UNITED STATES DEPARTMENT OF EDUCATION
WASHINGTON, D.C. 20202

In the Matter of **Docket No. 96-23-SL**

STUDENT LOAN MARKETING ASSOCIATION (SALLIE MAE), Student Financial Assistance Proceeding
Respondent.

Appearances: Sheldon D. Repp, Esq., and Robert S. Lavet, Esq., Office of the General Counsel, Student Loan Marketing Association, Washington, D.C., for Student Loan Marketing Association.

Brian P. Siegel, Esq., Office of the General Counsel, United States Department of Education, Washington, D.C., for Student Financial Assistance Programs.

Before: Judge Richard F. O'Hair

DECISION

On July 14, 1995, the Office of Student Financial Assistance Programs (SFAP) of the U.S. Department of Education (Department) issued a notice of intent to limit the eligibility of the Student Loan Marketing Association (Sallie Mae) to participate as a lender in the Federal Family Education Loan (FFEL or FFELP) Program. This action was based on an alleged violation of Section 435(d)(5)(A) of the Higher Education Act of 1965, as amended (HEA). 20 U.S.C. § 1085(d)(5)(A). Pursuant to the provisions of 34 C.F.R. § 682.706, Sallie Mae filed a request for an oral hearing. After having been assigned to act as the designated Department official and hearing officer, I conducted an evidentiary hearing on August 6, 1996, in Washington, D.C.

Section 435(d)(5)(A) of the HEA prohibits lenders from offering, directly or indirectly, "points, premiums, payments, or other inducements, to any educational institution or individual in order to secure applicants" for FFEL loans. The issue presented to this tribunal is whether Sallie Mae violated this provision of the HEA by entering into a contract with the Dr. William M. Scholl College of Podiatric Medicine (Scholl College) whereby the latter would make FFEL loans to its students with the understanding it would later sell these loans to Sallie Mae at a previously agreed upon price which was profitable to Scholl College. Furthermore, pursuant to another contract, Scholl College has a line of credit with Sallie Mae which is used to fund these FFEL loans to its students. SFAP alleged that these contracts violate Section 435(d)(5)(A) because they provide Scholl College with an improper financial inducement to solicit more FFEL loan applications from its students than they would have solicited without such an inducement. After analyzing the evidence presented during the hearing and applying it to the law, I find Sallie Mae has not violated the statute and its eligibility to participate in the FFEL Program should not be limited.

Sallie Mae is a creature of statute, having been authorized by Congress in 1972 as a federally-chartered, for-profit corporation that is publicly held and financed by private sector capital. Pursuant to its charter, which is set forth in Section 439 of the HEA, 20 U.S.C. § 1087-2, Sallie Mae's primary responsibility is to provide a national secondary market and warehousing facility for student loans. See footnote 1 1 In addition to its authority to purchase these loans, it is also authorized to service such loans and to enter into commitment agreements to finance them. 20 U.S.C. § 1087-2(d)(1)(A). These varied customer services are best described in its pre- hearing brief:

Sallie Mae's principal products and services for lenders (primarily financial institutions, but also educational

institutions and state and nonprofit agencies) include loan purchases, operational support and secured loans, called warehousing advances. Most of Sallie Mae's purchases are accomplished under multi-year (typically, three-year) forward purchase commitments. . . . One of Sallie Mae's operational support products is ExportSS® -- offered to lenders who choose to outsource the loan origination and servicing function. . . .

Sallie Mae also offers secured loans and lines of credit ("warehousing advances") to lenders to fund FFELP loans. . . . These advances are collateralized at levels equal to at least 100 percent with insured education loans, or with other acceptable high quality collateral.

Sallie Mae has developed a unique and comprehensive set of loan programs and services for those FFELP borrowers whose loans it owns and services. Students who borrow through those institutions which have an ExportSS® or another operational support agreement with Sallie Mae are assured of access to these benefits. . . . Sallie Mae's borrower benefits include: (1) Great Rewards®, a program that gives borrowers who pay on-time for each of the first 48 months of active repayment a 2 percentage point reduction in their rate for the remaining term of all of their Stafford Loans with Sallie Mae; (2) Direct Repay® which lets borrowers automatically transfer their monthly loan payments from their checking or savings account and reduces their interest rate by 0.25 percentage points; and (3) Great Returns® which credits the accounts of borrowers who make on-time payments on their Stafford Loans for each of the first 24 scheduled months of repayment with an amount equivalent to origination fees in excess of a $250 cap.

