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**Lessons Learned**  
**From**  
**The Privatization of Sallie Mae**

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**DRAFT**



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**U.S. Department of the Treasury**  
**Office of Sallie Mae Oversight**  
**MARCH 2006**

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# FOREWORD

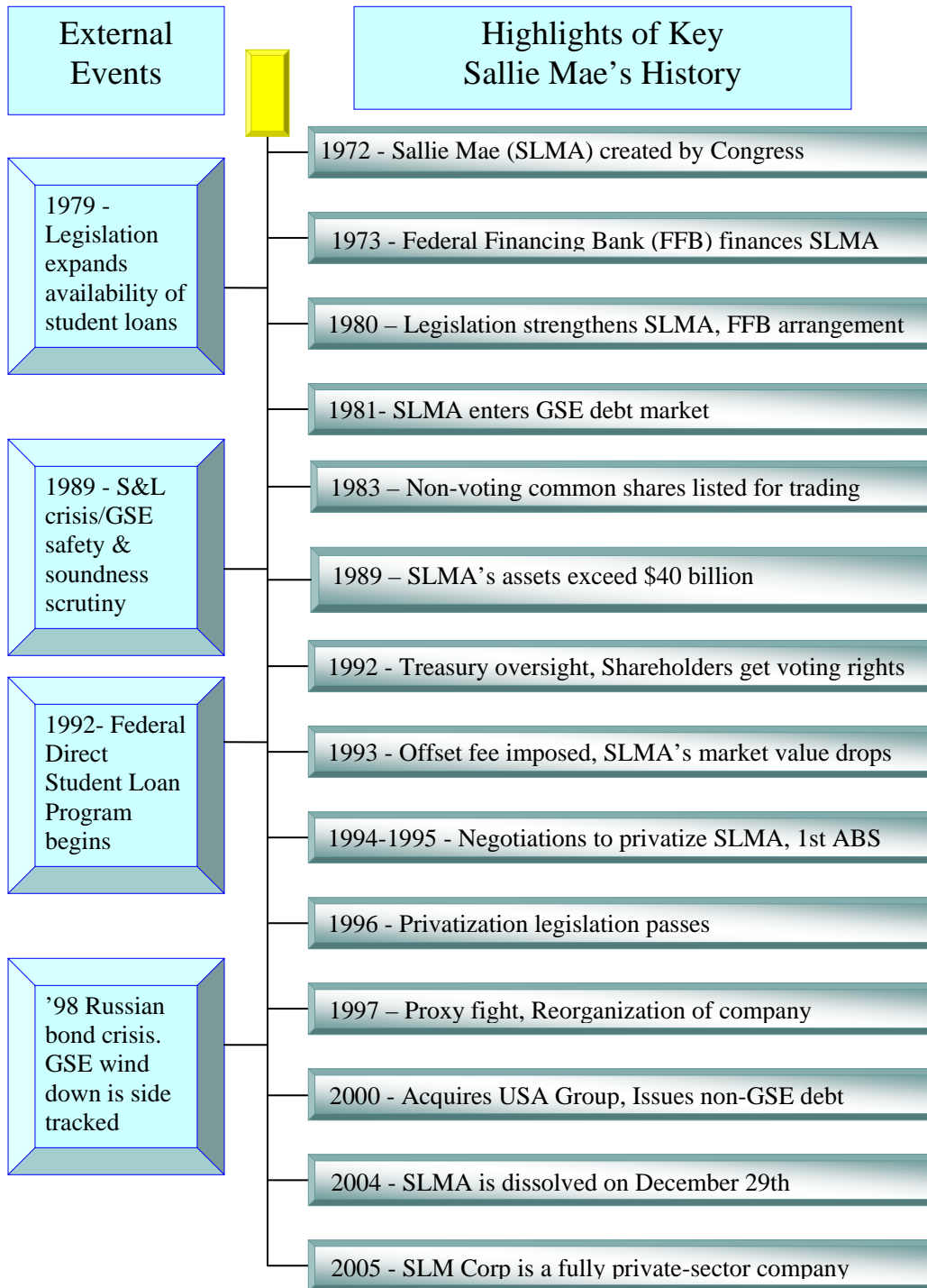
In 2004, after Sallie Mae accelerated its actions to fully privatize, then-Assistant Secretary Wayne Abernathy directed the undertaking of this study. He strongly believed that a careful examination and analysis of the history of Sallie Mae's successful privatization would provide Treasury information and lessons learned that would be helpful to Treasury and others as we look forward.

