

EduCap: Trailblazing Through the Private Student-Loan Forest

Joseph Williams

Author of *Cheating Our Kids: How Politics and Greed Ruin Education*

joewilliams2@gmail.com

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A 2-page color advertisement in the in-flight magazine of American Airlines in the summer of 2006 warned readers against the dangers of tapping into home-equity in order to finance the rapidly rising costs of a student's higher education. Instead of putting your home at risk, the ad suggested, readers should consider the safety and flexibility of a private student loan program called "Loan to Learn." Variations of the same advertisement, directly aimed at consumers, appeared on television and on Internet newspaper sites as well.

In the booming business of private student loans, also known as alternative student loans, "Loan to Learn" is a loan product from one of the oldest players in the game – an innovative company called EduCap. What was noteworthy about the magazine and other paid advertisements was just how far things had come for the scrappy, innovative student loan company that began as a germ of an idea in the mind of a diocesan priest in Washington, D.C. more than 20-years earlier.

The Rev. John P. Whalen came up with the idea for a new type of student loan at a time when the federal government pretty much controlled the entire loan market and "marketing a loan" meant little more than passing out a brochure from a lender in a university's student loan office. The idea that a private student loan provider would be advertising in a general readership magazine to people flying all over the Continental United States would have sounded like pure folly in the mid-1980s when middle class families were anxiously looking for help in paying for the rising costs of college. Whalen and the company he founded that eventually became known as EduCap broke down the walls that had been erected by the government, banks, and college financial aid offices

and brought easy-to-obtain private student loans to the masses. Along the way they changed the industry in innovative ways that are still being felt today.

To understand the pioneering private student loan phenomenon known as EduCap, it is helpful to consider the context in which it played out in Congress, not to mention living rooms and college financial aid offices all over the nation in the 1970's and 1980's. The conditions in which Whalen would find fertile ground for his private enterprise would stem from a series of policies and counter-policies, each with its own set of consequences – both intended and unintended. A host of forces gathered steam during those decades that contributed to the “buy now, pay later” mentality that eventually infused the higher education landscape.

Concern about the middle class' ability to afford higher education was certainly not new. Following President Lyndon Johnson's “War on Poverty,” the 1965 *Higher Education Act* was built around the promise of helping the poor find their way to colleges and universities that had been traditionally closed to them, either by de-facto segregation practices or by economic reality. The *Higher Education Act* introduced the Educational Opportunity Grant program, which provided need-based grants (essentially vouchers) to low-income students to use toward tuition. For much of the next decade, policy-makers encountered rising levels of frustration from middle class families who felt they were being left out of the federal financial aid picture. In response, the 1978 *Middle Income Student Assistance Act* brought college loans to the middle class for the first time by loosening income requirements for what we now call Pell Grants and removing entirely the income limit for participating in federal student loan programs. MISAA, as the act

was called, thus defined any student facing college costs as needy enough to warrant federal support.<sup>1</sup>

This 1970's-era focus on helping the middle class access higher education caused two important things to happen that would impact the eventual emergence of EduCap and other private loan providers to the higher education scene. It began a shift, which accelerated during the Reagan years, of federal support of college students from grants to loans. It also created a scenario – which some regarded as a loophole that worked against the stated intentions of the loan program – where families who could already afford to pay for college found it financially beneficial to take advantage of lower-interest (approximately 7 percent,) federally-guaranteed student loans, while parking their tuition money in a money market account paying around 10 percent or more in interest at the time. Thus, some critics charged, a federal program designed to offer opportunities to students who needed them ran the risk of being used as a form of educational arbitrage by students who probably didn't need the financial help.

These concerns came to a head in 1980 with the reauthorization of the *Higher Education Act*, which redesigned the federal aid programs and sought to put a lid on their growth. So as the 1980's began, student borrowing for higher education found itself again limited by financial need. Students with family incomes over \$30,000 became subject to need analysis tests for loan eligibility.

The Reagan administration itself contributed to the growing reliance on loans for education because it was committed to reducing federal involvement in financing higher education (by providing increases in funding that didn't keep pace with increases in

tuition) and because it believed that shifting from grants to loans placed more of an emphasis on a student's self-help, a value the administration found appealing.<sup>2</sup>

The Reagan-era movement to regain control of federal spending on student loans coincided with an unprecedented increase in the cost of attending four-year colleges and universities nationwide. Tuition throughout the decade soared at average rates that were two to three times the rate of inflation.<sup>3</sup> In 1980, for example, the average tuition at private, four-year colleges was \$3,279 per year. By the end of the decade, the average tuition at the same schools soared to \$9,391.

The upshot of the federal government's attempts to rein in an out-of-control federal program was that it started defining "need" in a way that locked out a majority of students, forcing those who couldn't pay outright for tuition and room and board to take on high-interest bank loans, tap into home equity lines of credit, or put the cost of a semester or two on high-interest credit cards. Even if a student did qualify for a government-backed student loan, the loans were capped at \$4,000 per year at the time, which was less than many private schools were charging for tuition.

