BIG MONEY ON CAMPUS

In the multibillion-dollar world of student loans, big lenders are finding new ways to drain Uncle Sam's coffers

By Megan Barnett, Julian E. Barnes, and Danielle Knight

INVESTIGATIVE REPORT

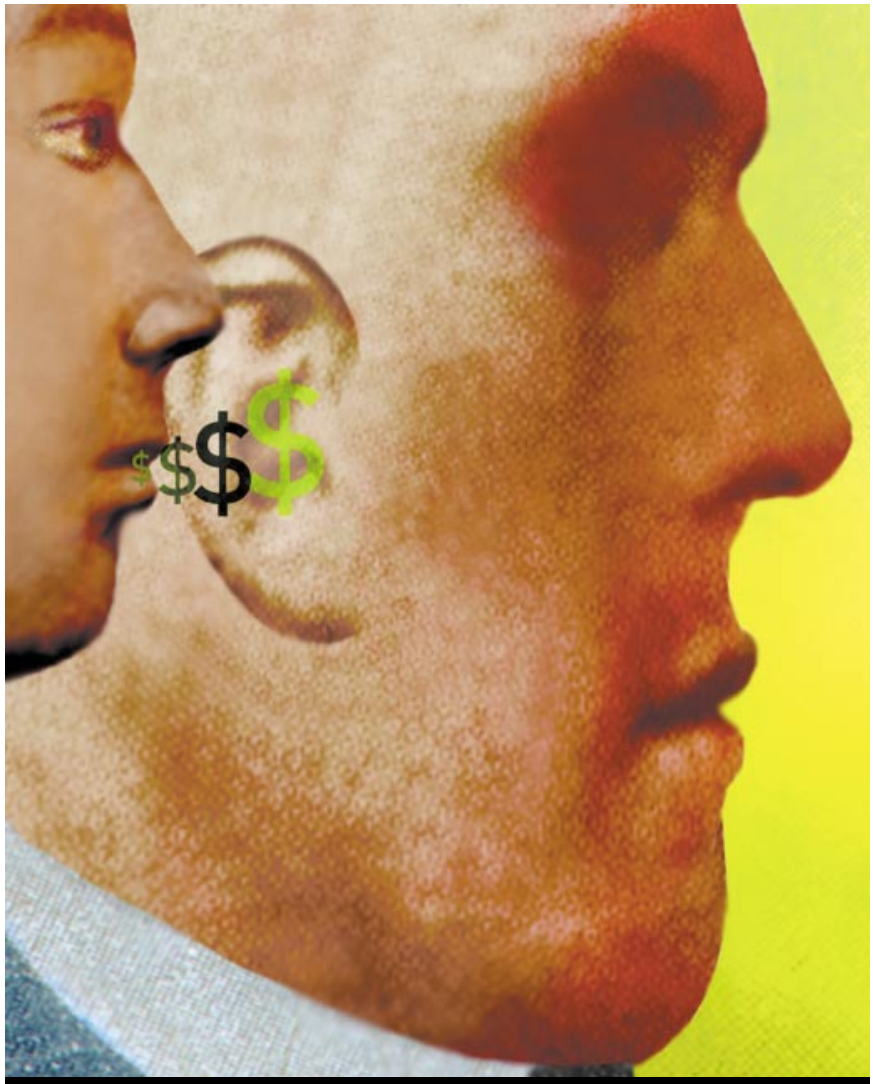
For eight years, students at Michigan State University borrowed tuition money directly from the federal government. But last spring, university officials shucked that arrangement and signed up with private lenders and a state agency that provided loans under a separate federal plan. They guaranteed a profit to the university—something the federal government could not do. Sounds sweet for Michigan State, but it's not so terrific for federal taxpayers, who will almost certainly wind up shelling out $23.5 million more each year as a result of the change.

Michigan State is not unique. Today, dozens of colleges and universities are abandoning the Department of Education's direct-loan plan, lured by the promise of a quick buck from banks, state lending agencies, and, most significantly, Sallie Mae, the giant private lender based in Reston, Va. In all, 62 colleges and universities have dropped out of the Education Department's direct-loan program since 2000, and the list is growing. Sallie Mae says it has won over $1 billion in loan business from former direct-loan schools. The development is costing the U.S. treasury perhaps as much as $250 million a year, according to *U.S. News* calculations based on information provided by the government.