This study was prepared by the staff of the Office of Sallie Mae Oversight, who monitored the safety and soundness of Sallie Mae during the privatization process. Every effort was made to ensure the accuracy of the information it contains and to provide an impartial assessment of what occurred. As is the case with any history, the interpretations made by the authors are important to the structure and conclusions, and these interpretations are not necessarily those of Treasury or the Administration.

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March 2006



## *SLMA Timeline 1972-2005*





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## Introduction

On December 29, 2004, in a ceremony at the U.S. Treasury Department, the Student Loan Marketing Association (SLMA), a government-sponsored enterprise or GSE, ceased to exist. On that day Assistant Secretary for Financial Institutions Wayne Abernathy signed documents that completed the historic transformation of the GSE into SLM Corporation, a fully private sector corporation, nearly four years sooner than the law required. This moment marked the culmination of over a decade of work on the part of the government and the private sector to transform a congressionally chartered, quasi-public entity into a successful private sector company.



**Albert Lord of SLM Corporation (left), and Wayne Abernathy of Treasury dissolve SLMA.**

The process of converting Sallie Mae, as the GSE was commonly known, into a fully private corporation meant that the GSE ceased issuing tens of billions of dollars of GSE debt. Eliminating this debt also eliminated the perceived risk to taxpayers that the Federal government might step in and bail out the GSE if it failed. The conversion also did away with SLMA's special privileges, including its \$1 billion contingent line of credit with Treasury and its exemption from state and local taxes.

The privatization of SLMA is a success story. But what was it about SLMA that made it possible? Are there lessons that the government can glean from the SLMA experience? How and why was SLMA able to successfully cut its ties to the government and become a fully private-sector company? This paper seeks to answer these and other questions through an examination and analysis of events leading to SLMA's privatization, the wind down itself, and the markets in which SLMA operates.

### Various Perspectives - Multiple Interests

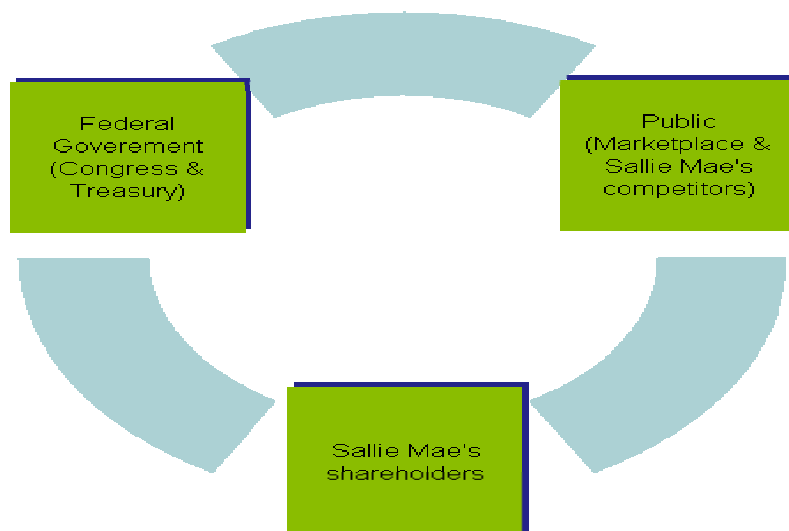
The SLMA story is one of a basic conflict: the GSE as an instrument of public policy versus the GSE management's need to drive value to shareholders. The GSE's special links to the Federal government caused investors to treat GSE securities very much like Treasury issues. SLMA's many Federal benefits gave its debt a status and value to investors. As Treasury noted in a May 1990 report:

The GSEs are entities established by Congress to perform specific credit functions but are privately owned. The market perception of Federal backing for GSEs weakens the normal relationship between the availability and cost of funds to the GSEs and the risk that these enterprises assume.

Congress intended that this special treatment would facilitate the GSE's ability to fulfill its public mission of providing liquidity and stability to the student loan market, which it did. At the same time, the special treatment decreased risks for shareholders and increased their profit.

However, the company's GSE status had a downside for shareholders in that it limited the business activities the GSE could pursue. When that limitation became a liability, GSE status lost its appeal. As alternative methods for raising capital were nearly as good as issuing GSE debt, SLMA's impetus for cutting Federal ties became stronger. When the Federal government added costs and began to compete in the student loan market, SLMA and the Federal government agreed that privatization made sense.

