FDIC
Federal Deposit Insurance Corporation
3501 Fairfax Drive, Arlington, VA 22226-3500
Legal Division

September 13, 2012

TO: Executive Secretary

FROM: Kathleen M Russo, Supervisory Counsel
Legal Division

SUBJECT: Meeting Related to Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act

Please include this memorandum in the public file on the Notice of Proposed Rulemaking relating to Credit Risk Retention (RIN 3064-AD74), 76 Fed. Reg. 24090 (the "NPR").

On September 12, 2012, FDIC staff (Kathy Russo and Rohit Dhruv) participated in a conference call with Vince Sampson from the Education Finance Council, Ben Litle from Brazos Higher Education Service Corporation and Mathew LaRocco from Arnold & Porter. Also participating in the call were representatives of certain of the other agencies which approved the NPR, including the Securities and Exchange Commission and the Federal Reserve Board.

The discussion focused on matters relating to the application of risk retention to non-profit student loan lenders. Attached are materials submitted in advance of the meeting.

Nonprofit Student Lenders and Risk Retention: How the Dodd-Frank Act Threatens Students' Access to Higher Education and the Viability of Nonprofit Student Lenders

Brad Toben[1]

I. Introduction

Over the last several decades, changes in the American economy have made higher education increasingly important to career prospects. While the need for higher education has increased, its cost has also risen sharply. Still worse, this increase in costs has occurred during a time of stagnant or decreasing average family income. Lower- and middle-income students, including large numbers of Latino and African-American students, therefore face an increasingly challenging environment in which to find funding to cover the costs of postsecondary education. The federal government administers well-known grant and loan programs, but federal aid is limited in amount and may not be available for certain postsecondary programs that lead to available, well-paying jobs. As a result, many students face a significant gap between the actual costs of education and the aid provided by federal programs. These students frequently turn to private financing in the form of loans from banks, student loan companies, and other financial institutions.

The ability of students to secure such loans in order to bridge the funding gap, and to do so on the best possible terms, is vital. Without affordable gap-bridging loans, many students will find it impossible to complete their education. The failure of students to attain college and post-graduate degrees produces adverse effects for the students themselves, who earn significantly less money over the course of their lives. It also harms their communities, which often must intervene to pay for basic needs for families headed by an un- or under-employed parent, and the

[1] Dean and M.C. and Mattie Caston Professor of Law, Baylor Law School.

national economy, which increasingly depends on the long-term, relatively recession-resistant jobs held by college graduates.

Nonprofit student lenders play a critical role in providing loans that allow students to bridge the funding gap. The presence of nonprofit institutions alongside the for-profit banks that offer private student loans entails a simple arithmetic benefit: More lenders offer more available loans, allowing more students to attend college. But nonprofit lenders also generate a second, equally significant, benefit for students. Nonprofit lenders cannot retain most surplus revenues, are not permitted to maximize their profits, have no shareholders, cannot make profit distributions, and can only act in accordance with their governing charters. As a result, nonprofits provide better repayment terms for students; in other words, they give students cheaper gap-bridging loans.

Ironically, students' access to these affordable gap-bridging loans is now threatened by a statute aimed at consumer protection—the Dodd-Frank Act. In order for private lenders to provide efficient and cost effective loans to students, access to the capital markets is crucial. In the student loan context, capital markets transactions begin when lenders create bonds secured by the lenders' right to receive interest and principal payments on a large pool of student loans. Those bonds are sold to investors in exchange for the capital necessary for the lenders to originate additional student loans. When repeated, this process provides lenders with two benefits: stable access to enough capital to make high volumes of student loans and lower total financing costs on those loans. Both of these benefits are passed on to students, who have access to larger pools of financing at lower rates.

The Dodd-Frank Act includes the general requirement that securitizers retain a part of the credit risk associated with the assets being securitized. This requirement is intended to prevent lenders from selling all securitized credit risks to investors while retaining no credit risk themselves, a practice common in the pre-2008 residential mortgage market. Prior to Dodd-Frank, securitizers achieved this disassociation of credit risk by transferring assets to legally independent entities prior to selling bonds to investors. As a result, investors looked only to the underlying assets for repayment of their investments and could not reach securitizers' other assets.

Dodd-Frank's risk retention rule is intended to alter this typical structure by requiring securitizers to retain a portion of the credit risk for the assets they securitize. When applied to capital markets transactions involving student loans, however, the risk retention requirement has an unintended and highly undesirable consequence. Unlike many other securitizers, nonprofit student lenders already retain substantial credit risk for the assets they securitize, because they typically continue to own the assets that support the bonds. Nonprofit student lenders, in other words, already possess extremely strong incentives to issue high credit quality securities. The imposition of Dodd-Frank's risk retention requirement on nonprofit student lenders is therefore not necessary to protect investors.

Further, because nonprofit lenders are legally required to retain only a small fraction of their revenues as a condition of maintaining their nonprofit status, they do not possess the capital necessary to satisfy the risk retention requirement. Dodd-Frank thus threatens the ability of nonprofit lenders to access the capital markets. Without this ability, nonprofits—which cannot operate secondary businesses to generate capital—would quickly exhaust their available funds and be unable to originate new and affordable gap-bridging student loans.

Fortunately, it is not clear that the risk retention requirement will be applied to nonprofit student lenders. The definition of "securitizer" in Dodd-Frank arguably excludes lenders that, like the nonprofits active in the student loan market, issue bonds but never transfer ownership of the underlying assets. And even if student lenders are "securitizers" within the meaning of the Act, Congress recognized that the risk retention requirement is not a one-size-fits-all rule. As a result, it delegated broad discretion to a group of federal agencies to determine when the requirement should, and should not, apply. Those agencies are currently considering public comments to a proposed rule interpreting the scope of the requirement and its exceptions. The incentives nonprofit lenders face, and the benefits students receive from gap-bridging loans issued by nonprofits, provide complementary and powerful reasons for the agencies to exclude nonprofit student lenders from the risk retention requirement.

The remainder of this article explores these issues in greater depth. Part II discusses the individual and social benefits of higher education and the emergence of the funding gap, while Part III examines the unique role of nonprofit student lenders in bridging that gap. Finally, Part IV explains both the threat Dodd-Frank poses to students and the statutory grounds for exempting nonprofit student lenders from the risk retention requirement.

II. Higher Education and the Funding Gap

The financial advantage a postsecondary education provides to individual students is straightforward and well-known; the more education a student receives, the more income the student can expect to earn. In addition to creating earning potential for individual students, however, higher education produces substantial benefits for society as a whole. Indeed, maintaining access to postsecondary education is nothing less than essential to the economy and social fabric of the United States.

These individual and social benefits are currently imperiled by a convergence of economic trends. The costs of higher education have risen dramatically over the past several decades, while financial aid levels have lagged. At the same time, American household incomes have generally remained flat or declined. The result is an ever-widening funding gap that students must cross between the cost of education and the available sources of aid. Many students, particularly students from low- and middle-income backgrounds, rely on non-federal loans issued by private financial institutions to bridge that gap.

A. The Individual and Social Benefits of Post-Secondary Education

1. The Income Premium

The economic benefits that accrue to students who complete a postsecondary education are unquestionable. A decade ago, the Census Bureau estimated that a student who earns a bachelor's degree would earn $2.7 million over the student's lifetime—75% more than a high school graduate could expect.[2] The income premium a college degree provides has, if anything, increased in subsequent years.[3] Recent research suggests that workers with a bachelor's degree can expect to earn 84% more than high school graduates who never enter college.[4] And for an increasing number of workers, college is not only the key to a well-paying job but a prerequisite

---

[2] *See* ANTHONY P. CARNEVALE ET AL., GEORGETOWN UNIV. CTR. ON EDUC. AND THE WORKFORCE, THE COLLEGE PAYOFF: EDUCATION, OCCUPATIONS, LIFETIME EARNINGS 1 (2010), http://www9.georgetown.edu/grad/gppi/hpi/cew/pdfs/collegepayoff-complete.pdf [hereinafter COLLEGE PAYOFF].

[3] *See id.*

[4] *See id; see also* DAVID AUTOR, CTR. FOR AM. PROGRESS & THE HAMILTON PROJECT, THE POLARIZATION OF JOB OPPORTUNITIES IN THE U.S. LABOR MARKET: IMPLICATIONS FOR EMPLOYMENT AND EARNINGS 2 (April 2010), http://www.americanprogress.org/issues/2010/04/job_polarization_report.html ("As is well known, the earnings of college-educated workers relative to high school-educated workers have risen steadily for almost three decades."). Autor notes that "the relative earnings of college graduates [is] due both to rising real earnings for college workers and falling real earnings for noncollege workers—particularly noncollege males." *Id.* (emphases omitted).

for *any* job. Although the national unemployment rate continues to hover above 9%,[5] the rate for individuals who hold a college degree is just 4.5%.[6]

This income premium from higher education is not a categorical, one-time benefit that suddenly accrues on the day a student crosses the stage to receive her bachelor's degree. Instead, median lifetime earnings rise steadily as a student progresses through the levels of higher education.[7] Obtaining just *some* postsecondary education adds nearly $250,000 to lifetime earnings even if the student never finishes her degree, and the income premium is even greater for students who enroll in postgraduate programs.[8] At the highest end of the spectrum, individuals with a professional degree can now be expected to earn a median total of $3,648,000—nearly three times the earnings of a typical high school graduate.[9] An elementary or middle school teacher with a master's degree, for example, will earn a total of $2.2 million, while a teacher at the same levels who holds only a bachelor's degree will make $1.8 million.[10]

Students, of course, do not march in lockstep up an income ladder as they progress through higher education. Earnings expectations vary greatly by occupation, meaning that the

[5] *See* Bureau of Labor Statistics, Econ. News Release, *Employment Situation Summary*, tbl.A-4 (Oct. 7, 2011), http://www.bls.gov/news.release/empsit.nr0.htm; *see also* LUMINA FOUND. FOR EDUC., A STRONGER NATION THROUGH HIGHER EDUCATION 4 (Sept. 2010), www.luminafoundation.org/publications/A_stronger_nation.pdf [hereinafter LUMINA FOUNDATION] ("For better or worse, the Great Recession is putting the relationship between higher education and the economy into stark relief.").

[6] *See* Bureau of Labor Statistics, *supra* note 5, at tbl.A-4. Young college graduates have fared less well in the job market than their predecessors; 9.1% of such graduates were unemployed in 2010. *See* Beckie Supiano, *Class of 2010 Graduates Who Borrowed Took Out an Average of $25,250 in Loans, Report Says*, CHRON. HIGHER EDUC., Nov. 3, 2011. But those in their early twenties without a college education are in a substantially worse position. The unemployment rate for that cohort is an astounding 20.4%. *Id.*

[7] The exception to this rule is for doctoral degrees. Students who earn Ph.D.s earn less on average than students who complete (shorter) professional degree programs. *See* COLLEGE PAYOFF, *supra* note 2, at 3 fig.1.

[8] *See id.* at 3-5 & fig.1.

