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Reducing Government Involvement in a Market: Lessons from the Privatization of Sallie Mae

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Abstract

Government intervention shapes institutions and markets; even when government seeks to reduce its involvement, it must protect against resulting market distortions. Government provided substantial benefits to Sallie Mae as a government-sponsored enterprise (GSE). Giving up GSE status allowed Sallie Mae to expand the scope of its financial services beyond restrictions of its GSE charter. Benefits of GSE status led to scale economies and low cost structure that now propel the company's dominance and growth as a non-GSE. Lessons from Sallie Mae apply to removal of GSE status from other GSEs and to restructuring and deregulation in other economic sectors.

INTRODUCTION

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Reducing government involvement in a sector extends beyond the familiar examples of utilities deregulation. Removal of government sponsorship from a government-sponsored enterprise (GSE) shows how reducing another type of government intervention, in this case by terminating a preferential financial services charter, can cause distortions through poor design of the process and outcome.

Sallie Mae gave up its GSE charter in 2004, after a transition period beginning with enactment of privatization legislation in 1996.[3] Government provided Sallie Mae significant advantages, both as a GSE and during the transition from GSE status, that the company has been able to turn into economies of scale and scope so that it remains the dominant student loan firm even after removal of government sponsorship. These issues are important not only to understand the student loan market today, but also because the removal of government sponsorship from Sallie Mae should inform future deliberations how best to privatize other GSEs that have served their public purposes.[4] It also stands as a lesson about the importance of reducing government involvement carefully in other parts of the economy with due regard for the market implications of proposed policy changes.

As an organizational form, the GSE stands at the intersection of two sectors where government has had significant experience trying to reduce the extent of its intervention: finance and public utilities. The role of the GSE as a financial institution is seen in the classic definition by Moe and Stanton: it is a government chartered, privately owned and privately controlled financial institution that lacks an express government guarantee but benefits from the perception that the government stands behind its financial obligations. In return for tax benefits, regulatory exemptions, and reduced borrowing costs (thanks to the perception of the government's implied guarantee), the GSE is confined by its charter to serving specified market segments through a limited range of authorized services.[5]

The GSE also manifests characteristics of a public utility: “Fannie Mae and Freddie Mac [the two largest GSEs] resemble a traditional investor-owned utility in possessing large economies of scale, having a dominant market position that may enable them to earn profits above competitive levels, and operating in limited markets that constrain their ability to grow their profits.”[6]

Government has had mixed success trying to withdraw its control over aspects of both public utilities and financial institutions. As Paul MacAvoy and others have documented, the federal government's partial deregulation and restructuring of public utilities, notably telecommunications, natural gas, and electric power production, caused significant market distortions.[7]

In the financial sector, the expansion of charter powers of savings and loan institutions in the early 1980s, at a time when the industry had lost its aggregate net worth and institutions were prone to make financial gambles, helped to exacerbate the dimensions of the savings and loan debacle. Liberalization of charter powers, especially of state-chartered thrift institutions, gave their owners,

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advantages in a highly successful manner.[9] Section II briefly recounts the mechanics of privatization. Removal of GSE status involves a trade-off: in return for giving up its beneficial charter, a firm gains the ability to expand into markets and offer goods and services that its GSE charter would not have allowed. Section III looks at changes in the company since enactment of the 1996 privatization law. A liberal transition period allowed Sallie Mae to use continuing operations of the GSE to support expansion into new market segments. Section IV assesses Sallie Mae's role in both the market and the political process as a non-GSE today. What did privatization achieve? Section V concludes with lessons from the privatization of Sallie Mae that are applicable to the design for privatizing other GSEs and for reducing other forms of government involvement in key economic sectors.

The Sallie Mae experience is a case study of the need to design and execute a reduction of government involvement in a manner that reduces rather than exacerbates market distortions. Removal of government sponsorship meant withdrawal of GSE-type benefits that government had provided to Sallie Mae. In return for giving up these benefits, the company was allowed to expand into other lines of business, beyond providing a secondary market for student loans. Freed from its GSE charter constraints, the company has now integrated vertically to dominate not only the secondary market segment of the student loan business that it served as a GSE, but the market for federal and nonfederal student loans more generally, including the entire credit cycle of loan origination and servicing, guarantor service functions, and—increasingly—debt collection.

To the extent that government failed to recoup for taxpayers benefits that it had provided to Sallie Mae as a GSE, the company could deploy them into new parts of the market. In other words, partial deregulation of Sallie Mae, because it gave the company freedom from its earlier charter constraints, potentially may have created greater market distortions than if the company had remained a GSE within the confines of its GSE charter.

The scale that Sallie Mae achieved as a GSE helped to propel the company's growth as a firm that now operates under a general-purpose charter. Sallie Mae achieved economies of scale as a GSE, especially with respect to servicing, that permit it now, as a fully private company, to maintain a cost structure below other competitors. Thus, even though the Congress has enacted policy changes that reduce returns on the federal guaranteed loan program (the Federal Family Education Loan, or FFEL, Program), analysts expect Sallie Mae to continue to retain its dominance in that segment of the student loan market.[10]

Sallie Mae is the largest company in the student loan business, holding total assets of $116.2 billion at year-end 2006. This is about four times the assets held by Nelnet ($26.8 billion) and Citibank's Student Loan Corporation ($22.6 billion), the next two largest student loan companies.[11] Sallie Mae operates with higher leverage than its competitors and, despite its size, is growing much faster, in terms of student loan volume, than any of them.

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from its dominant role such that, in a crisis, government would fear that it could not afford to let the company default on its obligations or otherwise go out of business.

