

Merchants of Opportunity: Risks and Rewards

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One doesn't so much talk with Raza Khan and Vishal Garg about their new student loan company, known by the marketing friendly name of MyRichUncle, as try to follow along as they unspool their theories of human capital formation, risk transference, market inefficiencies, and what they call natural versus artificial financing. They're both 28 and handsome, wearing jeans and sweaters during an interview in a conference room of their Midtown Manhattan offices. They are fashionably, even a bit insolently, scruffy, young entrepreneurs poised on the cutting edge of what is the highly lucrative and increasingly crowded business of student loans. Only those who haven't noticed that average college tuition seems to be rising just slightly slower than the price of the Iraq war while limits on subsidized loans have barely budged since the Reagan Administration will think that last sentence sounds odd. But students, their parents, anyone who Googles "student loans" and, as one former industry executive put it, "any venture capitalist doing his or her job," all know that the business of loaning money to college students is in the throes of an entrepreneurial spasm.¹ And Khan and Garg are right in the middle of it, taking out ads in the *New York Times* that question the integrity of colleges and financial aid officers and their competitors and accusing them of conspiring in a "racket" that harms student borrowers.

Khan and Garg exude the confidence of young people with talent, ambition and energy who think they have a superior idea that's obvious to them but that the rest of the world has failed to see. Their earnestness borders on idealism. They believe their way of helping students attend college – by providing the most deserving with private credit – will serve the public good by unleashing talent. But make no mistake. They also are in it

to make money. “This is going to be a huge, huge market,” Garg said. “There’s a massive amount of opportunity in this space. We’ve barely scratched the surface.”

When President Lyndon Johnson in 1965 proposed federal guarantees and incentives to get private lenders to loan money to students to help them attend college, he was arguing that the country would benefit from investing in the intellectual and vocational potential of its young people. Loans backed with federal guarantees have been the major source of tuition assistance ever since. But, increasingly, entrepreneurs, banks, specialty finance companies, debt collection companies and others are betting that private credit, which turns out to carry the potential of greater rewards for the companies involved as well as greater risks, will play a bigger and bigger role in helping students get their degrees. Meanwhile, though, concerns are growing among stock analysts, some industry insiders, student advocates, educators and borrowers themselves that the cost of that private credit will do exactly the opposite of what it was intended to do, and squelch potential by saddling borrowers with unmanageable debt loads.

Khan and Garg grew up in Queens, and met at Stuyvesant High School, the downtown Manhattan exam high school for math, science and technology that’s tougher to get into than Harvard. They were classmates in an economics class taught by a legendary Stuyvesant teacher that left a lasting impression. Both attended New York University on academic scholarships. Showing their entrepreneurial instincts early, both started businesses while students. Garg traded equities on the Hong Kong stock exchange and then, right after college, co-founded a \$125 million technology investment fund that bought stakes in call centers in India and other emerging businesses. Khan launched an Internet marketing business called Silk Road Interactive.

After college, the friends would get together for dinner and talk late into the night about what they now call their “far-out economic” theories. Garg was reading essays by Ronald Coase, the economist who in 1937 wrote an article called “The Nature of the Firm” that first identified what are today called “transaction costs” and argued that companies are the size they are because that’s the size that’s necessary to cover their sales costs – marketing, distribution, transportation and so on. That became one of the most widely cited economics articles ever and in 1991 Coase won the Nobel Prize. As Garg and Khan discussed Coase’s ideas, they realized that, while investors or banks could get access to capital, via loans, individuals couldn’t attract capital investments in their own futures. Their parents could get loans or the students themselves could get loans their parents cosigned, based on their parents’ incomes. But, outside of government-backed loans, which limit how much students can borrow, students who needed extra money were mostly stuck. “We wanted to try to address the inefficiencies that existed in the marketplace for human potential,” Khan said.

Buying equity in individuals has long been championed by economists at the University of Chicago including Gary Becker, Richard Posner and Milton Friedman. Just as stock in a company becomes more valuable if the enterprise is successful, an investor who buys an equity stake in an individual earns more profit if the individual succeeds and earns a big salary. The idea, Garg said, “struck an emotional chord.”

“If you found the right demographic and put small amounts of capital in lots of different people with a model of forecasting what their incomes would be and what percentage of their income to buy, you could create a new market,” he said.

As Friedman, another Nobel laureate economist, said, “There is considerable empirical evidence that the rate of return on investment in training is very much higher than the rate of return on investments in physical capital.”

Khan and Garg joined forces in 2000 to found a company called Iempower to act on their ideas. “We weren’t interested in student loans,” Khan said, implying that they were looking to do something with their creative and intellectual gifts – immediately evident in person – that would be more interesting and make a bigger mark on the world. “The goal originally was to use this mechanism to radically change the way people fund their educations.”

Their seemingly implausible pitch was received with enthusiasm on the campuses of selective private schools up and down the East Coast that they visited in a battered station wagon. They quickly “invested” all of their own capital as well as several hundred thousand dollars they had raised from family members and \$3 million from Michael Roberts, the inventor of MP3 players. Even so, they had a hard time persuading stodgy investment banks and venture capital funds that their theories were sound. To keep cash flowing they gingerly dipped a toe into the more traditional business of student loans, at first just by referring students to more lenders in return for a finder’s fee.

They did not abandon their belief that they could figure out which students were better credit risks – or, to use their term, investment prospects – than others. They had built a model for analyzing the relative risk of student borrowers by assembling a team of 15 actuaries and data researchers who mined statistics at various colleges on earnings of alumni, starting salaries in various fields, default rates and then added in factors such as grade point average, extra-curricular activities and even motivation and imagination.²

Khan said it was a “massive research project to unearth every possible piece of data to understand income, post-education. Initially, we weren’t interested in education lending. But right off the bat, we wondered why interest rates on education loans weren’t done this way. We assumed the players out there were smarter than we were and had already done this. But they hadn’t.”

“What we realized was that banks weren’t making student loans, they were making loans to the government,” Khan said. He was referring to the fact that almost all student loans, at least to that point, were backed by government guarantees that ensured companies a profit margin and also insulated the lenders from most risk. To Garg and Khan, such guarantees, along with other practices by lenders designed to win them beneficial treatment from colleges, skewed the market and tended to make it sloppy and costly. “We said we can do this better. And the first way is to charge less to students who are better credit risks.”³

Opportunity Regulated

For most of the 40 years since the government began guaranteeing students loans, the business has been anything but innovative. College financial aid officers were gatekeepers who told students how much they could borrow. The industry was essentially a government-regulated private utility that generated predictable profits based on regulations rather than competition. What that utility delivered was opportunity, rather than electricity or water, in the form of loans offered at lower rates than would have been possible in a purely commercial market. The federal government assumed most of the risk of default, guaranteed lenders a profit and assured investors who were the ones who actually put up the capital that they would be repaid. Banks loaned the money but did

little to market the products and didn't want the low-margin loans on their balance sheets. So the loans, and the income stream they generated, were quickly sold off, mostly to Sallie Mae (formerly known as the Student Loan Marketing Association), established in 1972 by the federal government just to buy up student loans. Sallie Mae created what is called a "secondary market" that purchased loans using cash raised by issuing government-backed bonds.

That whole infrastructure was based on one assumption: without incentives and safety nets, and the involvement of the federal government, the private sector would not be willing to risk lending money to 18-year-old undergraduates or 22-year-old graduate students at reasonable rates. After all, the only marketable asset that most students have is intangible, which is to say, the skills and knowledge they are acquiring on campus.

But the demand for loans to pay for college is growing rapidly. The causes are many. College-going has gone up steadily as more students recognize that a high school education is all but a dead end and so seek additional education. For the past decade, average tuition has risen almost twice as fast as family income, a trend a federal advisory committee concluded that, were it to continue, would put college financially out of reach for two million qualified students by 2010.⁴ Meanwhile, the growth in federal grants to students based on financial need has slowed relative to higher education costs. More and more institutional aid is used to lure high-achieving students rather than to ease the financial burden of college on middle-income students. MyRichUncle estimates what it calls the "funding gap," the difference between the price of higher education and all sources of outside assistance, at \$100 billion.⁵ Others are more conservative, estimating that gap at less than \$60 billion.⁶ Still others shoot higher, saying the true number is \$130

billion.⁷ Whatever figure is correct, that gap is growing and families are making up the difference with borrowing, whether from the government or private sources. But the government-backed loans are not keeping up. The ceiling on the amounts students can borrow has barely budged, now just over \$23,000 over five years.