The stakes are enormous, for the private loan industry—and for taxpayers. Since last October, under the federal student loan program, 6.3 million students and their families have borrowed a total of $44 billion to help cover the cost of tuition. There are two basic types of federally backed loans: Students can borrow directly from the government—at schools that have signed up with the government's direct-loan plan—or they can borrow from a lender such as Sallie Mae as part of the Federal Family Education Loan Program, or FFEL. Typically, a college or university participates in one program or the other, but not both.

Many education finance experts consider the direct-loan program more efficient than FFEL. Simply put, direct loans cut lenders out of the

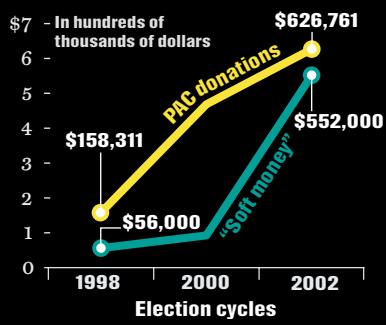
Illustrations by Brian Stauffer for *USN&WR*



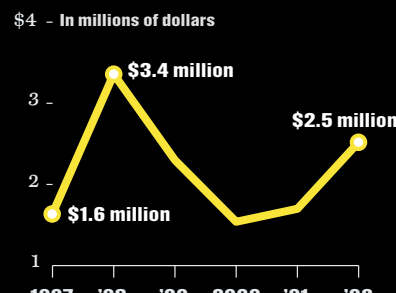
THE TACTIC Giving money, gaining influence

Big private lenders such as Sallie Mae and Nebraska-based Nelnet have rising Washington profiles. They're equal-opportunity donors, giving campaign cash to Democrats and Republicans. Lobbying money rises or falls depending on the agenda in Congress.

POLITICAL CONTRIBUTIONS



LOBBYING EXPENDITURES



SOURCES: CENTER FOR RESPONSIVE POLITICS, U.S. SENATE

picture. Instead of paying subsidies to banks for making loans, the government earns the profits. Government figures show that direct loans typically bring in 22 cents for every $100 borrowed, after deducting for administrative expenses. FFEL, meanwhile, *costs* the treasury $12.80 for every $100 borrowed.

But for private lenders, the FFEL program is a no-lose game. The federal government guarantees repayment of defaulted loans. The loan program, growing each year, can be a hugely profitable business. Sallie Mae, formally known as the SLM Corp., earned $792 million last year, and its chief executive, Albert Lord, pocketed $33.6 million in salary, bonus, and stock option payments the year before (box, Page 40). Its student loan business provided the lion's share of Sallie Mae's profits.

Things weren't always so rosy. Just six years ago, the government's new direct-loan program was gobbling up more and more student business. What to do? For Sallie Mae and other private lenders, the answer was simple: Go for the jugular.

What follows is the inside story of how these powerful private interests turned things around, undercutting the direct-loan program and wooing away big schools like Michigan State. Much like old-time political ward bosses, they used money and favors, along with their friends in Congress and the Department of Education, to get what they wanted. Sallie Mae, for one, engineered changes in education laws that increased its profits and damaged the direct-loan program. One such change, adopted last year, could cost taxpayers up to $8 billion by 2011. Critics of the private lending industry also fault President Bush's education team for undercutting direct loans. Says Barmak Nassirian, an official of the American Association of Collegiate Registrars and Admissions Officers: "The administration is causing a slow strangulation of the direct-loan program."

In a four-month inquiry, *U.S. News* canvassed more than 100 colleges and universities to determine which had abandoned the Education Department's direct-loan program—and at what cost to taxpayers. The review included interviews with lobbyists, federal lawmakers, private bankers, and officials at state lending agencies, Sallie Mae, and the Education Department.

Among the findings:

- Some of the tactics banks and other private interests have used to win student loan business, critics say, are highly questionable. Lenders use proceeds

GRAPHICS BY *USN&WR*

THE RIGHT LOAN FOR YOU

NEWS YOU CAN USE

You're entering college. There will be classes to choose, roommates to meet, and also the small matter of that tuition bill that needs to be paid—anywhere from a few grand to five figures. A student loan will help. But with dozens of lenders out there, does it matter which loan you choose?

The good news, for now, is that with interest rates at historic lows, most students can't be steered too far wrong. But it's still possible, by heeding some simple lessons, to save a few hundred dollars.