Home equity loans, in particular, became a popular solution for a generation of Americans who had invested in their homes before the stagflation of the 1970's and seen their values increase to the point of becoming an asset of sorts. The value of a family home that was paid for, free and clear, worked against a student in terms of defining "need" under federal formulas at the time, but represented an asset against which families could borrow on their own to pay for the costs associated with higher education. Once known as "second mortgages," a phrase that conjured up images of families fighting to stay afloat financially, banks began marketing them in the 1980's as a common-sense

way to tap into value that had been earned by homeowners. Because the *Tax Reform Act* of 1986 eliminated the taxpayers' ability to write-off interest from consumer loans and credit cards, banks began selling their customers on the notion that the interest paid on many home equity loans remained tax deductible. If you had to take a loan for college, why not get a tax deduction, the pitch went. "For me, it's clearly the best way to go and it is for a lot of other people too," Robert Giarruso, senior vice-president at Syracuse's Merchants Bank, said in 1987, a year after home equity loans nationwide doubled in size to \$70 billion.<sup>4</sup> Since homeowners were free to spend their equity lines of credit where they pleased, firm tallies of the number of students who funded their college educations this way are hard to come by. However, banks at the time were marketing home equity lines of credit as easier forms of financial aid than federal programs because applicants only needed to apply once rather than annually as required by the federally-backed programs.<sup>5</sup>

The downside of using a home equity loan to pay for college, however, was that since the family home served as the loan's collateral, it could make things sticky for the entire family if a student and his or her parents defaulted on the loan. Home equity loans also usually required families to pay both interest and principal right away (federal student loans didn't need to be repaid until after graduation,) and sometimes carried interest rates that were slightly higher than federally-guaranteed student loans.

Such was the environment in which Whalen, a diocesan priest, was working in 1985 when he came up with the seed of an idea that would eventually pave the way for the rapidly growing, privately-backed student loan company known as EduCap. As former president of Catholic University and executive director of the Consortium of

Universities in the Washington area, a coalition of 12 universities and two colleges near the nation's capitol, Whalen saw with his own eyes that as the cost of higher education increased, the needs-based federally-guaranteed student loan system simply wasn't helping middle class students keep pace, particularly at higher-priced Georgetown and George Washington universities.

Whalen knew that creating a significant student loan operation within a single university would be difficult, especially as colleges were undergoing belt-tightening of their own. But a pool of colleges, like the Consortium, might make it a more cost-effective operation. Still, it would need considerably more funding than even a pool of universities could produce to get started. Working with officials from the District of Columbia, Whalen developed a plan to issue \$50 million in municipal bonds on behalf of area colleges, using the proceeds to make low-cost loans available to students who needed help financing their education. It is not uncommon for municipalities to raise vast sums of money cheaply for large public works projects like highways and hospitals, but selling municipal bonds to create a loan fund for college students was unusual. "It is absolutely imperative for middle-income families to have financial help for education," Whalen said.<sup>6</sup> The Consortium had some political pull in the District of Columbia. In 1984, to cite one example, six universities – American, Catholic, Georgetown, George Washington, Howard, and the University of the District of Columbia – contributed about \$2 billion per year to the city's local economy, according to one estimate.<sup>7</sup> Whalen found himself in the unique position of being able to not only recognize growing demand for an alternative student loan service, but to leverage the power of several major institutions with access to the highest levels of city government to give his idea a try. The D.C.

Council, responding to the needs of a significant local constituency (the local universities), signed off on the bonds, which were then used for loans for several thousand students in the district.<sup>8</sup>

Understanding that middle class students could benefit from this type of loan approach nationwide, Whalen created a nonprofit firm, then known as University Support Services (the name would years later be changed to EduCap, as the loan company will be referred to hereafter in this paper), to bring the concept to market. In 1987, the entrepreneurial diocesan priest and EduCap unveiled a new loan program called ConSern, and the landscape for financial aid for higher education changed forever.

For the first time, private money would be widely thrown into the mix for the growing national market for financial aid, a measure that would ensure that students and colleges would get their loans, and that Wall Street and a web of banks and loan processing services would reap some significant returns along the way. Rather than relying on D.C. municipal bonds, financial backing for the nationwide ConSern loans came from Shearson-Lehman Brothers, which raised money for the loans by issuing unsecured, short-term commercial paper notes. Whalen convinced the National Bank of Washington to actually make the loans, most of which would be quickly repurchased by ConSern. The Continental Insurance Company insured the loans against defaults and Wachovia Services agreed to collect and keep track of payments.<sup>9</sup>

On the operations side of the program, revenue from the bond sales on Wall Street was used to provide the loans to students. EduCap marketed the loans, which students repaid with interest, and which allowed the nonprofit to cover its administrative costs and

repay the original bonds. It's a rather basic formula, but before Whalen and EduCap came along, it had only rarely been attempted for college loans.