In 1996, Congress enacted amendments to the Higher Education Act providing for the reorganization and ultimate dissolution of the GSE. The wind down was a period of tumultuous change for Sallie Mae as it changed its leadership and expanded its markets and operations through non-GSE subsidiaries. Treasury restrained some activities of the GSE and helped to facilitate the GSE's transformation.



### **GSE Ownership**

Congress originally established SLMA in 1972 as a private, for-profit corporation. Stock ownership was initially restricted to financial and educational institutions participating in the Federal student loan programs. In 1983, SLMA became publicly owned and its non-voting stock was listed on the New York Stock Exchange. In 1992, this stock was converted to voting stock. In July 1997, SLMA shareholders approved the exchange of SLMA stock for SLM Corporation stock. The reorganization was effective August 7, 1997, and the "Sallie Mae" trademark was assigned, with restrictions on its use, to SLM Corporation.

### **Normalization Rather than Privatization**

As discussed above, Congress provided SLMA with certain privileged benefits not available to other private companies. These benefits and other GSE characteristics are

outlined in the following chart and compared to the state corporation charter that SLM Corporation now operates under.

### Normalization - Federal Links That Have Been Cut

| Feature  | GSE Charter                        | State Charter            |
|--|------------------------------------|--------------------------|
|  | Student Loan Marketing Association | SLM Corporation          |
| Charter by Act of Congress   | Yes                                | No                       |
| President appoints board members   | Yes (7 of 21)                      | No                       |
| Treasury lending authorized  | \$1 Billion                        | No                       |
| Debt eligible for Fed open market purchases  | Yes                                | No                       |
| Use of Fed as fiscal agent for debt  | Yes                                | No                       |
| Debt eligible to collateralize public deposits (all US Government; most State & local)                           | Yes                                | Depends on credit rating |
| Exempt from SEC registration (1933 Act)  | Yes                                | No                       |
| Exempt from financial and other filings with the SEC (Government Securities for purposes of the SEC Act of 1934) | Yes                                | No                       |
| Eligible for unlimited investment by banks and thrifts   | Yes                                | No                       |
| Earnings exempt from state and local income taxes  | Yes                                | No                       |
| Earnings exempt from Federal income tax  | No                                 | No                       |
| Federal safety and soundness oversight regulator   | Yes                                | No                       |

### Report Organization and Presentation

The report is divided into four main sections.

- Section I - The Decision to Privatize.** Explains why Sallie Mae wanted to privatize. It also explains why the Federal government supported privatization and lays out where the opposition to privatizing came from. Legislative history and negotiations that shaped the 1996 SLMA Reorganization Act and proxy fights for control of the GSE that occurred are also discussed.

- **Section II - Business Summary.** Provides a brief overview of the student loan market and key SLMA history.
- **Section III - The Wind Down.** Covers the actual wind down experience and outlines the issues that arose during the privatization of this GSE.
  - Chapter 1 is a summary of the challenges, successes, and problems of privatizing Sallie Mae.
  - Chapter 2 discusses planning for and implementation of the wind down.
  - Chapter 3 presents issues encountered with establishing and funding the privatization defeasance trust.
  - Chapter 4 documents the interest rate environment during the wind down period and how the privatization impacted Sallie Mae's cost of funding.
  - Chapter 5 covers OSMO's experience and lessons learned from conducting annual safety and soundness examinations of SLMA.
- **Section IV – GSE Mission and Policy Discussions.**
  - Chapter 1 covers GSE mission-related issues including: why did Congress create the GSE, why privatization was appropriate for Sallie Mae, what are the consequences for a fully private secondary market for student loans, how well did Sallie Mae accomplish its mission and stay within its mission limitations.
  - Chapter 2 discusses the overall experiences of presidentially appointed public directors for Sallie Mae and related policy issues.
  - Chapter 3 discusses public policy issues related to a GSE having advantageous capital requirements.
  - Chapter 4 discusses how the Sallie Mae story provides evidence that while a GSE benefits from investors purchasing its debt at lower interest rates, it also demonstrates a market discipline problem and a public policy concern.
  - Chapter 5 pulls together discussions and proposals on GSE exits strategies and sunsets.
- **Appendices.** The report includes a number of appendices that cover certain peripheral topics in some depth, including: SLMA's pre-privatization history, complex accounting issues that affected SLMA and SLM Corporation, transcripts of interviews of three Sallie Mae executives regarding Sallie Mae's history and the privatization process, testimony provided to Congress by Treasury regarding SLMA's privatization, documents related to the privatization defeasance trust, and Sallie Mae's and Treasury's press releases on December 29, 2004 on the completion of the privatization of Sallie Mae.