The first thing to keep in mind when navigating the loan maze is that there are two federally backed programs that help make loans available. The direct-loan program is simple enough: At colleges that participate, students borrow straight from the government. At other schools, students borrow from a lender—such as Citibank or Bank One—as part of the Federal Family Education Loan Program, or FFEL.

Multiple choice. At FFEL schools, there are more choices and potentially more pitfalls. Financial aid officers at these schools usually steer students to their "preferred lenders." Lesson 1: You may choose none of the above. Schools select favorite lenders because it's more convenient for the *school* to deal with a single company, such as Sallie Mae. Sometimes students get better loans as a result. Other times there are better deals available.

For example, many nonprofit organizations and state agencies with excellent reputations offer low-priced loans. For graduate students, the nonprofit Access Group offers no-fee federal loans. For undergraduates, the Pennsylvania Higher Education Assistance Agency (PHEAA), the Michigan Higher Education Student Loan Authority, and other government agencies offer no-fee loans and sharp interest-rate discounts to students who are either from that state or attending school in it.

Lesson 2: Read the fine print on interest-rate deals. Most lenders will offer to cut or waive origination fees or dangle a lower interest rate. The fee cuts mean real savings. But most lower-interest-rate deals require students to make a long series of on-time payments. For graduates hunting for a first job, that's tough. An internal study by PHEAA showed that only about 7 percent of borrowers managed two years of perfect on-time payments. Miss a payment, and lose the deal on the rate.

At schools that participate in the direct-loan program, students borrow from the government through the school aid office. The government is not allowed to match all deals offered by lenders, but it can cut fees by more than half.

Lesson 3: Explore repayment options. Another key benefit of direct loans: They allow for repayment plans that are tied to a graduate's income, a benefit designed to help students who take public-service positions (but open to anyone with a low-paying job) by slashing monthly payments. After a set time, currently 25 years, the remainder of the loan is forgiven. *–J.E.B.*

from federal loans to entertain financial aid officers, providing them with free meals and drinks, golf outings, and sailboat cruises. Sallie Mae goes even further: It offers schools special pools of money that can be lent to students. In exchange, schools agree to promote other Sallie Mae loans on campus. In one case, an internal Sallie Mae E-mail shows, the company offered $4 million in special loans to a major university in exchange for its business. Sallie Mae says its program is legal, but Education Department officials say the offer merits further investigation.

- Lenders offer the prospect of millions of dollars in profits to universities—if they drop out of the Education Department's direct-loan plan. In effect, the lenders set up the universities as temporary banks, and the schools are guaranteed profits on federally backed loans they make to graduate students. In return, the lenders often win the exclusive right to make loans to the university's undergraduates, a lucrative business.
- Several lenders, including the powerful Nebraska-based National Education Loan Network, discovered a loophole in federal law that forces the government to pay them a premium on top of the interest they already earn from students. According to Department of Education records, the subsidy cost taxpayers about $432 million last year. The tab this year could top $500 million.
- The Bush administration has appointed longtime opponents of the direct-loan program to oversee the Education Department's student loan operation. Some of these insiders have moved to weaken the direct-loan program.
- Sallie Mae and other lenders have forged close ties with key members of the

House and Senate education committees and have spent millions of dollars on lobbying and campaign contributions. They have reaped their share of legislative rewards. Since 1997, Sallie Mae has spent more than $13 million to finance its high-powered Washington lobbying operation; an independent ranking placed the company third within the credit industry on lobbying expenditures.

Sallie Mae, easily the biggest player in the student loan business, says that its tactics are fair and that the rivalry with the direct-loan program has improved services for financial aid offices. "Schools and borrowers have been the direct beneficiaries of these enhancements," says Tom Joyce, a company spokesman. "In short, competition works." The company and others in the industry also argue that the deals they cut with schools reduce student debt.

THE INSIDE GAME

When students borrow *directly* from the Education Department, the government lends the money, and students pay the government back. If a student defaults, the government is left holding the bag. Under the FFEL version, students obtain loans from private lenders, such as Sallie Mae and Citibank's Student Loan Corp. Students pay the lenders back. If a student doesn't make payments, the Education Department still covers 98 percent of any default. In certain instances, the government also pays lenders a subsidy for *making* the loans. FFEL is the larger of the two programs, with $31 billion in new loans issued since October 2002; direct loans totaled $13 billion. All told, the federal government guarantees repayment of some $293 billion in outstanding loans, many dating back 10 years or more.

