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IMPLICATIONS OF THE PRIVATIZATION OF SALLIE MAE

John E. Dean, Saul L. Moskowitz and Karen L. Cipriani*

ABSTRACT. In 1997, Congress enacted legislation to transition the Student Loan Marketing Association (Sallie Mae) from status as a government-sponsored enterprise (GSE) to a fully-private, non-federally chartered organization. The process through which this legislation was enacted will have precedential value for future legislation affecting other GSEs. This article reviews the unique context in which the Sallie Mae Privatization Act was considered and enacted. Sallie Mae was an active participant in the development of the privatization legislation, and Congress had little precedent in considering the diverse interests of stakeholders such as other entities involved in student loans, taxpayers, and Sallie Mae shareholders. Full assessment of the 1997 legislation requires a review of how the "privatizing" of Sallie Mae changes the student loan marketplace.

INTRODUCTION

Over the last sixty years, Congress has periodically identified policy objectives it believed would be best served through creation of governmentally supported financial intermediaries. In response, the Congress has created eleven federally-chartered organizations known as Government Sponsored Enterprises, or GSEs.[1] The traditional GSE is a privately-owned financial institution with a federal charter and special government benefits, such as tax exemptions and an implicit federal guarantee of its debt.[2]

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With few exceptions,(3) these entities have been successful in terms of their own viability and in meeting the needs for which they were created. However, the market and political forces that made GSEs attractive in the late 1960s and early 1970s have largely faded. In addition, financial markets have diversified and created new sources of liquidity and guarantees. Further, technological initiatives have greatly altered business processes and improved the ability of financial markets to sustain themselves.

In this environment, the case for GSE status is less compelling. Concerns over the continued existence of federally chartered financial institutions with special privileges have led to calls for the privatization of the GSEs.(4) Specifically, some critics argue that the implicit federal guarantee of the GSE's financial obligations preempts competition in the marketplace the GSE was created to serve (Bothwell, 1996) and artificially influences overall national economic behavior (U. S. Department of Housing and Urban Development, 1996).

One of the nation's most prominent GSEs, the Student Loan Marketing Association (SLMA or Sallie Mae), was created in 1972 (the Higher Education Act Amendments of 1972, PL 92-318) to address the perceived need for a market to purchase federally guaranteed student loans. However, as the need for a federally-chartered student loan entity has decreased, legislation was introduced to privatize Sallie Mae; on the basis of this legislation, the company's shareholders voted to privatize the company earlier this year (Sallie Mae, 1997). This article will provide an overview of Sallie Mae's role in the student loan marketplace, including the rationales which supported the conversion to private status. The analysis will review concerns raised by Congress and others during consideration of the Sallie Mae privatization legislation and the political and business environments in which the privatized Sallie Mae will operate. The article will also address Sallie Mae's immediate plans and the implications of the Sallie Mae experience for privatization of other GSEs.

SALLIE MAE AND THE MOVE TOWARD PRIVATIZATION

Issues regarding the privatization of Sallie Mae cannot be fully appreciated without a basic understanding of the Federal Family

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Education Loan Program (FFELP), the largest federally-supported student loan program.[5] Under the FFELP, loans are made to a borrower by eligible lenders (primarily financial institutions).[6] Insurance against the risk of default, death, or total and permanent disability of the borrower is provided by a guaranty agency, which in turn is supported with reinsurance provided by the Department of Education.[7] Originating lenders either hold their loans, sell them to a secondary market entity or other eligible lender, or securitize them through the issuance of student loan asset-backed securities.[8]

Sallie Mae, established for the explicit purpose of providing liquidity for lenders in a student loan program in which borrower access to student loans was a concern,[9] has been an unambiguous success in supporting the availability of FFEL loans. The company serves over 900 financial and education institution clients and by October 1997 had reported a managed portfolio of student loans totaling approximately $41 billion (SLM Holding Corporation, 1997a).

The success of Sallie Mae in this regard led Congress to consider what other special program needs the company could fulfill, the most prominent being the need to assure the availability of loans to high-risk borrowers who might otherwise be unable to secure FFEL loans.[10] The company also received authorization to enter the college housing finance market[11] and to originate Health Education Assistance Loans directly.[12] All of these special missions were consistent with the concept of a GSE.

Context

As Sallie Mae developed and advocated its plan for privatization over a three-year period, it had to negotiate its terms with the Executive Branch and the Congress amidst significant political and market developments.[13] Major changes in the guaranteed student loan program were occurring, prompted in part by competition from the Direct Loan program and radical changes in subsidy payments in the program. These changes included industry agreement on a common data format for electronic transmission of application information,[14] development of common administrative procedures by guaranty agencies,[15] development of a non-profit corporation to maintain student enrollment data,[16] and development of the first large-scale data switch and Internet-based loan

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management software.[17] These services made participation in the student loan program easier for many lenders. When combined with new avenues for financing loans, lenders were provided with several alternatives to selling loans to Sallie Mae.