THE STUDENT LOAN MARKETING ASSOCIATION AS A GSE

The federal government chartered the Student Loan Marketing Association (SLMA or Sallie Mae) in 1972 as part of an effort to provide government funding for the recently established federal student loan program. Student loans were small and costly to service in small numbers. Banks tended to offer student loans to their customers primarily as a way to build consumer loyalty for other financial products. Sallie Mae offered an opportunity to create a specialized financial institution that could purchase large volumes of student loans and develop profitable economies of scale.

Under its charter, Sallie Mae was limited to serving as a secondary market institution; it could purchase loans that lenders originated, but could not itself originate the loans. The theory, as with other GSEs that serve a secondary market function, was that Sallie Mae would support a competitive primary market by serving as a secondary market source of funds for lenders.

GSEs receive an array of benefits, varying slightly according to the terms of the enabling legislation, compared with their non-GSE competitors.[12] As a GSE, Sallie Mae enjoyed financial, tax and regulatory preferences:

- Perhaps most important, the law permits GSEs to issue obligations that have many of the attributes of U.S. government obligations. The market infers from these attributes and other statutory provisions of the GSE charter that government implicitly backs the obligations of GSEs and that government would not let investors in these obligations take a loss if a GSE failed to meet its obligations. As a result, Sallie Mae as a GSE was able to borrow money in much greater quantities and often at lower cost than many competitors. In contrast to other GSEs, Sallie Mae also obtained charter benefits that allowed the company to borrow with a full-faith-and-credit guarantee for many years.

- As a GSE Sallie Mae could operate at higher leverage and with lower capital requirements than its competitors;

- Sallie Mae's securities were deemed to be exempt securities under the laws administered by the Securities and Exchange Commission, and thus exempt from SEC registration;

- Sallie Mae was exempt from state and local income taxation;

- Interest on Sallie Mae's obligations was exempt from state income taxation.

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mortgages that are not insured or guaranteed by government. The Farm Credit System, another GSE, also deals predominantly in loans without government backing.

The removal of government sponsorship from Sallie Mae thus had market implications that differ from possible privatization of other GSEs. Many of the loans that Sallie Mae held at the time of privatization were guaranteed by the federal government and bore a stated rate of interest to borrowers, independent of Sallie Mae's GSE funding advantages. This is different from the prospect of privatization of Fannie Mae and Freddie Mac, because the cost of mortgages to future borrowers would be expected to increase by a small amount if the companies' funding costs increased after privatization. Privatizing Sallie Mae, the largest holder of federal guaranteed student loans, did not increase the interest rates that borrowers paid on those loans.

GSE Benefits and Sallie Mae's Rapid Growth

Sallie Mae grew in the context of a student loan market that was growing rapidly. As a result of its special benefits, Sallie Mae was ideally positioned to capture a dominant part of that loan market. Table 1 shows how, similar to the other GSEs, the company more than doubled in size on average every five years, in terms of its outstanding obligations.[13] In addition in the mid-1990s, Sallie Mae began a new form of growth, by securitizing student loans in off-balance-sheet transactions.

Table 1.
Growth of Sallie Mae as a GSE, 1975–1995 (Outstanding Obligations)

1975	1980	1985	1990	1995
$0.3 billion	$2.7 billion	$13.4 billion	$39.0 billion	$47.5 billion

Source: Congressional Budget Office,[14] Sallie Mae, and USA Education Inc., annual financial statements.

Throughout most of its history, Sallie Mae has been the dominant firm in the student loan business. A 1991 Congressional Budget Office (CBO) report noted that, although the student loan market included numerous competitors, “Sallie Mae not only holds the largest share of all guaranteed student loans, but its share is much greater than any of its competitors; while Sallie Mae held 27 percent of all guaranteed loans outstanding as of September 30, 1989, Citibank, possessing the second largest guaranteed student loan portfolio, held only 4 percent.”[15] Despite the creation of the Federal Direct Student Loan Program (FDLP) in the 1990s, which took up a 23 percent market share at the end of FY 2006, Sallie Mae held 27 percent of outstanding federal student loans while Citibank, still the second-

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Sallie Mae's Corporate Culture

As a GSE, Sallie Mae manifested distinctive corporate hallmarks including (1) generation of high returns to shareholders, (2) commitment to high-quality technology systems, and (3) focus on management of political risk.[18]

Alex Pollock, former President and CEO of another GSE institution, the Federal Home Loan Bank of Chicago, points out that, "For executives of a GSE, it is a fiduciary duty to extract the maximum value from government support and the Treasury's credit in order to profit the GSE's shareholders."[19] Sallie Mae has always been candid that its first responsibility is to shareholders. Edward Fox, the first President and CEO of Sallie Mae, once told a Senate subcommittee:

> "We are a private corporation and as such, with stockholders and bond holders, we have a fiduciary responsibility to those individuals. … We are not charged with subsidizing the guaranteed student loan program or subsidizing the students."[20]

Reflecting this principle, the corporation used its GSE status to provide its shareholders high returns. For example, in 1983, the year of Mr. Fox's statement, the company's shareholders earned a 33.8 percent return on their common equity.

Another part of the company's corporate culture was use of the scale that derived from its GSE benefits to support the development of high quality technology systems. Especially servicing of FFEL loans according to the Department of Education's so-called "due diligence" rules increased the value of scale in servicing.[21]

The department's regulations are definitive in their requirements. The lender must contact a borrower within 10 working days of an initial delinquency and monthly for a prescribed number of months thereafter. The lender must send a final demand letter to the borrower at least 30 days before the lender files a default claim. The lender must conform to all due diligence requirements in order to make a claim against the federal guarantee. In short, the student loan regulations allow easy verification of a servicer's compliance with the rules but do not promote effective servicing that could keep more loans from becoming delinquent or going into default.