Twice each decade, lawmakers overhaul this system. They get the chance again soon. Debate begins early next year on loan provisions of the Higher Education Act. Opponents of direct loans want the Clinton-era program eliminated. At a recent education conference, Rep. Peter Hoekstra, a Michigan Republican, was blunt: "We should put a stake through its heart." However, Democratic Sen. Edward Kennedy of Massachusetts wants to strengthen the direct-loan program so that it can compete more aggressively against private banks. Sen. John Edwards, a North Carolina Democrat, would wipe out the FFEL program and switch all schools to direct loans. At current interest rates, he says, his plan would save up to $4 billion a year. "We have to use taxpayer money efficiently," Edwards told *U.S. News*. "That money

shouldn't be used to provide subsidies to lenders but to get kids in college."

This tension has persisted ever since President Clinton signed the direct-loan plan into law in 1993 and positioned it to replace the FFEL program. Supporters thought schools would flock to the new system. Within five years, direct loans had captured 34 percent of the business, an alarming development to private lenders.

By then, Sallie Mae was on a war footing. First, it reinvented itself. Originally a government-sponsored enterprise, Sallie Mae got approval to privatize in 1997, which allowed it to originate its own loans and acquire other companies. The new company quickly bought its two major rivals and improved its loan-processing services to compete better against the direct-loan program. Along with other companies, Sallie Mae began offering discounts on fees and interest rates that the government was not allowed to match.

At the same time, Sallie Mae stepped up its lobbying presence in Washington and began scoring big. In 1999, its lobbyists persuaded lawmakers to create a new interest-rate formula that boosted the company's profits, allowing it to offer further discounts to schools. Then, last year, Sallie Mae got Congress to eliminate a planned interest-rate reduction that would have curbed the company's profits and reduced student-borrower debt. That change may cost taxpayers $8 billion by 2011, say education and banking lobbyists.

Sallie Mae cemented its political ties with campaign donations. The company and its employees poured large sums of money into the coffers of Republicans and Democrats alike, according to the

THE TACTIC Playing the inside game

The Bush administration appointed executives and lobbyists from the student loan industry to prominent positions at the Department of Education, especially in subcabinet posts, where many important policies are made and implemented.

William Hansen

Deputy secretary of education from 2001 to 2003. A top lobbyist for private lenders, Hansen was CEO of the Education Finance Council, a lender trade group. He also led a political action committee that backed candidates who favored private lending. After leaving the No. 2 post at Education in July, he rejoined the private sector.

Sally Stroup

Assistant secretary for postsecondary education She was a top aide to former Rep. William Goodling, head of the House Education Committee, and in the late 1990s helped Goodling try to rein in the Clinton direct-loan program. From 1981 to 1993, Stroup worked for the Pennsylvania Higher Education Assistance Agency, a state lender.

Theresa Shaw

Head of the Office of Federal Student Aid In 2002, she took charge of the government office that administers all federal student loans. Before that, Shaw worked in private industry for 22 years, mostly for Sallie Mae, where she served as a senior vice president and as chief information officer.

Jeffrey Andrade

Deputy assistant secretary from 2002 to 2003. He worked for lobbying firm Dean Blakey & Moskowitz. Its clients included the Consumer Bankers Association and the Coalition of Higher Education Assistance Organizations. He lobbied to limit the ability of the direct-loan program to compete with commercial lenders.

Center for Responsive Politics, a Washington watchdog group. Its "soft money" donations alone—those not restricted by federal contribution limits, until outlawed last year—jumped to $552,000 in the 2002 election, a 10-fold increase over 1998. Others in the student loan industry also cranked up their giving, pouring tens of thousands of dollars into congressional campaigns.

Sallie Mae is well positioned as Congress prepares to debate the student loan provisions of the Higher Education Act. Some of its campaign gifts went to important members of budget, appropriations, and education panels, all of which deal with the student loan program. The company's political action committee and its employees were the second-largest donor to last year's reelection campaign of Rep. Howard "Buck" McKeon, a California Republican and chairman of a key House education panel. They gave him $11,500. McKeon has been a speaker at Sallie Mae events, and the company has paid for his travel to Las Vegas and Panama City, Fla.