Even more significantly, the Federal Direct Student Loan Program was enacted in 1993 and immediately cut into the volume of privately-made student loans that constitute the basis of Sallie Mae's business. Faced with the possible elimination of its primary product, Sallie Mae considered other business options, but the limitations of its charter precluded it from performing other, non-education credit functions.[18] This threat and other factors drove Sallie Mae publicly traded shares to record lows and prompted the company to cite Direct Loans as a rationale for allowing the company to enter new markets.[19]

By early 1993, enactment of a new delivery system for student loans, under which the government rather than the private sector made loans, was also considered likely.[20] The proposal had been highlighted in the 1992 Clinton Presidential campaign and enjoyed strong Congressional support in both the House of Representatives and the Senate.[21] To some, the combination of these events made complete elimination of the guaranteed student loan marketplace appear inevitable.[22]

This perception was short-lived. By 1994, Republican majorities were elected in both the House of Representatives and the Senate, replacing pro-Direct Loan majorities with anti-Direct Loan majorities and removing any immediate prospect of Direct Loans replacing FFEL loans. Republicans adopted a special budget scoring rule on the FY 1996 Budget Resolution that resulted in estimated savings from the replacement of Direct Loans with FFEL loans.[23] Legislation was introduced calling for the repeal of Direct Loans and, eventually, a cap on Direct Loan volume at 10 percent of total loan volume (H.R. 2491). The bill severely restricting Direct Loan volume, which also contained the Sallie Mae Privatization Act, was vetoed by President Clinton on December 6, 1995.

When the dust had settled, the Clinton Administration's commitment to move to 100 percent direct lending had changed (U. S. Department of Education, 1996). Interest in privatizing Sallie Mae, expressed both within Sallie Mae and outside the organization, had not.[24] As the student

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loan market stabilized, largely due to the efforts of Sallie Mae, the company continued on a path towards privatization.[25]

The Privatization Act

In considering the need to change the operating structure of Sallie Mae, no option other than simply privatizing the company was actively considered. The privatization plan was largely defined by Sallie Mae itself and was actively promoted by the company's own lobbying effort. Two other options--liquidating the company and paying off shareholders, or breaking the company into several smaller companies--were never seriously considered, in part due to a belief that there would be no adverse impact on the student loan market from the simple privatization option (U. S. House of Committee, 1995a: 29-33).[26] One of the options--liquidation no doubt would have been seen as potentially harmful to the student loan marketplace, given the size of the company's recent loan purchasing activities ($8.4 billion in 1996).

Legislation permitting the privatization of Sallie Mae was ultimately signed by President Clinton on September 30, 1996 (P. L. 104-208), with the legislative history reflecting the diverse concerns of the Congress and others regarding the privatization of the entity. For example, then-Sallie Mae CEO Lawrence Hough testified at a Joint Hearing before Subcommittees on the House Committee on Economic and Educational Opportunities and the House Committee on Government Reform and Oversight on May 3, 1995. Hough noted that there were three compelling reasons to privatize the company: Sallie Mae had achieved its mission of increasing access to student loans; if the GSE is no longer needed, unnecessary borrowing with federal backing should be reduced; and the "life cycle" of the GSE was complete, and Sallie Mae would be an ideal candidate to test GSE privatization.[27]

Under the legislation, Sallie Mae was to be privatized upon a majority vote of its outstanding shares, with a gradual phase-out of its GSE activities. After a bitter proxy battle on July 31, 1997, shareholders voted overwhelmingly to reorganize the company into a fully private entity and install new management. A total of 43.7 million votes were cast in favor of privatization, or 83% of the approximately 53 million shares outstanding. As a result of the privatization vote, a private, state-

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chartered holding company, SLM Holding Corp., was created, and the GSE became a subsidiary of the holding company in August of 1997. The GSE debt currently outstanding and new debt issued in the future by the GSE subsidiary will maintain its GSE status until it is phased out on or before September 30, 2008.

THE PRIVATIZED SALLIE MAE'S BUSINESS ENVIRONMENT

The business environment the privatized Sallie Mae enters is fiercely competitive. Of a total student loan volume estimated at about $30 billion in academic year 1997-98, Direct Loans are estimated to capture 38 percent of this volume.(28) Of the remaining 62 percent of loans, or the FFEL share of the total, banks may be expected to hold 45 percent of that volume; non-profit and state secondary market participants are expected to hold 20 percent; therefore, only about 35 percent of FFEL loans are likely to be acquired by Sallie Mae.(29) Given the volume of Direct Loans currently being made, the privatized Sallie Mae will enter a market in which over one-third of student loans are unlikely to ever be available to Sallie Mae for purchase.(30)

The FFELP market will become progressively more competitive for Sallie Mae, as both a loan originator and a loan holder, for a variety of reasons:

1. The Clinton Administration remains firmly committed to the FDSL program;(31)
2. Not-for-profit secondary markets continue their competition with Sallie Mae for those loan portfolios that become available for purchase;(32)
3. State-based guaranty agencies are competing aggressively for new loan originations;(33)
4. Lenders are employing increasingly targeted advertising, such as direct mail marketing, to reach students and their families;
5. Asset securitizations and other forms of alternative financing for student loans have become an increasingly attractive option for lenders that might otherwise sell to Sallie Mae.(34)

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At the same time, the sheer size that Sallie Mae has been able to attain with the benefit of its GSE status will make it a formidable competitor as a private entity.[35] In particular, the volume of loans serviced by Sallie Mae in its servicing centers enables it to achieve a per loan cost of servicing well below that of most other lenders and servicers. In addition, its financial strength enables it to offer a lender indemnification against loss due to servicing error that is backed by the deepest pockets in the servicing sector.