[9] *See id.*

[10] *See id.* at 2.

income distribution at any given educational level is relatively wide;[11] a financial sector worker with a bachelor's degree will earn more than a college graduate who teaches elementary school. In part for this reason, there is a substantial overlap in earnings among those in different educational groups. Some individuals with a high school diploma will, for instance, earn more than some individuals who attended college.[12] On balance, however, those who complete more years of education obtain a significant financial return on that investment.[13] In short, "[m]iddle-class earnings are increasingly secured by those with at least some postsecondary education."[14]

2. Social Gains

Although they are less frequently discussed, the benefits of post-secondary education to society are equally significant. Higher education produces at least two such benefits. First, and quite simply, educated workers fill the needs of the American economy. In recent decades, the United States has "transformed from an industrial to a service[-based] economy, with all of the pain and upheaval that accompanies such change."[15] One substantial piece of this upheaval involves a shift from jobs that necessitate only a secondary education to jobs that require a postsecondary degree or certification. The statistics show this change clearly. The total number of jobs in the United States has increased by 63 million over the past forty years, but the number

---

[11] *See id.*
[12] *See id.* at 6.
[13] The income premium is, unfortunately, neither race- nor gender-blind. Women who work full time earn 25% less than men with similar educational credentials, and African Americans and Latinos earn less than whites. *See id.* at 2. The racial disparity is so severe that the median African American or Latino with a master's degree will earn less than the median white with a bachelor's degree. *Id.* Nonetheless, the minority worker with a college degree will earn more on average than a minority worker who did not graduate from college. *See id.* at 12 & fig.6.
[14] ANTHONY P. CARNEVALE & STEPHEN J. ROSE, GEORGETOWN UNIV. CTR. ON EDUC. AND THE WORKFORCE, THE UNDEREDUCATED AMERICAN 9 (June 2011), http://cew.georgetown.edu/undereducated/ [hereinafter UNDEREDUCATED AMERICAN].
[15] ANTHONY P. CARNEVALE ET AL., GEORGETOWN CTR. ON EDUC. AND THE WORKFORCE, HELP WANTED: PROJECTIONS OF JOBS AND EDUCATION REQUIREMENTS THROUGH 2018, at 1 (June 2010), http://cew.georgetown.edu/jobs2018/ [hereinafter HELP WANTED].

of jobs which can be performed without a postsecondary education has *fallen* by 2 million over the same period.[16] As a result, there are currently three million unfilled jobs in the United States even though 14 million workers are unemployed.[17] The vacant jobs require an education many available workers lack—"a good high-school education, *plus* [either a] specialized postsecondary career education, [a] two-year or four-year college degree[], [a] one- or two-year college occupational certificate[], or a two- to three- year apprenticeship."[18]

The recent economic downturn has only accelerated this transition to jobs that require more education.[19] Hundreds of thousands of jobs in the agricultural and manufacturing sectors were lost to the recession and will not return.[20] Although the economy will, sooner or later, create new jobs, one study suggests that almost two-thirds of job openings[21] between 2011 and 2018 will require at least a partial college education.[22]

---

[16] In 1973, 72% of 91 million American workers had a high school education or less. By 2007, only 41% of the 154 million American workers had no post-secondary education. *See* JOHN BRIDGELAND ET AL., ACROSS THE GREAT DIVIDE: PERSPECTIVES OF CEOS AND COLLEGE PRESIDENTS ON AMERICA'S HIGHER EDUCATION AND SKILLS GAP (March 2011), www.civicenterprises.net/pdfs/across-the-great-divide.pdf.
[17] *See* Edward Gordon, *The Global Talent Crisis*, FUTURIST (Sept.-Oct. 2009), http://findarticles.com/p/articles/mi_go2133/is_200909/ai_n35627726/.
[18] *Id.* (emphasis added).
[19] HELP WANTED, *supra* note 15, at 9-11.
[20] *Id.* at 11.
[21] The existence of an educated workforce may even be a prerequisite for creating these new jobs. *See* LUMINA FOUND., *supra* note 5, at 4-5. We often assume that other structural forces create jobs for higher education to fill with college graduates. But there is an emerging belief that the causality may run the other way and that an economic recovery is being hindered by an insufficient supply of educated workers. *See id.* On this view, the "vitality of [an] econom[y]"—be it the economy of a city or a nation—"depends less on 'home runs' (such as securing a new manufacturing plant) than on the skills and knowledge of the workforce." *Id.* at 5; *see also* CONGRESSIONAL BUDGET OFFICE, COSTS AND POLICY OPTIONS FOR FEDERAL STUDENT LOAN PROGRAMS 13 & n.34 (2010), www.cbo.gov/doc.cfm?index=11043&type=1 (citing studies to support the views that "college education creates positive spillovers in productivity and wages" and that there is "empirical evidence of a causal relationship between educational attainment and growth rates among countries"). If the United States does not produce the necessary talent, that shortage invites businesses to locate elsewhere, leaving the

The second social benefit of higher education is that increased access to higher education alleviates income inequality and strengthens the middle class. As discussed above, while the overall unemployment rate remains high, that rate largely reflects an oversupply of workers without a college education. This imbalance between employers' needs and employees' skills has contributed to recent increases in income inequality in the United States.[23] An increase in the number of Americans who complete a higher education would reduce this inequality by reducing the supply of less-educated workers, significantly raising the wages of those who remain without a college education.[24] These economic gains by workers without a post-secondary education would not harm those with college degrees. The wages of the latter group would also continue to rise, albeit at a slower pace than the salaries of less-educated workers.[25]

Third, higher education improves our social fabric in a variety of ways. Some of these gains represent economic consequences of the income premium: Better-educated, and therefore better-paid, workers contribute more in taxes.[26] Further, because workers with postsecondary educations tend to receive health care and pensions from their employers[27] and are less likely to be out of work,[28] they rely on public assistance programs at much lower rates.[29] But higher

---

U.S. economy to stagnate. Gordon, *supra* note 16. Gordon provides the decision of Advanced Micro Devices ("AMD") to build new high-tech plants in Dresden in 1999 and 2004 as a cautionary tale. AMD examined locations in California and Texas but "felt that the communities they investigated could not produce enough qualified entry-level technicians for their needs." *Id.*

[22] HELP WANTED, *supra* note 15, at 13.

[23] UNDEREDUCATED AMERICAN, *supra* note 14, at 8.

[24] *See id.* at 9, 17; *see also* AUTOR, *supra* note 4, at 1 ("[S]ince the late 1970s and early 1980s, the rise in U.S. education levels has not kept up with the rising demand for skilled workers . . . . The result has been a sharp rise in the inequality of wages.").

[25] UNDEREDUCATED AMERICAN, *supra* note 14, at 9.

[26] *See* COLL. BD., EDUCATION PAYS 2010, at 22 (2010), http://trends.collegeboard.org/education_pays.

[27] *See id.* at 23-24.

[28] *See id.* at 20-21.

[29] *See id.* at 22, 26.

education also has more profoundly *social* impacts. Education improves a community's governance by increasing voting rates and newspaper readership[30] while lowering the incidence of public corruption.[31] Education also aids our civic culture and health. Both volunteerism and charitable contributions are higher among those with more education,[32] while the relatively healthy lifestyle of college-educated adults spills over into the community at large, decreasing overall mortality rates.[33] There is even some indication that increased levels of education reduce a community's crime rates.[34] Finally, higher education has a beneficial impact on families. Just as individuals with more education are healthier, so too are their children.[35] Mothers with higher levels of education give birth to fewer underweight children and are more likely to breastfeed.[36] More educated parents also read more frequently to their children, who are better-prepared for school as a result.[37]

A more educated populace, in other words, will both match the needs of the U.S. economy and materially strengthen individual families and communities. It is therefore essential that as many students as possible have access to postsecondary education.

B. The Funding Gap in Higher Education

Despite the central importance of higher education to individuals and to society, students wishing to obtain a postsecondary education face an increasingly formidable obstacle in the

---

[30] *See* Walter W. McMahon, *Education Finance Policy: Financing the Nonmarket and Social Benefits*, 32:2 J. EDUC. FIN. 264, 269-70 (2006).

[31] *See* GLENN C. BLOMQUIST ET AL., ESTIMATING THE SOCIAL VALUE OF HIGHER EDUCATION: WILLINGNESS TO PAY FOR COMMUNITY AND TECHNICAL COLLEGES 9 (2009), http://www.inpathways.net/ipcnlibrary/ViewBiblio.aspx?aid=8781.

[32] *See* EDUCATION PAYS 2010, *supra* note 26, at 32; McMahon, *supra* note 30, at 270.

[33] *See* BLOMQUIST ET AL., *supra* note 31, at 7.

[34] *See id.* at 7-8; *see also* McMahon, *supra* note 30, at 271-72 (describing research related to secondary education and crime).

[35] *See* EDUCATION PAYS 2010, *supra* note 26, at 5.

[36] *See id.* at 30.

[37] *See id.* at 31.

challenge of paying for that education.[38] The costs of postsecondary education have risen dramatically, and student aid has not kept pace. These trends have resulted in a funding gap between the assistance available to students and educational costs, and for many students, the private loan market provides the principal mechanism for filling this gap. As described below, the combination of rising tuition rates and relatively flat amounts of federal aid caused the funding gap to open in the 1980s and 1990s. The gap most heavily affects students at more expensive institutions and students from lower- and middle-income families. And the gap—and thus private loans—will remain a part of American life for the foreseeable future.

1. Causes of the Funding Gap

As all college students—and parents of college students—know, tuition rates have increased dramatically in recent years. In fact, since the early 1980s, the cost of attending college has increased at four times the rate of inflation,[39] with tuition outpacing inflation by an average of 5.6% per year over the past decade at public four-year colleges at 2.6% per year at private four-year colleges.[40] To put that in perspective, while much attention has focused on the dramatically rising costs of healthcare, the costs of education have risen substantially faster.[41] It

[38] U.S. Government Accountability Office, Letter to Congressional Committees: *Higher Education: Factors Lenders Consider in Making Lending Decisions for Private Education Loans*, GAO-10-86R (Nov. 17, 2009), www.gao.gov/new.items/d1086r.pdf.
[39] *See* NAT'L CTR. FOR PUB. POL'Y & HIGHER EDUC., MEASURING UP 2008: THE NATIONAL REPORT CARD ON HIGHER EDUCATION (2008), http://measuringup2008.highereducation.org/ [hereinafter MEASURING UP].
[40] COLL. BD., TRENDS IN COLLEGE PRICING 2011, at 3 (2011), http://trends.collegeboard.org/college_pricing/. Between the 2010-11 and 2011-12 academic years, the average published cost of total in-state charges (including tuition, fees, room, and board) for four-year public institutions increased 6%, and the equivalent charges for out-of-state students rose 5.2%. *Id.* Total charges at private nonprofit four-year colleges and universities rose 4.4%. *Id.* Published tuition and fees at public two-year colleges, meanwhile, rose 8.7%. *Id.*
[41] *See* Penelope Wang, *Is College Still Worth the Price*, CNNMoney.com, Apr. 13, 2009, http://money.cnn.com/2008/08/20/pf/college/college_price.moneymag/. Tuition has also than housing prices did during the pre-2008 housing bubble. *See* Chris Nolter, *For-Profit Education*

is true that, thanks to grants and institutional discounts, many students do not pay the full "sticker price" for their school's tuition.[42] But even using a "net price" estimate that accounts for grants, tuition waivers, and other price reductions, the trend of sharply increasing educational costs is unmistakable.[43]

Particularly for low- and middle-income families, this rise in educational costs has been exacerbated by flat or declining real family incomes. When adjusted for inflation, average family incomes in the United States in 2010 were down from 2000 levels over the entire income distribution. Low-income earners have been hardest hit, with real income decreases of 16% for the lowest quintile of households by income and 9% for the second quintile.[44] Thus, while the burden of paying for college has increased for all families, those with low and moderate incomes have thus been the most heavily affected.[45]

Students do have access to a variety of external funding sources, including "federal loans, grants and work-study, state grants, institutional grants and loans and, sometimes, outside

---

Gets Called up to the Blackboard, DEAL PIPELINE (Oct. 28, 2011), http://pipeline.thedeal.com/tdd/ViewBlog.dl?id=42399.

[42] *See* TRENDS IN COLLEGE PRICING 2011, *supra* note 40, at 8.

[43] *See id.* at 15 & fig.7. The exception is that net costs decreased sharply for some students in 2009-10 because of one-time increases in federal Pell grants and benefits for veterans. *Id.* at 15.

[44] *Id.* at 24 & fig. 16A. The upper three quintiles each saw real incomes decline by 3-6% between 2000 and 2010, although the top 5% of earners suffered 11% declines in income. *Id.*

[45] *See* MEASURING UP, *supra* note 39, at 8. The availability of substantial tuition grants may alleviate the cost burden somewhat for students from the lowest-income families. *See* TRENDS IN COLLEGE PRICING 2011, *supra* note 40, at 15-17. Nevertheless, Pell Grants cover a much lower percentage of tuition than they did in the 1970s. Paul Gackle, *The Book of Broke: SF Students Rethinking Whether Student Debt Is Worth It*, S.F. EXAMINER, Nov. 6, 2011, http://www.sfexaminer.com/local/2011/11/book-broke-sf-students-rethinking-whether-student-debt-worth-it (last visited Nov. 9, 2011). Perhaps for that reason, many lower-income students have begun to eschew pricey four-year colleges and universities in favor of two-year schools. *See* Tamar Lewin, *College Graduates' Debt Burden Grew, Yet Again, in 2010*, N.Y. TIMES, Nov. 2, 2011.

scholarships."[46] Even combined, however, these sources have not increased as quickly as educational costs. This discrepancy stems in part from the structure of federal financial aid programs.