The company also has close ties to New Hampshire's Sen. Judd Gregg, a Republican who heads the committee that oversees education issues. Two years ago, President Bush appointed Gregg's wife, Kathleen MacLellan Gregg, to the board of directors of the Student Loan Marketing Association, the branch of Sallie Mae that remains government sponsored. She receives about $20,000 a year for being a director, according to a congressional aide. Another board member, J. Bonnie Newman, once served as Gregg's chief of staff.

Equally important, Sallie Mae has friends inside the Bush administration (box, above). As CEO of the Education Finance Council, an industry trade group, William Hansen denounced the direct-loan program in testimony before Congress. Bush later made Hansen the No. 2 official at the Education Department. All told, the White House installed four officials from the lending industry—including Hansen—to run the direct-loan program. Hansen left the department this summer.

From the beginning, the direct-loan program has been unpopular among Republican conservatives, who argue that private industry should handle the job. Soon after taking office in January 2001, the Bush team began to undermine direct loans. First, officials stopped marketing the program and competing for new schools. Then, last year, the Bush administration proposed selling the government's direct-loan portfolio to a private company. Critics called this a veiled effort to kill the program. Education Department officials deny this. "This is money we could have invested back in the student loan program," explains Sally Stroup, a senior department official. For now, the idea has been shelved.

Bush insiders also challenged a central pillar of the direct-loan program: the notion that it saves taxpayers money. In early 2002, Hansen argued inside the Education Department that when administrative expenses were included, the cost of direct loans was much higher than official figures indicated. As a matter of fact, he said, taxpayers saved no money. However, government figures don't support his claims. They show that the FFEL plan costs the treasury far more than direct loans, even after deducting administrative costs. In an interview, Hansen denies attempting to kill direct loans and says he was only trying to strengthen the overall loan program.

The Education Department's actions, however, caused some colleges to second-guess the direct-loan program. Richard Shipman, the financial aid director at Michigan State, says that's one reason he decided to quit it. "I don't want to be a part of a program," he says, "that is no longer supported by the folks that made it."

ROMANCING THE SCHOOLS

Private lenders certainly know how to entice schools. Each year, the big players in the industry mix with several thousand college officials at the annual conference of financial aid administrators. One year it was Las Vegas and its rollicking casinos, another year New Orleans and Bourbon Street.

This July, the conference was held in

U.S. DEPARTMENT OF EDUCATION (4)

a more sedate setting, Salt Lake City, but the wine still flowed freely, and partying was the name of the game. Key Bank, a lender based in Cleveland, hired an ersatz Elvis, who urged school officials to attend the bank's party at the Hard Rock Cafe. Exclusive guests of the Access Group, a Delaware-based nonprofit lender, were treated to a show by the U.S. ski team at the site of the 2002 Olympic Games. Sallie Mae transformed a hotel ballroom into a lights-and-mirrors 1970s disco. In all, including direct conference expenses, lenders spent hundreds of thousands of dollars to outdo one another in the eyes of the college reps.

The loan industry's romancing of school officers continues year-round. Major lenders appoint university officials to ad hoc advisory boards, which hold regular meetings at high-end resorts. The lenders say the get-togethers allow school officials to offer insights into lending. Critics say the meetings are junkets. Lenders also ply university officials with free lunches and golf outings. "It's an endless stream of invitations," says Ellen Frishberg, the financial aid director at Johns Hopkins University, who turned down a Sallie Mae offer of tickets to a concert this month by Huey Lewis and the News. "It's quite comical at times."

To win loan business, some lenders offer sweeteners the government can't match. At Tuskegee University, for instance, Sallie Mae offered to provide loan counseling for students and install free software for the financial aid office, and even promised free extra workers to perform tasks typically done by objective counselors. "I have only praise for Sallie Mae," says Barbara Chisholm, Tuskegee's financial aid director. "They are making sure we have what we need."

Sallie Mae has introduced another, even more controversial, tactic to lure schools away from the direct-loan program. Three years ago, the company created something called "opportunity loans," in which Sallie Mae agrees to lend money to students, at the direction of schools. These loans are not part of the federal program, and the government does not guarantee repayment in the event of default. Sallie Mae is more than willing to shoulder the risk. Here is why: These private loans are available *only* if a school, in return, promises to leave the direct-loan program and market Sallie Mae's separate federally backed loan program to students. Unable to borrow unlimited amounts under federal programs, many students can use opportunity funds. Colleges like opportunity loans because they keep enrollment up and tuition flowing.