That situation – excess demand, insufficient supply and little appetite in D.C. for addressing the mismatch with public funds – seemed to invite an aggressive capitalist response. Increasingly, that response is what MyRichUncle specializes in, alternative or private loans. The interest rate of the loans is adjustable and based on the credit rating of a student and, often, a co-borrower. There are no income limits, making the loans attractive to middle-income borrowers. The private loans allow students to borrow far more than federally guaranteed or subsidized loans—in some cases up to \$50,000 per year and \$200,000 over four years, for graduate students. The additional money can be used for travel back and forth to campus, in some cases to buy a computer, books, dorm furniture or even to cover previous education-related debts. Rejection rates have been high, as high as 70 percent or even 80 percent, at least without a co-signer, according to research done by MyRichUncle. At the same time, however, colleges, especially higher priced colleges with small endowments and trade schools that charge, say, \$30,000 or more to learn to become a chef, are pushing lenders to open their wallets wider.

Researchers at the Institute for Higher Education Policy, in a 2003 report, said private education loans make it possible for students to choose the schools “they *want* to attend, rather than schools they might *have* to attend” for financial reasons. The report also said that private loans, which fill the gap between financial aid and tuition, help students who are struggling academically and thus lose eligibility for federally

guaranteed loans to continue attending school. The report also said that these loans are taken out so that students or their parents can maintain their current lifestyle and not drain savings or forego vacations.⁸ Whatever the reason, private loans are in demand. The College Board estimated in 2003 that private loans accounted for 18 percent of higher education borrowing. That percentage has continued to rise.⁹ But little information is collected about the private loans outside of the proprietary information kept by lenders so it's hard to know how much students are borrowing. Some worry that the borrowers don't always know what they're getting into. That has prompted some in the industry to call for uniform disclosure of rates, as is required for mortgage loans, so that borrowers can better evaluate competing loan programs.

Consumer Choice

But most in the industry believe in the genius of the consumer and the marketplace. Individuals, not the government, not financial aid officers, should determine how much they want to borrow and from where. "Financial aid officers didn't want private loans from the beginning," said Catherine Reynolds, a pioneer in the private loan industry who now heads up a lender called EduCap, which advertises on television and in magazines for its Loan to Learn program. "They're like real estate agents. They want to control the transaction. I love the empowerment of the individual. You have to empower individuals, require transparency and give them choices. They know their needs."

Loan to Learn's marketing efforts are casting a wide net. Instead of targeting only the relatively well-to-do with significant assets to back up the education debts, Loan to Learn and Sallie Mae and other lenders are reaching out to students who are headed to community college or trade schools. Obviously, such students, no matter how well they

do in school, are not likely to end up in highly paid professions. And because of that it is those students who are charged the most for the loans because – and this is the irony – they are the least likely to pay the money back. According to a new website aimed at bringing transparency to the costs of private loans by comparing fees and interest rates, Loan to Learn could charge a community college student in New Jersey with no co-signer, for example, a 19.37 percent interest rate.¹⁰ A community college student borrowing \$20,000 at that rate would end up paying back \$106,000 over 20 years, making monthly payments of \$439 per month. Those rates could go even higher, because the interest rates are adjustable and as money becomes more expensive, former students' loan payments will go up. The rates for government guaranteed loans are fixed at 6.8 percent but might not allow a student to borrow enough to cover his or her costs. Moreover, the private loans lack many of the safety valves of federally subsidized or guaranteed loans. Repayment of private loans cannot be deferred if a borrower becomes ill or unemployed or cancelled altogether in the case of permanent disability. Bankruptcy isn't an alternative either, as, by federal law, the loans cannot be discharged.

“We have to be mindful of young people obtaining a lot of debt and managing that debt,” Reynolds said. “We already see as a society that we are saving less and less and that people are growing more and more comfortable with it. But from a philosophical perspective, if there's a need, then we should fulfill it.” Besides, Reynolds argues, borrowing money for education is a smart move, because “education is the best investment.”

But Doug Dolton, who, as president of Servus Financial Corp. once worked for Reynolds, is less sanguine. The high interest rates lenders charge “students who have

marginal credit...will be crippling in the long run” both to the individuals and to the nation. “The cumulative impact on this next generation, if they are financing a significant portion of their education with private loans, is not where we should be as a country. It’s bizarre to me.”

A Successful Launch

Since it was formed MyRichUncle has attracted hundreds of millions of dollars in working capital. Early investors were leery of over-reliance on an unproven underwriting process to decide who to lend to and at what rates, wanting the country to give more weight to borrowers’ pasts, or, in other words, their credit histories and income ratios. But in the spring of 2006 the company raised \$100 million that will be loaned using MyRichUncle’s model for predicting the future of borrowers. That will allow them to reach out to students who have never previously borrowed a dime and who do not have a rich co-signer but who, for example, are attending M.I.T. and studying bioengineering and therefore can be presumed to have a good chance of earning a healthy income.

MyRichUncle also is developing new products, offering loans specifically for students to live on while they’re studying abroad or completing unpaid internships. And, perhaps most revolutionary of all, the company is competing for business by offering lower interest rates than it could legally charge on federally guaranteed loans, which it also offers, as well as some of the lowest rates in the industry on private loans. It appears that in the case of MyRichUncle the innovativeness and competitive spirit that we often consider characteristic of the private sector is serving students well – at least those students the company considers worthy.

Khan, MyRichUncle's president, and Garg, the company's CFO, work out of 30th-floor offices just up the Avenue of the Americas from Bryant Park in Manhattan. "We grew up around people who were academic and who had the drive to become successful, but had to find a way to finance their educations and pursue their career goals," Khan said in an interview. "Our friends were people who had choices. They could go to Dartmouth or Cornell or Columbia or Baruch." But, like Garg and Khan, most of their friends could attend high priced schools only if they could find the money to do so.

MyRichUncle's approach is to find students of great promise, like themselves and their friends, and then charge them an interest rate that is generally lower than their competitors. If they guess right, they'll still make plenty of profit. Other lenders, including many that are just now jumping into the private loan business, try to use traditional underwriting criteria to minimize their risk. But they want to lend to as many customers as possible, to increase their profits. That means they can't be as choosy as they might like in deciding who to lend money to. So, to cover possible losses, they boost their interest rates. Many in the industry are watching closely to find out which approach works best.

An Explosion of Choices

In summer 2006 the website www.finaid.org listed no fewer than 33 purveyors of private loans. The industry publication *Greentree Gazette* in May 2005 printed the names and products of 76 lenders. Only eight did not offer private loans. It was estimated that in 1997 students could choose from 79 different private loan programs with varying prices and conditions; by March of 2003 it was estimated that companies were offering 272 different private loans to choose from, based on interest rates, eligibility rules and

repayment terms. That number has multiplied since then and where once most of the companies involved were not-for-profit service agencies now for-profit companies are shouldering their way into the mix. “This is not your father’s student loan business anymore,” said John Hupalo, executive vice president at First Marblehead Corp., a highly profitable, publicly traded company that specializes in designing loans, buying loans made by others, and selling shares of the cash stream generated by payments on those loans to investors.¹¹

Over the past decade, private loans have grown in value from about \$1 billion a year to \$19 billion.¹² Projections show the market for private education loans exploding to more than \$80 billion within a decade.¹³ (In comparison, the value of the total federal subsidized loan program this year is about \$60 billion.) A decade ago, most of the private loans were taken out by graduate students going into relatively well-compensated fields such as law, medicine, dentistry or business.¹⁴ These days, undergraduates attending high priced private schools, students attending school only part-time or who are not passing enough courses to remain eligible for federal loans, community college students and students enrolled in private, for-profit trade schools, some of them little more than fly-by-night diploma mills or bait-and-switch storefronts, are all taking out private loans. The demand has translated into 25 percent, 30 percent or even 40 percent annual growth in the volume of private loans in recent years. Private loan volume now exceeds that of government-guaranteed PLUS loans to parents.