It has long been recognized among lenders that the due diligence requirements do not conform to commercial practice. To take but the most salient attribute of the due diligence requirements, they apply across the board to all FFEL borrowers and loans regardless of the individual characteristics of the borrower. By contrast, private lenders in the commercial world have developed analytical models

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power was essential for the company to deal with what equity analysts call political risk. Sallie Mae was immensely successful in its statutorily permitted student loan market. On the other hand, this specialization meant that unfavorable changes in federal law—and especially the Higher Education Act, which authorizes federal student loan programs—and regulations could seriously affect the company's balance sheet.[25]

Sallie Mae as a Special-Purpose Company

While Sallie Mae did attempt to diversify, for example to purchase home equity loans used to fund education, the company remained focused on serving as a secondary market for the federal guaranteed loan program (now FFEL). Based on its specialization in federal student loans, Sallie Mae developed management systems and operational support services. In 1987, Sallie Mae began offering systems and support to lenders to improve the processing of student loans. Sallie Mae also developed an electronic system that gave guaranty agencies the ability to attach their guarantees within 24 hours to loans submitted by lenders.[26] CBO reported that Sallie Mae provided servicing technology to lenders and thereby solidified its market position. The company used its technology and economies of scale in servicing, and consequent lower servicing costs, to attract lenders into business relationships. CBO noted that in 1989 almost one quarter of Sallie Mae's loan purchase volume came from commitments with clients that used Sallie Mae's operational support products and services.[27]

Together, Sallie Mae's government benefits and the technology systems that the company built on the basis of these benefits allowed the company to reap remarkable returns on shareholder equity year after year. Sallie Mae's profits were especially generous because the federal guaranteed loan program set the interest rates paid by students and therefore protected Sallie Mae from much of the price competition that might drive down the spread between Sallie Mae's returns on student loans and its borrowing costs.

Sallie Mae and the 1993 Budget Act

In the early 1990s unusual factors came together to turn political risk into a serious threat to the company. The Credit Reform Act of 1990 instituted new budget rules for federal student loans and other federal credit programs.[28] This change eliminated the budget scoring advantages of federal guaranteed loans and made the idea of direct student loans an attractive alternative.

The Clinton Administration came into office and launched an initiative to create a new Federal Direct Loan Program (FDLP) for students. Analysts and policymakers objected to the complicated structure and high budget cost of the guaranteed student loan program itself, compared with the prospect of a direct loan program operated through schools and funded by low-cost borrowing from the U.S. Treasury.[29]

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point) offset fee on Sallie Mae, measured as percentage of some of the student loans that Sallie Mae that the company acquired and held in its portfolio after the effective date of the act.[32] With respect to the loans to which it applied, the fee largely offset Sallie Mae's funding advantage from its GSE status in the debt markets.

Sallie Mae responded actively to its changed circumstances. The company litigated and won a court decision clarifying that the offset fee applied only to loans that the company held on its books; student loans that Sallie Mae securitized were not subject to the fee. The company then began participating in the growing U.S. asset-backed securities (ABS) market with an active program of securitizing student loans. (The growth in volume is seen in Table 2.) Because the fee covered only part of the credit that the company provided, Sallie Mae was able to continue growing its portfolio as well.

Table 2.
Sallie Mae's Growth Student Loans Held and Securitized 1997–2006 (Billions of Dollars)

Year	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Student Loans Held	$29.4	$28.3	$33.8	$37.6	$41.0	$42.3	$50.0	$66.0	$82.6	$95.9
Student Loans Securitized	$14.3	$18.1	$19.5	$29.9	$30.7	$35.8	$38.7	$41.5	$39.9	$46.2
Total Managed Student Loans	$43.7	$46.4	$53.3	$67.5	$71.7	$78.1	$88.7	$107.5	$122.5	$142.1

Sources: SLM Form 10-K for years 2000, 2005, and 2006.

Sallie Mae also cranked up operationally to meet the challenge of the direct loan program. CEO Lawrence A. Hough told a Consumer Bankers Association conference that the industry would need to improve the quality of its loan origination practices:

> The critical task before us is to more closely incorporate the attractive features of the direct loan front-end processing approach into the FFELP. We are now well aware that the federal government has designed direct lending to be free of difficult FFELP steps and has alleviated some of the associated paper. The resulting processing speed has become the

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The company presented a plan for restructuring to remove government sponsorship from Sallie Mae. It sounded themes that resonated with policymakers, and especially those at the Treasury Department, about the benefits of ending GSE status:

> In creating the various GSEs, Congress did not contemplate the need at some point to unwind or terminate their federal charters. However, Congress did not assume the perpetual existence (and continual expansion) of individual GSEs in the context of changing social and economic priorities. The missing element in the GSE concept is the notion of a life cycle for government sponsorship. GSEs are *created* to increase the flow of funds to socially desirable activities. If successful, they grow and *mature* as the market develops. At some point, the private sector may be able to meet the funding needs of the particular market segment. If so, a *sunset* may be appropriate.[34]

Sallie Mae rolled out its privatization proposal in 1994 and achieved success with enactment of the Student Loan Marketing Association Reorganization Act in 1996. As the Clinton Administration stated when it supported the privatization of Sallie Mae:

> The Treasury has for a number of years, in Democratic and Republican Administrations, believed that it is appropriate to wean a GSE from government sponsorship once the GSE becomes economically viable and successfully fulfills the purpose for which it was created with Federal sponsorship, or when the purpose for which it was created ceases to exist.[35]

PRIVATIZING SALLIE MAE

From the time that the idea of privatization became public, Sallie Mae's competitors expressed concern that removal of GSE status would allow the company to enter the business of originating loans.[36] However, Sallie Mae's CEO, Lawrence Hough, sought to reassure lenders that, because Sallie Mae depended on its partnership with them, Sallie Mae would not be a threat to them after privatization.[37]

Before supporting privatization, policymakers at the Department of Education sought assurance that removal of GSE status from Sallie Mae would not disrupt the student loan market or any of its parts. Would privatization disrupt nonprofit student loan secondary market institutions, for example, in case the GSE no longer would furnish them with letters of credit and other support? What would happen to

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Fourth and finally, because Sallie Mae played a dominant role in the negotiations to give up its government sponsorship, the 1996 legislation provided for a generous transition period. The act provided that Sallie Mae could not issue any GSE obligations with a maturity extending beyond September 30, 2008, and this limitation would not apply to any debt issued to finance any lender-of-last-resort or secondary market purchase activity that the Secretary of Education might request. In other words, Sallie Mae was able to negotiate an exit that provided immediate benefits of privatization (authority to enter new lines of business), while winding down the company's GSE operations at a more leisurely pace. The company was permitted to transfer profits from the GSE to fund the holding company's new non-GSE activities and acquisitions.