Originally, Congress authorized the GSE Sallie Mae to make "loans of last resort" to students who were otherwise unable to obtain student aid, thereby increasing access to postsecondary education.[36] Future subsidy reductions and those enacted in 1998 (for example, the Higher Education Amendments of 1998, PL. 105-XXX) could increase the demand for such loans, and with Sallie Mae no longer required to make loans of last resort, some critics are predicting a problem with access to education funding for the most disadvantaged students. It is important to note that the lender-of-last-resort program is a creature of Congress, and Congress can change the terms of student and institutional eligibility if it chooses.[37] Alternatively, Congress could require other entities to make loans of last resort, or provide incentives to the private sector to encourage them to perform this function. However, as the largest FFEL financial participant regardless of its status, the privatized Sallie Mae will remain the obvious solution to this kind of problem.

Finally, the market that the privatized Sallie Mae inherits may be substantially altered due to the very fact that the Sallie Mae GSE will soon no longer exist.[38] While a strong network of secondary markets[39] has emerged since Sallie Mae was created, it is possible that the absence of a GSE will reduce market liquidity. This is particularly true since Sallie Mae is the dominant provider of letters of credit and similar support to other nonprofit secondary market entities. Without Sallie Mae's support, it is unclear whether those entities will be able to continue to issue bonds to finance their activities. It will, therefore, be imperative to ensure that the secondary market structure remains viable for student loans, and that there is no lack of holders as a result of Sallie Mae's privatization.[40]

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In short, the impact of a privatized Sallie Mae on the marketplace will change in terms of the previous market dominance that the GSE has enjoyed,[41] and Sallie Mae's ability to compete effectively in the market has become the most closely watched aspect of the privatization.[42]

THE PRIVATIZED SALLIE MAE'S POLITICAL ENVIRONMENT

For good or bad, the privatization of Sallie Mae is not likely to relieve the company from intense oversight by the Congress and the Department of Education. As the largest financial intermediary in the student loan program, the company will continue to represent the cornerstone for success of the FFELP. This perception could operate to the benefit of the company, as a means of negotiating favorable treatment for the company from Congress and regulatory agencies. However, the company will also be looked to as a logical source for budgetary savings, for example, by bearing the brunt of a differentiated holder return on loans held by very large lenders.[43] Similarly, continued emphasis on the guaranteed student loan market may lead some Congressional critics of the program to review compensation issues, lobbying expenses, and other practices of the company because its profits will be seen as deriving directly from the federal student loan programs.

The newly privatized Sallie Mae is also subject to political forces in new and unexpected ways. For example, during consideration of the Higher Education Act, Sallie Mae proposed an amendment that would have facilitated its affiliation with an insured financial institution. The amendment was not adopted after House Banking Committee Chairman James Leach (R-IA) objected on the basis that it would have led to unfair competitive advantages for Sallie Mae in competition with other financial institutions. The Banking Committee action was interpreted by some to suggest that Sallie Mae's status as a former GSE will continue to subject it to special scrutiny in the future, at least on some instances.

It is likely that the political environment will continue to change along with Sallie Mae's change in status. Whereas Sallie Mae was formerly seen as a different animal from other student loan providers, Sallie Mae will now join the rest of the private market and will be required to compete and compromise just like everybody else.[44] Given Sallie Mae's size, federal ties, and experience in the student loan

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business, the privatized company is assured of a significant role in the student loan market if it chooses to remain there. However, privatization has eliminated the implicit federal guarantee of its debt; while this "guarantee" was considered by some to be more of a psychological than a tangible asset,[45] SLM Holding Corp. is expected to lose political power when it stands on its own without the official sponsorship of the government. It is reasonable to expect that the Congress, the Department of Education, and the White House will be less deferential to a privatized Sallie Mae than has previously been the case.

FUTURE PLANS FOR THE PRIVATIZED SALLIE MAE

While Sallie Mae has always had a corporate structure and been required to consider shareholders and profitability, Sallie Mae is now faced with an unusually large number of corporate problems as it completes the transition to private status. Longstanding Sallie Mae management was ousted in the privatization vote, and members of the dissident Committee to Restore Value (CRV) were elected in their place and are promising significant change. Thus, in addition to the normal problems associated with any transition, Sallie Mae has also been forced to confront more basic corporate problems. It is likely that such problems will plague the company in its early post-privatization years, possibly diverting the company from new business initiatives. Political considerations will play little role in business planning, except to the extent that enactment of reduced lender subsidy rates, as repeatedly proposed by the Clinton Administration, are enacted.