**Use of the “Sallie Mae” Name**

Congress originally established the Student Loan Marketing Association, or SLMA, in 1972. The SLMA acronym was pronounced “Sallie Mae,” a nickname that stuck, became widely recognized and therefore had value. Ownership of the right to the Sallie Mae name was the source of some debate during the privatization negotiations. In August 1997, SLMA’s successor, SLM Holding Corporation, paid a licensing fee relating to its ongoing use of the “Sallie Mae” name, with certain statutory restrictions on its use.

In this report, Sallie Mae and related monikers are used in three basic ways, as follows:

- **“Sallie Mae”** is used to refer to the company as a whole as it existed at a given point in time. For 1973 - August 6, 1997, that would mean the Student Loan Marketing Association (SLMA or the GSE), for August 7, 1997-2004 it would refer to SLM Corporation and all its subsidiaries including SLMA, and for post 2004 it would refer to SLM Corporation and all its subsidiaries excluding SLMA, which was dissolved on December 29, 2004.
- **“SLMA”** or **“GSE”** are used to refer to the Congressionally chartered government-sponsored entity.
- **“SLM Corporation,” “SLM Corp.” “holding company,” “non-GSE subsidiaries,”** or **“non-GSE affiliates”** are used to refer to the private-sector state-chartered entity/entities.

We also note here two prior names that have been used by Sallie Mae, “SLM Holding Corporation” and “USA Education, Inc.” These names are not used in this report but were used for filings with the SEC from 1997 to 2002.



## **Executive Summary**

Congress chartered the Student Loan Marketing Association (SLMA), or Sallie Mae as it was called, in 1972 as a government sponsored enterprise (GSE). Its purpose was to enhance access to education by serving as a secondary market and warehousing facility for student loans. Congress prohibited it from originating loans directly to students.

In 1996 Congress provided for Sallie Mae's charter to terminate, giving shareholders the choice of dissolving or reorganizing and winding down the GSE. The shareholders chose to reorganize.

This summary highlights significant events and lessons learned during the life cycle of SLMA and its transition to a private-sector company, SLM Corporation. It discusses the difficulties of oversight of financial soundness and mission limits during the GSE's wind down.

### **Federal Instrumentality and the Decision to Fully Privatize**

#### **Sallie Mae Dominated the Student Loan Market**

To facilitate its mission, Congress provided SLMA with benefits not available to other companies. As a GSE it had access to low funding costs in the "agency" debt market, exemption from most state and local taxes, and low required capital as compared to banks. SLMA built a business on student loans, aggressively purchasing them and making warehouse advances to student loan lenders so that by 1990 Sallie Mae held nearly half of the outstanding federally guaranteed student loans. Servicing student loans was its core competency but it also provided marketing expertise for lenders and expanded its focus to include schools and students.

Sallie Mae was generally successful in managing political risk, winning from Congress expanded powers to hold private student loans and other assets. It succeeded in convincing Congress to expand ownership of its stock beyond the original banks and schools that participated in the federally guaranteed student loan program. In 1983 non-voting stock became listed and traded on the NYSE. In 1992 Congress allowed all of the stock to convert to voting stock. Allowing its common stock to be publicly held and traded with no restrictions was a critical event, which is linked to a primary finding of this report -- the inherent conflict of a private company obligated to act in the interest of its shareholders, while at the same time bound to serve a public purpose set by Congress. The publicly-traded attribute of Sallie Mae stock added to that tension.

Despite its success in managing its political risk as a GSE, SLMA saw benefits in becoming a completely private-sector company and in the 1980s it unsuccessfully lobbied the Reagan Administration to allow it to privatize. After the savings and loan crisis in the late 1980s Congress began to worry about GSE risks and the CBO suggested privatizing SLMA by breaking it apart on the AT&T model. In 1991 SLMA looked into

a preferable alternative of using a holding company as a mechanism to privatize. However, it took a several more years before events pressured the company, Congress and the Administration to make full privatization a key objective and a reality in 1996.