Federal benefits are easily the most significant source of financial aid, accounting for almost three-quarters of all aid to students.[47] Federal programs take a variety of forms, including grants, work-study programs, tax credits and deductions, and federal loans.[48] But loan programs make up more than half of federal assistance; federal loans constitute roughly 39% of total student aid from all sources.[49] This figure includes the need-based Perkins and subsidized Stafford loans, unsubsidized Stafford loans, and PLUS loans, which parents with a good credit history may obtain to aid dependent students. Some graduate and professional students also qualify for PLUS Loans.[50]

Federal aid is nevertheless limited by year and by student. Pell grants, for example, can total no more than $5,550 per student per academic year.[51] Perkins loans have a yearly cap of $5,500 for undergraduate students and $8,000 for graduate students,[52] and while eligible parents and graduate students can receive up to the full cost of attendance in PLUS loans, not all families

---

[46] BRITTA ANDERSON, USA FUNDS, GUIDE TO STUDENT LOAN ISSUES 135 (2003), http://www.usafunds.org/Media/Reports%20and%20White%20Papers/GuideStudentLoanIssue.pdf.
[47] *See* COLL. BD., TRENDS IN STUDENT AID 2011, at 10 tbl.1 (2011), http://trends.collegeboard.org/downloads/Student_Aid_2011.pdf. The figures in Table 1 apply to undergraduate student aid, but the significance of federal aid to postsecondary education is clear across the spectrum.
[48] *See id.*
[49] *See id.* at 11 fig. 2A.
[50] *See* U.S. Dep't of Educ., *Federal Student Aid: Loan Programs Fact Sheet* (2011), http://studentaid.ed.gov/students/attachments/siteresources/factsheet_LoanProgram.pdf.
[51] *See* U.S. Dep't of Educ., *Federal Student Aid: 2010-2011 Grant Programs Fact Sheet*, http://studentaid.ed.gov/students/attachments/siteresources/Grant_Programs_Fact_Sheet_04_2009.pdf.
[52] *See* U.S. Dep't of Educ., *Loan Programs Fact Sheet*, *supra* note 50.

will qualify. Most importantly, Stafford loans—which are the chief federal source of financial aid for many middle-income students—are subject to both a yearly cap and an overall limit on the amount a single individual can borrow.[53]

The ceiling on these financial aid resources can only be raised by Congress, which is to say that increases in federal aid, unlike increases in tuition, are both periodic and haphazard. As a result, the ceiling is almost always too low to meet students' total need for financial aid, either in a single academic year or over a student's entire educational career. As Christopher Dodd, the former Chairman of the Senate Committee on Banking, Housing and Urban Affairs, stated in 2007, "[f]ederal [student] aid in the form of grants and federal loans has failed miserably to keep up with rising costs. By some estimates, the national gap between the cost of tuition and available aid is approximately $120 billion and growing."[54]

This funding gap presents many students with a particularly stark choice: Find supplemental sources of funding or drop out of school. To forestall the second possibility, students frequently turn to the non-federal private loans offered by a variety of financial institutions. As a result, private loans have, in Senator Dodd's words, come to "play a very critical and needed role . . . in providing students with the ability to finance college."[55]

2. A Brief History of the Funding Gap

---

[53] *See id.*

[54] *Paying for College: The Role of Private Student Lending: Hearing Before the Senate Comm. On Banking, Housing and Urban Affairs*, 110th Cong. 2 (2007) (statement of Chairman Christopher J. Dodd), http://www.gpo.gov/fdsys/pkg/CHRG-110shrg50319/pdf/CHRG-110shrg50319.pdf.

[55] *See id.* Ranking Member Richard Shelby seconded the point, stating that "there is a large and growing gap between the cost of tuition and the funds available to students through [f]ederal lending programs," with the result that "more and more students and parents are turning to the private lending industry to make up the difference." *Id.* at 4; *see also* ANDERSON, *supra* note 46, at 135.

Because students frequently use private loans to fill the funding gap between their total educational costs and the amount of available federal and institutional financial assistance, private loans roughly track the funding gap. They are, in other words, directly correlated with tuition costs but inversely correlated with federal financial assistance. Students at institutions with higher tuition rates are more likely to take out private loans,[56] while past increases in federal aid, such as the expansion of the PLUS loan program to include graduate students in 2006 and the 2009 increase in Pell grants, decrease the demand for private loans.[57] Because some students do not exhaust all other financial aid options before borrowing from private lenders, and because not all students who face a funding gap turn to private loans, the correspondence between private loans and the funding gap is not perfect.[58] Nevertheless, trends in private loan origination provide a basic understanding of the evolution of the funding gap.

Private loans—and thus the funding gap—began to play a noticeable role in higher education in the 1980s.[59] Private loans remained a relatively insignificant component of student financial aid for some years, largely because federal loan limits were raised in 1986 and again in 1992.[60] Over the medium term, however, these increases in federal funding could not compete

---

[56] JENNIE H. WOO, STATS IN BRIEF: THE EXPANSION OF PRIVATE LOANS IN POSTSECONDARY EDUCATION 7, (Oct. 2011), http://nces.ed.gov/pubs2012/2012184.pdf.
[57] *See id.* at 12.
[58] The strong consensus is that students should exhaust their federal loan eligibility before turning to the private market. *See, e.g.*, *id.* at 10. Some students nonetheless "may not have a pressing financial need and may bypass need-based financial aid resources in favor of a private loan." ANDERSON, *supra* note 46, at 135. Other students may bridge the funding gap by drawing on family resources or taking fewer credits in order to devote more time to paid work. The Department of Education reports that in 2007-08, 46 percent of all undergraduate private loan borrowers had exhausted their federal loan maximum. *See* WOO, *supra* note 56, at 10.
[59] *See* CATHERINE A. WEGMANN ET AL., INST. FOR HIGHER EDUC. POL'Y, PRIVATE LOANS AND CHOICE IN FINANCING HIGHER EDUCATION 5 (July 2003), http://www.ihep.org/assets/files/publications/m-r/PrivateLoans.pdf.
[60] *Id.* Unsubsidized Stafford loans—those that accrue interest while the student is still in school—were also introduced in 1992. *Id.*; *accord* ANDERSON, *supra* note 46, at 136.

with the rapid rise in tuition and costs. The funding gap widened dramatically in the mid-1990s, and "both for-profit and nonprofit lenders" developed a substantial presence in the expanded private loan market that resulted.[61] The growth of that market is astonishing: Although no definitive figures exist, the College Board estimated private loan volume at $1.1 billion for the 1995-96 academic year, $5 billion for 2001-02, and $17 billion for 2005-06—more than a fifteen-fold increase in just over a decade.[62] In individual terms, 5% of undergraduates borrowed from private lenders 2003-04, but 14% did so in 2007-08.[63] Moreover, these loans were not for insignificant amounts; students who used private lenders in 2007-08 borrowed $6,533 on average.[64]

The upward swing in private loans has more recently reversed.[65] In part, this is because Stafford loan limits increased for both the 2007-08 and 2008-09 academic years.[66] The recent decline in private loan volume, however, appears to be driven more by economic conditions than by a decreased need for gap-bridging loans. The crisis in the global financial markets—and the restrictions subsequently placed on lending by governments around the world—resulted in very tight credit markets.[67] Because of the difficulty of securing credit, some private student lenders

---

[61] ANDERSON, *supra* note 46, at 138; *see also* WEGMANN ET AL., *supra* note 59, at 13 ("Private for-profit and not-for-profit lenders . . . continually monitor and adapt their private loan offerings to reach a larger share of the market.").
[62] *See* ANDERSON, *supra* note 46, at 136-37; WEGMANN ET AL., *supra* note 59, at 7.
[63] *See* WOO, *supra* note 56, at 3.
[64] U.S. Gov't Accountability Office, Letter to Congressional Committees, *supra* note 38 (citing the Institute for College Access and Success's 2007-08 National Postsecondary Student Aid Study).
[65] *See, e.g.*, TRENDS IN STUDENT AID 2011, *supra* note 47, at 13 (showing private loans as a percentage of all student loans).
[66] *See, e.g.*, Finaid.org, *Historical Loan Limits*, http://www.finaid.org/loans/historicallimits.phtml (last visited Oct. 26, 2011).
[67] *See, e.g.*, Jonathan Sibun, *Credit Markets Frozen as Banks Hoard Cash*, TELEGRAPH, Sept. 30, 2008, http://www.telegraph.co.uk/finance/financialcrisis/3109892/Credit-market-frozen-as-banks-refuse-to-lend.html (last visited Nov. 14, 2011); JOHN H. WALTER & SAMUEL HENLY, FED.

either scaled back their operations or ceased originating student loans altogether.[68] Private loans nevertheless remain a significant presence. In the 2009-10 academic year, students borrowed $6 billion in private loans, a figure that represents 7% of all student loans originated during that academic year.[69]

3. Who Faces the Funding Gap?

The correlation between the funding gap and the origination of private loans also provides a rough picture of which students are most likely to face a shortfall in federal and institutional aid. The answer is, in many ways, intuitive. According to a 2003 study, three groups of students borrow private loans at substantially higher rates. Two of these groups comprise undergraduates at (relatively higher-priced) private four-year institutions and undergraduates who face very high non-tuition costs, such as room, board, and other living expenses.[70] The contrast between high- and low-tuition colleges is clear: At schools charging more than $10,000 in tuition and fees, 32% of students took out private loans, compared to 11% of students at lower-cost colleges.[71]

The third group of private borrowers identified by the 2003 study is equally intuitive, because it includes students who face dual limits on federal aid. Professional students, especially

---

RESERVE BANK OF RICHMOND, ECONOMIC BRIEF: TURMOIL IN THE STUDENT LOAN MARKET 2 (2008), http://www.richmondfed.org/publications/research/economic_brief/2008/eb_08-03.cfm?WT.si_n=Search&WT.si_x=3.

[68] *E.g.*, U.S. Gov't Accountability Office, Letter to Congressional Committees, *supra* note 38 ("Many of the lenders offering private loans have exited the market in response to limited access to capital resulting from the credit crisis, according to researchers, lenders, and experts we interviewed.").

[69] TRENDS IN STUDENT AID 2011, *supra* note 47, at 13.

[70] *See* WEGMANN ET AL., *supra* note 59, at viii. In each case, students who had reached the lifetime Stafford loan maximum were more likely to borrow private loans. *See id.*

[71] PROJECT ON STUDENT DEBT, PRIVATE LOANS: FACTS AND TRENDS 1 (updated July 2011), http://projectonstudentdebt.org/files/pub/private_loan_facts_trends.pdf. Fifteen percent of all undergraduates attend schools with tuition and fees of more than $10,000 in 2007-08. *See id.*

law students, borrow private loans at higher rates.[72] This reliance on outside funding undoubtedly reflects both the high cost of professional schools and the tendency of students in postgraduate programs to reach the lifetime maximum on Stafford loans.

These three categories bear out the commonsense notion that students who incur more costs are more likely to require gap-bridging loans. The categories nonetheless obscure two extremely salient facts about students who borrow private loans. First, these students are more likely to have been raised in low- or middle-income families. Among students who are categorized as dependent for financial aid purposes, those from middle-class backgrounds are the most likely to take out private loans.[73] These students are squeezed; they often do not have sufficient family resources to bridge the gap between available federal funding and educational costs, but they also do not qualify for much need-based financial aid. And among independent students, who obtain private loans at higher rates overall,[74] those most likely to borrow from private lenders hail from lower-income families and are often employed for a time before entering a postsecondary institution.[75]

Second, the limits on federal financial aid have a unique impact on community college students. Community colleges play an indispensable role in the American educational system. They are open to all, serve as gateways to four-year institutions, and train students to fill important positions in the U.S. economy through associate degree programs, certificate

---

[72] *See* WEGMANN ET AL., *supra* note 59, at viii.
[73] Roughly 20% of students in the middle income brackets receive private loan funding, while 15% in the lowest income bracket and 16% in the highest bracket did so. *See* WOO, *supra* note 56, at 8.
[74] *See id.* at 8 fig.4.
[75] *See* SANDY BAUM & PATRICIA STEELE, COLL. BD., WHO BORROWS MOST? BACHELOR'S DEGREE RECIPIENTS WITH HIGH LEVELS OF STUDENT DEBT 4 & n.5 (2010), http://advocacy.collegeboard.org/sites/default/files/Trends-Who-Borrows-Most-Brief.pdf.

programs, vocational training, and technical programs. Community colleges also serve more low-income and minority students than any other type of postsecondary institution.