Under new leadership, the privatized Sallie Mae has vowed to be aggressive in shaping its new identity. The following are several elements of the new leadership's plans for the SLM Holding Corp.:

1. ***Increased Asset Acquisition***. The company, as well as outside analysts, project continued asset growth.[46] New management has indicated that it will use direct origination of loans as a means of minimizing or eliminating secondary market purchase premiums, and otherwise taking full advantage of the increasing Sallie Mae brand awareness. The question is not whether Sallie Mae will pursue loan origination, but how much and how fast.[47] Critics have questioned the wisdom of an aggressive entry into the origination marketplace, given that

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this may damage its existing relationships with lenders and therefore its ability to make secondary market acquisitions.[48]

The aggressive pursuit of assets could be made somewhat more difficult by privatization. While close Congressional scrutiny of innovative marketing practices is likely to be substantially reduced once the federal charter is repealed, Sallie Mae has also lost access to the lowest cost capital due to the elimination of the implied federal guarantee on its debt.

2. ***Increased Use of Asset Securitization***. Sallie Mae has established itself in the financial markets as the largest issuer of student-loan backed securities. New management has indicated that it will step up the company's use of asset securitization upon privatization. Some critics argued that Sallie Mae should pursue securitization somewhat less aggressively, because that strategy results in "front-loading" profits on the loans securitized, causing increased pressure in succeeding years for additional asset acquisition to maintain the appearance of strong earnings growth. However, off-balance sheet treatment of securitized assets is advantageous, as is the ability to raise funds cheaply and recognize income immediately upon securitizing. Further, Sallie Mae has won the final round in its longstanding lawsuit with the Department of Education; the GSE had argued it did not need to pay the 30 basis point offset fee charged against all of its loans on securitized assets, and the administrative law judge agreed ("Student Loan Marketing Association v. Riley," 1997). All these factors make securitization an extremely attractive option for Sallie Mae, and the new company has stated that it will continue to issue securitized transactions through subsidiaries and separate trusts which will not be guaranteed by the GSE.

3. ***Diversification***. New management has criticized the old regime's interest in diversification as contrary to shareholder value, and suggests that it will abandon diversification projects initiated by former management. These initiatives include development of private label loans, consulting services, and facilities financing. However, uncertainties in the student loan marketplace will inevitably lead the company to consider diversification into related areas. If existing diversification efforts are terminated, the company will ultimately have to initiate new ones, such as third party loan servicing both for other

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FFEL loan holders and entities under contract to the government for Direct Loans, as well as collection services.

CONCLUDING REMARKS: SLMA'S FUTURE DIRECTIONS AND RISKS OF GSE PRIVATIZATION

Sallie Mae privatization is looked at by many as a prototype for the possible future privatization of other GSEs. However, Sallie Mae differs from other GSEs in that the need for its services today is questionable.[49] In part, this is due to the very limited role Sallie Mae plays in defining the terms and conditions for the heavily regulated FFEL loans. Because basic loan terms are defined in the Higher Education Act, Sallie Mae bears little credit risk and has little influence on the cost of the loan to the consumer or expanding borrower access to loans. Sallie Mae's privatization should therefore be regarded as somewhat unique.

Notwithstanding the uniqueness of Sallie Mae and the federal program giving rise to its creation, the events surrounding the GSE's privatization permits several conclusions to be drawn:

First, privatization, when it consists of a repeal of a GSE's federal charter, changes the market which the GSE was established to serve. In the case of Sallie Mae's market, student loans, the privatized Sallie Mae emerges as an entity approximately seven times larger than its nearest competitor. Because of the size advantage created by the company's former GSE status, it will arguably enjoy the benefits of GSE status for many years to come.

The residual effects of GSE status should be taken into consideration in the privatization of any future GSE. While ascribing a value to corporate characteristics that emerge during the GSE's life cycle will be difficult, it is indisputable that characteristics such as size convey a value to shareholders for which taxpayers should arguably be compensated.

Second, the privatization process creates turmoil within the GSE which in turn affects future corporate behavior. In the case of Sallie Mae, the debate over whether to support or oppose privatization gave rise to a dissident shareholder movement which ultimately succeeded in gaining control of Sallie Mae. New management, appropriately, did not feel bound to support representations made by prior management in the course

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of privatization. From a policy perspective, however, many of the representations made by the former management during the privatization process were intended to persuade Congress to minimize the establishment of any "exit fee" in relation to privatization of the company.

In any future privatization, consideration should be given to the turmoil the privatization process may create. Any particular expectations Congress or the Administration has of the privatized GSE, such as continued service in a specific marketplace, perhaps should be included in the privatization legislation.

Third, GSEs will substantially influence the course of their own privatization legislation. Although GSEs are the creation of Executive and Congressional action, any legislation to privatize or terminate a GSE is likely to be dominated by the GSE itself. Without a doubt, in the case of Sallie Mae the company's own lobbying throughout the privatization process substantially influenced the final version of the legislation. Without Sallie Mae's lobbying, the lengthy transition period would likely have been shorter, and options, other than simply repealing Sallie Mae's former federal charter, would have been more actively considered.