There was one issue that government did not address: what would happen if Sallie Mae gave up its GSE status but retained its market power? What if the company used the transition period to upstream profits from the GSE subsidiary and used those profits to make acquisitions that helped to lock in the company's dominance in the student loan market? The prospect of an exit fee had been discussed in the debate concerning Sallie Mae's privatization, but not in the context of the implications for market structure. Such a fee could have helped to offset the substantial benefits that GSE status had conferred on Sallie Mae and that would be reflected in the market strength of the new non-GSE company.[39]

In the end, Sallie Mae was able to avoid an express exit fee in exchange for (1) structuring the wind-down so that the 1993 offset fee would continue to be paid so long as GSE securities remained outstanding, (2) offering stock warrants to the District of Columbia Financial Control Board, (3) paying a fee to support Treasury Department oversight of the privatization process, and (4) paying a fee of $ 5 million to retain use of the “Sallie Mae” name. The District of Columbia soon sold its Sallie Mae stock warrants for a total of $36 million.[40]

Government did impose two limitations on Sallie Mae during the transition period: (1) the company could not originate loans through the GSE until it had completed the process of giving up GSE status, and (2) except under specified conditions, the company could not purchase a bank so long as it was a GSE.

The mechanics of privatization are not difficult.[41] The law permitted the board of directors of Sallie Mae to propose a simple reorganization to convert the GSE into a subsidiary of a non-GSE holding company. The final winding up of the GSE's debt obligations was done through a transaction known as a defeasance. Under this transaction, the organization irrevocably transferred sufficient funds or Treasury obligations to a trust and, under the trust agreement, assured that the trustee would make full repayment of all liabilities on outstanding GSE obligations. Under GAAP rules, a defeasance transaction permits the organization to remove all of the defeased liabilities from its balance sheet. On July 31, 1997, Sallie Mae shareholders voted overwhelmingly to reorganize the company into a

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The company continued its practice of using technology and economies of scale in servicing, and consequent lower servicing costs, to create profitable relationships with primary lenders and also expanded its relationships with schools and their financial aid offices.[42]

Sallie Mae also began transforming itself into a completely integrated company that managed virtually all parts of the student loan business, including origination, both directly through a non-GSE subsidiary of the holding company and indirectly through special relationships and major acquisitions of loan originators, guaranty agency functions, servicing, and collection on defaulted student loans. Sallie Mae also expanded the products and services that it offered to educational institutions and other participants in the educational finance system.

The company's transition was not completely smooth. CEO Lawrence Hough had tried to reassure policymakers that a privatized Sallie Mae would not enter the business of loan origination. However, Sallie Mae underwent a hard-fought proxy battle that resulted in the installation of new management for the reorganized institution.[43] The new managers were led by Albert L. Lord and other former senior Sallie Mae officials who objected to the business plans put forth by the incumbents. In contrast to the statements by Mr. Hough, Mr. Lord strongly advocated entering the loan origination business.[44]

New Acquisitions

The company increased its horizontal and vertical expansion mostly through a series of acquisitions. For example, in 1999 Sallie Mae purchased Nellie Mae, a large New England lender with a $2.6 billion student loan portfolio. The acquisition of a competitor helped Sallie Mae to expand its presence in the New England student loan market. Sallie Mae also entered into an exclusive relationship with Chase Manhattan Bank to purchase all student loans originated by Chase. As a part of the arrangement the company purchased $ 5 billion of student loans.

In 2000 Sallie Mae “stunned the student-loan industry” when it announced the acquisition of guarantee servicing, student loan servicing and secondary market operations of USA Group Inc., the nation's largest student loan guaranty agency.[45] The company stated that the acquisition allowed Sallie Mae to expand its array of education-related services to include servicing and administrative support for guaranty agencies.[46]

Acquiring USA Group allowed Sallie Mae to provide a full spectrum of administrative support services to loan guarantors, ranging from loan origination and account maintenance to default prevention and post-default collections. Sallie Mae provided administrative support to USA Funds and also acquired guarantor-servicing contracts with guarantors serving 12 other states. Acquiring the USA Group also gave Sallie Mae a stream of fee income from the provision of delinquency and default management

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portfolios to Sallie Mae's holdings. Sallie Mae also acquired a large collection company that served sectors outside of student loans. By the end of 2004, Sallie Mae had over 9,000 employees.

Continuing High Returns on Equity

Throughout the transition period, Sallie Mae continued to reap high returns for its shareholders. Table 3 shows that returns on common equity ranged between 30 and 81 percent in the years 1996–2004, far higher than returns of other major lenders.

Table 3.
Sallie Mae's Returns on Common Equity 1996–2004

1996	1997	1998	1999	2000	2001	2002	2003	2004
50%	65%	81%	78%	49%	30%	46%	66%	73%

Source: Sallie Mae Annual Forms 10K, various years.

In summary then, Sallie Mae used the liberal transition period between 1997 and 2004 to expand its size substantially and to integrate vertically in the education finance market, from origination through guaranty agency services, to servicing and collections. The dominant position that the company had built as a GSE, and especially its servicing economies of scale, technology platforms, and relations with lenders and schools, provided a strong base for the company's rapid expansion.