At the individual level, a community college education can make an enormous difference in a student's expected earnings, particularly in fields that are growing. For example, the number of accounting jobs is expected to increase 22% by 2018, and students can qualify for accounting positions with salaries that average $100,000 per year by completing a certification program that lasts less than a year.[76] At Texas State Technical College's Waco Campus, a partnership with Toyota Motor Sales allows students to complete Toyota and industry certifications and then step immediately into automotive service jobs.[77] And in the oil and gas industry, in which new technologies are creating a an economic boom in states including Pennsylvania and North Dakota, workers are in immediate demand.[78] A community college education can lead to jobs in that industry that pay substantially more than the salary earned by oil and gas workers without a postsecondary education.[79]

Community colleges thus provide a way for many students, including many low-income students, to reach stable, well-paying jobs. But students faced with even the relatively modest tuition of community colleges often face a funding gap because a significant proportion of

---

[76] *See* David Carpenter, FIVE JOBS THAT BODE WELL FOR THE FUTURE, ST. PETERSBURG TIMES, July 8, 2011, http://www.tampabay.com/news/business/workinglife/five-jobs-that-bode-well-for-the-future/1179472.

[77] *See Toyota-trained*, TSTC TECH TIMES, May 5, 2011, http: http://www.tstctechtimes.com /focus-on-technology/toyota-trained-1.2220855.

[78] *See* Simone Sebastion, BOOM FUELS OIL FIELD TALENT SEARCH, HOUS. CHRON., Nov. 14, 2011, http://www.chron.com/business/article/Boom-fuels-oil-field-talent-search-2269115.php.

[79] *See* Jeremy Smerd, LOOKING TO HYDROFRACKING TO REBUILD UPSTATE, CRAIN'S N.Y. BUS., Oct. 30, 2011, http://www.crainsnewyork.com/article/20111030/ECONOMY/310309979; *see also* David Sears, EAGLE FORD SHALE OFFERS MORE THAN OIL JOBS, KSAT SAN ANTONIO, Nov. 14, 2011, http://www.ksat.com/news/29768841/detail.html (describing efforts of the Texas Workforce Commission and Alamo Community Colleges to train and match workers with available jobs relating to South Texas oil and gas fields).

community colleges do not participate in the federal loan program.[80] About 9% of enrollees at community colleges—a total of over one million students—attend institutions that do not provide access to federal loans.[81] In part for this reason, students at community colleges are less likely than their peers at four-year colleges to receive financial aid sufficient to meet their needs.[82]

The data on private loans suggests that the funding gap has increased as tuition has increased. Moreover, both students who face high educational expenses and those who enter postsecondary education with relatively few resources will more often face a funding gap. As a result, many students—especially those whose families are not wealthy—currently need private loans to finance their higher education. The remaining question is how these trends are likely to develop in the future.

4. The Future of the Funding Gap and Private Loans

Unfortunately, the funding gap caused by the failure of federal aid to keep pace with educational costs[83] is likely to remain—and to grow. The trend of rising costs shows no sign of slowing.[84] Further, although a 2009-10 federal increase in Pell grants and other funding helped to ameliorate the funding gap for some students, that boost in federal aid seems unlikely to be repeated in the foreseeable future. To the contrary, Congress is already facing proposals to scale

---

[80] *See* PROJECT ON STUDENT DEBT, STILL DENIED: HOW COMMUNITY COLLEGES SHORTCHANGE STUDENTS BY NOT OFFERING FEDERAL LOANS 1 (2011).

[81] *Id.* Many of these colleges may fear that if the students they serve default at too high a rate, they will lose access to all forms of federal aid, including Pell grants. *See id.* at 7. Others may believe they are protecting their students from indebtedness. *Id.*

[82] *Id.* at 2. Even compared with the overall population of community college students, the subgroup that cannot receive federal loans is disproportionately composed of African Americans and Native Americans. *Id.* at 1.

[83] *See, e.g.*, COLL. BD., FULFILLING THE COMMITMENT: RECOMMENDATIONS FOR REFORMING FEDERAL STUDENT AID 19 (Sept. 2008), http://advocacy.collegeboard.org/sites/default/files/rethinking-stu-aid-fulfilling-commitment-recommendations.pdf.

[84] *See, e.g.*, TRENDS IN COLLEGE PRICING 2011, *supra* note 47, at 13 fig. 5.

back Pell grant funding as way to reduce the federal budget deficit.[85] Disputes over whether the federal budgeting rules underestimate the full costs of the current federal loan program[86] may also render it more difficult to expand that program in the future. At best, then, federal aid will probably grow slowly, while the rate of increase in tuition shows no signs of slowing. In other words, the funding gap is here to stay and likely to widen.[87] Private educational loans will therefore continue to play a critical role in access to postsecondary education.

III. The Importance of Nonprofit Student Lenders

As described above, the persistent gap between the cost of higher education and the levels of financial aid provided by educational institutions and the federal government means that many students require assistance in the form of loans from private lenders in order to complete their education. Because both individual and social benefits flow from increased college graduation rates,[88] it is vital that gap-bridging loans be available to students at the lowest possible costs.

---

[85] *See* Kelly Field, *House Republicans' Spending Bill for Remainder of 2011 Would Cut Pell Grant by 15 Percent*, CHRON. OF HIGHER EDUC., Feb. 13, 2011, http://chronicle.com/article/House-Republicans-Spending/126356/; Nolter, *supra* note 41.

[86] *See* CONGRESSIONAL BUDGET OFFICE, *supra* note 21, at ix-xi; Kevin Bruns, *The Hidden Costs of Direct Loans*, CHRON. OF HIGHER EDUC., June 22, 2007.

[87] To be sure, there is ongoing concern about rising debt burdens, *see, e.g.*, Abbye Atkinson, *Race, Educational Loans, & Bankruptcy*, 16 MICH. J. RACE & L. 1 (2010), and over whether students are receiving sufficient financial counseling before making potentially life-altering decisions about funding their higher education, *see, e.g.*, BAUM & STEELE, *supra* note 75, at 1. Federal policymakers, however, have grappled for decades with the issue of balancing grants, loans, work-study programs, and tax credits to ensure access to postsecondary education, and loans have always remained the dominant component in the mix. *See* ROBERT B. ARCHIBALD, REDESIGNING THE FINANCIAL AID SYSTEM: WHY COLLEGES AND UNIVERSITIES SHOULD SWITCH ROLES WITH THE FEDERAL GOVERNMENT 45 fig.2.2 (2002). In short, for better or worse, loans will continue to be the principal way in which students finance their postsecondary education for the foreseeable future.

[88] *See, e.g.*, ARCHIBALD, *supra* note 87, at 36; Section III.A, *infra*.

The participation of nonprofit lenders in the student loan market is a crucial means for ensuring student access to such loans. Numerous nonprofit organizations currently provide gap-bridging loans. They are, of course, not the only institutions that do so; the list of private student loan originators includes a large number of for-profit banks.[89] Because of the constraints on nonprofit organizations and the favorable treatment that nonprofits receive under federal law, however, the presence of nonprofit lenders in the marketplace for private student loans allows students to access more funding on better terms than would be available in a market composed exclusively of for-profit firms. After briefly tracing the history of nonprofit lenders in the student loan market, this Part explains why nonprofit lenders generate these benefits for students.

A. Nonprofit Involvement in the Student Loan Market

As discussed in Part II, *supra*, the federal government is now the dominant player in the student loan market. Significant government involvement with student loans is not new. The government has created and regulated student loan markets since the enactment of the Higher Education Act of 1965 ("HEA").[90] The role of nonprofit organizations in student lending, however, predates even the HEA. The first guaranteed student loans were issued in Massachusetts in 1957.[91] "Private lenders . . . provide[d]" the capital to issue those loans, and "a nonprofit corporation . . . cover[ed] the risk of defaults with a reserve fund created from philanthropic contributions."[92] The Massachusetts arrangement worked, and it was soon

---

[89] *See* Finaid.org, *Private Student Loans*, http://www.finaid.org/loans/privatestudentloans.phtml (last visited Oct. 8, 2011) (listing popular lenders).
[90] Pub. L. No. 89-329, 79 Stat. 1219 (codified as amended in various provisions of Title 20, U.S. Code). For the importance of the HEA, *see, e.g.*, FRED GALLOWAY & HOKE WILSON, REFRAMING THE STUDENT LOAN COSTING DEBATE: THE BENEFITS OF COMPETITION 2 (2005), http://educationalpolicy.org/pdf/loandebate.pdf. On the history of government involvement generally, *see, e.g.*, ARCHIBALD, *supra* note 87, at 21-45.
[91] GALLOWAY & WILSON, *supra* note 90, at 2.
[92] ANDERSON, *supra* note 46, at 12.

emulated by a number of other states, each of which also used nonprofit corporations as guaranty agencies.[93]

The HEA then drove nonprofit corporations to expand their participation in the student loan market. As part of the HEA, Congress established the predecessor to the Federal Family Education Loan Program ("FFELP").[94] "Under the [FFELP], loan capital [was] provided by private lenders, and the federal government guarantee[d] lenders against loss through borrower default."[95] Although the federal government insured the lenders, it delegated to "state and nonprofit guaranty agencies" the task of administering that insurance.[96] Nonprofits thus filled the same function under the FFELP as they had in the earlier state loan programs.

Nonprofit lenders also played two other roles. The FFELP was a public-private partnership in which the government provided incentives to lenders to make loans to students, including those without credit histories, who would not otherwise be eligible for loans.[97] The FFELP became so successful that lenders began to exhaust the capital available for issuing student loans.[98] To forestall this possibility, Congress created the Student Loan Marketing

[93] *Id.*
[94] *See generally* ARCHIBALD, *supra* note 87, at 123-24 (delineating the major players in the student loan market). The FFELP was originally called the Guaranteed Student Loan program, *e.g.*, ADAM STOLL, THE ADMINISTRATION OF FEDERAL STUDENT LOAN PROGRAMS: BACKGROUND AND PROVISIONS, at CRS-1 (2005), http://projectonstudentdebt.org/files/pub/Admin%20of%20Student%20Loans.pdf, but for simplicity, I refer to the program as the FFELP throughout this article. For a detailed history of the transition from the Guaranteed Student Loan program to the FFELP, *see* BENJAMIN MILLER, RETHINKING THE MIDDLEMAN: FEDERAL STUDENT LOAN GUARANTY AGENCIES 7 (2009), http://www.newamerica.net/files/nafmigration/Rethinking_the_Middleman_24pp_PDF.pdf.
[95] STOLL, *supra* note 94, at CRS-1.
[96] *Id.* at CRS-1, CRS-5; *see also* WEGMANN ET AL., *supra* note 59, at 4 ("Originally, the [Guaranteed Student Loan] program aimed to encourage states to create insured student loan programs by providing federal advances; funds could also be provided to non-profit private loan insurance programs . . . to encourage their expansion.").
[97] *See, e.g.*, GALLOWAY & WILSON, *supra* note 90, at 3; STOLL, *supra* note 94, at CRS-1.
[98] GALLOWAY & WILSON, *supra* note 90, at 4.