When Scholl College became an eligible lender of FFEL student loans in 1989, it entered into a Forward Financing Commitment Agreement, an ExportSS® Loan Origination and Loan Servicing Agreement, and an ExportSS® Comprehensive Commitment and Loan Sale Agreement with Sallie Mae. Scholl College's most recent ExportSS® and Revolving Finance agreements with Sallie Mae are dated April 1, 1995, and July 14, 1995, respectively. Pursuant to the first referenced ExportSS® agreement, Scholl College accepts loan applications from its students and reviews them for completeness.See footnote 2 2 The loan applications are forwarded to Sallie Mae, which processes them and performs loan origination activities on behalf of Scholl College. After the loans are approved and the funds disbursed, Sallie Mae services the loans for the period Scholl College remains the payee and legal owner of the loans. Scholl College pays an agreed upon competitive market rate fee for these contractual services. Pursuant to the second referenced ExportSS® agreement, Scholl College agrees to sell to Sallie Mae all loans originated under the first ExportSS® agreement at a point in time just prior to the borrower entering a repayment status. Sallie Mae pays Scholl College a negotiated amount equal to 100 percent of the par value (the principal balance plus any accrued interest) on each loan, plus an amount described as an "incentive fee" of up to 2.5 percent over the par value of the loan. The exact amount of this incentive fee is determined by taking into account the amount of the average borrower indebtedness (size of the loan) and the number of serial loans (separate loans from the same borrower) in the sale portfolio.

Under the Forward Financing Commitment Agreement (also referred to as a Revolving Financing Agreement), Sallie Mae provides Scholl College with a line of credit of up to twenty million dollars which is available to fund Scholl College's lending activities. Scholl College draws upon the line of credit as loans are originated and the resulting loan account is credited as the loans are sold to Sallie Mae. Scholl College pays a competitive interest rate for this line of credit which is set by the 13 week Treasury bill rate plus 1.25 percent.

During the time Scholl College is the payee/holder of these FFEL loans, the student borrowers are in a period of payment deferment. Therefore, Scholl College, like any other holder of subsidized guaranteed student loans, is authorized to receive interest and special allowance payments from the Department until such time as the student borrower enters a repayment status. The rate for these payments is based on the 13 week Treasury bill rate plus 2.5 percent and this rate is applied to the unpaid principal amount of the loan. See 20 U.S.C. §§ 1077a(g)(2), 1078(a)(3)(A)(I), 1087-1(b)(2)(E). These interest and special allowance payments compensate the lender for its loss of interest payments during the period when payments from the borrower are deferred and cover its overall administrative costs, thus making these guaranteed student loans attractive to lenders and providing assurances there will be a ready supply of money allocated to these types of loans. Since Scholl College is paying Sallie Mae interest at a rate of the 13 week Treasury bill rate plus 1.25 percent under its Revolving Financing Agreement, and is receiving interest and special allowance payments from the Department at a rate 2.5 percent over the 13 week Treasury bill rate, Scholl College theoretically has a spread, or profit, of 1.25 percent for all the FFEL loans it holds. As a result of this spread, SFAP alleges Scholl College netted $150,000 in income on its student loans in 1994 and approximately $60,000 for part of 1995; however, these figures do not take into account that Scholl College also had to pay an origination fee and servicing costs to Sallie Mae for each of its loans, thus reducing the college's alleged profit.

SFAP states in its brief that it and Congress have been concerned for some time about improprieties committed by participants in the FFEL Program who utilize payments or other incentives "to ensure that loans are made to particular students or by particular lenders." Section 435(d)(5)(A) of the HEA apparently is the culmination of their efforts to prohibit eligible lenders from offering inducements to educational institutions or individuals in order to secure applicants for subsidized federal student loans. Looking to the legislative history to more narrowly define the limits of this legislation is not particularly elucidating. In the Report of the House of Representatives Committee on Education and Labor it is reported that:

[T]he Committee has become aware of practices that use incentives to attract new borrowers to certain lending institutions. The committee considers such activities to be contrary to the best interests of the program and feels that they represent exploitation of student and parent borrowers. Thus the Committee adopted language prohibiting such undertakings and disqualifying any lenders who continue these practices from participating in the Federal student loan programs.See footnote 3 *3*

In its report, the Senate Committee on Labor and Human Resources was equally vague in its description of the specifics of the problem to be corrected:

The Committee bill clarifies that no lenders can offer inducements to institutions or individuals to take out loans or to provide services unrelated to loans, such as insurance policies. The Committee bill also prohibits lenders from using any fraudulent or misleading advertising to attract students. Specific examples of such practices were brought to the Committee's attention during our deliberations. These actions were not intended in the originating legislation, nor are they the intent of this Committee. State guarantee agencies are also forbidden to undertake these actions.See footnote 4 *4*