That’s translating into big profits for lenders and for some of their executives, some of whom have pulled down tens or even hundreds of millions of dollars in salaries and stock options from the outwardly staid student loan business. Also in the money are

marketers of loans that collect a fee from the lenders themselves; syndicators of loans who profit from rounding up investors and then profit again by making sure the investors are repaid; servicers of loans that perform the basic but lucrative ABCs of accounting, billing and collecting; customizers of loans, who calculate risk, set the interest rates and design software and then turn the package over to a marketer or a bank; guarantors of loans, who collect a fee when a loan is made to build up a reserve fund to cover losses; the higher education equivalent of repo men, the companies that strong-arm borrowers into repaying even when they are disabled or unemployed; and, finally, the colleges themselves, which profit by racking up referral fees paid by the lenders or by cutting advantageous package deals that give certain lenders “preferred” status on their campus.

The Players

Industry leaders include Sallie Mae, which became a fully private, publicly traded company in 2004, in a move designed to let the company compete more effectively in a rapidly changing industry. Sallie Mae not only makes loans, it raises money from investors to loan, buys loans, oversees repayment, and earns fees for collecting from delinquent borrowers. Sallie Mae’s net profit in 2005 topped \$2 billion and its stock has risen by 1,900 percent since 1995, leading *Fortune* magazine to call the company a Wall Street “superstar.”¹⁵ A quarter of Sallie Mae’s 2005 income came from its holdings of \$19 billion in private loans. The company said its private loans were more than three times as profitable as its much larger portfolio of federal loans.¹⁶ Big banks including Citibank, Wells Fargo, and Chase are all lenders and all have purchased pioneer companies in the field, so that they, too, can profit from different aspects of the loan process. The Access Group, founded in 1993 to provide private loans to law students, in

2006 loaned \$1.8 billion to graduate students, especially those attending law, dental, medical or business schools. About \$800 million of that was in private loans, making it the largest private lender after Sallie Mae.¹⁷ Another important and highly profitable company is First Marblehead, based outside of Boston. The behind-the-scenes company has set the terms – rates, maximum amount borrowed, borrower qualifications and so on – for more than 680 loans that are sold by 64 non-profits, private companies, banks and other private lenders. First Marblehead, too, has begun offering loans itself.

The biggest source of the company's income is the fees it earns for raising money from investors to buy loans from lenders and to make new loans. The source of the money for those investments is what is known in the field as "asset-backed securities." Anyone who has taken out a mortgage to buy a house knows that the lender that originally loaned the money often passes the debt on to another company. That's why you might start out making payments to your local bank and soon be writing checks to some other company entirely. Basically, mortgages are bundled together into "trusts" and then are used as collateral to borrow billions of dollars from investors. The investors then receive a share of the money you and thousands of other homeowners pay each month. Cash-generating assets used as collateral for those securities have included everything from apartment leases and auto loans to royalty payments on the music of James Brown and David Bowie.¹⁸ And, starting in 1991, private education loans.

Securitization, as the process is known, lowers the costs of borrowing. First Marblehead did not create that process but it perfected it and each year it issues billions of dollars in such securities. First Marblehead's profit margin through the first half of 2006 was 41 percent.¹⁹

The largest guarantor of loans in the country is called USA Funds, which is a non-profit that is generating hundreds of millions of dollars in fees for making sure that both federally backed loans and private loans are being repaid. The service is so lucrative that the non-profit is trying to find ways to spend all of its cash. Other companies, such as the Great Lakes Educational Loan Services or Affiliated Computer Services, process loan payments. ACS, as it is known, processes payments for more than 800 colleges and lenders, handling 5 million accounts and more than \$31 billion in debt.²⁰ All aspects of the private loan business can generate profits and that is why banks and other companies are trying to perform as many of those services themselves as possible. One executive, the president of a large higher education lending company that is just getting into private loans, summed up the goal of many in the industry when he claimed to stock analysts in March 2006 that “what we have is a vertically integrated education finance company.”²¹

Tiny Start Up With Interesting Name

In that league, MyRichUncle is tiny, with only \$24 million in loans outstanding. But like David, the company is fearlessly standing up to industry Goliaths. One of the company’s best assets is its name. Back when they were still trying to sell the idea of investing in individuals Garg and Khan were wracking their brains for ways of explaining the idea to investors. One of them suddenly flashed on the idea that “it’s like getting money from a rich uncle, not like going to a bank,” Khan recalls.²² The business partners bought the rights to the Internet portal name “MyRichUncle” for \$18,000 from a Florida man. “It seemed like a lot at the time,” Khan says.

The name gives the company a recognizable brand in a marketplace crowded with such uninspiring names as “Collegiate Funding Services,” “The Student Loan

Company,” “StudentLoanExpress” or “The Student Loan People.” To build on the distinctiveness of the name, the company’s website (www.myrichuncle.com) features the company’s iconic avatar – an invisible man wearing a black suit, tie and a bowler sporting a red star iconic – and blunt, no-spin rhetoric. (“We know your pain.” “Debt is no laughing matter.” “We’re not here to rip you off.” “Yeah, we need to be profitable but only so we can still be here next year.”).

“The information should be obvious, instant and exciting,” Khan, the former Internet marketing executive, said of the website, which the company, like other lenders, expects to generate a healthy share of its business. “We want to make it ‘pop-digestible,’ as easy to understand as soap.” Other lenders’ websites place more emphasis on how easy it is to borrow and feature pictures of beaming students, seemingly thrilled to pay double-digit interest rates. Commercials for Astrive loans, which is funded by Charter One Bank, shows attractive, active young people happily talking about how easy it is to sign up for a college loan of up to \$30,000 and stresses that the money will show up within five days. No interest rates are mentioned. The website called www.educatedborrower.com, which is sponsored by The Student Loan Corporation, opens with a video of a couple appearing to be in their 40s, a shimmering swimming pool and the rear of a large, suburban home over their shoulders. “It’s easy to put your kids through college these days,” the smiling mother says, her voice dripping with irony. “No more vacations. No more shopping.” Not to mention, the father says, “draining your 401k.”²³ The couple says they both have business degrees but they couldn’t figure out the federal financial aid forms. So, they turned to a private loan which was quickly approved. “Smaller payments would be ideal,” the father says. “That we could afford,” says the mother, finishing his statement. Astrive

is the name of a private student-loan. The website says that a typical \$10,000 loan would cost more than \$18,000 to repay over 20 years at the lowest possible rate of 7.89 percent.

But many companies, as with many credit card solicitations, boast of the interest rates they offer to borrowers with the very best credit and applicants won't know how much they're paying until they actually receive the loan. MyRichUncle, on the other hand, puts the interest rate up front and even compares it to the interest rate, payments, and total cost of a loan at another company. Company officials say the loan they use for comparison purposes is one offered by a number of lenders and created by First Marblehead. Moreover, MyRichUncle's website tells its users that the example it features is for a student with good credit. A borrower whose credit is excellent and who has a co-signer will get an even better rate.

In October of 2004 MyRichUncle secured \$50 million to start its own loan guaranty agency. That's like an insurance fund in which borrowers pay a small fee up front and lenders lower their interest rates, knowing that if the student defaults the loan will be repaid out of this fund. In early 2005, the company announced it had received \$300 million from a major Japanese investment bank to use for loans. In 2006, the company lined up \$175 million from Merrill Lynch and then \$100 million from a German company, Universal Finanz Holding Co. Stock analyst Audrey Snell of the firm ThinkEquity Partners wrote in a February 2006 report that MyRichUncle is one of the fastest growing private student loan companies. She predicted it would lend more than \$1 billion a year by 2009.

Underwriting Breakthrough

She said the company's method of evaluating the creditworthiness of borrowers is "an important breakthrough in underwriting." Instead of looking at what students might earn in the future, competitors' methods for deciding whether to loan to a particular applicant and at what interest rate were "retrospective, homogeneous and one-dimensional," meaning that they treated all potential borrowers alike and looked backward instead of ahead.²⁴ Other analysts have been more cautious, saying that the method is not yet proven. Such doubts have kept MyRichUncle from using its method of evaluating risk as much as Garg and Khan would like. Only the \$100 million raised from the German investors can be loaned solely based on MyRichUncle's innovative methods. But the company hopes to expand by being able to "securitize" those loans, which means selling an interest in the income from the loans to investors. Analysts say such an offering might be as much as \$1 billion.²⁵ In April 2006 the company had a market value of about \$135 million of which Khan and Garg each controlled about 13 percent. They were at that time on the verge of being listed on the Nasdaq, which would attract investors and fuel further expansion.