The loans are catching on. Schools including Seton Hall University in New Jersey, Harding University in Arkansas, Austin College in Texas, Tuskegee, and the University of California–Los Angeles all offer Sallie Mae opportunity loans. They all also have exclusive arrangements to market federal loans from Sallie Mae or its partners to their students.

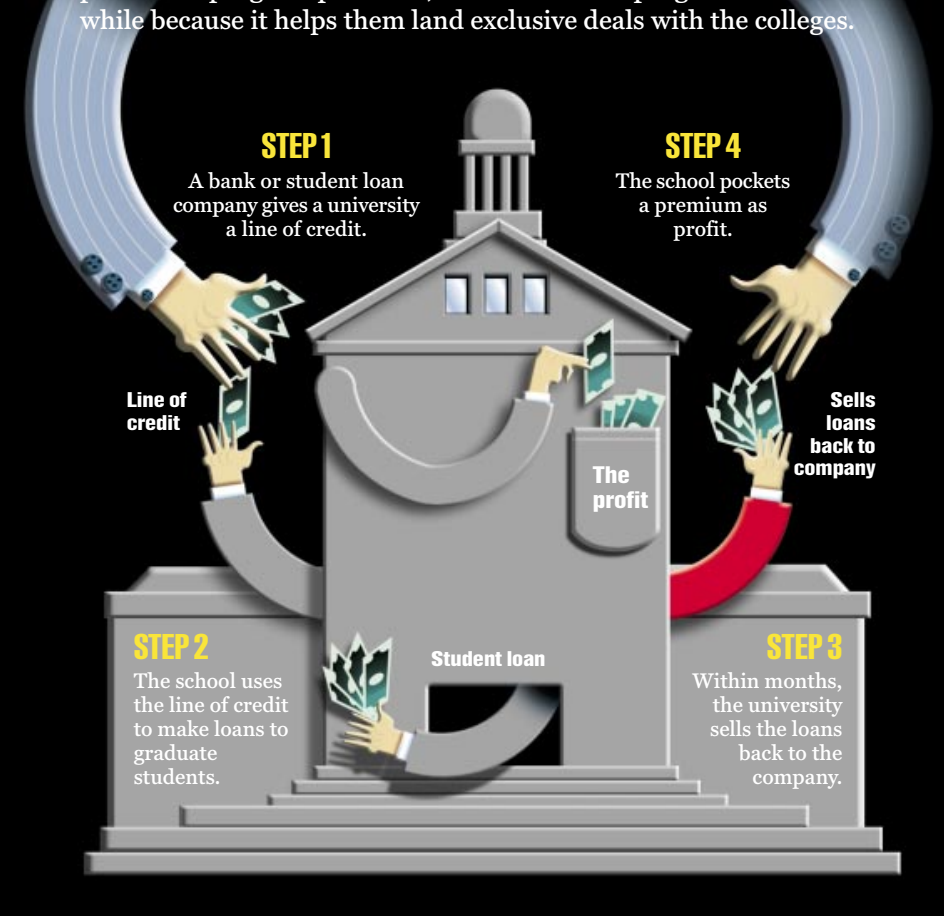
However, some education experts believe opportunity loans amount to improper inducements. Federal law prohibits lenders from offering direct or indirect inducements to educational institutions, including "points, premiums, [and] payments" to obtain federally backed loans. "It is like someone coming to me and bribing me," argues Leo Kornfeld, an education official in the Clinton administration.

Sallie Mae says opportunity loans are legal. The company defends them as a way to help students with bad credit or no history of credit. "We think an individual's credit as they enter school is not indicative of their credit when they get a job," says Barry Goulding, a senior vice president at the company.

Education Department officials seldom pursue inducement cases. Officials say that opportunity loans are legal if offered simply as a benefit to schools. However, Sallie Mae could have a problem. In an April 2002 E-mail obtained by *U.S. News,* Sallie Mae proposed this deal to Pace University, which is based in New York City: If Pace made Sallie Mae its "exclusive lender," the company would provide $4 million in opportunity loans over a four-year period. The school declined the offer. *U.S. News* disclosed the contents of the E-mail to two Education De-

THE TACTIC Turning schools into banks

More and more schools are entering into "school as lender" deals with student loan companies. Universities are enticed by the guaranteed profits the program promises; lenders find the program worth their while because it helps them land exclusive deals with the colleges.



partment officials. Both said the offer merits further investigation.