SFAP presented evidence during the hearing before this tribunal of examples of improper inducements to borrowers which had come to its attention. These examples included situations where a bank manager offered cash bonuses to each of the tellers for each student loan that teller was able to recruit. In another instance, bank lenders were offering free Walkman radios to students who agreed to obtain student loans from that lender. A third example was a situation where a bank "took a group of financial aid administrators on a cruise to encourage them to do business with that particular bank." However, when questioned, neither of SFAP's witnesses were aware of any instances of similar improprieties committed by either Sallie Mae or Scholl College. They also testified they had received no complaints from anyone, including the borrowers, or parents of borrowers, at Scholl College regarding the FFEL loan acquisition/origination/servicing process at the school. Thus, there are no allegations from anyone that borrowers are being improperly induced to acquire FFEL loans that were either unnecessary or excessive to the needs of the borrowers. In addition, there was testimony that SFAP's real objection to Sallie Mae's relationship with Scholl College concerns the timing of the sale of these loans. If the agreement provided for Sallie Mae to buy a portfolio of loans already in existence, rather than one to be assembled in the future, SFAP would not be objecting.

Although Section 435(d)(5)(A) was enacted in 1986, the Department did not attempt to provide guidance to lenders on what it considered to be permissible lender activity until it published Dear Colleague Letter, 89-L-129 in February 1989. In that letter it reported that:

The Department believes these provisions were broadly intended to prohibit the direct or indirect offering or payment of any kind of financial incentive by a lender to any entity or person to secure applicants for Part B loans, or by a guarantee agency to a school or affiliated entities or individuals for that purpose, regardless of the form of the incentive or its mode of payment.

Following this interpretation of the statute, the letter provides examples of both prohibited and permissible activities by lenders and guarantee agencies. The first listed example of a permissible activity mirrors the contractual relationship which exists between Sallie Mae and Scholl College.

A lender purchases a loan made by another lender at a premium. This is not a transaction involving the securing of applicants, but rather the acquisition of loans already made. A purchasing lender may also act as the agent of a selling lender on a loan to be purchased for purposes of originating and disbursing the loan, and purchase the loan at a premium

immediately following disbursement. The funds used to make the loan would be deemed to have been advanced to the seller by the purchaser and subsequently repaid from the sale proceeds.

When it was pointed out that the instant limitation proceeding against Sallie Mae was inconsistent with Departmental philosophy reflected in the Dear Colleague Letter, SFAP's witness explained that when this Dear Colleague Letter was published, schools were not acting as lenders. At that time loans were being offered only by traditional lending institutions, such as banks and savings and loan institutions. In that scenario, the Department concedes that buyers of those student loans can legitimately offer premiums to the holders of the loans, other lenders, to enhance their liquidity.

In a further attempt to refine and explain the application of the Section 435(d)(5)(A) limitations, the Department published Dear Colleague Letter, 95-L-178, in March 1995. In that publication the Department avers that Section 435(d)(5)(A) "excludes from eligible lender status any lender that offers, directly or indirectly, any 'inducement' to a school in order to secure applicants for FFELP loans." The letter proceeds to describe a prohibited activity in which non- school lenders arrange

for the schools to be the lenders of record and receive the interest subsidy for part or all of the in-school period on loans later "bought' by the non-school lenders. The actual processing of the loan origination is done by the non-school lender in its own name or in the name of the school, the school receives all the income on the loan during its most desirable phase, when both the expense and risk of default are the least. Often the non-school lender also provides the financing for the school to fund its "holding" of the loan at an advantageous rate.

Without referral to any authority other than its personal interpretation of the statute, SFAP now characterizes this type of financial arrangement between the loan purchaser and the school lender as providing an inducement to the latter and SFAP concludes it is prohibited by Section 435(d)(5)(A). Although not described as such in this letter, this arrangement is similar to that which Sallie Mae has with Scholl College, as well as with several other postsecondary schools who participate in the FFEL Program. The letter also encourages schools and lenders to contact SFAP to discuss particular loan purchase contracts to ensure they comply with the statute. During the hearing, SFAP chastised Sallie Mae for failing to take advantage of this suggestion because it may have avoided the necessity of this proceeding. Because Sallie Mae's contracts with Scholl College mirror the permissible activity described in the first Dear Colleague Letter, I can appreciate why Sallie Mae concluded it was unnecessary to engage in such an exchange.See footnote 5 5