There is little debate today that the ground was fertile for some fresh and innovative thinking in the student financial aid world at the time. A 1988 survey by the International Association of Financial Planning found that 25 percent of families who sought help from a financial planner listed paying for college as one of their most pressing financial needs. Only retirement and home-ownership ranked higher. Much of the \$24.5 billion in financial aid that was awarded each year at the time was going to needy students alone.<sup>10</sup> Jonathan Pond, a Massachusetts financial planner at the time, remarked: "It's the single-greatest concern of upper-income as well as middle-income families... They know they don't have a prayer of getting financial aid."<sup>11</sup>

When EduCap's ConSern loans were publicly announced in the spring of 1987, George Washington University President Lloyd H. Elliott told reporters that the loans would fill a "glaring niche on the campuses" and that previously, loans were "not available to thousands of students across the country in the form which they can manage."<sup>12</sup> As a nonprofit company, exempt from federal taxes, EduCap's stated mission was to help make higher education affordable to families in their quest to achieve the American Dream.

Students who received the loans were originally charged a \$45 application fee and paid approximately 10.45 percent in interest. Payments started after 30 days, and students had to make interest-only payments while they were still in school. These loans were considerably cheaper than consumer loans offered by banks, but more expensive than the taxpayer subsidized federally guaranteed student loans, which charged 8-10 percent

interest and didn't require students to pay them back until they were no longer enrolled in classes. In order for a student to qualify for a ConSern loan, among other criteria, the borrower (usually the parent) needed to have an acceptable fixed expense to income ratio below 40 percent or else a net worth of at least ten times as much as the loan amount.

In this way, the alternative loans looked a lot like other types of consumer debt (the credit or asset requirements, the co-signer, the up-front fees.) They also had features unique to education loans, although not government education loans. The borrowers paid interest on these private loans when they were still in school. For government loans those payments were either covered by the government or allowed to accrue without payment. The ConSern loans could be used to cover incidental expenses, whereas traditional loans could not. Proceeds of the ConSern loans were given directly to the students rather than directly to the college. All of these features, pioneered as part of the ConSern loan, now are considered commonplace in the private loan industry.

In many ways, despite the strong demand and its innovative and unorthodox approach, EduCap found itself in a healthy competition with not only federally-subsidized loans, but with consumer loans and home equity lines of credit. EduCap marketed themselves to families as easier loans with significantly less red tape than government loan programs and as a loan specifically designed to work with the financial rhythms of a family who had children in higher education. Good service and easy-to-use applications became the hallmarks of University Support Services and later, EduCap. Those types of consumer-oriented values were by-and-large absent from the industry at the time.

“Our programs were about ‘customer delight’ and we set out to create a product that worked with the financial rhythm of the family – something that was affordable for families on a monthly cash-flow basis,” said Catherine B. Reynolds, who was hired to be EduCap’s comptroller in 1988, and within 9 months was named executive vice president, and then president shortly thereafter.<sup>13</sup> Payments on the (federally-backed) Guaranteed Student Loan at the time typically stretched over a period of only 10 years, for example, which meant that average monthly payments for graduates were essentially increasing as fast as college tuition. The rigid repayment timelines and the increasing monthly costs for student borrowers raised widespread concerns that graduates entering relatively low-paying fields like social work and education would have tremendous difficulty paying back their loans. Even worse, some said, high monthly payments might have the effect of forcing some students out of those same career fields, which would arguably have a tremendous negative ripple effect for society. By doubling the amount of time for repayment on EduCap loans to 20-years, which was billed as “a more flexible repayment schedule,” monthly payments could be lowered to more reasonable levels. Students thus would be able to select their field of study based on factors other than their future earning potential and whether it would be enough to pay off their 10-year loans. Today, 20-year repayment schedules are commonplace for student loans.

In addition, while government-backed loans didn’t require repayment to begin until after a student graduated (a feature called “total deferment”) EduCap’s requirement that students start making small payments toward the interest on the loan immediately (a feature called “partial deferment”) also had an upside that was sold to prospective students and their families. Because interest nonetheless accumulated under the federal

loans even while students were still in school, EduCap promoted the feature as one that would save costs in the end because students wouldn't end up paying interest on the interest that accumulated while the loan was deferred.

Reynolds estimated that 30 percent of the college-bound market had been covered under the previous student aid format – the poorest 15 percent of students who qualified for federal grants and loans, and the richest 15 percent for whom paying tuition was simply a matter of writing a check from the family account. “We were looking to offer help to ‘Middle America,’” Reynolds said, “The people who didn't have great wealth, but paid their bills every month and believed in the value of education as a catalyst for achieving the ‘American Dream.’” The company estimated in the late 1980's that some 7 million middle-class students nationally needed financial assistance with their college bills.<sup>14</sup> By making simple changes to the status quo of student loan policies, such as extending the repayment period, EduCap was helping to open the doors to new possibilities for students, some of whom were now able to choose colleges based on their academic fit rather than merely on the tuition that was being charged.

