



UNITED STATES DEPARTMENT OF EDUCATION

WASHINGTON, D.C. 20202-.....

MARCH 1995

95-G-278

95-L-178

95-S-73

SUMMARY: *Limitations on lending by schools and prohibition on inducements to schools by lenders must be observed.*

Dear Colleague:

It has recently come to our attention that there may not be sufficient awareness in the student financial assistance community of the substantial limitations imposed by section 435(d)(2) and (5) of the Higher Education Act of 1965, as amended. These provisions address the participation of schools in the Federal Family Education Loan Program as lenders and the offering of inducements by any lenders to schools or individuals to secure loan applicants.

Congress has focused on this subject several times. One common theme to these reviews has been the desirability of separating the academic and lending functions when possible. Such separation of functions is designed to prevent the student from confusing his/her obligations as a borrower with his/her feelings about the school and removes an economic interest that may affect the school's objectivity as it advises the student with respect to financial assistance. Another common theme has been the desirability of having students' borrowing decisions made on the merits of the loans rather than extraneous marketing incentives to students and their schools. To deal with these concerns, Congress restricted the activities of school/lenders in paragraph (d)(2) and of all lenders in paragraph (d)(5).

Paragraph (d)(2) provides that in order to be an eligible lender in FFELP, a school must, among other things, not make any loan to a first-time undergraduate borrower unless the borrower has been denied a loan by an eligible lender. This is an important limitation flowing from the desirability of separating the academic and lending functions whenever possible. It may not be evaded by arrangements in which some other lender formally originates the loan and holds it for a short period of time, but the arrangements between that lender and the school allocate all but a small portion of the lender's economic risk and profit to the school. In determining whether a school has complied with paragraph (d)(2), the Secretary will look at the substance of the arrangements rather than merely at their form.

Paragraph (d)(5) excludes from eligible status any lender that offers, directly or indirectly, any "inducement" to a school in



order to secure applicants for FFELP loans. Loan decisions by students may affect their entire lives significantly, and such decisions should be based on the merits of the loans and not on extraneous factors, particularly not on monetary benefits given to the schools on which students often rely in such matters. In this respect it does not matter whether the lender offers the monetary benefit to the school directly or simply arranges for the school to receive the benefit from a third party. Here, too, the Secretary will look at the substance of any arrangements rather than merely at their form.

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

Although providing "inducements" to a school is not permitted for any lender, it becomes part of an improper activity for the school as well when it is structured to enable a school "lender" to evade the limitations of paragraph (d)(2) on an undergraduate loan. We have heard of situations, for example, in which the non-school lender itself originates the loan acting as "trustee" for the school and subsequently "buys" the loan from the school after the school has received substantial interest payments or in which the non-school lender that ultimately "buys" the loan arranges for some other "lender" to be the originator of record. Arrangements such as these put both the school and the non-school lender at risk of losing their eligibility under FFELP.

Congress has provided severe sanctions for conduct by an eligible lender exceeding the limitations of paragraphs (d)(2) and (d)(5). In addition to the general sanctions in the Higher Education Act, paragraph (d)(5) expressly provides for the disqualification of the lender from participation in FFELP. Although the same procedure is not expressly provided by paragraph (d)(2), both disqualification and the loss of benefits on the particular loans involved could follow from a finding that a school had exceeded the paragraph's limitations. The Department considers lender activity exceeding these statutory limitations as extremely serious and will not tolerate its continuance. Arrangements designed to enable schools to evade the statutory limitations on their lending activities or to confer a monetary benefit on them to induce the securing of FFELP loan applicants must be ceased

immediately.

We appreciate your attention to this important provision of the Higher Education Act.

Sincerely,

A handwritten signature in dark ink, appearing to read 'Leo Kornfeld', with a long, sweeping horizontal stroke extending to the right.

Leo Kornfeld
Senior Advisor to the Secretary