Even the most cautious of the stock analysts believes that MyRichUncle's risk analysis method, if it works, would give the company "an unmatched ability to customize products for applicants" and increase sales.²⁶ The company acknowledged that during its first year in business, and operating only with the funds it had been able to raise from outside investors, it approved only 20 percent of the applications it received. The company looked for borrowers with good credit, with a co-borrower, and attending a school where a high percentage of student borrowers repaid their loans. In the spring of

2006 the company announced what it called its Preprime loans, which apply in the real world the theories that had fascinated them in the first place—the possibilities of estimating students’ potential. The company expects that the percentage of loans approved will triple or even quadruple under the Preprime program. The company also expects to charge more for those loans, although far less than the top rates charged by other companies.

In June 2006 MyRichUncle announced that it was cutting the interest rates it would charge for traditional student loans backed by the federal government by 1.5 percent to 2 percent. Garg, the company’s chief financial officer, says MyRichUncle is able to cut rates because it has rejected industry practices that add to costs and that the company publicly likens to what it calls “payola,” “kickbacks,” and, in advertisements in the *New York Times*, a “racket.” The company’s website urges borrowers to “ask the right questions” and “save thousands.”

“Your school’s Financial Aid Administrators may be overworked and underpaid, and may recommend lenders that make their lives easy, rather than lenders who offer the best loans,” the company’s website declares. “In fact, some schools accept flat-out cash to refer you to certain lenders.”

What that refers to is “preferred lender lists” that most schools keep. To get on the lists, lenders offer services, such as software for keeping track of loans, or even promises to provide loans to students that the college wants to attract but that otherwise would not meet the lender’s underwriting criteria. Indeed, according to Jacqueline King, an expert in financial aid at the American Council on Education, colleges put out “requests for proposal” that specify the interest rates and other services the lenders are expected to

provide in order to be recommended to students.²⁷ Lenders are asked to create “opportunity pools” that will provide loans to students who would otherwise be considered too risky. MyRichUncle contends that lenders pay colleges “kickbacks” for each loan its students take out and its website urges student to ask if the college accepts “payola” in the form of trips, gifts or other inducements from lenders. Other lenders make the same charges, privately at least. But MyRichUncle is the only one to have made the claims in full-page ads in the main news section of the Sunday *New York Times*.²⁸ In June 2006 the company stepped up the pressure, and took out a two-page ad to make blunt accusations regarding the lending practices of Sallie Mae, suggesting that the company cut deals with colleges under which it loaned money to students who were more likely to default in return for the school helping it peddle its services. “The school profits from the extra tuition received from that student,” the website says, “and the lender profits from all the borrowers it receives thanks to the school.”²⁹

Garg said that MyRichUncle doesn’t engage in such practices and is able to save money that it passes on to borrowers, in the form of lower rates. “We have been extremely strategic and disciplined in growing our business, and that efficiency has placed us in an exceptional position to fund students with innovative products and better rates.”

The ad repeated charges that had been widely discussed in the industry and even in such publications as the *Chronicle of Higher Education*.³⁰ But it ruffled feathers in financial aid offices, apparently. David R. Gelinas, the financial aid director at the University of the South told the *Chronicle* that as a result of the ad he refused to see a sales representative for MyRichUncle. Another financial aid officer predicted a

“backlash” against MyRichUncle. And a comment on the weblog called Generation Debt from a financial aid officer said that “it wouldn’t be a huge surprise to hear that a few MRU applications accidentally got put to the side or in the recycling bin instead of the filing cabinet this year.”³¹

Getting to be a Preferred Lender

For its part, a Sallie Mae spokesman said he was not aware of the practices described by MyRichUncle. In particular, he said Sallie Mae would never ignore its usual standards for deciding who should receive one of its private loans, just to get on a preferred lender list. But in 2002 Sallie Mae approached Pace University, which has campuses in New York City and Westchester County, New York, with a deal. Sallie Mae offered Pace \$4 million in private loans to needy students who had had credit problems if the school would agree to drop out the federal “direct” loan program.³² That program shuts private lenders out because the schools loan federal money without going through a middleman such as a bank or Sallie Mae. Sallie Mae officials have told stock analysts that they are “very ambitious” about getting such schools to abandon that program and let it become a college’s preferred lender instead.³³ Federal law prohibits companies from “offering, directly or indirectly, points, premiums, payments, or other inducements to any educational institution or individual to secure applicants” for federal loans.³⁴ But Sallie Mae and other companies do give schools free software and other services to sweeten the pot and competitors contend that tickets to sporting events, golf trips and other niceties also come into play.

Although Sallie Mae is by far the largest, other lenders also are trying to attain preferred status at as many schools as possible. Alicia D. Hurley, an administrator at New

York University, told the *New York Times* in 2006 that she was being approached by many unfamiliar companies asking to be put on the school's preferred list. "It's quite a market out there," she said. "These companies put a lot of pressure on the institutions" by offering price breaks and extended payment terms.³⁵

The lists may serve the interest of the schools but students don't always benefit. In 2002, the *Wall Street Journal* conducted a study of schools' preferred lenders and found that very often students can find better deals on federal loans elsewhere.³⁶ But if lenders can get on schools' "preferred" list for federal loans, it gives them a foot in the door to provide the more highly profitable private loans. In fact, Sallie Mae officials acknowledged in an interview that "the federal loans are something you do to get the private loans" because the private loans are three times as profitable.³⁷

Sallie Mae was established by Congress in 1972 with a single purpose, to issue government-backed debt to purchase government-subsidized loans from banks and other private lenders. By the 1990s, however, the loan business was changing rapidly and the guaranteed profit on government loans had begun shrinking. Moreover, during the Clinton Administration, the federal government launched the direct loan program as a way of lowering the government's costs. Instead of paying fees to Sallie Mae, guarantors, processors, bad debt collectors and others, the government would loan the money directly and the interest students' paid would more than cover the government's costs of borrowing the money. In addition, a provision to reduce what had become double-digit default rates in the early 1990s allowed students to "consolidate" their loans at a lower interest rate. Sallie Mae and every other company involved in the federal loan programs

in whatever capacity unleashed a furious lobbying blitz in Washington in opposition to the direct loan program. They also worked to find other sources of profit.

Sallie Mae, because of its limited charter, could do little to find new sources of revenue. In 1996, Albert L. Lord, who had become chairman and CEO of Sallie Mae, persuaded Congress to let the company transform itself from a purchaser of government-backed student loans into a wholly private, for-profit entity. With its new status, Sallie Mae would be able to not only purchase loans from banks and other lenders but also make loans on its own and charge a variety of fees. Rather than start a marketing arm from scratch, Sallie Mae went on a shopping spree for companies and non-profits already in the loan business. “Our goal is not to be buying loans in the marketplace,” Lord said in June 2000 when announcing the purchase of USA Group, which included the nation’s largest guarantor of federal loans.³⁸ Sallie Mae paid \$400 million in cash and \$370 million in stock for the company, which included several for-profit subsidiaries that marketed and purchased both public and private loans. The purchase eliminated one of Sallie Mae’s largest competitors and gave the company the ability to control all aspects of the loan process, from making loans to guaranteeing them to collecting on them.³⁹ Previously, Sallie Mae had purchased two other nonprofit lenders: Boston-based rival Nellie Mae and a Cincinnati-based company called Student Loan Funding Resources.

