviews with 13 school lenders. We selected school lenders that have been FFELP lenders for several years and some that have just begun lending. Moreover, the school lenders selected included public and private institutions, schools that had once participated in the FDLP, and some of the largest school lenders in terms of loan volume. We also interviewed 12 other lenders, including secondary markets; two state-designated guaranty agencies; and related higher

[1]The NSLDS is a national repository of information about federal loans and grants awarded to students.

[2]IPEDS is a collection of information obtained from surveys of all schools whose primary purpose is to provide postsecondary education and provides school-level data for a variety of characteristics.

[3]FDLP data is from Education's Committed Loan Volume Report, which includes data reported by schools and contractors.

education and financial aid associations. We reviewed contracts between schools and secondary markets and servicers. To determine the types of lenders purchasing loans from all 64 school lenders in school year 2003–2004 and the 17 in the process of establishing their loan programs, we interviewed officials with the school lender or with the secondary market.

To assess existing safeguards for borrowers and taxpayers, we reviewed the Higher Education Act (HEA), related regulations, guidance issued by Education, and court decisions. We also interviewed officials in Education's Office of Federal Student Aid, Office of General Counsel, Office of Inspector General, and Office of Postsecondary Education.

Appendix II: Top 100 FFELP Originating Lenders in Fiscal Year 2003

(Volume in millions of dollars)

Lender	Loan volume	Lender	Loan volume
Bank One Ed Fin Group	$3,318	Comerica Bank	$192
Sallie Mae	3,161	Rhode Island Student Loan Authority	187
Citibank, Student Loan Corp	2,995	New Hampshire Higher Ed Loan Corp	176
JP Morgan Chase Bank	2,466	Regions Bank	172
Bank of America	2,158	Provincial Bank Academic Funding Group	164
Wells Fargo Education Financial Services	2,042	Twin City Federal Savings Bank (TCF)	162
Wachovia Bank/Classnotes (Educaid)	1,781	All Student Loan Corp	154
National City Bank	1,378	First National Bank	153
U.S. Bank	1,031	Stillwater National Bank	148
Pittsburgh National Corp	671	Manufacturers & Traders Bank	141
Suntrust Bank	661	Fifth Third Bank	130
EdAmerica	652	Connecticut Student Loan Foundation	124
Northstar Guarantee	635	Bancorpsouth Bank	117
Penna Higher Education Assistance Agency	633	Zions First National Bank	112
Fleet Bank	593	EFS Finance Co	106
Academic Management Services	480	First Midwest Bank	104
College Foundation Inc.	477	National Ed Loan Network (Nelnet)	98
Citizens Bank, Education Finance	441	**University of Pennsylvania**	**96**
College Loan Corp	427	Louisiana Public Facilities Authority	96
Union Bank & Trust Company	417	Boone County National Bank	93
Nova Southeastern University	**376**	Union Planters National Bank	90
S C Student Loan Corp	370	Hibernia National Bank	88
Key Corp	366	University of Southern California FCU	87
Education Lending Group	318	Bank of Oklahoma	79
Teachers Insurance & Annuity Assn of America	307	Bank of North Dakota	79
Brazos Group	289	Maine Educational Loan Marketing	76
Illinois Student Assistance Comm/IDAAP	280	Plains National Bank	75
Commerce Bank	257	New Mexico Ed Assistance Foundation	75
Amsouth Bancorp Ed Fin Group	253	Frost National Bank	71
Washington Mutual Savings Bank	235	Kansas State Bank	69
AELMAC/Southwest Student Services Corp	229	Colorado Student Obligation Bond Auth	62
Kentucky Higher Ed Student Loan Corp	224	**Kirksville College of Osteopathic Medicine**	**62**
Vermont Ed Loan Finance Program	223	University Federal Credit Union	61
HSBC Bank USA	196	Independence Federal Savings Bank	59

(Volume in millions of dollars)			
Arkansas Student Loan Authority	59	Indiana Secondary Market	50
Midwestern University	**59**	Southtrust Bank	49
Georgia Student Finance Authority	58	**Western University of Health Sciences**	**47**
Carnegie Insurance Company	57	First Federal Savings Bank	45
Michigan State University	**56**	First National Bank	44
University of Chicago	**56**	First National Bank	43
Trustmark National Bank	54	Compass Bank	43
Simmons First National Bank	54	Navy Federal Credit Union	42
University of Missouri	**54**	Security Service Federal Credit Union	41
First Tennessee Bank	53	CA Higher Ed Loan Authority (Chela)	41
Palmer College of Chiropractic Medicine	**52**	Purdue Employees FCU	39
Marshall & Ilsley Bank	51	**Dr Scholl College of Podiatric Medicine**	**39**
Michigan Higher Ed Stud Loan Auth	51	Whitney National Bank	39
University of Miami	**50**	Wyoming Student Loan Corp	37
University of Denver	**50**	**Widener College**	**36**
BancFirst	$50	**Regis University**	**$33**

Source: Financial Partners, Department of Education, “Top 100 Originators of FFELP.”

Notes: Fourteen school lenders are on the top 100 list; they are highlighted in bold.
The top 100 FFELP lenders represented 91.7 percent of the overall FFELP volume.