It is unlikely that future policymakers will be able to impose a restriction on a GSE's communications to Congress either at the time of creation of a GSE or prior to consideration of the GSE's termination. For this reason, additional focus on the role of the GSE in the consideration of legislation calling for its privatization should be reviewed.

If future proposals for privatization place a greater priority on the taxpayers or on other participants in the market in which the GSE exists, Congress' willingness to follow suggestions and lobbying of the GSE might be reduced.

Fourth, a methodology for evaluating the benefits of former GSE status has not yet been developed. Although substantial discussion took place during the consideration of Sallie Mae privatization legislation as to the appropriateness of an exit fee on the company, no generally accepted methodology for calculating the benefits of GSE status to Sallie

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Mae shareholders was agreed upon. This suggests that substantial additional scholarship in this area is warranted.

Because of the public nature of GSEs, the legislative expectations of shareholders are not well defined. One school of thought would suggest that GSE investors should consider the possibility of adverse Congressional action including statutorily mandated liquidation of the company at the time of making the investment. A second school of thought suggests that Congress has a fiduciary duty to minimize disruption to the company, and by extension to its shareholders in the course of removing GSE status from the company. At a minimum, the ultimate disposition of a GSE should be considered with regard to any GSE that is established in the future.

Fifth, the privatization of Sallie Mae had little or no immediate impact on the market which it served, raising the issue of whether Sallie Mae privatization should have been enacted several years earlier. Thusfar, Sallie Mae's experience in the student loan marketplace immediately following the transition to privatization suggests that the company's GSE status was not crucial to liquidity in the student loan marketplace. Importantly, Sallie Mae management made this representation during the privatization debate. The experience of the marketplace, however, raises the issue of whether the Sallie Mae GSE was allowed to retain its GSE status for long after it was serving a necessary or even beneficial function in the student loan marketplace.

Research into GSE privatization should include development of a methodology to determine when GSE status is no longer necessary. To the extent that such a methodology can be identified, consideration should be given to requiring privatization of GSEs when certain conditions are met.

ENDNOTES

1. Other GSEs include the Banks for Cooperatives, the College Construction Loan Corporation (Connie Lee), the Farm Credit Banks, the Federal Agricultural Mortgage Corporation (Farmer Mac), the Federal Home Loan Banks, the Federal Home Loan Mortgage Corporation (Freddie Mac), the Federal National

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Mortgage Association (Fannie Mae), the Financial Assistance Corporation (FAC), the Financing Corporation (FICO), the Resolution Funding Corporation (Refcorp), and the Student Loan Marketing Association. Of these eleven GSEs, only one has converted to private status (Connie Lee).

2. Lavargna (1993: 992-993) describes GSEs as follows: "The enterprises are privately owned corporations chartered by Congress to further public policy goals. Congress created each enterprise to benefit the public by serving as a financial intermediary for particular sectors of the economy that were inadequately served by the private capital markets. Through secondary markets, the enterprises buy and sell mortgages and student loans, thereby enhancing the availability of reliable credit to farmers, homeowners, colleges, and educators." Lavargna (1993: 1007) goes on to characterize GSEs as "hybrid governmental entities [which] have split personalities, combining both public and private characteristics." See also Thomas Stanton (1995: 27) who states: "A government-sponsored entity can be defined as a privately owned, federally chartered financial institution with nationwide scope and specialized lending powers that benefits from an implicit federal guarantee to enhance its ability to borrow money."

3. The Farm Credit System is cited as an example of a GSE that has not been wholly successful. The Farm Credit system proved unable to repay its debts in 1985, necessitating a government bailout. Its losses of $4.6 billion in two years set a record for a U.S. financial institution ("Sallie Mae Prepares to Cut Federal Ties; Process to Test Government-Sponsored Enterprises' Potential for Privatization," 1997).

4. In 1991, for example, then Deputy Assistant Secretary of the Treasury for Federal Finance Michael E. Basham (U. S. House Committee, 1991: 2) testified before the House Education Committee that "Financial safety and soundness regulation of GSEs must be given primacy over other public policy goals.

5. Federal Family Education Loans (FFEL) were originally authorized under the Higher Education Act of 1965, Title IV, part B. Prior to enactment of the Higher Education Amendments of 1992 (P.L. 102-

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325), the program was known as the Guaranteed Student Loan Program (GSLP). Both names are used in this article. The nuances and history of the FFELP are beyond the scope of this article. The second major federal student loan program, the Federal Direct Student Loans or FDSL Program, was enacted as part of the Student Loan Reform Act of 1993, a title of the Omnibus Budget Reconciliation Act of 1993 (P. L. 103-66). Direct Loans are authorized under part D of Title IV of the Higher Education Act. Under the Federal Direct Student Loan Program, educational institutions either originate loans using federal funds or such loans are originated through an alternative origination contractor. Loan servicing is performed by contractors.

In addition to the FFEL and the FDSL, federally-supported student loans are also made under the Federal Perkins Loan Program and various programs administered by the Department of Health and Human Services.

6. The statutory definition of "eligible lender" is set forth at Section 435(d)of the HEA [20 U.S.C. 1085(d)] and includes, among others, National or State chartered banks, pension funds, insurance companies, certain State agencies, and guaranty agencies. Sallie Mae and State agencies acting as a secondary market are authorized to be eligible lenders only for purposes of purchasing and holding loans made by other lenders.