Sallie Mae insists that it doesn't require schools to make it an exclusive lender. But in an internal document, Sallie Mae writes that one factor used to determine whether a school gets an opportunity loan is the amount of *other* business the school gives the company. Investigators in the Education Department are critical of Sallie Mae's tactics. In August, the inspector general's office found that the company had "negotiated preferred lender status [with schools] in exchange for a specified dollar amount of private loans" and urged strengthening the anti-inducement law.

Other arrangements also lure schools away from the direct-loan program. In "school as lender" deals, Sallie Mae and others in the industry in effect turn schools into temporary banks as a way to get their business. The schools pocket a nice fee, sometimes topping $1 million, for acting as a lender. "It is a new way to . . . pay a school to force business to a specific lender," complains Dan Davenport, financial aid director at the University of Idaho and former chairman of the Direct Loan Coalition.

Despite the complaints, a federal court decision permits this arrangement, which is used only for loans involving graduate students. Case Western Reserve University in Ohio illustrates how the tactic works. In 2001, Key Bank lent the university $22 million. The school, in turn, lent the money to graduate students. Soon after, it sold the loans to Sallie Mae at a premium of several hundred thousand dollars. As part of the deal, Case Western dropped out of the direct-loan program and gave its undergraduate loan business to Sallie Mae. A Case Western official says students are getting cheaper loans.

Don Bouc, the president of the National Education Loan Network, or Nelnet, defends the practice as "a necessary evil." He explains, "The expectation is if the graduate school goes school-as-lender, you have a leg up in getting the undergraduate loans. It's something we have to do to be competitive."

The aggressive marketing of the program by companies such as Nelnet and Key Bank is having an impact. Since last year, 26 universities have become temporary lenders, including six that dropped the direct-loan program. "We figure we'll bring in $1.3 million a year," says Bryan Terry, financial aid director at Detroit's Wayne State University, which dropped out of the direct-loan program and signed with Nelnet. "We will use it for scholarship money."

Many universities are under financial pressure to join the school-as-lender scheme and drop their direct-loan programs. The University of Michigan–Ann Arbor says it is now studying whether to let Nelnet handle undergraduate loans and set up the school as a graduate lender, a development that could bring in several million dollars in special premiums.

When schools become lenders, every new loan brings in extra profits to the school. That poses a conflict of interest for financial aid officers, who are supposed to serve as objective counselors, steering students to the best aid packages. Critics fear the temptation will be to push more loans. "People will see we make more money by making more loans," says Karen Fooks, financial aid director at the University of Florida. "The linkage is so obvious it ruins our credibility." Rep. Dale Kildee, a Michigan Democrat, has launched an inquiry.

THE LOOPHOLE

Perhaps the biggest blow to the direct-loan program came when Michigan State University left the plan last spring. The school was the second-largest participant in direct lending, with $183 million in loans a year. It was lured away by a lucrative deal assembled by three banks and a state agency, the Michigan Higher Education Student Loan Authority. The group offered students a rebate on fees, and it even guaranteed the school a profit of at least $2 million.

The deal raised eyebrows throughout the industry; competitors wondered how the loan authority and its banking partners could afford to be so generous. The answer lies in an obscure loophole in fed-

GRAPHIC BY ROD LITTLE—*USN&WR*

WHEN ALBERT MET SALLIE

At Sallie Mae, the student loan giant, stock options haven't gone out of fashion: In 2001, Sallie Mae CEO Albert Lord made $33.6 million, mostly because he exercised options. Last year, the No. 2 executive at Sallie Mae, Thomas Fitzpatrick, took home $27.2 million in salary, stocks, and bonuses.