The message is clear that SFAP seriously objects to the financial arrangements Sallie Mae has with its FFEL Program customers who are school lenders whereby the institution agrees to sell to Sallie Mae all student loans acquired during the contract period. SFAP's witnesses admitted that they would not object to Sallie Mae's purchase of these loans if the arrangement were entered after, not before, the loans were made. SFAP views Sallie Mae's existing arrangement with Scholl College as one which provides the school with a financial incentive to encourage as many students as possible to apply for student loans in potentially greater numbers and amounts than the students would under other circumstances. Neither party to this proceeding would disagree that inducements of this nature should be prohibited. The more difficult issue, however, is whether the legislation upon which SFAP relies specifically prohibits Sallie Mae's conduct, or whether SFAP wishes the proscription were broad enough to encompass this version of school lending activity which was not contemplated at the time of the enactment of the legislation, but which SFAP would now like to prohibit. In my opinion, SFAP is attempting to legislate a prohibition which exceeds the bounds of the enabling statute.

After review of the statute, facts of the case, and arguments of the parties, SFAP has not met its burden of proving that the contractual relations Sallie Mae has with Scholl College violate Section 435(d)(5)(A) of the HEA. To be in violation, SFAP must present evidence that Sallie Mae pays a premium to Scholl College "in order to secure applicants for loans." (Emphasis added.) From a factual perspective, Sallie Mae does not secure applicants for loans, it only secures the consummated loans from the original lender. SFAP argues that I should disregard the individual servicing, funding, and purchasing contracts which Sallie Mae has with Scholl College which are legitimate, permissible and were negotiated using competitive, market pricing, and that I should concentrate on the final, overall result of these transactions -- one where Sallie Mae purchases student loans from Scholl College at a price which nets a profit to the seller. This business arrangement is not the type of conduct which Congress intended to prohibit. Indeed, SFAP conceded that if Scholl College were a bank or other traditional lender, Sallie Mae's arrangement with the institution would be permissible. SFAP has presented no evidence that this arrangement has encouraged Scholl College students or

their parents to secure unnecessary student loans, so there is no hint of a compromise of the best interests of the program. There also is no suggestion that Sallie Mae's activities are fraudulent, are in any manner misleading, or consist of offers to provide services to borrowers which are wholly unrelated to loans, such as insurance policies. I must admit that, as a result of these separate, permissible business ventures, there may be a financial incentive to Scholl College, and every other institution enjoying similar arrangements with Sallie Mae, to secure as many and as large a portfolio of student loans as possible and to encourage student borrowers to avoid loan competitors. There is no evidence, however, that any of Scholl College's students were inappropriately counseled about the student loan process or were improperly encouraged to secure loans in amounts excessive to their needs, which is the true concern of SFAP.

The bottom line is that the prohibited conduct does not apply to Sallie Mae because it does not secure loan applicants, but only secures the final product, consummated loans. If SFAP is intent on eliminating this potential for improper inducements, the best method would be to support legislation which prohibits educational institutions from becoming eligible lenders.

ORDER

On the basis of the foregoing, it is hereby ORDERED that Sallie Mae not be limited from participating as a lender in the FFEL Program.

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Judge Richard F. O'Hair

Dated: September 26, 1996

SERVICE

A copy of the attached initial decision was sent by certified mail, return receipt requested to the following:

Sheldon Repp, Esq.
Robert S. Lavet, Esq.
Office of the General Counsel
Student Loan Marketing Association
1050 Thomas Jefferson Street, NW
Washington, DC 20007-3871

Brian P. Siegel, Esq.
Office of the General Counsel
U.S. Department of Education
600 Independence Avenue, S.W.
Washington, D.C. 20202-2110

Footnote: 1 *1 Although Sallie Mae functions as a secondary market for student loans and is specifically prohibited by statute from originating loans, it is still referred to as an "eligible lender" of student loans covered by federal loan insurance. 20 U.S.C. §§ 1087-2(d)(1)(E)(I), 1085(d)(1)(F).*

Footnote: 2 *2 Scholl College financial aid counselors advise students of the many potential lenders available to them; however, approximately 95 percent of its student borrowers submit applications directly to Scholl College for their FFEL loans.*

Footnote: 3 *3 Higher Education Amendments of 1985, H.Rpt. 99-383, 99th Cong., 1st Sess., at 37 (1985).*

[Footnote: 4](#) *4 Higher Education Amendments of 1986, S.Rpt. 99-296, 99th Cong., 2d Sess., at 30 (1986).*

[Footnote: 5](#) *5 Sallie Mae has suggested that the Department was motivated to initiate this proceeding as a means of advancing its own competitive interest in promoting the Federal Direct Loan Program; however, I find no support for this allegation.*