Association, or "Sallie Mae," for the express purpose of purchasing student loans on the secondary market. Doing so returned capital to lenders, who then used that capital to originate new loans.[99] Nonprofit institutions also purchased loans on the secondary market;[100] as of 2006, roughly thirty nonprofit or state-based organizations participated in that market.[101]

In the late 1970s, nonprofit organizations broadened their operations further and began directly issuing FFELP loans. The impetus for this shift is found in the Tax Reform Act of 1976.[102] That statute allowed nonprofit corporations "established by a state or local government" to issue tax-exempt bonds as a mechanism to secure capital used to issue student loans.[103] The combination of this tax exemption and the rising interest rates of the late 1970s induced many states either to form nonprofits that issued loans or to expand the operations of existing guaranty agencies to encompass direct lending functions.[104] Although these state nonprofit institutions remained relatively small players in the market, they nevertheless came to "play a significant role in providing loan capital" for the millions of educational loans issued under the FFELP.[105]

---

[99] *Id.*; *accord* STOLL, *supra* note 94, at CRS-1.
[100] *See* STOLL, *supra* note 94, at CRS-5.
[101] ANDERSON, *supra* note 46, at 15; *see also* Education Finance Council, Membership List, http://www.efc.org/cs/root/membership/efc_members?key=memberType&val=Member (last visited Oct. 11, 2011) (stating that the twenty-seven listed organizations "are not-for-profit and state-based student loan secondary market organizations").
[102] Pub. L. No. 94-455, 90 Stat. 1520 (codified in scattered sections of Title 26, U.S. Code (1976)).
[103] CONGRESSIONAL BUDGET OFFICE, STATE PROFITS ON TAX-EXEMPT STUDENT LOAN BONDS: ANALYSIS AND OPTIONS 3-4 (1980), http://www.cbo.gov/ftpdocs/111xx/doc11176/80doc11aa.pdf.
[104] *See id.* at ix-xi; MILLER, *supra* note 94, at 15.
[105] ANDERSON, *supra* note 46, at 14. In 1997 and 1998, for instance, the Pennsylvania Higher Education Assistance Authority, a state nonprofit, was the fifteenth-largest FFELP lender. *See* U.S. Dep't of Educ., *Top 100 Originators of FFELP Loans—FY97 and FY98*, http://www2.ed.gov/finaid/prof/resources/finresp/origin.html.

The enactment and success of the FFELP therefore drove nonprofits to act as originators of student loans and as purchasers of student loans on the secondary market. Nonprofits later came to play still another role in the student loan market. As discussed above, the combination of limited aid and rising tuition drove the emergence of the funding gap in the 1980s[106]—and its explosion in the 1990s. To bridge this gap, many students turned to private loans, and both nonprofit and for-profit corporations began issuing loans in response to that demand.[107]

In 2010, Congress radically altered the student loan landscape by ending the FFELP and opting instead for a system in which the federal government directly issues all federal loans.[108] Under this system, funding for all new loans comes directly from the U.S. Treasury.[109] The result is that private lenders will only issue private, gap-bridging loans in the future. Both for-profit and nonprofit corporations continue to play this role in the student loan market. For the reasons discussed below, however, all private lenders are not alike. The unique features of nonprofit organizations mean that nonprofits' continued existence in the private loan market is crucial to ensure that students have access to affordable gap-bridging loans.

B. The Benefits of the Nonprofit Form

---

[106] The federal government did expand students' options by creating the Parent Loan for Undergraduate Students ("PLUS") program in 1980—but PLUS loans came with unappealingly high interest rates. *See* ANDERSON, *supra* note 46, at 135; WEGMANN ET AL., *supra* note 59, at 5.

[107] *See* ANDERSON, *supra* note 46, at 135; WEGMANN ET AL., *supra* note 59, at 5. The "[c]ompetition between lenders, guarantors and services" produced cost savings and better service for students. Bill Spiers, *Why I'm Sticking with FFELP*, INSIDE HIGHER ED, May 21, 2009, http://www.insidehighered.com/views/2009/05/21/spiers (discussing both competition among FFELP lenders and between the FFELP and the direct loan program).

[108] *See* Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 2201, 124 Stat. 1029, 1074. The interest rate on most loans is the same under the direct loan program as it was under the FFELP. *See, e.g.,* Finaid.org, *Direct Loans v. the FFEL Program*, http://www.finaid.org/loans/dl-vs-ffel.phtml. Because the transition to direct loans was so recent, it is not yet clear if the government will be able to efficiently perform its expanded role or even if the new system is in students' best interests.

[109] *E.g.*, STOLL, *supra* note 94, at CRS-18.

1. The Nondistribution Constraint

Because nonprofit organizations perform a remarkable array of functions in American life, it is difficult to find a single feature that all nonprofits share and that distinguishes nonprofits from other organizations.[110] One candidate for that distinction, however, is the rule that nonprofit organizations may not make profit distributions—what Henry Hansmann has famously termed the "nondistribution constraint."[111] This constraint "is imposed, explicitly or implicitly, by the . . . nonprofit corporation statutes under which [organizations] are formed."[112]

The nondistribution constraint serves to remove, or at least greatly reduce, the incentive that firms otherwise have to maximize profits. Thus, when applied to nonprofit corporations that provide goods and services, the constraint nullifies any temptation to gouge consumers: In for-profit corporations, "rais[ing] prices and cut[ting] quality" can lead to greater short-term profits and therefore to shareholder contentment.[113] By contrast, nonprofit organizations have neither shareholders nor any analogous group that could directly secure a portion of increases in short-term revenues.

---

[110] *See, e.g.*, Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 500 (1981) [hereinafter *Reforming Law*] (noting that "as many as one-fifth of all of the corporations in the United States are nonprofit" while arguing that "[c]onfusion continues to surround even the most fundamental issues" of nonprofits).
[111] Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980) [hereinafter *Nonprofit Enterprise*]; *accord, e.g.*, *Reforming Law*, *supra* note 110, at 501; *see also, e.g.*, Thomas H. Boyd, *A Call to Reform the Duties of Directors Under State Not-for-Profit Corporation Statutes*, 72 IOWA L. REV. 725, 729 (1987) ("Not-for-profit corporations differ from for-profit corporations in that the former are absolutely prohibited from making any distribution of income or profit to their directors, officers, or members.").
[112] *Reforming Law*, *supra* note 110, at 502.
[113] *Id.* at 844.

The nondistribution constraint does not always benefit consumers, but it often does so.[114] The transparent overpricing of low-quality goods will, by definition, be detectable by consumers, who therefore need little help in avoiding the producers that market those goods. Whenever "consumers [are] incapable of accurately evaluating the goods" or services they seek, however, the different incentives given to nonprofit organizations by the nondistribution constraint *do* yield benefits.[115] When quality (or, for that matter, pricing) is opaque, a profit-maximizing incentive is likely to lead to undetected profiteering,[116] and in such a situation, the nondistribution constraint aids consumers by imposing an alternate bulwark against overpricing. Put another way, because they cannot distribute profits, nonprofit corporations that function in opaque markets have incentives more closely aligned to consumers' interests than do for-profit firms operating in the same markets.[117]

2. Other Features of the Nonprofit Form

Several other strictures placed on nonprofit organizations also work to "the benefit of the organization[s'] patrons."[118] For example, a corollary of the nondistribution principle is that nonprofits must, instead of distributing profits, "retain[] and devote[]" their earnings "to

[114] Because this article focuses on student lenders, I use "consumers" as a shorthand for all beneficiaries of nonprofit activities.
[115] *Nonprofit Enterprise*, *supra* note 111, at 843.
[116] *See id.* at 843-44.
[117] *See, e.g.*, *Reforming Law*, *supra* note 110, at 504 ("The advantage of the nonprofit form . . . is that it makes the producer a fiduciary for its purchasers, and thus gives them greater assurance that the services they desire will in fact be performed as they wish."); *id.* at 516-17 (arguing that a business corporation that "finance[d] all of [its] capital needs through debt," "issue[d] some common shares to the directors . . . for token consideration," and "follow[ed] a firm policy of never paying dividends on the common stock" would nevertheless differ from a nonprofit "because it would not be legally bound to the nondistribution policy").
[118] *Id.* at 507.

financing further production of the services that the organization was formed to provide."[119] The consequence for nonprofits engaged in the provision of consumer goods and services is that the organization reinvests the vast majority of surplus revenues for the benefit of consumers.[120]

The charters of nonprofit organizations provide a closely related constraint on organizational behavior. In order to obtain an exemption from federal income taxes, a nonprofit's charter must list some "religious, charitable, scientific . . . or educational purpose[],"[121] and a nonprofit will lose its tax exemption if it undertakes significant activities that fall outside the scope of that purpose.[122] Both for this reason and because of the reinvestment requirement, the "purposes clause" of a nonprofit's charter "can essentially be viewed as [a] term[] in the organization's agreement with its patrons concerning the uses that will be made of funds."[123]

---

119 *Nonprofit Enterprise*, *supra* note 111, at 838; *see also, e.g.*, Boyd, *supra* note 111, at 729 ("Net income must be retained and used to further the purposes for which the [nonprofit] corporations were founded."); Eric C. Hallstrom, *Here We Go Again—The Conversion of Qualified Scholarship Funding Corporations from Nonprofit to For-Profit Status: What We Can Learn from the Health Care Conversion Bonanza*, 25 J. CORP. L. 659, 662 & n.18 (2000).

120 In addition, upon dissolution, the funds of a nonprofit must "be distributed for one or more exempt purposes, or to the federal government, or to a state or local government, [or] for a public purpose." BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS § 4.3(b), at 69 (10th ed. 2011). The nondistribution constraint thus binds a nonprofit even after the organization ceases to exist. *See id.*

121 I.R.C. § 501(c)(3); *see also, e.g.*, HOPKINS, *supra* note 120, § 4.3(a), at 66 ("In no case will an organization be considered to be organized exclusively for one or more tax-exempt charitable purposes if, by the terms of its articles of organization, the purposes for which the organization is created are broader than the specified charitable purposes."); Nina J. Crimm, *An Explanation of the Federal Income Tax Exemption for Charitable Organizations: A Theory of Risk Compensation*, 50 FLA. L. REV. 419, 428-29 (1998) (discussing this requirement).

122 *See, e.g.*, *Davidson v. Colonial Williamsburg Found.*, 817 F. Supp. 611, 614 (E.D. Va. 1993) (noting that courts look to the charter of an organization to determine whether it is entitled to "charitable status"); *Davis Hosp., Inc. v. Comm'r*, T.C.M. (P-H) P 45,097, 1945 WL 7342 (Mar. 14, 1945) (referring to "the incorporation of a new nonprofit corporation limited to the objects and purposes specified in its present charter").

123 *Reforming Law*, *supra* note 110, at 615.

Numerous other regulations also constrain the activities of nonprofit organizations. The Internal Revenue Service ("IRS"), for example, has promulgated a host of regulations that restrict the business and legislative activities of nonprofit entities.[124] State-law fiduciary duty principles, meanwhile, constrain the actions of the directors and officers of nonprofits.[125]

Nonprofit corporations also face significant disclosure obligations: With the exception of religious entities, "[n]onprofits with gross receipts above $25,000" must "report revenue, net assets, and expenses—including fundraising and compensation to officers and directors."[126] A nonprofit must provide copies of its three most recent reports—as well as copies of any documents related to its initial application for a tax exemption—to any member of the public upon request.[127] And when nonprofit entities use the capital that results from the sale of tax-exempt municipal bonds, they are required to make extensive and continuing financial disclosures under Securities and Exchange Commission Rule 15c2-12.[128]

There are several mechanisms for enforcing these restrictions. "The IRS aggressively monitors tax-exempt entities to ensure" that they are not "misus[ing] charitable funds."[129] State attorneys general also have the power to investigate any breaches of fiduciary duties committed

---

[124] The applicable regulations are too voluminous to enumerate here. For a complete treatment, *see* HOPKINS, *supra* note 120, Part 5, at 505-729.
[125] *Id.* § 5.3, at 121-23.
[126] Nicole Gilkeson, *For-Profit Scandal in the Nonprofit World: Should States Force Sarbanes-Oxley Provisions onto Nonprofit Corporations?*, 95 GEO. L.J. 831, 837 (2007) (discussing IRS Form 990); *accord, e.g.*, HOPKINS, *supra* note 120, § 3.4, at 55-56.
[127] *See* HOPKINS, *supra* note 120, § 27.10, at 836-37 (discussing I.R.C. § 6104(d) and associated rules).
[128] Specifically, the disclosure requirements of Rule 15c2-12 apply when nonprofit entities purchase municipal student loan bonds.
[129] Gilkeson, *supra* note 129, at 836; *accord* Jane Heath, Comment, *Who's Minding the Nonprofit Store: Does Sarbanes-Oxley Have Anything to Offer Nonprofits?*, 38 U.S.F. L. REV. 781, 791 (2004).

by the directors of nonprofit organizations.[130] And the reputation of a nonprofit organization is of exceptional importance.[131] Nonprofits that misappropriate funds or stretch the boundaries of the law remove the "extra degree of assurance" consumers have "that the firm will not behave opportunistically toward them,"[132] and once "trust is broken," many nonprofits "often struggle just to survive."[133]

In other words, in addition to the nondistribution constraint and the requirement to act in accordance with the organizational charter, there are numerous regulatory, disclosure-based, investigatory, and reputational checks on the behavior of nonprofit firms. All of these restraints provide good reason to believe that nonprofits will not engage in profitable but unscrupulous activities vis-à-vis consumers. This lack of a profit motive is reflected in the numerous public policy choices that make it easier for nonprofits to expand their operations and to become more efficient. The most famous such policy choice, of course, is the decision to exempt qualifying nonprofits from federal corporate income taxes under I.R.C. § 501(c)(3). But a number of other laws also provide nonprofit organizations with more funds and easier access to capital.[134] For instance, tax-exempt nonprofit organizations that issue securities may do so without being constrained by many provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934.[135] The consequence of these laws is that nonprofits have a greater capacity to provide goods and services—and to do so at lower cost to consumers.