Appendix III: School Lender Loan Volume in School Year 2003–2004

School lender	Loan volume	School lender	Loan volume
NOVA Southeastern University	$302,613,491	University of Missouri, St. Louis	$15,056,767
University of Pennsylvania	86,090,323	Pennsylvania College of Optometry	14,033,796
Michigan State University	65,186,038	Life Chiropractic College West	13,819,336
A.T. Still University of Health Sciences	60,757,687	University of Dayton	12,864,455
Midwestern University	57,428,863	University of Oklahoma	11,950,895
University of Chicago	52,951,854	Claremont Graduate University	11,787,491
University of Missouri - Kansas City	48,119,655	St. Mary's University	10,189,486
Palmer College of Chiropractic	46,215,953	Northwestern Health Services University	10,084,693
University of Denver	41,243,023	National University of Health Sciences	9,833,038
University of Miami	39,965,978	The University of Tulsa	9,519,514
Northwestern University	38,761,198	The University of Health Sciences	9,480,644
Western University of Health Sciences	37,645,505	Illinois Institute of Technology	9,365,766
SCPM at Finch University	36,885,485	Sherman College of Straight Chiropractic Medicine	7,352,179
University of Phoenix	35,772,707	Stanford University	6,768,517
Widener College	34,046,555	Southwest College of Naturopathic Medicine	6,614,267
Regis University	29,950,388	Naropa University	6,156,301
Case Western Reserve University	28,952,721	National College of Naturopathic Medicine	6,084,159
Tufts University	27,190,067	Western Illinois University	5,572,536
Simmons College	20,744,189	Pepperdine University	5,541,699
Southern Methodist University	19,632,868	Creighton University	5,421,886
Wayne State University	19,511,499	Oklahoma City University	5,102,086
George Washington University	19,035,444	Indiana Weslyan University	4,798,824
Santa Clara University	18,526,486	Eastern Michigan University	4,317,410
Washington University	18,219,650	Drexel University	3,938,519
Duquesne University	17,959,741	Philadelphia College of Osteopathic Medicine	3,275,418
University of Maryland, Baltimore	16,871,252	University of San Francisco	3,107,009
Yale University	16,788,402	University of Northern Colorado	2,335,397
Duke University	16,697,753	University of La Verne	1,049,680
Illinois College of Optometry	16,508,709	Texas Chiropractic College	360,336
Detroit College of Law (Michigan State U.)	16,421,996	Florida State University	220,448
Cleveland Chiropractic College	15,591,030	Texas Christian University	186,235
Parker College of Chiropractic Medicine	$15,400,240	Des Moines University	$136,280

Source: GAO Analysis of Education Data.

Note: Total school lender loan volume in school year 2003–2004 was $1,534,011,817.

Appendix IV: Comments from the Department of Education

UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF POSTSECONDARY EDUCATION

THE ASSISTANT SECRETARY

JAN 10 2005

Ms. Cornelia M. Ashby
Director, Education, Workforce,
and Income Security Issues
United States Government
Accountability Office
Washington, DC 20548

Dear Ms. Ashby:

Thank you for the opportunity to respond to the U.S. Government Accountability Office's (GAO's) draft report entitled "Federal Family Education Loan Program: More Oversight Is Needed For Schools That Are Lenders" (GAO-05-184).

We appreciate GAO's review of this important and growing area in the Federal Family Education Loan Program and agree with the draft report's recommendations that increased oversight is necessary given the very recent, substantial growth in the number of school lenders and the loan volume associated with these school lenders.

The data presented in the draft report suggest that, in general, school lenders are those that the Congress intended – relatively large institutions of higher education that have significant graduate and first-professional programs. The fact that these programs generate institutional revenues is not problematic if these revenues are used appropriately. As you know, section 435(d)(2)(F) of the Higher Education Act provides that revenue derived from interest and special allowance payments must be used to support need-based student financial aid. We believe that there are a number of other appropriate uses of revenue received by an institution as a result of its status as an FFEL lender. For example, the institution may use such resources to support its educational programs, to increase educational access, or to reduce the rate of increase in tuition and fees charged students.

We appreciate you noting the importance of ensuring that lenders, including school lenders, submit required annual compliance audits that attest to the lenders' financial stability and compliance with applicable statutes and regulations. We believe that the steps we took to verify that such audits were submitted for fiscal year 2002 were instrumental in ensuring compliance. As you indicated, Federal Student Aid (FSA) can report that all school lenders that are required to submit such audits for fiscal year 2003 have done so. Therefore, your criticism that "FSA has little information about how school lenders are complying with laws and regulations" is misplaced.

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Our mission is to ensure equal access to education and to promote educational excellence throughout the Nation.

We also appreciate you noting the importance of monitoring school lenders through program reviews. As you indicated, FSA has inquired of 31 school lenders regarding compliance with the regulation pertaining to the use of interest income and special allowance payments for need-based grants. As you additionally indicated, FSA plans to conduct a more thorough review of 10 school lenders. Again, we agree that increased oversight of school lenders is necessary given the very recent, substantial growth in the number of school lenders and the loan volume associated with these school lenders. FSA is taking steps to meet that important responsibility.

I appreciate your examination of this important issue.

Sincerely,

Sally Stroup

Appendix V: GAO Contacts and Staff Acknowledgments

GAO Contacts

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Andrea Romich Sykes, Analyst-in-Charge (202) 512-9660

Staff Acknowledgments

In addition to those named above, the following people made significant contributions to this report: Rebecca Christie, Jeffrey W. Weinstein, Richard Burkard, Margaret Armen, Mimi Nguyen, and Cynthia Decker.

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