7. The Department of Education (1998: M-3) described the FFEL program as follows in its FY 1998 budget request: "Under the FFEL, banks provide loan capital but assume minimal [2%] risk as the Federal government provides the ultimate loan guarantees [through reinsurance provided to guaranty agencies corresponding to 2, 12, or 22% of the losses paid to lenders, depending on the guaranty agency's overall default experience] that cover most loan default and other write-off costs. Lenders also may receive special allowance interest subsidies that are based upon a government T-bill rate plus an amount that will ensure the lender a guaranteed rate of return... State and private nonprofit guaranty agencies act as intermediaries between lenders and the Federal Government's guaranty... The FFEL delivery system is extremely complicated due

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to the multiple players and interactions required to make the system work...".

8. For example, a group of dissident Sallie Mae shareholders from the Committee to Restore Value noted during the proxy fight that "the development of the market for student loan securitizations has reduced the financing advantage of the Company's [Sallie Mae's] GSE status and provided large loan originators a source of liquidity that bypasses the Company" (SLM Holding Corporation, 1997b: 6).

9. Former Sallie Mae CEO Lawrence Hough (1995: 2) noted, "When Sallie Mae was created by Congress, few lenders were willing to support the fledgling student loan program. One reason was a lack of secondary market outlets for student loans."

10. Program statistics show wide variations in default experience of students attending different categories of schools or coming from different economic backgrounds. Because of the high federal costs associated with defaults, Congress enacted legislation in the 1980s limiting the participation of high default rate schools in the program. This legislation reduced the volume of high default schools, but did not fully resolve difficulties some students found in securing FFEL loans, especially in California and Texas. To address this situation, Congress required guaranty agencies to make so-called lender-of-last-resort loans. Because of the limited financial ability of guaranty agencies to support such loans, Congress also authorized the Secretary to require Sallie Mae to make such loans, if the need arose [Section 439(q) of the Higher Education Act (20 U.S.C. 1087-2)].

11. Sallie Mae supported its entry into the college housing market and its participation in the creation of another GSE established for this purpose, the College Construction Loan Authority (Connie Lee).

12. See Title VII, Part A, Section 701(c) of the Public Health Service Act, and Section 439 (d)(1) of the Higher Education Act. Health Education Assistance Loans (HEAL) were loans made to students pursuing specified health professions education programs including medicine, dentistry, psychiatry, and chiropractic medicine. The loans were guaranteed directly by the Department of Health and

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Human Services. Congress declined to continue authorization for the program in 1996.

13. An interesting aspect of Sallie Mae's advocacy for its privatization was its treatment of the widely fluctuating price of Sallie Mae common stock. In 1995, for example, former Sallie Mae CEO Hough noted, "Since February 1993, over $4 billion of shareholder value has been lost for Sallie Mae investors, principally as a result of market response to the introduction of direct lending, the Sallie Mae offset fee, and other budget cuts affecting the FFELP. Our shareholders have already paid a huge fee, a real economic loss." As Sallie Mae stock rose, this argument disappeared from the arsenal it used in support of privatization and was replaced, in part, with wider discussion of the potential adverse impact on Sallie Mae employees.
14. A service known as CommonLine, sponsored by the National Council of Higher Education Loan Programs.
15. An initiative known as the Common Manual.
16. A Sallie Mae-led initiative known as the National Student Loan Clearinghouse.
17. The service is offered by ELM Resources, a mutual benefit corporation formed as an alliance of FFEL lenders. Through ELM's products, colleges and universities' management of loans are simplified, removing some of the disadvantages associated with the participation of multiple lenders and guarantors in the FFEL program.
18. Among the products explored was financing for workforce retraining and data processing services for the health care industry.
19. That the depressed price of Sallie Mae stock was an argument for privatization as well as against imposition of a possible exit fee in connection with privatization was cited by Robert E. Torray, President and Chief Executive Officer of Robert E. Torray & Company, Inc. in testimony on Sallie Mae privatization on May 3rd, 1995 (U.S. HouseCommittee, 1995a: 74-75). See also prepared

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statement of Darcy Bradbury, Deputy Assistant Secretary of the Treasury for Federal Finance (U. S. House Committee, 1995a: 9).

20. Senior Advisor to the Secretary of Education Leo Kornfeld, for example, noted at the May 3rd hearing, "the authorization and successful launching of the William D. Ford Federal Direct Loan Program has raised the question of the extent to which the functions currently assigned to Sallie Mae under the FFEL program will be necessary in the future (U. S. House Committee, 1995a: 20).

21. Primary Congressional supporters of the Direct Loan Program included Representative William D. Ford (D-MI), the Chairman of the House Committee on Education and Labor, and Senator Paul Simon (D-IL), a member of the Senate Committee on Labor and Human Resources. Both had supported adoption of a Direct Loan program during the 1992 reauthorization process.