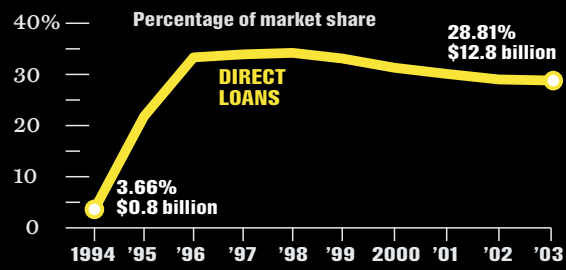
Fair enough. But Sallie Mae does not count those compensation expenses as operating costs on its income statement—a practice that is controversial on Wall Street. Corporate-reform advocates say that income from stock options distorts executive pay and dilutes the value of stock held by shareholders; therefore, it should be counted as a cost of compensation. A research report from Morgan Stanley last month estimates that Sallie Mae's earnings would have been 13 percent lower than the $373 million it reported in the second quarter if it had expensed its options. Sallie Mae Senior Vice President Kathleen deLaski says the company isn't required to account for the options and informs investors "what the impact of the options is."

Makeover. Reston, Va.-based Sallie Mae is in the midst of a corporate makeover that began shortly after the government direct-loan program—which threatened Sallie Mae's business—was created in 1993. After Sallie Mae was established by Congress in 1972, it served as a secondary market for student loans, freeing up money for banks to continue lending to more students. But Sallie Mae's status as a government-sponsored company limited its ability to respond to the challenge posed by the direct-loan program, which quickly grabbed a third of the student loan market. In 1995, Lord, who had left the company, led a group of shareholders in a revolt against management. During a two-year boardroom brawl, Lord argued that Sallie Mae needed to originate loans itself and branch out into related businesses in order to compete. Ultimately, that meant cutting its ties to the government. In 1996, Congress gave the go-ahead to privatize. And in July 1997, Lord prevailed as shareholders voted to oust the senior management. He was appointed chief executive. Sallie Mae expects to become fully privatized by 2006.

Sallie Mae quickly diversified. Today, it counts online recruitment, credit cards, insurance, and mortgages among its businesses. Student loans still account for the bulk of its revenues, and it remains the largest in the industry. As of the end of September, it managed $86 billion of the estimated $293 billion in outstanding federally backed student loans. On revenue of $3.4 billion in 2002, Sallie Mae's profit more than doubled to $792 million. Company stock outperformed the S&P 500 by about 40 percent during the past two years and trades at 17 times earnings. *–M.B.*

WHAT GOES UP...

Sallie Mae helped roll back the direct-loan program's market share.



CEO Albert Lord diversified Sallie Mae; he took home $33.6 million in 2001.

SOURCE: OFFICE OF MANAGEMENT AND BUDGET

eral law. The provision allows certain lenders to reap windfall profits. The state authority in Michigan, for example, earned $12 million last year from this special federal subsidy. It used that money to bankroll the deal with Michigan State. There was a side effect, however. Michigan State's decision to drop direct loans and switch to the FFEL program will cost taxpayers at least $23.5 million annually, according to a *U.S. News* analysis. "Essentially, the federal government is paying an excessive fee to drive its own, less expensive program out of business," says one Education Department official. "As a taxpayer, that makes no sense."

Where does the windfall come from? The subsidy guarantees lenders a return of 9.5 percent on certain loans; that's quite a bonus at a time when most students are paying only about 3.5 percent in interest. Lawmakers thought they had done away with the subsidy a decade ago, but some lenders discovered that by exploiting an Education Department ruling and using creative refinancing, they could issue a nearly infinite number of subsidized loans.

The subsidy was originally designed to help nonprofit groups that issued special bonds to finance student loans. But today, the biggest holders include Sallie Mae ($2.1 billion in loans that qualified for the subsidy in 2002) and Nelnet ($495 million in 2002). Both companies acquired nonprofits that qualify for the subsidy. "It's a windfall that has no benefit to taxpayers or students," says Thomas Wolanin of the Institute for Higher Education Policy, a Washington think tank. The bill to taxpayers for the subsidy is likely to exceed $3 billion over the next decade, according to Education Department officials. Nelnet president Bouc acknowledges that critics consider the payments a waste of taxpayer money. "I don't want to argue," he says. "I am not sure I would say anything different." Still, his company is aggressively trying to win more of the special subsidies. Education Department officials told *U.S. News* that they are now reviewing the loophole but caution against any quick fix.

In the end, there is good reason the lending industry has come up with one scheme after another, cultivated so many friends in Washington, and sought to gut the taxpayer-friendly direct-loan program. College is getting ever more expensive. On average, a four-year education means graduates with loans will be writing checks to pay off nearly $17,000 in debt. Private lenders want those checks made out to them, not to the government. ●

FROM LEFT: GRAPHIC BY *USN&WR*; CAROL T. POWERS