For families that took on high-interest consumer loans from banks to pay for the costs of sending their kids to college “it was like buying a new car every year, for four years, but with no trade-in value,” Reynolds said. In addition to making student loans accessible to a greater percentage of college students, EduCap also set out to provide a more consumer-friendly (meaning less red-tape) loan application process. The existing federal programs at the time required a great deal of paperwork and a strict adherence to application deadlines. Decisions typically were drawn out over a period of months. Reynolds said the goal was to help families quickly determine whether they qualified and

then to promptly process applications and make the loans. “Many people felt at the time that [the government’s application process] was almost as painful as doing their taxes,” Reynolds said.

Educap’s first loans were given out in August 1987, and by the end of 1988, the non-profit made approximately 12,000 loans totaling \$80 million. The private student loan industry was relatively wide-open at the time, in part because of tremendous uncertainty about whether or not students would repay the loans, Reynolds said. The default rate on federal loans at the time was in the double digits, and there was a considerable gap between the time when a student received his or her check and the time they would theoretically satisfy their debt. The gap caused a great deal of uncertainty on the part of lenders, who were used to the notion that the federal government should be the ones assuming the risk for these kinds of education loans.

When Reynolds joined EduCap in 1988, for example, the non-profit was technically bankrupt. There were far more liabilities (\$8 million in debt) than assets (\$3 million) – unless, of course, you had enough faith in the student loan recipients that you dared to think of your liabilities and assets as one in the same. Reynolds did exactly that, in ways that would eventually revolutionize the way student loans were funded. (See section: Trailblazing Move: Securitizing Student Loans.)

Reynolds was brought in to try to find a way to make the enterprise survive. “I didn’t need anybody saying, ‘We can’t do this.’ I needed someone saying, ‘let’s figure out how we do this,’” Whalen recalled in 2002, describing Reynolds’ hiring years earlier.<sup>15</sup> Reynolds studied economics and business administration at Vanderbilt University and

then went to work for Arthur Young as an accountant. From there she was hired by Raymond Mason, founder of the Charter Co., one of the original conglomerates.

“I was very idealistic about it,” Reynolds said. “I believed if we did it right and treated our borrowers with dignity... I believed they would pay us back.” Idealistic, perhaps, but Reynolds also notes that this was still a calculated business decision. “It’s about understanding the risk and the price of that risk. We thought of it as an investment in human capital – you earn your return over the long-term.” As Reynolds’ involvement in EduCap increased, Whalen began to take more of a backseat in the day-to-day operations.

Among the most skeptical critics of what EduCap had to offer at the time were the financial aid officers at most mainstream universities. Not only did the financial aid community tend to dislike the idea of non-federally-backed debt for students, they had what Reynolds later described as a long-term working relationship with the existing financial aid providers (preferred lenders who provided federally-guaranteed student loans) and weren’t quick to embrace the privately-backed newcomer or their slightly higher interest rates. EduCap officials argued that their interest rates were competitive (and significantly less than typical consumer loans), but many colleges complained they were too high for students.

### **Trailblazing Move: Securitizing Student Loans**

In 1991, EduCap faced a crisis of sorts. The non-profit company had raised money to lend to students by using letters of credit from Japanese banks and protected itself against losses by maintaining a reserve fund and buying surety bonds, which are like insurance. New changes to banking regulations at the time threatened to cut off this type of

arrangement for the loan company. Reynolds estimated that by the early summer, EduCap was about 60 days from potentially going bankrupt.

Reading an article about how issuers of credit cards were bundling debt and using debt itself as collateral to sell securities to investors, Reynolds said she began wondering whether that type of arrangement might not be what could save EduCap. Residential mortgages had long before been securitized this way, but student loans had not. Under such an arrangement, investors would buy the notes and would be paid from the cash flow from loan repayments.

Reynolds said she had to go before a rating agency and persuade it to create a completely new asset class for the student loans. She said she closed the deal for an initial round of \$79 million in financing fifty-seven days later and, in doing so, “set the standard in the industry.” Today, this type of securitization is commonplace in the private and government-backed student loan industry. By getting investors with capital to understand that properly-administered student loan debt was a good bet financially, EduCap helped open the doors of the student loan industry to investors who wanted to help college students and realize almost sure-thing financial returns.