22. Ironically, the prospect of the government's taking over all student lending responsibilities caused some worry for lawmakers: in questioning the panel at the May 3rd hearing, Rep. Gunderson theorized that if "we get 100 percent direct lending, based on the experience with the value of Sallie Mae stock since you began this initiative [direct lending], you are not only not going to get an exit fee, you are going to have a defaulted company on your hands. I mean, it bewilders me that on one hand you are supporting legislation that, frankly, puts them out of business, and secondly you are going to ask them to pay you for the privilege of surviving after you've put them out of business in the first place" (U. S. House Committee, 1995a: 58).

23. The amendment was included on H. Con. Res. 67, the Budget Resolution for Federal Fiscal Year 1996.

24. Rationales offered included elimination of the implied federal guarantee on Sallie Mae debts and freedom for the company to enter new markets.

25. Former Sallie Mae CEO Hough (U. S. House Committee, 1995a: 25) noted, "the corporation you created ... is now ready to move on and allow the government to remove itself from a market where the private sector is no longer in need of the government's assistance."

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26. Authors' discussions with Congressional authorizing committee staff.

27. Interestingly, when this hearing on the Sallie Mae privatization was held, the Congressional subcommittees involved chose not to hear witnesses from other parts of the student loan community who may have been able to opine on the impact of Sallie Mae privatization on the student loan marketplace.

28. The GSE will be governed by an independent board of directors, but its new business activities are limited. It may purchase loans through September 30, 2007, but its other activities, such as warehousing advances, letters of credit and standby bond purchase commitments, are limited. During the wind-down period, the non-GSE subsidiaries of the new Holding Company are prohibited from acquiring loans (P. L. 104-208). The privatization legislation places other interim restrictions on Sallie Mae, such as a prohibition on the use of the name "Student Loan Marketing Association;" limitations on business activities that could result in enhanced financial risk for debt issues by the GSE; and close supervision of the company during the transition period. The company is also prohibited from acquiring an interest in a financial institution. This prohibition was placed in amendment to the Federal Deposit Insurance Act at 12 U.S.C. 1828(s) and the Federal Credit Union Act at 12 U.S.C. 1781(e) (P. L. 104-208).

29. See U. S. Department of Education (1998: M-10). Volume projections are also included in Sallie Mae SEC filings, including the Post-Effective Amendment to Form S-4 (Sallie Mae, 1997c: 39-40).

30. A future option for the U.S. Government in managing its sizable Direct Loan portfolio (over $9 billion as of mid-1997) would be to sell part or all of it to the private sector. Should this option arise, Sallie Mae would likely be a bidder.

31. Evidence of continuing administrative support for the program is the observation in the Administration's FY 1998 budget request that "Direct Loan borrowers with previous loans were almost twice as likely as FFEL borrowers with prior loans to cite their 1994-95 loan

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experience as more positive than their previous experience." All loans made prior to 1994-95 were under the FFEL program.

32. In its July 10, 1997 letter, the dissident Committee to Restore Value at Sallie Mae noted during the proxy battle, "[l]arge volumes of loans are now being made by originators that do not participate in traditional secondary markets. This has lessened the supply of loans that are sold to secondary market participants and has increased the price demanded by sellers of those loans that are sold. For example, between 1993 and 1996, the average secondary market cash premium paid by the Company to banks for student loans increased from .70% to 2.10%."

33. The Pennsylvania Higher Education Assistance Agency (PHEAA) offers Pennsylvania students its Keystone Direct Loan program. The program offers reductions in otherwise applicable borrower origination fees and is recommended by many schools in Pennsylvania. Sallie Mae has recognized the emerging market dominance of Keystone Loans and similar programs offered in other states. In Pennsylvania, Sallie Mae purchases Keystone Loans from PHEAA.

34. Smith Barney estimates that over $14 billion in FFEL loans will be securitized in 1997, of which $4.5 billion will be on behalf of holders other than Sallie Mae.

35. According to a recent report (Bernstein Research, 1997: 12), "Sallie Mae's current share of the student loan market is slightly larger than the mortgage market shares of Fannie Mae and Freddie Mac combined. Sallie Mae is roughly seven times the size of its next largest competitor, The Student Loan Corp. (80% owned by Citibank). It seems reasonable to us that Sallie Mae can compete successfully with bank lenders."

36. As discussed above, it will be important to ensure that a viable market remains in place so that Sallie Mae's change of status will not adversely affect loan access for borrowers who need financial aid. Leo Kornfeld, in testifying before the House Committee on Educational And Economic Opportunities in May1995, argued that a major concern of the Department of Education was that "Sallie

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Mae is our lender of last resort. We have a contract with Sallie Mae on that basis. If that-- if Sallie Mae were a private company and did not want to honor that commitment, and again, if GSL is a major entity in the marketplace, we would have serious concerns as to how we would cope with lender of last resort" (U. S. House Committee, 1995a: 53).

37. As Rep. Kanjorski (U. S. House Committee, 1995a: 54) noted in the May 1995 privatization hearing, "Sallie Mae was going along very well until we changed the policy and, therefore, changed their potential market and had a very negative impact on their stock and the portion of the market they were servicing.... So, something that man has made man can take away or correct."