The poor design of Sallie Mae's privatization contributed significantly to this result. Peter Wallison has written:

> “Sallie Mae was permitted to continue buying and selling student loans through the GSE for … years from the date of enactment, and few controls were placed on the transfer of assets to the holding company, so that the holding company received significant benefits, courtesy of the taxpayers.[47]”

The company had successfully applied the benefits provided by government to build a strong dominant company. By the end of 2004 Sallie Mae's leadership decided that it was time to wind up the GSE and enter the market as a completely private general purpose company.

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the time that the transition to non-GSE began in 1997 to 2006, the company's managed loans grew by 225 percent. The company reported that it had a market share in 2005 of 27 percent of federal student loan originations, compared with a 6 percent share by Citibank (i.e., the Student Loan Corporation), the second largest student loan company.[48]

The company reported that it had over 11,000 employees in 2006, including the largest sales force in the student lending industry. The company also reported on its success at enticing schools to leave the direct lending program.[49] While continuing to expand and deepen its relationships with schools, Sallie Mae is also supplementing these relationships with a direct-to-consumer approach to student lending.

The company branched out in other ways, including through acquisition of an industrial bank charter. Sallie Mae Bank began funding and originating federal and private student loans in 2006. Sallie Mae Bank's charter as an industrial bank also allows the company to expand the range of products and services that it offers.[50] In 2006 the company reported that, in addition to its education lending, it originated $ 1.6 billion of mortgages and consumer loans. The bank allows Sallie Mae again to have access to the Federal Reserve payment system, the lowest cost way to process financial transactions.[51] The company had lost this access when it gave up GSE status.[52]

Finally, in April 2007, Sallie Mae announced that it would retire its publicly traded shares and be bought out by a consortium of two private-equity firms and two banks. This had two benefits for the company: (1) it would remove the company's share price from fluctuations caused by political and reputational risk; and (2) following Sallie Mae's strategy of building relationships with competitors, two major student loan lenders, Bank of America and JPMorgan Chase & Company, each would own 24.9 percent of the new private company.[53] One question was whether this transaction, given Sallie Mae's other activities, would come under antitrust scrutiny. The paradox is that Sallie Mae probably could avoid an effective antitrust challenge thanks to the share of the FDLP, which the company has done so much to weaken, in the student loan market.

Continuing Statutory Constraints and Political Risk

Even though it has expanded both vertically and into a broader scope of services for the student loan market, Sallie Mae continues to face statutory constraints in its primary line of business, federal student loans. As of September 30, 2006, 85 percent of the company's managed student loans carried a federal government guarantee.[54]

This is a highly regulated business that subjects the company to political risk, such as when policymakers potentially decide to take steps that may reduce the profitability of providing federally guaranteed loans. Sallie Mae continues to wield considerable clout with policymakers.[55] However,

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leverage would increase significantly if Sallie Mae consummates its leveraged buyout, an outcome that was doubtful certain at this writing.

The company also continued to benefit from economies of scale and technology systems to keep its costs below those of competitors. One analyst report compared Sallie Mae's overhead costs to several leading competitors, the Student Loan Corporation, Nelnet, and First Marblehead, and found that Sallie Mae had significantly lower costs, expressed as a ratio to managed portfolio or to originations of federal and private student loans.[60] Sallie Mae's approach to technology continued to pay dividends as well. Fitch Investors Services assigned Sallie Mae its top rating for FFELP loan origination and servicing.[61]

Sallie Mae also continued to rely heavily on a range of financing approaches to keep its funding costs low and to limit the amount of interest rate mismatch between its assets and liabilities. In October 2006, the company reported that it had issued 48 percent of student loan ABS for the year-to-date.[62]

New Issues: Questions Arising from Horizontal and Vertical Expansion

As it grows, Sallie Mae is becoming more visible than before. Stronger congressional oversight of companies and schools active in education finance, and of the Department of Education itself, has placed Sallie Mae's name in unfavorable contexts. In 2007, as a part of a general crackdown on practices in the student loan industry, the New York Attorney General signed a settlement agreement with the company and imposed a small civil penalty.[63]

The question is whether, similar to its large former siblings, Fannie Mae and Freddie Mac, Sallie Mae's pattern of relentless expansion and market dominance was beginning to incur reputational risk that might affect the company in the future.[64] Bethany McLean raised this issue in *Fortune*:

> “Student loans aren't just another business like software or laundry detergent. If the ugly headlines escalate, causing colleges, students, and politicians to think twice about Sallie Mae loans, its business will suffer. In the end, Sallie may find that if it doesn't do well by students, it won't do well by investors either.[65]”

Kenneth Posner, a senior equity analyst for Morgan Stanley, in a largely positive review of the company, cited the work of Sydney Finkelstein, *Why Smart Executives Fail* (2003), and sounded a note of caution: “Finally we worry about Sallie's culture, because companies that are used to dominating their environments sometimes become overconfident.”[66]

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SALLIE MAE: A CASE STUDY IN PARTIAL WITHDRAWAL OF GOVERNMENT INVOLVEMENT

How much has changed for Sallie Mae because it gave up its status as a GSE? One major change has been the direct result of removing the company's GSE charter: the company has expanded from a secondary market institution into a vertically integrated firm that dominates student loan origination, servicing, guaranty agency services and, increasingly, collections.

As a GSE Sallie Mae developed the economies of scale, technological strength, low-cost structure, extensive relationships with lenders and schools, and rapid growth that propel the company's continuing dominance today. The deregulation of Sallie Mae was only partial. In a striking echo of Herbert Sandler's warnings about deregulation of the savings and loan industry, one person interviewed for this study states: “Sallie Mae is a federal creature let loose” into the marketplace.[68] In contrast to the thrifts that were largely unequipped to meet the rigors of market competition, Sallie Mae shows the opposite possibility that a GSE may continue and expand its dominance after privatization.