### **Trailblazing Tactic: Taking the Concept Directly To Consumers**

Understanding early on that American universities and their closed-shop financial aid offices were not going to do the marketing work for them (most financial aid offices were actively marketing government loans through a list of “preferred lenders” that had established relationships with universities), EduCap took the unusual step at the time of marketing their loans directly to students and their families. “We tried to go through the school channel, but could not compete with the long-established relationships between

school and federal lenders,” Reynolds said. “So we tried something new and went directly to the consumer. The need for families to have options to pay for higher education was just too great to give up.” Hindsight would suggest that because the traditional doors to students had been closed to EduCap, the renegade loan company had no other choice but to find their own innovative methods of overcoming what essentially amounted to an old-boy’s network of lenders.

One way EduCap marketed its loans was through strategic marketing partnerships with large groups that reached into communities all over the country such as the National Rifle Association and the U.S. Chamber of Commerce, as well as powerhouses like BellSouth, Chrysler, AT&T, Goodyear Tire and Rubber, Ford, General Motors, United Parcel Service, and J.C. Penney’s.

These types of partnerships, in which some of the organizations were paid marketing fees by EduCap, put information about the private loans into the hands of millions of the organizations’ members. The non-profit student loan company reportedly paid the NRA \$10,000 in fees in 1996, for example, to promote the loans to its members.<sup>16</sup> This style of affiliate-led mass marketing was unique within the student loan business at the time.

The Chamber of Commerce example is particularly interesting, as the chamber pitched the loan program as an employee benefit that its corporate members nationwide could extend to its employees at very little cost. Most of the effort that was required by the corporate members involved simply finding effective ways to let their employees know they could access the loans. In the first year that the U.S. Chamber was marketing ConSern loans, more than 6,500 businesses nationwide signed on. The Chamber noted in

a press release that in the first quarter of 1989 alone, more than 700 companies had signed on as partners each month. Essentially, the personnel offices at these companies took on the role of selling the private loan option to their employees, which they did by hanging posters in lunch rooms, stuffing flyers in pay envelopes, employee newsletters, and in each company's benefits handbook. It was the kind of marketing partnership that worked for everyone: the Chamber of Commerce wanted ways to provide value for its members, its corporate members had little to lose and lots to gain by providing a new employee "perk" at very little cost, and EduCap, of course, was able to make an end-run around financial aid offices and get their marketing materials directly into the hands of consumers.

"An educated workforce is crucial to America's future in the global marketplace," explained Richard L. Leshner, the president of the U.S. Chamber of Commerce, in April 1989. "Through ConSern, businesses can offer a flexible benefit that allows them to retain high caliber employees and enables the next generation of employees to gain the skills they will need in a high technology environment."<sup>17</sup>

Just as college financial aid offices were able to market directly to anyone matriculating at their universities, these companies allowed EduCap to likewise market directly to the parents who were desperately trying to find alternative methods of putting their kids through school.

"To corporate America's credit, they embraced the idea," Reynolds said, looking back. Participating companies paid EduCap a minor service fee, depending on the size of the corporation, of which the Chamber retained 10 percent as a commission. Internal Revenue Service records showed that the Chamber was paid \$2.4 million over 8 years,

before discontinuing the partnership in 1996 due to a decline in interest on the part of the Chamber's corporate members.

Even as new competitors popped up on the alternative loan landscape in the 1990's, EduCap was able to retain a large percentage of the overall private loan business due to its many corporate partnerships, which extended the reach of the company into homes all across the country. In 1991, the loan company partnered with Apple Computers to offer an "Apple Loan Program," where students or teachers could take out loans to purchase computers. Years later, in 1999, the company became the first private lender to offer loan packages designed for college fraternities and sororities. Most recently, the loan company in 2005 became what appeared to be the first student loan provider to award frequent flyer awards on American and Delta Airlines for students who take out their "Loan to Learn" loans.

Reynolds told the Florida Times Union in 2003:

"In my business, student lending, everyone thought you had to market through colleges and universities. We didn't have the clout to compete in that very established market so we went through corporations who then offered it to their employees as a benefit. That's what put us on the map."<sup>18</sup>

The tactical decision to work around uninterested financial aid officers ruffled feathers at some campuses, especially as EduCap found previously unconventional methods to get their message to the masses. In an industry that had been marked by bureaucratic process and unsophisticated (if any) marketing to a relatively captive audience of customers, EduCap was helping change the face of customer-outreach by introducing actual guerilla marketing tactics to the sphere. A flat-footed market was

getting spunky as it was pushed by innovators working from the sidelines. While student customers responded with a vengeance, the old-style financial aid offices at universities were initially annoyed. “I actually came out to my car one day last month and found under my windshield wipers an ad for them, under every car in the parking lot at Hopkins,” Johns Hopkins University financial services director Ellen Frishberg told the *Washington Post* in 1997. “I can understand there is a market imperative to do that, but coming to the school without stopping into the aid office?”<sup>19</sup> Johns Hopkins at the time recommended to students that they steer clear of EduCap’s private loans because of their higher interest rates than federally-backed loans.