C. The Benefits of Nonprofit Student Lenders

---

[130] *See, e.g.*, Gilkeson, *supra* note 129, at 838-39; Heath, *supra* note 129, at 790-91.
[131] Gilkeson, *supra*, note 129, at 841.
[132] Henry B. Hansmann, *The Evolving Law of Nonprofit Organizations: Do Current Trends Make Good Policy?*, 39 CASE W. RES. L. REV. 807, 813 (1989).
[133] Gilkeson, *supra* note 129, at 842.
[134] *See, e.g.*, *Nonprofit Enterprise*, *supra* note 111, at 836-37.
[135] *See, e.g.*, 15 U.S.C. §§ 77c(3)(a)(4) & 78c(e); HOPKINS, *supra* note 120, § 3.3(g), at 51.

All of the constraints discussed above apply to nonprofit student lenders, and each type of constraint produces specific benefits for student borrowers. As a threshold matter, the nondistribution constraint matters in the market for private student loans because that market is not perfectly transparent to consumers. To be sure, both nonprofit and for-profit lenders disclose terms up front; students (and parents) are told the interest rates, fees, repayment terms, and incentives the lender provides. The problem from the borrower's perspective, however, is two-fold. First, loan products are often not easily comparable.[136] Second, as with all credit-based loans, the terms most lenders offer vary from student to student. Taken together, these complications mean that the path to finding the best possible deal can be time- (and credit inquiry-) intense.[137]

For these reasons, lenders with a profit motive could surreptitiously increase borrowers' expenses. The existence of nonprofit lenders governed by the nondistribution constraint accordingly serves as a potentially critical check against guileful lending practices. The nondistribution constraint is reinforced in this context by restrictions on a key source of nonprofit lenders' capital. Historically, nonprofit lenders either directly or indirectly issued tax-exempt bonds backed by student loans under I.R.C. § 150(d) and then used the resulting capital to originate new student loans.[138] When doing so, the interest rates nonprofit lenders earned on the student loans could be no more than 2% higher than the interest rate on the tax-exempt bonds.[139]

---

[136] *E.g.*, *Private Student Loans*, *supra* note 89 (listing the repayment terms, fees, and range of interest rates offered by a variety of lenders).

[137] *See id.* (noting that offered terms depend on credit scores and, in some instances, on the creditworthiness of a co-signor).

[138] *See* Part IV, *infra.*

[139] *See, e.g.*, FREDERIC L. BALLARD, JR., ABCS OF ARBITRAGE: TAX RULES FOR INVESTMENT OF BOND PROCEEDS BY MUNICIPALITIES 121-23 (2007); INTERNAL REVENUE SERV., ARBITRAGE—YIELD RESTRICTION, http://www.irs.gov/pub/irs-tege/teb_phase_1_course_11204_-14module_m.pdf (last visited Nov. 14, 2011). If nonprofit lenders used any portion of the capital

The effect of this yield restriction and the nondistribution constraint would be felt in one of two ways in the student loan context: Nonprofit lenders might straightforwardly issue loans at better terms for student borrowers. Alternatively, if for-profit lenders proved responsive to the loans offered by nonprofits, the rates of all lenders would be lower than they would be in a market without nonprofit firms.[140] In either case, the net result is that the presence of nonprofit lenders allows students to receive more affordable gap-bridging loans.

The requirements that nonprofits single-mindedly pursue the purpose set forth in their charters and reinvest surplus revenues toward that purpose also help student borrowers. The express mission of most nonprofit student lenders is to help students afford higher education.[141] As a result, surplus revenues are put to that purpose—which, in practice, means that surpluses will be used either to originate more student loans or to offer student loans on better terms. In the first case, more students would be able to obtain gap-bridging loans and complete their higher education, while in the second case, existing student borrowers would save substantial

---

raised by issuing tax-exempt bonds to make non-student loan investments with higher interest rates than the issued bonds, the lender was, with certain exceptions, required to return to the government any difference in yield caused by the higher interest rate. *See id.*

[140] *See* WEGMANN ET AL., *supra* note 59, at 14 ("Competition drives private lenders and the products they offer."); *cf.* GALLOWAY & WILSON, *supra* note 90, at iv-v, 25-26 (arguing that competition between the FFELP and the direct loan program produced cost savings for taxpayers).

[141] *See, e.g.*, N. Tex. Higher Educ. Auth., Inc., *About NTHEA/HESC*, http://www.nthea.com/about.html (last visited Oct. 11, 2011) ("North Texas Higher Education Authority, Inc. . . . and Higher Education Servicing Corporation . . . were created to ensure access to higher education for Texas students and families."); Panhandle-Plains Higher Educ. Auth., *A Non-Profit Corporation and Secondary Market for Federal Family Education Loans*, http://www.pphea.org/public/index.php (last visited Oct. 11, 2011) (describing the Authority as "a nonprofit corporation[] chartered for the express purpose of helping aspiring students in the Panhandle and South Plains of Texas take hold of their college education"); *see also* Edsouth, *About Edsouth*, http://www.edsouth.org/AboutUs (last visited Oct. 11, 2011) ("Edsouth . . . is a nonprofit, public benefit corporation organized for the purpose of promoting access to higher education by acquiring postsecondary education loans").

amounts of money during the repayment period of the loans. Surplus revenues are also used for borrower education programs and clinics on financing higher education.

The remaining constraints on nonprofits likewise advantage students, albeit indirectly, by ensuring that nonprofit lenders act in accordance with the nondistribution constraint and their organizational charters. Specifically, the ability of the IRS, state attorneys general, and other regulators to enforce applicable rules extends to nonprofit lenders, as do the disclosure requirements discussed above.[142] Past media coverage of the student loan industry, meanwhile, leaves little doubt that even questionable practices will invite extensive public scrutiny and damage the reputations of the exposed organizations.[143]

Just as nonprofit student lenders are constrained by the same rules as other nonprofits, those lenders also enjoy the same favorable treatment under federal law. In the case of student lenders, it is easy to trace the pass-through benefits to consumers that such treatment produces. The income tax exemption directly leaves nonprofit lenders with a greater pool of funds to lend. And the fact that student lenders that issue securities[144] are provided with easier access to capital under the federal securities laws leads to the same result. More capital translates into more loans, and more gap-bridging loans mean more students who have access to higher education.

---

[142] *See, e.g.*, Access Group Disclosures, http://www.faqs.org/tax-exempt/DE/Access-Group-Inc.html (including similar information for the nonprofit lender Access Group, Inc.) (last visited Oct. 12, 2011); Pheaa Disclosures, http://www.faqs.org/tax-exempt/PA/Pheaa-Student-Loan-Foundation-Inc.html (reporting disclosures from the nonprofit lender Pheaa Student Loan Foundation, Inc.) (last visited Oct. 12, 2011).

[143] *See, e.g.*, *e.g.*, Jonathan D. Glater, *Offering Perks, Lenders Court Colleges' Favor*, N.Y. Times, Oct. 24, 2006, http://www.nytimes.com/2006/10/24/education/24loans.html?pagewanted=print; Amit R. Paley & Valerie Strauss, *Student Loan Nonprofit a Boon for CEO*, WASH. POST, July 16, 2007, http://www.washingtonpost.com/wp-dyn/content/article/2007/07/15/AR2007071501448.html (last visited Oct. 11, 2011).

[144] *See* Part IV, *infra*.

Both the constraints and the benefits that accompany the nonprofit form should therefore greatly benefit students.

Although the discussion so far has been largely theoretical, the available evidence concerning the student loan market confirms that nonprofits produce precisely the benefits described above. There can be no question that nonprofit lenders have played a major role in allowing many students to complete undergraduate, graduate, and professional educations that otherwise would have proven too costly.[145] There is also "little dispute that" nonprofit lenders are "more generous with their income than are their for-profit counterparts"[146] and provide students with less costly loans.[147] As one former government researcher put it, "nonprofit agencies . . . give more money to students than for-profit lenders do," "pay their executives less," and have not "engag[ed] in such practices as making payments to college administrators or helping colleges . . . steer needy students into larger loans."[148] In short, because of their lack of a strong profit motive and related constraints on their actions, nonprofits "offer borrowers the best deals to be found."[149] The consumer orientation of nonprofit lenders also leads them to provide

---

[145] *See, e.g.*, WEGMANN ET AL., *supra* note 59, at viii, 12 (noting that private loans both help bridge the funding gap and allow students to attend the schools of their choice); Marilyn Yarbrough, *Financing Legal Education*, 51 J. LEGAL EDUC. 457, 457 (2001) (discussing the role of the nonprofit Access Group in providing funds for graduate and professional students); *cf. Nonprofit Enterprise*, *supra* note 111, at 860-61 ("[P]rivate lending institutions generally have not been willing to make [non-federal] loans, due to problems in arranging for adequate security . . . .").

[146] Paul Basken, *Nonprofit Lenders, While Helping Students, Help Themselves*, CHRON. OF HIGHER EDUC., Aug. 10, 2007.

[147] *See* Stephen Burd, *Showdown Looms on Student Loans*, CHRON. OF HIGHER EDUC., June 18, 1999, at A34 (describing the "aggressive discount program" run by one state-based nonprofit lender).

[148] Basken, *supra* note 146 (citing statements by a former U.S. Department of Education employee and whistleblower).

[149] Stephen Burd, *Critics Say Some Non-Profit Lenders Have Overstepped Their Missions*, Chron. of Higher Educ., June 18, 1999, at A36.

college, career, financial aid, and loan counseling services to large numbers of students[150]—thus making the student loan market significantly more transparent—and to be "'more responsive' to students"[151] than their for-profit counterparts.[152]

In both theory and practice, then, nonprofit student lenders provide students with more funds at better terms than would otherwise be available. As discussed in Part II, *supra*, those benefits entail significant positive consequences: More students—and more diverse students—

---

[150] *See, e.g.*, 155 Cong. Rec. S9626, S9628 (daily ed. Sept. 22, 2009) (statement of Sen. Lamar Alexander); 155 Cong. Rec. H9675, H9677 (daily ed. Sept. 17, 2009) (statement of Rep. Peter Welch); Basken, *supra* note 146. These counseling services are especially important in the current environment, both because the Department of Education, which now handles "debt counseling" related to federal loans, is ill-equipped for that task. Rep. Virginia Foxx, *Foxx Statement: Hearing on "Government-Run Student Loans: Ensuring the Direct Loan Program Is Accountable to Students and Taxpayers,"* http://edworkforce.house.gov/News/DocumentSingle.aspx?DocumentID=265695 (last visited November 2, 2011).

[151] Basken, *supra* note 146 (quoting the founder of StudentLoanJustice.org).

