Big U.S. role in lending to students

Jonathan D. Glater

The federal government has quietly increased its support of the student loan market to such a degree that the real question may be whether there is a role left for private lenders at all.

Veronika Lukasova for The New York Times

Arne Duncan, the education secretary, ordered a study of the department's purchase of student loans from private lenders.

The Education Department agreed in the waning days of the Bush administration to expand its commitment to buy student loans to keep the market working, much as the government has agreed to buy up all manner of loans, from mortgages to commercial paper, to unfreeze various credit markets.

The newest initiative was announced late last fall when there was great concern about the ability of college students and their families to get continued financing for education. The most likely size of the program, detailed in the Federal Register on Jan. 15, was $25 billion.

But in a contract signed just four days later, on the last day of the Bush administration, the Education Department effectively agreed to buy up to $60 billion in loans, $35 billion more than the figure published in the Federal Register. That is almost enough to purchase all the federal loans made to students last year.

The government already pays a subsidy to banks and others making what are called federally guaranteed student loans. It also covers nearly all the losses if a student defaults on such a loan. In the current economic crisis, it is buying the loans, thereby providing the banks with capital for new lending. That has caused critics to say they wonder whether a middleman is really needed in this business.

“What has happened is, we set up a system in which we ensure liquidity by allowing them to dump their paper on us,” said Barmak Nassirian, associate executive director of the American Association of Collegiate Registrars and Admissions Officers. If lenders rely on the government for money to make more loans, he continued, “What is the purpose of the loan industry?”

On the campaign trail in 2007, President Obama strongly criticized the guaranteed loan program, calling it “a wasteful system.”

During the Clinton era, the government began making some loans directly to students, but those loans accounted for a small portion of the market. The government backed about $53 billion in student loans made by banks and other lenders last year, compared with just $13 billion in loans it extended directly to students. (Those two categories account for the vast majority of student loans, though banks made about $18 billion in other student loans last year with no subsidy or guarantee from the government.)

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Under the federally guaranteed loan program, the government pays a subsidy to lenders like Citigroup, Wells Fargo and Sallie Mae. The subsidy is set by Congress, which also sets the maximum interest rate that the lenders may charge students, to foster lending at attractive rates.

Banks and their advocates have lobbied against the direct loan program and have filed lawsuits against it to stunt its growth. They have long contended that they offer superior terms and service to students.

Depending on which program their college participates in, students and their families are usually directed to either the government or an outside lender for say, a Stafford loan for students or a Plus loan for parents, and rarely compare the terms themselves. Whether the government or private lenders provide better deals to students and to taxpayers has been a matter of great dispute.

The lenders say they provide an essential function. “There’s a huge apparatus for administering the student loan program that the private sector assumes, in terms of marketing the loans, servicing, distributing the loans, repayment, that is not on the platter of the federal government,” said Kevin Bruns, executive director of America’s Student Loan Providers, a trade group.

Similarly, the lenders view the newest programs as a short-term necessity stemming from the credit crisis. “If you believe in having a strong private sector and having private capital in as much lending as possible, then some sort of fix to get us through this period makes sense,” Mr. Bruns added.

But the new program to support private lenders — and its mushrooming size — have drawn scrutiny from the Obama administration.

“It was a last-minute deal, done at the 11th hour, and we want to make sure that it makes sense for students and for taxpayers,” said Arne Duncan, who recently replaced Margaret Spellings as education secretary. The concern, Mr. Duncan said, is that the program may put taxpayer dollars at risk.

While saying the department would stand behind the agreements, he has asked for a complete report on the program by June 30.

The Education Department has already paid $24 billion to lenders over the last year. But under the newest program, the department has agreed to buy an additional $60 billion in existing loans from a company called Straight A Funding, a Delaware company set up last month.

Straight A aims to buy student loans with the backing of investors. If it has difficulty, it can borrow up to $60 billion from the Federal Financing Bank, supervised by the Treasury Department, and even sell that amount of loans to the Education Department. It will be administered by Bank of New York Mellon and advised by a committee of lenders including Sallie Mae, Nelnet, a Citigroup unit called the Student Loan Corporation, Access Group and the Pennsylvania Higher Education Assistance Agency. Like many other recent financial initiatives, it indirectly will shore up the balance sheets of lenders.

This new program will allow lenders to sell back to the government federally guaranteed loans made as long ago as October 2003. And that has some concerned that lenders will dump their worst loans, leaving the government with losses.

The program is supposed to cost taxpayers nothing, but the Obama administration has asked for additional analysis.

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“We have reviewed the analysis with the staff here, and we do not have confidence in the bottom line,” said a senior official at the White House Office of Management and Budget, who insisted on anonymity, citing administration policy. Referring to differences between agreements entered into by the departing Bush administration and public descriptions of the program, the official added, “The documents on their face raise serious questions about whether it’s cost-neutral.”

Ms. Spellings, the former education secretary, said in an interview this week that the Education Department would be the appropriate department to gauge the financial impact because it had extensive experience with student loans.

“We’re the only people that have the capability to do that sort of thing,” she said. The structure of the program was shared with Congress, she said, adding, “No one raised objections.”

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