38. Critics have argued that the market for student loans may change significantly if Sallie Mae chooses to leave the student loan business. Leo Kornfeld testified that the student loan market needed Sallie Mae's continued participation; "they have to make sure that they will still utilize their cash that they have, not for their new entities but to keep supporting the Guaranteed Student Loan Program, and that's going to be a very difficult decision for them to make year by year, because [they will] need additional cash for their acquisitions or their new businesses" (U. S. House Committee, 1995a: 61).

39. Nationwide, almost three dozen such entities exist in the form of not-for-profit corporations and state agencies. Some for-profit lenders also participate in the student loan secondary market.

40. In testimony before the House Educational and Economic Opportunities Committee in May 1995, Leo Kornfeld noted that 70% of all student loans are sold to secondary markets, with Sallie Mae purchasing 50% of those loans. Kornfeld argued that while the Department of Education supported privatization, "we have major concerns as to whether the remainder of the secondary market companies in this country could fill the gap" (U. S. House Committee, 1995a: 47).

Carrie Stradley Lavargna also asserts the importance of a sound secondary market structure. She notes that "The secondary markets have achieved success by reducing the economic risk of loss in

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owning mortgages and other loans. Rather than forcing primary lenders or individual investors to assume all risk, the secondary markets have reduced aggregate risk by spreading the risks among the investors through pooling mortgages and selling ownership interests in the pool. This reallocation of risks has expanded the availability of loans to disadvantaged borrowers. Linking the capital markets to this process has increased the supply of available capital and reduces the cost of loans through more efficient movement of capital" (Lavargna, 1993: 998).

41. Thomas Stanton described this phenomenon with regard to Fannie Mae and Freddie Mac in a way that is equally appropriate to Sallie Mae, as follows: "One of the most attractive consequences of privatization of Fannie Mae and Freddie Mac is the way that this would encourage these huge companies to devote their energies to success in the marketplace rather than dominance in the political process" (Stanton, 1995: 32).

42. As Stanton (1995: 38) puts it, "One problem with competition involves the transition period and the possible inability of today's GSE to take prompt advantage of any new freedom to engage in activities. GSEs are specialized lenders that lack experience making tradeoffs among multiple kinds of financial services for diverse customers in various lines of business. Commercial banks and other lenders tend to have such experience. The larger private financial services companies use sophisticated systems and internal rate of return calculations based upon marginal costs and revenues to decide how to allocate resources among alternative lines of business that are consistent with the overall corporate strategy; GSEs, confined currently to more narrow market niches, may have little experience making such decisions in a competitive and volatile market-based environment."

43. Sallie Mae is one of two publicly traded companies with a primary product focus on student loans. Public disclosure required by the Securities and Exchange Commission regulations results in profitability data being published that is unavailable for other program lenders.

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44. Interestingly, without a federal charter, the company will find its legislative opportunities narrowed from those in the pre-privatization period. The company will generally not be able to advocate a change in the statutory provisions affecting FFEL loans for itself without seeking a generally applicable change for all participants.

45. Critics suggest that the "implicit federal guarantee" is in some ways a fiction. For example, Lavargna argues that it is an "erroneous perception pervading the financial markets that enterprise debt is backed by the full faith and credit of the United States government" (Lavargna, 1993: 993-994). Citing a 1990 report by the Department of Treasury, Lavargna (1993: 998, FN 10) explains that "the enterprises receive virtually no government appropriations; they derive their financing from the issuance of short- and long-term debt. Because the enterprises have significant ties with the federal government, and because their debt obligations are issued in the same manner as United States Treasury debts (which are federally guaranteed), the public perception is that the federal government guarantees the enterprises' debt as well."

46. A comprehensive report by Bernstein Research (1997: 1), published in October 1997, predicts that volume growth will accelerate over the next five years, from 6% growth in new loan volume to a 12% pace.

47. As the Bernstein report opines, "If the future of student loan business bears any resemblance to its past, one should assume, as we have, further downward pressure on the profitability of the private sector program from political forces. All things being equal, this would likely foster further consolidation of the industry, with an increasing share of market held by those large bank lenders who either portfolio invest or sell and securitize, but do not sell to Sallie Mae. The effect would be for Sallie Mae's source of student loans to dry up. Thus, it appears inevitable that Sallie Mae would ultimately begin to originate or, more accurately, expand its role as an originator, thus going "up stream" to preserve its source of business" (Bernstein Research, 1997: 22).

48. Concern over disruptions to existing loan purchase agreements have apparently led SLM Holding Company to consider a quieter entry

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into the origination marketplace than was originally indicated during the control proxy battle.

49. Differences in the role of Sallie Mae in the student loan program from those played in the housing market by Fannie Mae and Freddie Mac has led Fannie Mae to question the reliance that Thomas Stanton placed on the Sallie Mae experience, suggesting the inevitability of privatization of those two GSEs. Sallie Mae, Fannie Mae notes, did not directly benefit consumers of student loans or the national economy, because of the unique characteristics of the student loan programs (U.S. Department of Housing and Urban Development, Office of Policy Development and Research, 1996).

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