GSEs start small but, if they receive sufficient competitive advantages under their charters, can grow rapidly into the largest firms in their markets. While they may perform useful public services at the beginning they soon reach a position where policymakers are unable to limit their further expansion. The GSE can resemble the sorcerer's apprentice; it soon produces too much of a good thing and cannot be stopped. Unless government acts to undo the distorting effects, a company may make the transition to non-GSE status while retaining the size and economies of scale that continue those effects.

An early CBO analysis recognized this problem and proposed that the GSE should be broken up into independent entities and then privatized.[69] The major disadvantage of that approach was political. Policymakers would have feared the consequences for the federal student loan programs of such a break-up. Indeed, at the time of Sallie Mae's privatization, a major concern of the Department of Education was whether others could step in to replace Sallie Mae's role in the student loan marketplace in the event that the company used its new freedom to enter different lines of business instead.

Another reality was that Sallie Mae itself played a major role in setting the terms for removal of GSE status. In a report on the possible privatization of Fannie Mae and Freddie Mac, CBO used an analogue to explain this:

> “Of course, such options [to prepare for removal of government sponsorship] beg a

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many years, and without addressing the issue of continuing dominance after Sallie Mae ceased to be a GSE,[71] government would seem to have few options today to improve the structure of the student loan market. Recent legislation to reduce the cost of student loans to students may have helped students, but is unlikely to shake the market dominance of Sallie Mae, with its low cost structure and economies of scale.[72] Any thought of assessing an additional fee on Sallie Mae to recoup the benefits provided to the company as a GSE would seem to be too late; government has completed its relationship with Sallie Mae as a GSE.

Policymakers should take note of the Sallie Mae experience when they consider removal of GSE status from other dominant GSEs. Many approaches are possible when negotiating an agreement on the terms of privatization; Sallie Mae's transition shows that government has little recourse once the agreement has been reached. Removal of government sponsorship requires close attention to assuring a more efficient market structure both during and after the transition from GSE status.

The Sallie Mae experience also offers lessons for deregulation and other reductions in government market intervention. Paul MacAvoy documents how political considerations played a significant role in producing some of the adverse effects of restructuring and deregulation of electric power, natural gas, and telecommunications.[73] Just as the politics of restructuring of major utilities resulted in serious distortions of the market, the politics of removal of Sallie Mae's government sponsorship also had negative consequences, fortunately not on the magnitude of market problems in California after electric power deregulation or other consequences of partial deregulation that MacAvoy documents.

One lesson is that it may be difficult to forecast the consequences of restructuring, and especially of partial deregulation. Would a privatized Sallie Mae enter the loan origination business or not? The answer appears to have turned, at least for the short term, on the outcome of Sallie Mae's bitter shareholder battle after the privatization act became law. Similarly, analysts who studied the electric power industry faced uncertainties how the deregulation should be designed and implemented.[74]

The second important lesson, of course, is that the politics of restructuring inevitably will shape the outcome. The liberal transition period that Sallie Mae enjoyed, and the absence of any serious exit fee to help offset taxpayer benefits that the company had enjoyed as a GSE, both showed the effects of the political process and constituency concerns.

This leads to a third lesson: it can be helpful, at least in some significant cases, for policymakers to consider the consequences of government interventions in the marketplace and develop an exit strategy *before* implementing the intervention. This is far easier to accomplish than to try to devise an exit strategy once major constituencies have built themselves around the benefits of government involvement. A promising model in this regard was legislation that Senators Paul Simon and David Pryor introduced in 1996 to provide a template for design of future GSE and wholly owned

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While Sallie Mae is not a GSE in name today, it continues to benefit from many of the basic attributes that characterized its former GSE status. The company continues to grow and expand in the market for education finance. There is nothing on the horizon, except for the company's GSE-type vulnerability to dependence on a specialized market segment, political risk or hubris, that seems likely to reduce the company's dominance in the foreseeable future. Policymakers need to consider beforehand the consequences of partial reductions in government involvement the next time that they seek to restructure institutions in an important economic sector.

Footnotes

- 1. Gardiner C. Means, *The Structure of the American Economy, Part I. Basic Characteristics*, National Resources Committee (Washington, DC: Government Printing Office, June 1939), 168–169.
- 2. See, e.g., Ellis W. Hawley, *The New Deal and the Problem of Monopoly* (Princeton, NJ: Princeton University Press, 1966).
- 3. While it is common to identify removal of government sponsorship from a GSE as "privatization," the term actually is a misnomer. GSEs are privately owned and privately controlled financial institutions.
- 4. See, e.g., Peter J. Wallison, Thomas H. Stanton, and Bert Ely, *Privatizing Fannie Mae, Freddie Mac, and the Federal Home Loan Banks: Why and How* (Washington, DC: AEI Press, 2004).
- 5. Ronald C. Moe and Thomas H. Stanton, "Government Sponsored Enterprises as Federal Instrumentalities: Reconciling Private Management with Public Accountability,"*Public Administration Review*, July/August 1989.
- 6. R. S. Seiler, " Fannie Mae and Freddie Mac as Investor-Owned Utilities," *Journal of Public Budgeting, Accounting and Financial Management 11, no. 9* (spring 1999): 120.
- 7. Paul MacAvoy, *The Unsustainable Costs of Partial Deregulation* (New Haven, CT: Yale University Press, 2007). By contrast, Alfred Kahn, architect of airline deregulation, a more complete process that included termination of the Civil Aeronautics Board and its price regulatory apparatus, finds the deregulation of airlines to have been "a nearly unqualified success." Alfred E. Kahn, *Lessons from Deregulation: Telecommunications and Airlines after the Crunch* (Washington, DC: Brookings Institution, 2004), 3.
- 8. R. Dan Brumbaugh, Jr., *Thrifts under Siege* (Cambridge, MA, Ballinger) 1988.
- 9. By contrast, other GSEs have stumbled badly on occasion. Thomas H. Stanton, " The Life Cycle of the Government-Sponsored Enterprise: Lessons for Design and Accountability," *Public Administration Review* 67, no. 5 (SeptemberOctober 2007): 837–845.
- 10. "[S]ince we think Sallie enjoys an important cost advantage over the competition, we model only moderate differences in our "bull" and "bear" valuations. … Sallie Mae appears to operate with a lower cost structure than the average lender. As a result, its returns on equity would level off around 30%, we estimate, in a scenario where FFELP subsidies are cut …" Kenneth Posner, "SLM Corporation: Stock Now Discounts Political, Balance Sheet Risk; Potential for Rebound," Morgan Stanley Research, 23 January 2007, pp. 14, 17.
- 11. These figures are taken from the companies' Forms 10K for 2006. The Citibank student loan company is formally known as the Student Loan Corporation. Citibank holds 80 percent of the stock of the Student Loan Corporation. Between 2005 and 2006 the Student Loan Corporation reduced its asset size by securitizing a substantial volume of student loans.
- 12. See, generally, Thomas H. Stanton, *Government Sponsored Enterprises: Mercantilist Companies in the Modern World* (Washington, DC: AEI Press, 2002).
- 13. The rapid growth of GSEs is documented in *Government Sponsored Enterprises: Mercantilist Companies in the Modern World*.
- 14. Congressional Budget Office, *Controlling the Risks of Government-Sponsored Enterprises* (Washington, DC: April