As of spring 2006 Sallie Mae held \$130 billion in student loans and had more than 10 million customers. Sallie Mae issues or buys from other lenders about 25 percent of the federal student loans in the country and in 2005 was responsible for \$6.5 billion in private student loans, a third of the private loan volume nationally and a 45 percent increase from a year earlier.⁴⁰ Its profit margin in 2005 also was 45 percent. Students

borrowed most of that money from banks such as Citizens Bank or Fifth/Third bank or one of the other 150 banks that are business partners with Sallie Mae. Under agreements with the banks, Sallie Mae then purchased those loans and began collecting the payments. But in order to capture even more of the potential profit from private education loans, Sallie Mae in 2005 began offering its own Tuition Answer private loan that it markets directly to students rather than through banks or the schools themselves. In just a year, Sallie Mae doled out \$850 million in Tuition Answer loans and the company expects that amount to grow by 25 percent to 30 percent annually.⁴¹

Sallie Mae: the Bete Noire of Student Lending

Sallie Mae's size, aggressiveness and outsized profitability in a field that most Americans believe is supposed to serve the interests of both the individual and the public at large in having educated citizens has turned heads and made it the bete noire of the student loan business. The company has been criticized for aggressive lobbying efforts that have included hundreds of thousands of dollars in political contributions as well as cozying up to members of Congress such as House Republican majority leader John Boehner, flying him by private jet to Florida to play golf at private courses with Sallie Mae chairman Albert Lord. The fees it charges, which can triple the amount students have to repay for their loans, also have made it a target of protests. In 2005, the newspaper in Allentown, Pennsylvania reported on the case of a private, two-year college that saddled students with expensive private loans rather than cheaper federal loans to pay tuition for programs such as massage therapy or auto mechanics. Sallie Mae acknowledged to the Pennsylvania House Consumer Affairs Committee that it charged those students an average interest rate of 13 percent. But loan documents obtained by the newspaper

showed that, with supplemental fees, Sallie Mae was charging students as much as 28 percent interest while they were in school. The company said it had to charge those high interest rates because the students at such trade schools can be bad credit risks.⁴²

The company says the average interest rate for its private loans is 9 percent; however, borrowers who are riskier are charged far more. Tom Joyce, a spokesman for the company, said the company offered “opportunity loans” for needy students who “fall through the cracks” and are not eligible for other loans, including federal loans. Such students, he said, may be enrolled part-time, have had credit problems or be unable to line up a co-borrower. Because of the increased risk of such loans, he said, Sallie Mae considers the quality of education offered by a school, in part by looking at the default rate of its students on other loans; how many loans are being made to students at that school, because more loans at a school means lower billing costs and more accurate measures of the likelihood students are to repay the loans; how many students at the school have been denied loans; and, finally, the size of the gap between how much it costs to attend the school and the other financial aid available.

The MyRichUncle ad in the *New York Times* in May 2006 echoed claims made about Sallie Mae a week earlier on CBS’ *60 Minutes* program. The intensity of the press coverage – articles in the *Village Voice*, *Forbes*, *U.S. News and World Report*, and elsewhere have made similar claims – has been such that Sallie Mae didn’t bother to offer up an explanation on camera for *60 Minutes*, with a spokesman issuing a statement saying that he did not think the company would get a fair hearing.

In response to the *U.S. News* story, Sallie Mae chairman Lord wrote a letter that said that “Our shareholders and employees have seen media distortions over our 30 years

but none so blatant as yours.”⁴³ Lord, who according to various publications received \$225 million in salary and stock options over nine years, said that “Taxpayers, schools and students have been well-served by private sector investment and competition in this era of spiraling college costs.”

A History of Private Loans

Private companies actually started getting into the student loan business before the federal government did in 1965, as part of Lyndon Johnson’s Great Society initiatives. But the challenge 40 years ago, when the first such efforts began, is the same as it is today: figuring out how to encourage lenders to give money to students, their careers yet to unfold before them, while insulating the lenders against losses. It’s not possible to repossess a college education.

In 1956, a group of Massachusetts bankers created a nonprofit corporation to guarantee loans made to needy college students. A \$1,000 deposit in a reserve fund would guarantee a \$12,500 loan because, just as with insurance, most borrowers would pay the money back. A Massachusetts state law authorized the loans but said all the money had to come from private sources, not the state treasury. About 15 colleges and universities and banks agreed to loan money through what was called the Massachusetts Higher Education Assistance Corporation.⁴⁴ The banks insisted on the reserve fund to shield them against losses if borrowers died, disappeared or became deadbeats.⁴⁵ New York, Maine and Rhode Island soon passed similar laws.⁴⁶

In 1960 an organization called the United Student Aid Funds was created in Indianapolis to knit together the private loan reserve funds that had formed in many of the states. The idea was to find a way to persuade most banks to make the loans. That did

not go well. So, the founders of the USA Funds, as they became known, persuaded colleges to put up the reserve money to guarantee the bank loans. The fund then “took off like a rocket.”⁴⁷ By 1964, the funds had deposits from 600 colleges to guarantee loans offered by 4,000 banks and the funds were endorsing \$10 million in private loans each year.⁴⁸ The federal government then got involved by guaranteeing lenders a profit, subsidizing interest rates and paying interest to the lenders while students were enrolled in college; the founders of the USA Funds were vehemently opposed. They feared that such government subsidies would encourage students to borrow too much and take out loans for convenience, rather than need.⁴⁹ Their protests were for naught, however. Soon, their private loans were no longer competitively priced and the loans disappeared from the student loan picture. Later, after USA Funds had expanded into a variety of businesses, including private loans, most of its assets were purchased by Sallie Mae.

A New Approach to Paying for College

By the mid-1980s, rising tuition had begun to price students out of expensive colleges and federal loan programs were not keeping up. It occurred to a Jesuit priest named the Rev. John P. Whalen in Washington, D.C. that the private sector might once again have something to offer. Whalen, who had been president of the Catholic University of America and the editor of the 15-volume New Catholic Encyclopedia, headed up a consortium of 12 colleges and universities in the capital. He persuaded the district’s City Council to issue \$50 million in bonds to raise money for loans to several thousand

students. Recognizing the broader appeal of the concept, Whalen formed a non-profit company to expand the service nationally.

Interest rates on the loans were above that of federal loans but far below what would be charged for standard unsecured bank loans. Borrowers had to have a certain income or decent assets. The money could be repaid over 15 years and be used for any educational expenses, including travel and computers, not just tuition, room and board and fees. Existing educational debts could be consolidated under the loan.⁵⁰

The rates were high but demand soared. Hundreds of companies, including UPS, AT&T, General Motors, J.C. Penney's, Ford Motor, Kmart and many others, signed up. But by 1991, the non-profit faced a crisis. For reasons having to do with international banking laws, the non-profit was running out of money. Catherine Reynolds, who, by then had become CEO, said ConSern was 60 days from going bankrupt. She said she was reading an article about how issuers of credit cards were bundling debt and using the package of loans as collateral to sell securities to investors. The purchasers of the notes would be repaid, with interest, with the cash flow from loan repayments. That process is now known as "securitization" and ConSern was the pioneer. Reynolds said she had to go before a rating agency and persuade it to create a new asset class. She said she closed the deal for an initial round of \$79 million in financing 57 days later and "set the standard in the industry."

In 1993, Reynolds, Whalen and a third business partner created a new, for-profit company called Servus Financial Services to handle all the processing and securitizing of the loans. Reynolds said the company served as EduCap's backroom operations in marketing, originating and servicing loans, a service for which EduCap paid Servus

substantial fees. Handling the mundane aspects of loans isn't glorious. Servus branched out and began carrying out the "back office" functions for Banc One and other lenders as well as EduCap.

Seven years later, Wells Fargo bought Servus, a private company, for an undisclosed amount. The move signaled the growing interest in mainstream banks in taking a more active, and more profitable, role in the student lending market, both public and private. Reynolds herself agreed to stay out of the education loan business for four years before launching Loan to Learn in 2006. Reynolds said she's trying to make the process of getting a loan as easy as she can – maximizing what she refers to as "customer delight" – by simplifying the application process and emphasizing customer service. But she acknowledges that she has to charge higher rates than other companies because Loan to Learn cannot count on the guaranteed profits that are generated by the federal programs.

Reynolds said that EduCap and Servus were the "catalyst[s], in my mind, for creating this industry that exists today. Banks wouldn't take that risk and it took this little nonprofit sort of chugging along like the little engine that could. 'I think I can, I think I can.'"

Investing in College Loans

Although Reynolds was the first to realize that it was possible to go to Wall Street to raise money for private loans, First Marblehead perfected the process and learned that it could be hugely profitable. First Marblehead was established outside of Boston in 1991 by Stephen Anbinder and Daniel Meyers, two securities traders, with the goal of helping colleges figure out how to raise private capital to cover loans made directly to students.