[152] To be sure, the benefits of the nonprofit form are not limitless either in theory or in the reality of the student lending market. Despite the nondistribution constraint, nonprofits can retain a small portion of their profits and may wish to grow, Burd, *supra* note ___, and the principals of nonprofit organizations are entitled to reasonable compensation, *Reforming Law*, *supra* note 111, at 505. Nonprofits' charters can be capacious, *id.* at 616, oversight by the IRS and state attorneys general may prove rigorous in theory but ephemeral in practice, *see* Gilkeson, *supra* note 129, at 838, 840; Heath, *supra* note 129, at 791 (noting that "there is no basis for IRS oversight if the business activities of a charitable organization do not violate the tax exempt[ion] provisions"); *id.* at 795, and disclosure obligations do not give consumers a full picture of the inner workings of the firm, *see* Crimm, *supra* note 121, at 434; *Reforming Law*, *supra* note 110, at 617. The imperfection of these constraints is reflected in the fact that nonprofit lenders have not proven immune to the criticisms leveled at the student loan industry in recent years. *See, e.g.*, Basken, *supra* note 146 (criticizing certain uses of funds by nonprofits while recognizing that these issues existed "on a smaller scale" at nonprofit firms than at for-profit lenders); Paley & Strauss, *supra* note ___. But even assuming that these criticisms are correct and that the difference between nonprofit and for-profit firms is accordingly one of degree and not one of kind, *see* Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 N.Y.L. Sch. L. Rev. 457, 457 (1996), it does not follow that the benefits of the nonprofit form are illusory. Even vocal critics recognize this fact: The statements in the text concerning nonprofits' generosity, low executive pay, and restraint were uttered by Jon Oberg, a former Department of Education researcher who is no friend of student lenders of any type. *See, e.g.*, Sam Dillon, *Whistle-Blower on Student Aid is Vindicated*, N.Y. TIMES, May 7, 2007, http://www.nytimes.com/2007/05/07/washington/07loans.html?pagewanted=all.

complete their higher education, enabling them to fill long-term, recession-resistant jobs, strengthening the national economy, and stabilizing students' communities. Ironically, students' ability to access lower-cost loans, and all of the resulting social and economic advantages that flow from that access, are currently imperiled by a piece of legislation ostensibly aimed at consumer protection. I now turn to the Dodd-Frank Act[153] and that Act's potential to throttle students' access to affordable gap-bridging loans.

IV. The Impact of Risk Retention on Access to Higher Education

Nonprofit student lenders typically raise capital by selling bonds backed by existing student loans on the capital markets. These transactions lower the lenders' capital costs—and therefore also lower the interest rates lenders charge borrowers. On a superficial level, these transactions somewhat resemble the transactions regulated by the Dodd-Frank Act, which seeks to align the incentives of the entities that issue securities with those of the investors that purchase securities by requiring the issuing entity to retain a portion of the risk in the securitized assets. But nonprofit lenders' capital market transactions fundamentally differ from transactions involving for-profit lenders and from typical securitizations in one critical way: Most nonprofit lenders that issue bonds backed by student loans, unlike for-profit lenders, never transfer ownership of those loans to a separate entity. Nonprofit lenders instead maintain ownership of student loans and continue to be exposed to the risk that borrowers might default on those loans.

Applying the risk retention rule of Dodd-Frank to nonprofit lenders would thus have no benefit; because such lenders share exposure to default risks with the investors who buy student loan-backed bonds, the incentives of nonprofit lenders and investors are already aligned. In addition, applying risk retention to nonprofit student lenders would entail significant social costs.

[153] Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

Nonprofit entities are legally prohibited from retaining more than a small fraction of their revenues and cannot engage in side businesses unrelated to the purpose in their charters. As a result, nonprofit student lenders would have much greater difficulty satisfying the risk retention requirement. Any attempt to subject nonprofit lenders to risk retention would likely drive them out of the student loan market, forcing borrowers to take out more expensive gap-bridging loans and making it significantly more difficult for many students to finance a higher education.

A. Capital Market Transactions in the Student Loan Context

In order to obtain the funds needed to provide gap-bridging loans, student lenders need continuous, long-term access to efficient sources of capital. To gain that access to capital, lenders typically create bonds that are secured by their right to receive interest and principal payments on a large pool of student loans. The bonds are sold to investors, who provide the capital necessary to originate additional student loans. This process can be repeated *ad infinitum*, yielding a stable source of capital with which lenders can issue many more loans.

If they lost the ability to sell bonds backed student loans, many lenders would be forced to wait for current student borrowers to repay the principal on their loans before issuing any new student loans. In light of the repayment terms on most loans, this process would take years, if not decades. In the meantime, lenders would have no reliable way to generate capital for new loans. This is particularly true of nonprofit lenders, which—as noted above—can retain only a small portion of their surplus revenues and generally cannot engage in side businesses unrelated to their chartered purpose in order to raise funds. Accordingly, access to the capital market is crucial to lenders' ability to originate student loans.

Lenders' access to capital markets, however, does not exclusively benefit market participants. It also yields a substantial, if often overlooked, benefit to the consumers whose loans secure the bonds sold on the capital markets. By aggregating a number of individual loans to provide collateral for bonds and creating a market for those bonds, lenders increase investor demand for individual loans, effectively making those loans more valuable.[154] And when loans that lenders sell fetch a higher price, lenders are able to "pay" more for those loans by offering lower rates on their lending. In other words, because bond issuance makes lenders' streams of future principal and interest payments more valuable in the marketplace, lenders are able to offer loans to consumers at lower interest rates. When lenders have consistent access to capital, student borrowers can obtain funds more cheaply.

This view may appear counterintuitive, because we tend to think of consumers merely as the *recipients* of a loan. That view, however, only provides a partial picture of the transaction. From a more holistic vantage point, lenders and borrowers are in a mirror-image relationship. Lenders trade cash at the time of the loan in return for the right to receive principal and interest payments in the future, while borrowers enter into a directly inverse transaction. For example, a student who borrows $10,000 to attend college can be said to "buy" the right to receive $10,000 in principal today in return for a promise to pay $10,000, plus interest, at some point in the future. Similarly, looking at the transaction from the other side, the lender is spending $10,000 today to "buy" the right to receive principal and interest payments in the future. In short, the amount of cash a borrower receives is directly tied to the amount the lender requires in return, and anything that lowers the amount the lender must receive to make a loan ultimately benefits the borrower.

---

[154] *See* JASON H.P. KRAVITT & JEFFREY SEIFMAN, SECURITIZATION OF FINANCIAL ASSETS § 1.01, at 1-3 (2d ed. 2010) ("Unlike whole loan sales and participations, securitization is often used to market small loans that would be difficult to sell on a stand-alone basis.") (quoting CHRISTINE A. PAVEL, SECURITIZATION 3 (1989)). *See also id.* § 3.02[C] (discussing securitization's ability to expand the investor base to investors who would not otherwise be able to participate in a particular market).

The rate at which lenders can spend today in order to receive principal and interest payments in the future, meanwhile, largely depends on the demand for the loans that represent those future payments. Individual student loans are not especially marketable, because the transaction costs associated with evaluating and selling individual loans are too high to justify a transfer. When aggregated and sold as bonds, however, the per-loan transaction costs decline, rendering the loans both marketable and easily transferable. In this way, bond issuance allows entities that do not originate student loans the opportunity to purchase those loans on the secondary market.

By definition, allowing loans to be more easily transferred to a broader set of potential purchasers increases the demand for loans, or, put another way, for the future cash flows from principal and interest payments. And it is axiomatic that as demand increases for a good, purchasers will pay more for that good. As a result, the capital market transaction allows student lenders to receive a higher price from loan purchasers for the same stream of future payments. Lenders can then either use the extra capital to originate an increased number of loans or, as more frequently happens, offer lower interest rates to borrowers. The net result is that when student lenders have effective access to capital markets, students receive less costly educational loans. As described at length in Part III, *supra,* this benefit is significantly magnified if the lender is a nonprofit entity, because nonprofits are already incentivized to offer better loan terms to borrowers than for-profit financial institutions do.

B. The Dodd-Frank Act and Risk Retention for Securitizers

Despite these benefits to borrowers, the process of issuing bonds or securitizing is deeply and understandably linked in current thinking to the recent financial crisis. The inflation of home prices and the overextension of credit that led to the crisis are well-known and resulted in part from reckless behavior by securitizers, especially home mortgage lenders. Banks and other lenders were able to separate themselves from the credit risk of the loans they issued by pooling loan assets and then selling securities backed by those assets. Some securitizers arguably misused this financial structure in order to obtain high short-term profits without fully considering the long-term consequences.[155] After these practices were revealed, Congress became concerned that the economic incentives of securitizers, who could separate themselves from the credit risks associated with pooled loans, were misaligned with the interests of securities investors, who took on that risk.

In response, Congress increased the regulation of securitization transactions in the Dodd-Frank Act. In § 941 of the Act, codified as Section 15G of the Securities Exchange Act of 1934, Congress sought to align the interests of securitizers with the interests of securities investors.[156] To this end, Congress directed the SEC and a number of federal banking and housing agencies[157] to adopt regulations that require "any securitizer to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security,

---

[155] *See*, *e.g.*, Mary L. Schapiro, Chairman, SEC, Remarks Before the American Securitization Forum 2011 Annual Meeting (June 22, 2011), http://sec.gov/news/speech/2011/spch062211mls.htm ("In the area of mortgage-backed securities, sound underwriting practices often took a back seat to immediate profits . . . and underwriting standards deteriorated.").

[156] *See* Dodd-Frank Act § 941, *supra* note 153 (adding Section 15G to the Securities Exchange Act of 1934, 15 U.S.C. § 78o-11).

[157] The agencies tasked with developing and adopting the rules required by Dodd-Frank § 941 are the Department of the Treasury's Office of the Comptroller of the Currency, the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Securities and Exchange Commission, and the Department of Housing and Urban Development. *See* Securities Exchange Act., § 15G(a)(1), (b)(1) & (2) (directing agencies to adopt rules); Credit Risk Retention, 76 Fed. Reg. 24090, 24090 (proposed Apr. 29, 2011) (listing agencies issuing the proposed Credit Risk Retention rule). The Federal Housing Finance Agency and Housing and Urban Development are only responsible for the rules as they relate to residential mortgages. *See* § 15G(b)(2).

transfers, sells, or conveys to a third party."[158] Congress specified that, at a minimum, securitizers must retain "not less than 5 percent of the credit risk for any asset."[159] This requirement is often referred to as "skin in the game."[160] Although the mortgage industry and the decline in the housing market were the primary impetus for the risk retention requirement, Dodd-Frank does not apply exclusively to mortgage securitizations. Instead, the risk retention rule is applicable on its face to the entire securitization market.

On March 29, 2011, the responsible agencies issued a proposed rule implementing the risk retention requirement and solicited public comments.[161] The proposed rule includes a variety of mechanisms designed to force securitizers to meet the 5% risk retention requirement, but the agencies also provided some accommodation for differences among various asset types and securitization structures.[162] During the comment period, an extensive number of suggestions and concerns were raised regarding the proposed rule,[163] and the proposal remains very much a work in progress. But although the specific contours of the Agencies' proposed regulations are

---

[158] Section 15G(b)(1) of the Securities Exchange Act of 1934.
[159] *Id.* § 15G(c)(1)(B)(i).
[160] *See* 76 Fed. Reg. at 24,096 (quoting S. Rep. No. 111-176, at 129 (2010)).
[161] 76 Fed. Reg. at 24,090. The comment period originally ran through June 10, 2011, 76 Fed. Reg. 24090, but that deadline was extended until August 1, 2011, in response to the near-unanimous request of potential commenters, *See* Credit Risk Retention, 76 Fed. Reg. 34,010 (proposed June 10, 2011). The agencies are currently considering the submitted comments. There has been no official indication as to when the agencies might issue a final rule.
[162] *See* 76 Fed. Reg. at 24,158-62 (Proposed Rule §§ __.3 - __.11 (setting out proposed rules for the various manners in which risk can be retained).
[163] *See* SEC, Comments on Proposed Rule: Credit Risk Retention, http://www.sec.gov/comments/s7-14-11/s71411.shtml (SEC location housing all comment letters received regarding the Credit Risk Retention proposed rule.). For a good summary of the perceived difficulties with the proposed rule as it relates to a number of different asset types, *see* Am. Securitization Forum, Letter Regarding Proposed Rulemaking on Credit Risk Retention (June 10, 2011), http://www.sec.gov/comments/s7-14-11/s71411-57.pdf [hereinafter ASF Letter].

likely to change, the general rule requiring substantial risk retention for most securitizers is here to stay.

C. Risk Retention and Nonprofit Student Lenders

The risk retention requirement in the Dodd-Frank Act is designed to address the types of securitization structures most commonly used in the marketplace, regardless of the underlying asset type. The requirement, however, sweeps exceedingly broadly and encompasses capital market transactions that use less common structures. It could, for instance, be read to cover bond offerings by nonprofit student lenders.