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- 19. Remarks at the American Enterprise Institute conference on “The Privatization of Sallie Mae and its Consequences,” May 30, 2007.
- 20. Edward Fox, testimony before the Subcommittee on Education, Arts and Humanities, Committee on Labor and Human Resources, United States Senate, *Oversight of Student Loan Marketing Association (Sallie Mae)*, Washington, DC, 12 August 1982, p. 135.
- 21. 34 CFR § 682.507, “Due diligence in collecting a loan.”
- 22. Richard George, Great Lakes Higher Education Corporation, “Thoughts on the Industry's Past and Present: An Insider's Perspective,” prepared for the American Enterprise Conference, “Footing the Tuition Bill: New Developments in the Student-Loan Industry and How They Are Changing the Way We Pay for Higher Education,” September 25, 2006, pp. 19–20. See also, Frederick M. Hess, ed., *Footing the Tuition Bill: The New Student Loan Sector* (Washington, DC: AEI Press, 2007), Appendix A, at 253.
- 23. *U.S. Treasury Department, Report of the Secretary of the Treasury on Government Sponsored Enterprises* (Washington, DC: May 1990), F-33.
- 24. See, e.g., Steven Waldman, *The Bill* (New York: Viking Penguin Books, 1995).
- 25. As a Brookings Institution study concludes: “Although the [FFEL] program makes heavy use of the nation's private credit system, the private banks in the program act not as sellers in a market system but as administrative agents in a centralized bureaucracy.” Michael S. McPherson and Morton Owen Schapiro, *Keeping College Affordable: Government and Educational Opportunity* (Washington, DC: Brookings Institution, 1991), 159–160.
- 26. Unlike other federal guarantee programs, the FFEL program relies on other institutions, called guaranty agencies, to attach the government's guarantee to a student loan.
- 27. Congressional Budget Office, *Government-Sponsored Enterprises and Their Implicit Federal Subsidy: The Case of Sallie Mae*, 248.
- 28. Thomas J. Cuny, “ Federal Credit Reform,” *Public Budgeting and Finance* 11, no. 2 (June 1991): 19–32.
- 29. See, e.g., U.S. General Accounting Office, *Student Loans: Direct Loans Could Save Money and Simplify Program Administration*, GAO/HRD-91-144BR (Washington, DC, 27 September 1991).
- 30. Steven Waldman, *The Bill*, 57.
- 31. Lawrence A. Hough, President and CEO, Sallie Mae, testimony before Subcommittee on Education, Arts and Humanities, Committee on Labor and Human Resources, United States Senate, “Privatization of Sallie Mae and Connie Lee,” hearing, June 20, 1995, 12.
- 32. The prospective nature of the fee was an important consideration in protecting the fee from Sallie Mae's legal challenge on grounds that it represented a “taking” of the company's property. See *Student Loan Marketing Association v. Riley*, 104 F.3d 397 (D.C. Cir.), cert. denied, 522 U.S. 913 (1997).
- 33. Speech of Lawrence A. Hough, President and CEO of Sallie Mae, to the Consumer Bankers Association student lending conference, December 6, 1994, prepared text, p. 3.
- 34. Sallie Mae, *The Restructuring of Sallie Mae: Rationale and Feasibility* (1994), 13–14 (emphasis in original).
- 35. Darcy Bradbury, Deputy Assistant Secretary of the Treasury for Federal Finance, testimony before the Subcommittee on Postsecondary Education, Training and Lifelong Learning of the Committee on Economic and Educational Opportunities, and the Subcommittee on National Economic Growth, Natural Resources and Regulatory Affairs of the Committee on Government Reform and Oversight, U.S. House of Representatives, May 3, 1995, 29. Treasury pointed to creation of the FDLP as a major reason why Sallie Mae's support for the Federal Guaranteed Loan Program (now the Federal Family Education Loan Program or FFEL program) was no longer required.
- 36. See, e.g., John Racine, “ Sallie Mae Unleashed? Future of Student Loan Marketing Association,” *American Banker* (13 June 1994), p. 4.
- 37. Joseph B. Cahill, “ Privatized Sallie Mae Wouldn't be Home Free,” *American Banker* (25 May 1995).
- 38. John E. Dean, Saul L. Moskowitz, and Karen L. Cipriani, “ Implications of the Privatization of Sallie Mae,” *Journal of Public Budgeting, Accounting and Financial Management* 11, no. 1 (Spring 1999): 56–80, p. 62.
- 39. When a tax exempt organization converts or is acquired by a for-profit firm the “charitable trust doctrine”