The colleges needed help analyzing the risk of lending money to a population of borrowers, which is to say, their students, such that they could set an interest rate that would ensure they weren't losing money. Unlike the private loans offered today, the colleges wanted to calculate a single interest rate that would average out of the risk of all of their students. Elite colleges had loaned their own money for a long time. But, they weren't very good at it. "Eventually, treasurers of colleges called a halt to it," said Ralph James, who was president of First Marblehead from 1995 until 2005.⁵¹ "Schools are good at some stuff but not good at being banks, getting promissory notes, counseling students on debt, collecting if collecting was needed." First Marblehead, James said, served as the "financial engineers that figured out the risk profile of a bunch of students at Clarkson University, which might be different from a bunch of students at USC, which might be different from those at Columbia."

A few years later, First Marblehead began designing its own loans, customizing the terms for different groups. The first market it targeted was families of students enrolled in prep schools. It added loans designed for the families of college students. Then it began developing loans for banks and companies to make, which First Marblehead would then buy, much as Sallie Mae bought government-backed loans. First Marblehead used the traditional measures of the parent's credit score and a loan-to-income ratio, as well as what it had learned from its earlier work with colleges about how likely students at different colleges were to repay their loans in order to figure out how much interest to charge. The goal of such calculations is to hit the sweet spot, such that investors are lured in, the company makes money, students are able to pay back the loans and everyone is happy.

The near-failure of another Boston-based organization, a non-profit known as The Educational Resources Institute, provides a powerful example of the importance of accurately estimating risk and how much to charge to offset it. TERI was established in 1985 to operate similarly to the way the USA Funds had operated years earlier. The source of the guarantee of repayment would be a reserve fund that would be created from fees paid to TERI by the lender. TERI would set the criteria for the loans it would guarantee and as long as banks or colleges used those criteria, they could have their loans insured, in a sense, by TERI.

Risk and Reward

But for all that, in the late 1990s, TERI stumbled with its risk estimates. A large percentage of TERI's loans had been made to law students, seemingly a good investment. But, when the market for high-priced associates went bust in the late 1990s, TERI was left holding the bag. The default rate soared to nearly 15 percent.⁵² By contrast, business school defaults are around 4 percent. As defaults rose, TERI's reserve fund hemorrhaged cash and appeared to be on the verge of insolvency. But TERI did have an enormously valuable asset – its data base of information about its borrowers, their record of repayments, incomes and so on.

Soon, First Marblehead came calling. In 2001, First Marblehead paid \$9 million for the database and its trove of information on \$9.5 billion in loans, according to First Marblehead's 2005 annual report. First Marblehead also agreed to pay TERI a quarter of the revenues generated by TERI-guaranteed loans. But, demonstrating how complicated this business is, TERI agreed to pay First Marblehead fees for processing the loans it

guarantees and for issuing securities to buy the loans and to free up the cast to make more.

Two years after purchasing the TERI database, First Marblehead and its founders and executives became fabulously rich. According to publicly available data, Anbinder, one of the founders, sold \$64 million worth of stock between May of 2004 and July of 2006 and he still held shares worth at that time \$164 million. Daniel M. Meyers, the co-founder, sold \$63 million of stock and still held stock worth \$320 million. Ralph James, who was the chief operating officer of the Harvard Business School when he decided to join First Marblehead in the mid-1990s, sold a total of \$60 million worth of stock in 2004 and 2005 and still owns shares worth \$28.6 million.⁵³

James is unapologetic about his success. Jumping from the business school to a new, unproven startup was a risk, he said in an interview recently. The hours were long and the money was uncertain. Four or five years after joining the company as president he still, at times, was writing personal checks to make payroll. But unlike the business school, he had a chance to earn equity in the company.⁵⁴

Today, First Marblehead and TERI are involved behind-the-scenes in private loans offered by Bank of America, JP Morgan Chase, Charter One, National City and other companies such as NextStudent, Total Higher Education, EdAmerica to name a few. All told, loans that meet TERI's underwriting criteria and that TERI insures are offered by 30 lenders and are available through 6,000 schools and colleges nationwide. About three-quarters of First Marblehead's company revenues come from selling interests in private label loans offered by a diverse range of groups. First Marblehead also earned fees from arranging to sell loans from JP Morgan Chase, Bank of America and

Charter One Bank. In an aside that demonstrated the intense competition for borrowers that's now underway, the company's annual report noted that Charter One, alone, is the actual lender for loans marketed by 26 different companies.

Business relationships, of course, come about because of and lead to, personal relationships. Executives play golf or tennis together share a cocktail, lunch or even dinner, while discussing deals and terms. In the fall of 2005, Daniel M. Meyers, one of the co-founders of First Marblehead, resigned abruptly after it was learned that he had given \$32,000 worth of gifts, including an expensive watch, to a student loan executive for Bank of America. During the 2005 fiscal year, First Marblehead had processed \$632 million of private loans for the bank, making it the company's second largest client.⁵⁵ The news of the relationship and Meyer's departure sent First Marblehead's shares tumbling to around \$22, close to a low for the year.⁵⁶

Later in the fall, it was reported that Bank of America would be ending its relationship with First Marblehead. Piling on the bad news, Collegiate Funding Services, a loan processor and marketer and a First Marblehead customer was purchased by J.P. Morgan Chase, First Marblehead's largest customer. That seemed to indicate that Chase would perform at least some of the services it had been outsourcing to First Marblehead and that Collegiate Funding Services might disappear as a customer altogether. In June of 2005, Collegiate Funding Services had announced that it was starting its own private loan program, which would mean that First Marblehead's services for some of that company's loans would no longer be required.

Despite all that negative news, First Marblehead's profitability, revenues and share price soared. The company announced in April of 2006 that it had reached a new

agreement with Bank of America that would enable First Marblehead to continue to earn fees for issuing the bonds to raise cash for the loans the bank marketed directly to students. Such arrangements are lucrative. In March 2006, First Marblehead announced that it was setting up a \$900 million “trust” to purchase loans and sell shares in the revenues to investors. First Marblehead expected to earn \$114 million from the trust, over the course of the loans’ repayment.⁵⁷ The source of the profit is the difference between the interest paid to investors to put up their cash and the interest paid by students. A new agreement was worked out in the spring of 2006 with Bank of America. By summer of 2006, new First Marblehead president Jack L. Kopnisky said the firm’s 2005 revenues had soared 74 percent and that the company was making a 49 percent return. According to the story in the *Boston Globe*, Kopnisky said the company’s success convincingly demonstrates that entrepreneurs who spot an overlooked business niche can do well.⁵⁸

The Lure of Profit

The growth of the private student loan business in general – and First Marblehead’s enormous profitability specifically – has compelled not just banks but membership organizations, unions, companies and non profits. One of those is the College Board, which is best known as the sponsor of the SAT college admission test and Advanced Placement classes and tests. The College Board also commissions research on education issues, including how much students are borrowing to pay rising tuitions. Since the early 1990s, however, the College Board has been marketing federal loans and, beginning in 2005, private loans. First Marblehead designed the terms of a loan program that the College Board markets to students and through college financial aid offices as “Connect Loans.”

Cynthia Bailey, executive director of the College Board's Education Finance Services Department., said the non-profit began offering student loans for the "altruistic" purpose of helping students and colleges. The "less than altruistic reason was there was a lot of money to be made," she said.⁵⁹

For many years, she said, the College Board resisted getting into the private loan business. But, she said, "it became clear to us in the past few years that... [an] alternative loan option has to be out there," especially for more affluent families whose children are attending high priced schools. "These days you can't not have an alternative or private loan; it's just where the business is going because federal loans...are woefully inadequate."

But Bailey acknowledged that another reason the College Board wanted to start marketing private loans is that it is paid a fee when students sign up with it for a private loan. Lenders typically pay marketers of loans a finder's fee or referral fee of 1 percent to 2 percent of the loan volume. Bailey said the College Board expects to sign students up for \$50 million to \$100 million in private loans over the next few years. That could generate a profit of \$500,000 to \$2 million.⁶⁰ "We look at it as money we wouldn't otherwise get," Bailey said.