For their part, other financial aid officers at colleges around the country argued that there were simply better deals to be had with other loan programs, like Sallie Mae, the student loan company which began operations as a government sponsored entity, but which became fully-privatized by 2004. “We certainly wouldn’t put [EduCap] loans at the top of our list, because generally speaking, their product has been out competed in recent years,” Nancy Coolidge, a financial aid expert for the University of California system said in 1997.<sup>20</sup>

### **Success in the Marketplace**

In the summer of 1997, the non-profit formally changed its name to EduCap, to emphasize that its core business now involved making capital available to the masses for use toward college tuition. “Our new name more accurately articulates our mission and it also allows us to put an accent mark on the future,” Reynolds said in a company-issued news release at the time.<sup>21</sup>

The company began giving loans in 1988 with one loan product, called ConSern. By 1997, EduCap with an affiliated federal entity, had introduced or offered 33 distinct aid programs, including both private and federally-backed loans (such as Stafford or PLUS loans.) The company marketed the many options it offered as the most comprehensive and customized financial aid stop for parents and students, providing access to all types of federal loans and aid, including federally-guaranteed loans.

In addition, EduCap offered an outfitter program to students, where they could purchase items for college and roll the price for those items into their student loans. The program included things like computers, refrigerators, telephones, and bicycles, among other dorm room items. The merchandise was shipped directly to the students.<sup>22</sup>

Consumers, for their part, had responded with enthusiasm, making EduCap the leader in one of the fastest-growing segments of the consumer loan industry. In 1991, the non-profit put out a news release claiming that applications for college loans in the first quarter of the year had soared by more than 30 percent over the same period in the previous year.<sup>23</sup> By the time University Support Services changed its name to EduCap Inc. in 1997, the non-profit had paid out more than \$1.5 billion in private loans to about 250,000 families.<sup>24</sup> By the time the core of EduCap's business was purchased by Wells Fargo in 2000, the company estimated it had loaned some \$3 billion since its inception. And, just as Reynolds and Whalen had suspected, students were paying them back. Unlike the double-digit default rates for federally-backed student loans, EduCap's publicly-stated default rate came in at less than 1 percent per annum. Reynolds insists the low default rate was directly tied to EduCap's willingness to build payment plans around the financial needs of families and their flexibility in terms of assisting customers who

were having a difficult time repaying the loans. A fundamental difference between EduCap's approach and the government-backed loan programs, however, was that EduCap provided loans based upon the kinds of factors used in conventional private loans, namely a student's future ability to pay back the loan.

### **Innovation Breeds Success**

Catherine Reynolds contends that the most significant innovation EduCap unleashed was a dedication to "customer delight" through product innovation and the "customer journey." Additionally, the national scope for its student loans, which she said also set EduCap apart from competitors in the early years of the alternative loans. The company also was one of the first in the sector to develop customized credit scoring models and incorporate risk-based pricing into education financing products, something that gave it a leg up on other competitors as it sought investors on Wall Street. Previously, technology didn't allow for risk of repayment (based on a number of factors involving each student) to be assessed with such precision as to make predicting future default rates somewhat of a science.

But as the company grew, its decision to differentiate itself from other competitors by promoting the comparative ease with which a family could secure an EduCap loan served as the driver for innovations in user-friendly technology. The company became the largest provider of private loans in large part because of its ability to break new ground, either in technological/process advances or in previously untested business partnerships.

EduCap, for example, in 1993 became the first in the sector to provide families with instant approval over the telephone. Previously, the most applicants could do over

the phone was request an application. The company referred to the development as “revolutionary” and “state-of-the-art.”<sup>25</sup> Applicants were able to get pre-approval in one phone call, in less than 30 minutes, and the subsequent paperwork could be completed within seven days.

But that was just the start of the push for those kinds of “customer delight” enhancements. Five years later, in 1998, EduCap’s popular P.L.A.T.O. loans became the first in the sector to offer on-line applications, with responses available within minutes. Today, online applications are the standard for all of the major student loan providers.

EduCap also participated in philanthropic activities, awarding scholarships to students and producing a free weekly current events newspaper called “Tomorrow’s Morning.” In addition, EduCap created a national program titled “Ready for School,” which was designed to identify and help children under the age of six who had preventable barriers to education. Examples included hearing, vision and learning impairments. The program was introduced at the *Presidents' Summit for America's Future* held in Philadelphia in April 1997. It was included in General Colin Powell's “America's Promise: The Alliance for Youth.”<sup>26</sup>

### **Servicing the Loans**

The rapid growth of EduCap created its own challenges, most notably the tremendous work involved with servicing the loans. In 1993, Whalen, Reynolds, and an associate named Pierre Escandar, the non-profit’s executive vice-president and chief operating officer, created a separate, for-profit company called Servus Financial Services to handle the operations involved in marketing, originating, and servicing the loans. The arrangement between the non-profit loan company, and the for-profit administrative firm

was approved by the Internal Revenue Service. Reynolds referred to Servus' work for EduCap as "the backroom operations."