Applying the risk retention rule to these bond offerings would have a catastrophic effect on students' access to gap-bridging loans. Because nonprofit student lenders cannot retain most surplus revenues, they are much less able to meet the 5% retention requirement. Without access to capital markets, nonprofit lenders—which may only retain a small fraction of surplus revenues and which cannot engage in side businesses unrelated to the purpose in their charters—would have no mechanism for raising new funds and would likely be forced to cease originating loans as soon as they disbursed any immediately available capital. Students would therefore face a much-diminished marketplace containing fewer and more expensive private loan options. This change would, in turn, cause at least some students to forego higher education, to the detriment of their communities and the national economy.

Fortunately, there is no need to make a difficult choice between gaining any benefits that might be produced by the risk retention rule and realizing the gains from expanded access to higher education. The capital markets transactions used by the vast majority of nonprofit student lenders differ in a critical way from the transactions Dodd-Frank aims to regulate, with the result that the risk retention rule produces no benefits when applied to transactions by most nonprofit student lenders. Explaining this result necessitates a more in-depth discussion of the Act and various types of capital markets.

Dodd-Frank seeks to regulate the normal universe of transactions typically considered to be securitizations, including common transactions backed by mortgage, automobile, and similar loans. In those transactions, a company chooses a pool of assets and sells that pool to a bankruptcy remote special purpose entity (often called an "SPV," or "special purpose vehicle").[164] The SPV finances its purchase of the assets by issuing securities purchased by capital markets investors.[165] The result of these transactions is that securities investors look exclusively to the cash flows of the underlying assets for payment, rather than relying on the general operating funds of the sponsoring company.[166]

This typical structure provides advantages to both investors and securitizers. From the perspective of investors, the transfer of the assets to a legally independent SPV ensures that the assets will be protected even if the securitizer becomes insolvent, because general creditors cannot seize assets held by SPVs. The use of an intervening SPV also protects securitizers by separating the assets held by the SPV from the securitizers' balance sheets, meaning that investors have recourse only against the assets that underlie the securities. As explained above,

---

[164] KRAVITT & SEIFMAN, *supra* note 152, § 1.01, at 1-6 ("Very often in the process of securitization, the applicable structure will be one that isolates the financial assets to be securitized from the credit risk of the originator of the assets. The isolation is structured in a manner such that the source of repayment for the investor in the financial assets will be the credit quality and liquidity of the financial assets … rather than the general credit quality and liquidity of the business enterprise in which the seller originated the financial assets."); *see also id.* § 2.02, at 2-13 (defining "special purpose vehicle"); § 4 (summarizing types of structures utilized in securitizations).

[165] *Id.* § 1.02, at 1-9 ("once the parties have packaged the applicable financial assets and issued the instruments, the proceeds of which will finance the liquidation of the financial assets, the instruments will normally be in the form of commonly known securities such as preferred stock, bonds, beneficial interests in trusts, or commercial paper or other evidences of short-term indebtedness").

[166] *Id.* § 1.01, at 1-6.

however, this benefit to the securitizer results in a potential disconnect between the incentives of securitizers and the interests of investors by allowing securitizers to insulate themselves completely from the risk attached to low-quality, high-risk assets that are securitized.[167] It is this perceived disconnect that the Dodd-Frank risk retention rule seeks to address. As a result, it is only natural for the entities that transfer assets directly or indirectly to the SPV to be subject to the risk retention requirement.

But not all participants in the capital markets use the structure described above or SPV intermediaries. The exceptions include nonprofit lenders that issue bonds backed by student loans. In fact, unlike normal mortgage or automobile securitizers, nonprofit student lenders issue bonds backed by loan assets but never transfer those underlying assets, or the risk related to those assets, to any other entity. The lender that underwrites the student loans instead continues to own all of the underlying assets and simply pledges those assets in support of the bonds it issues. As a result, while investors in student loan bonds rely on the cash flows from the underlying loans for payment, no transfer of assets occurs.

From the perspective of Dodd-Frank's overarching purpose, this distinction between typical securitizations involving SPVs and the way in which nonprofit student lenders participate in the capital markets is a fundamental one. Because nonprofit lenders do not transfer the underlying assets, the student loans remain on the lenders' balance sheets, and such lenders are therefore subject to *all* of the credit risk associated with the loans they originate. Lenders in this position have no incentive whatsoever to package poorly underwritten assets and foist those assets on unsuspecting investors. Doing so would leave nonprofit lenders exposed to claims by

---

[167] *See id.* § 3.02, at 3-4; *see also id.* (other motivations of originators include "(1) removal of assets and associated financing from an originator's balance sheet; (2) obtaining a lower all-in cost of funds; (3) obtaining a varied investor base; (4) obtaining financing when unable to do so in any other practicable manner; and (5) matching assets and liabilities").

investors if borrowers began to default on the loans. Effectively, then, nonprofit student lenders are subject to full risk retention, completely satisfying the intended goal of Dodd-Frank. There is simply nothing to gain by applying risk retention under the circumstances.

As discussed above, however, there is much to lose, because nonprofit lenders cannot retain capital sufficient to comply with the risk retention rule. Applying the rule to nonprofit student lenders would therefore effectively foreclose them from obtaining the capital necessary to issue new loans—and would do so even though nonprofit lenders do not suffer from the misaligned incentives that gave rise to the rule.

D. Exempting Student Lenders from Risk Retention

The best possible outcome, then, would be to exempt the many student loan bond offerings that do not involve asset transfers from the risk retention rule. Although Dodd-Frank is now binding law, and although the implementing agencies are in the midst of crafting a final rule, there are two ways to reach this result. Both are consistent with the statutory text and congressional intent. One is to acknowledge that nonprofit lenders that offer bonds while retaining ownership of the underlying assets are not "securitizers" for purposes of Dodd-Frank, while the other involves exercising the broad discretion given by Congress to the implementing agencies to grant exemptions.

1. "Securitizers" Under Dodd-Frank

The Dodd-Frank Act requires only "securitizers" to meet the risk retention regulations.[168] The Act defines the term "securitizer" to mean two things: "an issuer of an asset-backed security"[169] and "a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the

[168] *See* Securities Exchange Act of 1934, §15G(b).
[169] *Id.* §15G(a)(3)(A).

issuer."[170] Both of these definitions contemplate that only entities who transfer assets to other entities in the securitization process qualify as "securitizers."

The first definition of securitizer—"an issuer of an asset-backed security"—may seem very broad. But the commentary to the proposed risk retention rule clarifies that this definition encompasses only so-called "depositors." As the commentary explains, a depositor is an entity "*that deposits the assets that collateralize the [asset-backed security]* with the issuing entity."[171] That definition is consistent with the definition of depositor in a related regulation as one "who receives or purchases *and transfers or sells* the pool assets to the issuing entity."[172] In other words, for an entity to be a securitizer under the first clause of the definition, it must be a depositor, and for an entity to be a depositor, it must deposit assets with, or transfer assets to, a different legal entity.

The transfer requirement is transparently present in Dodd-Frank's second definition of securitizer. That definition explicitly speaks of one who "sell[s] or transfer[s] assets." The commentary to the proposed rule reinforces this plain meaning. According to the commentary, "the second prong of th[e] definition . . . is substantially identical to the definition of a 'sponsor' of a securitization transaction in the Commission's Regulation AB governing disclosures for [asset-backed securities] offerings registered under the Securities Act."[173] The agencies therefore read the two definitions the same way—and the meaning of "sponsor" in Regulation AB is a "person who organizes and initiates an asset-backed securities transaction *by selling or*

---

170 *Id.* §15G(a)(3)(B).
171 76 Fed. Reg. at 24,099 (internal footnotes omitted) (emphasis added).
172 Regulation AB, Item 1101(e) (emphasis added).
173 76 Fed. Reg. at 24098 (internal footnotes omitted).

transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity."[174]

This notion of an asset transfer is, of course, central to Dodd-Frank's purpose. When nonprofit student lenders or other participants in the capital market issue bonds without transferring asset ownership, they have not divested themselves of the risk attached to the underlying assets. The risk is instead one that they share with investors. That is precisely the result Congress intended when writing the risk retention requirement into Dodd-Frank. The agencies implementing the requirement should thus acknowledge the fact that entities who issue bonds without transferring asset ownership are not "securitizers" within the meaning of the Act.

2. Agency Discretion

Even if nonprofit student lenders are securitizers within the meaning of Dodd-Frank, there is a second, independent statutory ground for exempting those lenders from the risk retention rule. Both the Act and the agencies' proposed regulations implementing risk retention recognize that there are many circumstances in which the requirement is neither necessary nor appropriate. For example, at Congress's express direction,[175] the regulations incorporate an exemption for securities involving so-called "Qualified Residential Mortgages" that have "a low[] risk of default."[176] And in addition to creating express exceptions from the risk retention requirement, Congress recognized that there would be other, unenumerated situations in which risk retention should not apply.[177] Dodd-Frank thus grants the implementing agencies broad authority to issue exemptions for assets that are safe and for bond issuers that have incentives

[174] Regulation AB, Item 1101(l).
[175] *See* Sec. 15G(e)(4).
[176] Section 15G(e)(4)(B).
[177] *See* Section 15G(e)(1) and (2).

aligned with the interests of investors.[178] In crafting their proposed regulations, the agencies used this discretionary power to draft additional exceptions to the risk retention rule for several types of well-underwritten assets, including some commercial mortgages, commercial loans, and automobile loans.[179]

As these regulatory exemptions demonstrate, both Congress and the agencies recognize that many entities and asset types outside the securitization mainstream do not pose the same threat as the transactions that gave rise to the risk retention requirement.[180] Because nonprofit student lenders utilize a structure for issuing bonds that differs materially from the structures that inspired Dodd-Frank's risk retention rule, and because the structure of student loan bond offerings already guarantees the substantial alignment of interests between investors and bond issuers, student loan transactions on the capital markets fall snugly in that category. Thus, even if nonprofit student lenders technically qualify as "securitizers" within the meaning of Dodd-Frank, the agencies should exempt student lenders from the risk retention requirement.

V. Conclusion

Legislation, even generally beneficial legislation, has unintended consequences, some of which can be highly undesirable. The risk retention rule in the Dodd-Frank Act threatens to have

---

[178] *Id.*; *see also* Section 15G(c)(1)(G)(i) (directing there should be "a total or partial exemption of any securitization, as may be appropriate in the public interest and for the protection of investors").

[179] *See* 76 Fed. Reg. at 24167-72 (Proposed Rule §§ __.16 - __.20).

[180] Congress did craft one express exception regarding education financing in Dodd-Frank. That exception mandates that any securities "defined as a qualified scholarship funding bond in section 150(d)(2) of the Internal Revenue Code of 1986" should be exempted from risk retention. Section 15G(c)(1)(G)(iii). This exemption for one type of education security does not, however, mean that nonprofit lenders are necessarily securitizers as that term is used in the Act. At least theoretically, it is possible for a nonprofit to utilize the more familiar two-tier SPV structure described earlier even though nonprofit student lenders do not do so in practice. The exception is therefore best read not as expressing Congress's judgment that typical student loan transactions should be subject to risk retention but rather as the view that a particular type of bond is safe even when asset transfer mechanisms are used.

at least one such unforeseen negative result: If applied to nonprofit student lenders, the requirement would, in tandem with the rule that nonprofits cannot retain surplus revenues, foreclose the lenders from obtaining the capital they need to issue new loans. The resulting disappearance of nonprofit lenders from the student loan marketplace would force students to scrounge for fewer, and more expensive, gap-bridging loans, driving some students out of higher education entirely. Given the central nature of higher education to the welfare of individuals, American society, and the national economy, this is not a result Congress could have intended.

It is also not a result we need to accept. Because of the structure of most student loan transactions on the capital markets, there is no practical need to apply Dodd-Frank's risk retention requirement to nonprofit student lenders. There is also no statutory need to do so, because of the Act's definition of "securitizer" and the broad power of the implementing agencies to craft exceptions to that requirement. To preserve students' access to affordable gap-bridging loans, the agencies should use one of these rationales to exempt student loan bond offerings that do not involve any transfer of asset ownership from the risk retention rule. Any other course poses too much risk to us all.