Family and Friends in the Industry

Three companies in San Diego, all of which were started from scratch and have a connection to a single family, show how attractive student lending can be. In 1992, the chief executive of the Union Benefit Life Co., Robert deRose, and Marcus Katz formed the Education Funding Co. to market PLUS loans directly to parents. In 1997, deRose sold the student loan company to American Express. Marcus Katz went on to found a

company called the Education Lending Group with his son, Ryan. Cary Katz, Marcus' son, joined his father's company as a marketing manager.⁶¹ Cary then struck out on his own, starting College Loan Corporation and taking with him 10 employees of his father's company. In 2000, deRose jumped into the business again, hiring 40 people from his old company after American Express lost interest.⁶² That same year, Cary's brother, Ryan, founded an education finance company called Goal Financial.

The businesses have all been very successful. The company deRose founded went public and was purchased in 2005 for \$381 million by CIT Group, which saw the growth potential of student loans and wanted to get involved. At the time, deRose's company was managing \$4 billion in student loans and lending an additional \$1.5 billion each year. DeRose continues as the chairman and CEO of the company, which now markets all types of loans to students and their families under the corporate name of Student Loan Xpress. By 2006, Goal Financial had 250 employees and had a loan portfolio worth \$6.4 billion. It was the 7th largest loan company making what are known as consolidation loans, which are a way for students to refinance their education debt at lower rates. Goal Financial markets private loans issued by Wells Fargo and for the new loan program from EduCap, called Loan to Learn.⁶³

College Loan Corporation is the nation's seventh largest student loan company and now holds \$9 billion in loans. It expects to lend more than \$3 billion more in 2006.⁶⁴ The company handles government-subsidized loans and had been offering TERI-backed loans through First Marblehead. In 2006 it began selling its own private loans and even issued bonds to raise money to lend.

But unlike other loan companies – such as MyRichUncle – and loan marketers, Katz’ company is not trying to expand by signing up students directly. Instead, the company’s ultra-rapid growth has been driven by working through the schools themselves. The company has hired more than 70 former financial aid officers as what it calls “school relations professionals” and their job is to become a “preferred lender” at as many schools as possible. As of the spring of 2006, CLC had signed up more than 900 colleges.

“The primary gateway for students for decisions about financial aid is the college financial aid officer,” said Mark Brenner, who is vice chairman and executive officer of CLC. Preferred lender status, he said, means “they’re giving us their good housekeeping seal of approval.”⁶⁵ Although he acknowledged that such arrangements can be controversial, Brenner said that what accounts for the company’s success is its easy-to-use technology and excellent customer service. The company employs 90 full-time loan consultants who work in San Diego, not in India, and it boasts that every call to its 800-number is answered within 30 seconds. “No school wants egg on their face,” he said. “Our best advertisement is the other lenders not doing the same job that we do.”

Questions Raised

The future success of MyRichUncle as well as all of these other companies depends on whether they have properly estimated the risk of the investments they are making. But it also depends on whether the demand for private loans is as big as the companies, and many stock analysts, think it is. Thirdly, it depends on whether college graduates will be able to earn enough money to keep up with loan payments that might represent as much as a quarter to a third of their entry-level take-home pay.

“There’s a host of small startups that have seen the growth of the business and decided they want to get into it,” said Willis Huling, TERI’s president. “There are no barriers to entry in this business. If you have money, you can lend it. But there are barriers to success.”⁶⁶

Stock analysts are mixed in their views of the prospects of lenders who are placing a big bet on private loans. In May 2006, Morgan Stanley stock analyst Kenneth Posner said Sallie Mae’s growing reliance on private loans was boosting its profits. Sallie Mae “is doing better than we expected in the private loan space,” Posner wrote in a report. He said that competition among companies to grab a bigger share of federal loan business would drive down profits as companies had to offer bigger incentives, such as covering some of the upfront fees students pay for the federal loans, in order to keep growing. Private loans, however, would remain profitable and he said investors should consider owning shares of the company.⁶⁷ But other analysts worry that lenders don’t yet know how to properly analyze risk. Eric E. Wasserstrom of UBS Investment Research in April 2005 gave Sallie Mae only a neutral rating, citing the company’s “relative inexperience” at what he called “risk-based pricing.” He also worried the business was too new to evaluate. “Although the private loan product has existed for a number of years, it has only recently experienced explosive growth.” Basically, he was saying, it’s too soon to tell whether all of those loans will be repaid.⁶⁸

Most of the big players in private loans are now publicly traded companies. That means that they will be under enormous pressure to stoke the demand for private loans. Some of that pressure is already coming from colleges, which, in order to keep their tuition up, want private loans to be available to fill the gap left after students have gotten

Mom and Dad to write checks and money has come in from federal loan programs. The colleges say the investment is worth the cost, because more education will yield higher salaries. But is that always the case? Bank of America analyst Howard Block worries that it's not always true, especially in the case of trade schools, whose rapid growth has been fueled by the availability of private loans. Huling agreed. "We as an industry have to be careful," he said. "Everyone who goes to college presumes they'll make money to repay the loan. But we're very concerned about the amount of debt someone takes on. They go to school and they may not be able to buy cars, or a house, or get married."⁶⁹

It's true that major banks, such as Citibank, Wells Fargo and Chase, have shelled out hundreds of millions of dollars apiece to buy existing student loan companies. In 2000, Washington Mutual, a bank that goes back to 1889, announced that it was forming a partnership with Sallie Mae and that it planned to be a major player in student loans. "Our goal," a company official said, "is to become the country's top education lender, just as we are the nation's leading originator of adjustable rate mortgages." That plan fizzled, however. The profits the company expected did not materialize and in 2005 Washington Mutual quietly quit the student loan business altogether, even though it had a significant sales force.

As the housing market has slowed, and interest rates have started to creep up, analysts worry that home owners who bought at the top of the market and financed those purchases with risky interest-only or adjustable rate mortgages will be unable to keep up with their rising payments. Amid the growth in the private loan business, few have remarked on the fact that all of those loans are adjustable as well. What happens when a

newly graduated student sees his or her loan payments start to rise dramatically, just as he or she is getting started on a career?

Doug Dolton said he worries that the industry he has spent his career in is headed down the wrong path. He thinks the industry is vastly overestimating the public's ability to repay unsecured loans. And he thinks the growing reliance on private loans ignores the enormous success of federal loan programs. "We have one of the best operating social programs in the world to assist students in getting an education – it is highly competitive, the product offerings are awesome" and the interest rates are so low the money is virtually free.⁷⁰ He said it is "startling" that some politicians and higher education experts think the private loan business should replace federal loans for all except the poorest college students.

Private loans are fine for families with money, to help them with cash flow, he said. But they don't make sense for students who have marginal credit and who are being charged double-digit interest rates. Industry observers say that default rates on student loans vary from 2 percent to 12 percent, depending on the type of student, with someone going through an Ivy League school on a scholarship, say, less likely to default than a community college student learning to be a nurse's assistant.

"There are a lot of bad loans being made today," Dolton said. And he worries what will happen if banks or other lenders or Wall Street investors get cold feet. "We're such lemmings in U.S. banking," he said. "Let there be one burp, say a First Marblehead or a Sallie Mae having trouble with a securitization, and the sound of all the doors slamming shut on college students asking for loans will be deafening." Some of that concern was starting to emerge in the summer of 2006, when, despite enormous profits,

the stock prices of many of the large lenders were stuck and going nowhere. “People are beginning to realize that there isn’t as much gold in them there hills as they’d thought just seven or eight months earlier.”

Dolton, who in the summer of 2006 left his position at Nelnet, a large lender of federal loans based in Omaha, Nebraska, has his own strategy for dealing with the changing loan industry and the needs of students. He and some partners are trying to start a company with the goal of helping students get through school with as little debt as possible, helping them figure out the cheapest way to finance their educations. That, he said, is a very different orientation than he had throughout his career, when his goal was to make sure that students borrowed as much money as they could qualify for.

Unphased by Questions

If Raza Khan and Vishal Garg were worried about all of these trends, it was difficult to tell. As soon as it went into business MyRichUncle began getting an inordinate amount of attention, given its relative size, for its innovative way of identifying which students seem to be most worthy of their loans and most likely to repay them. It was earning praise for charging less than its competitors and for its relative transparency, even though competitors such as Sallie Mae and others contend that MyRichUncle loans are not as cheap as they seem. The two youthful entrepreneurs also seemed to enjoy the fact that many of their competitors were underestimating either their sophistication or their competitiveness.