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- 44. See, e.g., Jaret Seiberg, " Vote Pushes Sallie toward Loan Origination Business," *American Banker* (12 May 1997); and Olaf De Senerpont Domis, " Sallie Mae CEO Promises Bankers Vigorous Student Loan Competition," *American Banker* (10 December 1997).
- 45. Stephen Burd, " Should Borrowers Fear a Student-Loan Behemoth? Sallie Mae's Massive Growth May Reshape the Loan Industry," *Chronicle of Higher Education* (11 August 2000).
- 46. USA Education, Inc. (formerly SLM Holding Corporation), *Form 10-K for the Fiscal Year ended December 31, 2000*, p. 3.
- 47. Peter J. Wallison, "Introduction and Summary," in Peter J. Wallison, Thomas H. Stanton, and Bert Ely, *Privatizing Fannie Mae, Freddie Mac, and the Federal Home Loan Banks: Why and How*, 26.
- 48. Sallie Mae, "Debt Investor Presentation, Nine Months ended September 30, 2006," October 27, 2006, p. 26.
- 49. Sallie Mae, *Form 10-K for the Fiscal Year ended December 31, 2006*, p. 12.
- 50. Sallie Mae, *Form 10-K for the Fiscal Year ended December 31, 2005*, p. 15.
- 51. This benefit is discussed in, Peter J. Wallison, " Is Wal-Mart Leaving the Money Business? Don't Bank on It," *American.com* (March 19, 2007).
- 52. See the Sallie Mae website for the current version of the company's table of organization: **http://www.salliemae.com/about/corp_leadership/corp_str/**
- 53. See, e.g., Goldie Blumenstyk, " Loan Giant Sallie Mae Agrees to Buyout for $25-Billion," *Chronicle of Higher Education* (27 April 2007).
- 54. SLM Corporation, *Form 10-K for the Fiscal Year ended December 31, 2006*, p. 25.
- 55. See, e.g., Stephen Burd, " The Congressman and Sallie Mae; Representative Boehner's Links to Student-Loan Giant Could Complicate His Climb Up Capitol Hill," *Chronicle of Higher Education* (27 January 2006).
- 56. See, e.g., Kate Ackley, " Student Loan Rate Cuts Create Frenzy for Lenders," *Roll Call* (10 January 2007).
- 57. Kenneth Posner, "SLM Corporation: Stock Now Discounts Political, Balance Sheet Risk; Potential for Rebound," Morgan Stanley Research, January 23, 2007, p. 2.
- 58. Amit R. Paley, " Sallie Chairman Sold Shares Ahead of Cuts," *Washington Post* (February 10, 2007), p. D01.
- 59. "SLM Corporation: Stock Now Discounts Political, Balance Sheet Risk," p. 24.
- 60. "SLM Corporation: Stock Now Discounts Political, Balance Sheet Risk; Potential for Rebound," Exhibit 21, p. 18.
- 61. FitchRatings, Structured Finance, "Sallie Mae, Inc.," August 28, 2006, p. 1.
- 62. Sallie Mae, "Debt Investor Presentation, Nine Months ended September 30, 2006," October 27, 2006, p. 52. See also pp. 32, 40.
- 63. Press Release, "Attorney General Cuomo Announces Settlement with Sallie Mae over Its Student Loan Practices," New York State Department of Law, April 11, 2007.
- 64. Thomas H. Stanton, "The Life Cycle of the Government-Sponsored Enterprise: Lessons for Design and Accountability."
- 65. Bethany McLean, "When Sallie Met Wall Street; The Giant of the Education Lending Business Is a Red-Hot Stock. But to Drive Growth, Sallie Mae Is Socking Students with Interest Rates Up to 28%,"*Fortune*, 26 December 2005.
- 66. "SLM Corporation: Stock Now Discounts Political, Balance Sheet Risk; Potential for Rebound," p. 5.
- 67. Jeffrey Birnbaum, "Aiming to Free Sallie Mae from Red Tape,"*Washington Post*, April 19, 2007.
- 68. Barmak Nassirian, Associate Executive Director of the American Association of Collegiate Registrars and Admissions Officers, personal interview, March 2007, Washington, DC.
- 69. Congressional Budget Office, *Controlling the Risks of Government-Sponsored Enterprises*, April 1991, p. 261.
- 70. Congressional Budget Office, *Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac*, May 1996, p. 44.
- 71. In analyzing a privatization process that would be suitable for Fannie Mae and Freddie Mac, Peter Wallison, et al., proposed that (1) the GSEs be required to dispose of assets they held, and (2) copies of the automated underwriting systems and mortgage data in the hands of the GSEs should be placed into the public domain to remove a major competitive advantage that the GSEs otherwise would retain. The 1996 Sallie Mae privatization law

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- 77. Sallie Mae, *The Restructuring of Sallie Mae: Rationale and Feasibility*, p. 13.

NOTES

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Update: Since this article was written, Sallie Mae has committed a series of missteps. While the company remains operationally the dominant firm in the student loan business, the prospective buyout has been cancelled and the company's stock price has fallen to unprecedented lows. See, e.g., Steven Pearlstein, "In a Fight to His Finish at Sallie,"*Washington Post*, January 11, 2008, p. D01. The company manifested its misjudgments in a pattern similar to that which systematically besets GSEs. See Thomas H. Stanton, "The Life Cycle of the Government-Sponsored Enterprise: Lessons for Design and Accountability,"*Public Administration Review* 67, no. 5 (2007): 837–845.

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