The new for-profit company, Servus, absorbed 85 of EduCap's 100 employees at the time, and took over much of EduCap's Herndon, Va., offices and equipment. By 1996, EduCap and Servus were handling so many loans that the non-profit (EduCap) was paying the for-profit (Servus) more than \$15 million per year in fees, of which nearly \$3 million was profit.<sup>27</sup> The details of EduCap's spending and the circumstances surrounding the relationship between the for-profit and non-profit arms drew attention in the loan industry.

On July 7, 2000, Wells Fargo Educational Services, a part of Wells Fargo and Company, announced it had agreed to acquire Servus, along with "significant assets" of EduCap, Inc.<sup>28</sup> Terms were not disclosed, which itself was not unusual for a private transaction of the sort. Reynolds, who estimated that EduCap controlled 50 percent of the alternative student loan market at the time, said she agreed to stay out of the student loan origination business.

EduCap's portion of the sale to Wells Fargo (the portion of Servus that was owned by EduCap) reportedly amounted to approximately \$50 million. Combined with approximately \$300 million in student loans that were still being paid back to EduCap, the company had amassed a small fortune – even with the non-compete clause that had been put in place for Reynolds and the company.

Because of EduCap's non-profit and, thus, tax-exempt status, federal laws were clear that no individual could pocket the proceeds from EduCap's share of the Servus sale. The company's board of directors made the decision to start conducting EduCap's

philanthropic activities under the name “The Catherine B. Reynolds Foundation.” The foundation has attracted considerable attention for its philanthropic efforts, particularly in the District of Columbia. It is important to note, however, that the foundation’s fortunes are entirely separate from Reynolds’ portion of the sale of the company she helped create. As *Washington Post* writer David Montgomery put it in 2002: “The Reynolds Foundation is unusual in that an individual’s name went on a pot of gold that didn’t come from an individual’s personal fortune.”<sup>29</sup> Essentially, donations from the Catherine B. Reynolds Foundation are donations directly from the non-profit loan company EduCap.

In 2005, with the market for private student loans still surging, EduCap jumped back into the business. Its non-compete clause having expired, the non-profit company began marketing a new loan called “Loan to Learn.” Repeating its successful practices of the past, EduCap has already started marketing the loans through partners, including The Lending Tree online loan marketplace and Bank of America, and as an employee benefit to the National Association of Chain Drug Stores. One particularly interesting partnership links EduCap with the American Association of Retired People (AARP), one of the largest organized groups in America. “Give your children or your grandchildren the best gift of all - an education with AARP Education Loans from Loan to Learn,” the organization’s promotional materials state.

Under Loan to Learn, Students can borrow up to \$250,000 at interest rates that start at 6.75 percent and go as high as 16.65 percent for those who are the riskiest.<sup>30</sup> Students pay an up-front fee of between 0 percent and 10 percent. Reynolds said she still isn’t trying to compete on price. The appeal, she said, is still making these private, alternative loans as easy to get as possible.

## **Conclusion/Impact on the Student Loan Industry**

By understanding the tremendous need that existed in the then-unchartered territory of private student loans in the mid-1980's, Rev. John P. Whalen and Catherine Reynolds were in a unique position to unleash unproven and entrepreneurial ideas in ways that changed the way students finance the rapidly increasing costs of higher education. By taking their alternative loan industry directly to consumers they avoided the bureaucratic inertia and closed-shop nature of both college student aid offices and the process-based federally-backed student loan process. Treating outstanding student loan debt as an asset, which could be sold to investors based on the reliable repayment assumptions, generated massive amounts of cheap capital to keep up with demand from students and their families. Focusing on the customer led to a survival-based emphasis on what Catherine Reynolds called "customer delight," and led to the onset of user-friendly features like instant loan approval and rapid processing of paperwork that have since become industry standards.

Evidence of EduCap's impact can be found all over the face of the financial aid industry today, from more flexible repayment schedules for students to the newfound spirit of competition among lenders and the aggressive marketing it entails. Even the significant Clinton-era adjustments to federal lending, particularly the onset of direct federal student loans championed by the president, showed some signs of responding to the new world order in student lending that EduCap led the way in establishing. The direct federal loans included an option for students to repay them as a percentage of their income, a move that was considerably more flexible than earlier government student loan programs. The government itself also attempted to measure risk to an extent – identifying

approximately 800 schools with consistently high default rates and eliminating them from the program. Those three features – assessing risk, providing more flexible repayment options, and introducing non need-based federal student aid – that had proven successful for EduCap also helped significantly lower default rates for federal loans from 22.4 percent in 1990 to 6.9 percent in Fiscal Year 1998, to cite just one example.<sup>31</sup> Today, approximately 77% of the federal student loans (including consolidations) go to non needy students, EduCap notes, a testament to the market it helped pioneer.