At first, he said, “the industry didn’t get the product. They thought it was kookie. We want them to think about us as a bunch of space cadets.”

He said that “competition is a good thing” and that he and Khan welcome others into the business.

Khan was blunter. “Our whole DNA is different” from the rest of the industry, said Khan. “We’re taking on the whole machine and working out all aspects of it. We don’t claim we are perfect yet but we’re going to get there faster.”

“We’re excited,” he said. “By the time the industry catches up we’ll be OK. We’ll be on to 10 other products. We’re not a one trick pony.”⁷¹

¹ Ralph James, former president of First Marblehead Corp., in interview with author.

² Gateway Report on MRU Holdings. http://www.shareholder.com/mru/downloads/Gateway_Report.pdf. October 17, 2005.

³ Author interview with Raza Khan and Vishal Garg.

⁴ “Financial Facts on the Impact of Rising College Costs,” The Lumina Foundation on Education, www.collegecosts.info, accessed on April 28, 2006.

⁵ “Filling the Growing Funding Gap in Education Finance,” p. 9.

⁶ “Head of the Class—A Dominant Player in the Student Lending Business,” UBS Investment Research, April 15, 2005. p. 11.

⁷ Catherine B. Reynolds interview with author in Washington, D.C., Jan. 31, 2006

⁸ Catherine A. Wegmann, Alisa F. Cunningham, Jamie P. Merisotis, “Private Loans and Choice in Financing Higher Education”, Institute for Higher Education Policy, <http://www.ihep.org/Pubs/PDF/PvtLoans.pdf> accessed on June 24, 2006. 2003.

⁹ Sandy Baum and Kathleen Payea, *Trends in Student Aid 2004*, Trends in Higher Education Series, NY, New York: The College Board, 2005.

¹⁰ Analysis of the cost of various companies’ loans accessible at www.tuitionsimple.com

¹¹ Nancy Leinfuss, Feb. 1, 2006, “Private student loan ABS mkt seen growing in 2006,” *Reuters*.

¹² This figure includes consolidation loans, in which several loans are consolidated into one.

¹³ Audrey Snell, Feb. 3, 2006, “Initiating coverage of MRU Holdings.” San Diego, California. ThinkEquity Partners, LLC. p. 1.

¹⁴ Private loan report, NASFAA, etc. p.7-8

¹⁵ Stephen Burd, “Sallie Mae Moves to Buy State Agencies, Scaring Critics.” *The Chronicle of Higher Education*, March 31, 2006. p. 1.

¹⁶ The Associated Press, “SLM Shares Rise on Analyst Upgrade.” *Houston Chronicle*. May 8, 2006. Accessed on 5/14/2006 at www.chron.com.

¹⁷ 2006 Annual Report, The Access Group. Accessed on Aug. 25, 2006 at <http://www.accessgroup.org/about-access-group/pdfs/2006.pdf>

¹⁸ Andy Serwer, April 11, 2003, “Wall Street’s Green Genie Cashed in at the Perfect Time. But What’s the Real Story with his Bonds Now?” *Fortune* accessed at http://money.cnn.com/magazines/fortune/fortune_archive/2003/08/11/346812/index.htm on May 1, 2006.

¹⁹ www.finance.yahoo.com, accessed on Aug. 25, 2006 at <http://finance.yahoo.com/q/ks?s=FMD>

²⁰ www.finaid.org/loans/servicers.phtml

²¹ Steve Jordan, March 15, 2006, “Nelnet pins its future to broadening services,” *Omaha World-Herald*, quoting Jeffrey Noordhoek, president of Nelnet. Accessed at http://web.lexis-nexis.com.arugula.cc.columbia.edu:2048/document?_m=5b65d8 on April 23, 2006.

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- ²² Author interview with Vishal Garg and Raza Khan, New York City, March 22, 2006. All quotes from Garg and Khan come from this interview, unless specified.
- ²³ See www.educatedborrower.com. Accessed on June 24, 2006.
- ²⁴ Audrey Snell, "Initiating Coverage of MRU Holdings; Buy Rating and \$7.25 Price Target." ThinkEquity Partners, LLC. New York. Feb. 3, 2006.
- ²⁵ "Filling the Growing Funding Gap in Education Finance," a presentation by Raza Khan and Vishal Garg to the Roth Conference, Feb. 22, 2006. Accessible at the company website at mruholdings.com.
- ²⁶ Will Hamilton, "Report on MRU Holdings." Sanders Morris Harris. August 19, 2005.
- ²⁷ Author interview with Jacqueline King, May 2006, College Park, Maryland
- ²⁸ *New York Times*, May 14, 2006, full-page advertisement, A22
- ²⁹ Company website, www.myrichuncle.com
- ³⁰ See Chronicle of Higher Education articles Oct. 17, 2003 and Nov. 28, 2003.
- ³¹ www.blogger.com/comment.g?blogID=13824647&postID=115348834295230477
- ³² Stephen Burd, "A Deal Between Pace U. and Sallie Mae Raises Questions," *Chronicle of Higher Education*, November 5, 2004, p. A24.
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- ³⁴ Stephen Burd, "Education Department Does Not Plan to Investigate Lenders Over Inducements," *Chronicle of Higher Education*, November 28, 2003, p. A28.
- ³⁵ Jennifer A. Kingson, "College Costs and Sallie Mae, Rising Hand in Hand," *New York Times*, July 14, 2006, p. c6.
- ³⁶ Anne Marie Chaker, "Student Loans 101: Ignore Schools' Advice—Colleges Tout 'Preferred Lenders' on Their Websites but There are Better Bargains." *Wall Street Journal*, August 27, 2002, p. D1.
- ³⁷ Author background interview with officials from Sallie Mae's public affairs group.
- ³⁸ "SLM Holding Corp. buying loan servicing and secondary market operations from USA Group," June 15, 2000. SNL Financial. Accessed on May 14 at http://www.snl.com/financial_svc/manda/20000615sl.asp
- ³⁹ Stephen Burd, "In a Merger of Student-Loan Giants, Sallie Mae Will Buy Much of USA Group," *Chronicle of Higher Education*, June 23, 2000, p. A35.
- ⁴⁰ Annual Report
- ⁴¹ Author background interview with officials from Sallie Mae's public affairs group.
- ⁴² Bethany McLean, "When Sallie Met Wall Street," *Fortune*, Dec. 26, 2005. p. 135.
- ⁴³ Letter to *U.S. News and World* report from Sallie Mae chairman Albert L. Lord, provided by Sallie Mae
- ⁴⁴ This early history was related to the author by Joseph Cronin, one of the founders of Nellie Mae and The Education Resources Institute.
- ⁴⁵ Harold and Gwyneth Barger, 1983, *College on Credit*, Indianapolis, IN; Hackett Publishing Co., p.6.
- ⁴⁶ Barger and Barger, p. 6.
- ⁴⁷ Ibid. p. 11
- ⁴⁸ Ibid. p. 13
- ⁴⁹ Ibid. p.15
- ⁵⁰ Ibid.
- ⁵¹ Author telephone interview with Ralph James
- ⁵² Author telephone interview with Joseph Cronin, who was president at the time of Nellie Mae.
- ⁵³ NEED ATTRIBUTION
- ⁵⁴ Telephone interview by author with Ralph James
- ⁵⁵ Ibid.
- ⁵⁶ Sasha Talcott and Chris Reidy, "Tip on improper gifts led to CEO's exit," *Boston Globe*. September 29, 2005.
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- ⁵⁸ Reidy, May 16, 2006.
- ⁵⁹ Telephone interview with author.
- ⁶⁰ Ibid.

⁶¹ Mike Allen, "Loan Firm That Learns Education is Lucrative," San Diego Business Journal, October, 2004.

⁶² Ibid. Industry experts point out that it is difficult to calculate interest rates without a borrower's full credit history, but according to the company's website, a student with a co-signer who had poor credit history would be charged an interest rate of 17.75 percent and would pay more than \$34,000 over 15 years to borrow \$7,000, if the prime rate were 8 percent.

⁶³ Ibid.

⁶⁴ Author interview with Mark Brenner, College Loan Corporation executive vice president and operating officer

⁶⁵ Author interview with Mark Brenner

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⁶⁹ Interview with author

⁷⁰ Interview with author

⁷¹ Interview with author