Catherine Reynolds likes to say that EduCap’s experience shows that it is possible to “do well by doing good.” Because there have been profits to be made in all areas of student lending, nearly every major player in the industry (including Reynolds) has been subjected to some sort of criticism at times because, as critics note, these profits ostensibly come from the students themselves, who pay the fees and the interest. That sort of criticism is not likely to disappear anytime soon. If you believe the widely held notion that earning a college degree is itself an investment in one’s own human capital, however, it can be argued that EduCap has made such an investment possible for thousands of Americans who might otherwise have found themselves with few affordable higher education options. Students who might have been forced to select their college based on the financial aid packages put together for them by the schools themselves, found themselves able to open doors to schools on their own. By pushing the envelope through competition and basing its business plan on the ease of customer use and the customer’s ability to repay the loans, EduCap has helped change a growing industry that continues to impact students – even those who don’t have direct contact with EduCap or any of its services. By finding innovative ways to link capital markets with students in

need of assistance, EduCap has shown that good ends are attainable in ways that can be similarly beneficial to investors.

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<sup>1</sup> Mark Bateman and Richard Fossey, *Condemning Students to Debt: College Loans and Public Policy* (New York: Teachers College Press, 1998) p. 61.

<sup>2</sup> Edward B. Fiske, "Student Debt Reshaping Colleges and Careers," *New York Times*, Aug. 3, 1986, p. 34.

<sup>3</sup> *Ibid.*

<sup>4</sup> J. Michael Kelly, "Dollars vs. Degrees: Letting Your House Underwrite College Costs," *The (Syracuse) Post Standard*, June 22, 1987, p. D1.

<sup>5</sup> *Ibid.*

<sup>6</sup> *Business Wire*, "EDUCATIONAL LOANS: U.S. Chamber of Commerce educational loan program growing in popularity; 6,500 businesses participating," April 5, 1989.

<sup>7</sup> James L. Rowe Jr., "Local Universities Pool Resources," *The Washington Post*, Dec. 17, 1984, p. 1.

<sup>8</sup> Marcia Slacum Greene, "D.C. Bond Issue Sought To Finance Student Loans," *The Washington Post*, July 2, 1985, p. D5.

<sup>9</sup> Associated Press, "Loan Program for Affluent Students Initiated," *The New York Times*, April 12, 1987.

<sup>10</sup> Debbie Goldberg, "Creative Approaches To Tuition Tab," *Washington Post*, April 9, 1989.

<sup>11</sup> *Ibid.*

<sup>12</sup> Associated Press.

<sup>13</sup> Unless specifically noted otherwise, all comments attributed to Catherine B. Reynolds in this chapter came from an author interview with Reynolds in Washington, D.C. on Jan. 31, 2006.

<sup>14</sup> *Business Wire*, "EDUCATIONAL LOANS: U.S. Chamber of Commerce educational loan program growing in popularity; 6,500 businesses participating," April 5, 1989.

<sup>15</sup> David Montgomery, "Inspiration Investor: For Entrepreneur/Philanthropist Catherine Reynolds, Achievement is Both End and Means," *Washington Post*, April 9, 2002, p. C1.

<sup>16</sup> Valerie Strauss, "Executives Reap Rewards From Nonprofit Loan Firms Success," *Washington Post*, Oct. 28, 1997.

<sup>17</sup> *Business Wire*.

<sup>18</sup> Judy Wells, "A Look At Jacksonville Native Catherine B. Reynolds," *Florida Times Union*, May 25, 2003.

<sup>19</sup> Valerie Strauss.

<sup>20</sup> Valerie Strauss; The price of loans offered by Sallie Mae may be affected by their ability to group private loans with federally-guaranteed loans.

<sup>21</sup> PR Newswire, "University Support Services, Inc. Changes Its Name to Educap, Inc." Sept. 8, 1997.

<sup>22</sup> *Ibid.*

<sup>23</sup> PR Newswire, "College Loan Applications Up 30% in First Quarter, New Data Shows." May 9, 1991.

<sup>24</sup> PR Newswire, "EduCap Inc. Announces ConSern Scholarship Program For Education," Aug. 25, 1997.

<sup>25</sup> PR Newswire, "University Support Services Announces State-Of-The-Art Loan Application and Processing Service for Education Buyers," July 15, 1993.

<sup>26</sup> *Ibid.*

<sup>27</sup> Valerie Strauss.

<sup>28</sup> Wells Fargo News Release, "Wells Fargo Acquires Servus Financial Corporation," June 7, 2000.

<sup>29</sup> David Montgomery.

<sup>30</sup> These rates are pegged to the prime rate.

<sup>31</sup> "National Student Loan Default Rates Lowest Ever," U.S. Department of Education, news release, Oct. 2, 2000.