### **Federal Actions That Cut the GSE Benefit and Stock Value**

In 1992 Congress began to take actions that hurt SLMA's business. Congress set up a pilot for the "direct lending" program where the Department of Education made loans directly to students, avoiding both lenders and SLMA's secondary market. In 1993 the Clinton Administration made direct lending a priority and the pilot program became permanent. The Clinton Administration saw direct lending as a more efficient use of Federal resources, and set goals to largely eliminate Sallie Mae's and the private-sector's involvement in the Federal student loan program.

Also in 1993, Congress imposed on SLMA a special fee, called an offset fee, of 30 basis points on new federally guaranteed student loans that SLMA acquired for its portfolio. This offset fee applied to assets SLMA held rather than to the debt it issued, and did not apply to any other entity. The proceeds from the fee went to the Department of Education. From SLMA's perspective, the offset fee was a tax that reduced the franchise value of the GSE charter by effectively eliminating part of its funding advantage. The Courts upheld the offset fee but ruled that it did not apply to loans that SLMA securitized. Although the offset fee at first threatened to be very costly to SLMA, its actual financial impact was never greater than 15 basis points overall for on-balance sheet student loans, as it did not apply to loans that were consolidated under the Federal student loan program and private loans. Both of these classes of student loans grew rapidly during the wind down.

Because of the threat of direct lending and the reality of the offset fee, equity market participants began to question the long-term viability of SLMA. SLMA's stock lost nearly two-thirds of its value during the early 1990s, as investors expressed their concern about the long-term value of the company. An innovation that occurred during this period and facilitated privatization was the development of the student loan asset-backed securities market. SLMA saw the ABS market as a private sector alternative to GSE funding.

### **Privatization Negotiations and Legislation**

The actions by the Federal government, the change allowing shareholder voting rights, the limitations on its ability to originate loans and diversify into other lines of businesses, and the fact that securitization offered a good alternative to GSE borrowing all caused SLMA to begin serious privatization negotiations with the Administration and Congress in 1993. This process went on for several years and a consensus developed for privatization. During this time SLMA, the Administration and Congress considered various proposals regarding the best way to accomplish privatization.

### **The Privatization Act and Proxy Fight**

In 1996, President Clinton signed the SLMA Reorganization (Privatization) Act into law. Under the Act, shareholders were presented with a choice of: (1) a reorganization in



which their shares in SLMA would convert to shares in a fully private-sector holding company and SLMA would be phased out by 2008, or (2) a liquidation of the company by 2013. A contentious proxy fight followed in which two factions battled for control of the company. However, both sides in the proxy fight were in favor of privatization, so the dispute, which could have been more problematic, did not impede the goal of privatizing the company. Indeed it may have clarified the positions of each faction, encouraged them to make better proposals to shareholders, and may ultimately have given clear support for the new management team.

## **The Privatization of Sallie Mae – GSE Winddown and Oversight**

### **The Privatization Structure**

Shareholders approved a reorganization plan in 1997, and Sallie Mae reorganized itself into a private-sector, state-chartered holding company, a GSE subsidiary (SLMA), and various other non-GSE subsidiaries. The GSE would dissolve after a transition period during which it would transfer its operations and assets to SLM Corporation, the holding company. The Privatization Act established the basic framework governing the wind down of the GSE as follows:

Personnel and Asset Transfers All SLMA personnel, real estate and certain other assets were to be transferred from the GSE within various timeframes.

New Business The GSE could not undertake any new business activities. It could continue to borrow and hold financial assets while the holding company built up its business outside of the GSE. However, it had to discontinue student loan purchase activity once the holding company commenced such activity or, at the latest, by September 30, 2007.

Debt Obligations The Act restricted issuance of new GSE debt to maturities shorter than September 30, 2008. During the wind-down period, the GSE kept its GSE rights, privileges and obligations.

Restrictions on Inter-Company Relationships The statute required a firewall to be maintained between the holding company and the GSE so that the private holding company could not take advantage of GSE benefits. The holding company could not use the "Sallie Mae" name for non-GSE debt issuance purposes and when it used that name for other purposes it had to make disclaimers. Transactions between the GSE and any non-GSE affiliate had to be arms' length, and each had to keep separate books and records.

Dissolution Date and GSE Debt Obligations The GSE had to dissolve on or prior to September 30, 2008, and establish a defeasance trust, subject to Treasury's approval, to pay the principal and interest on the remaining GSE debt obligations.

### **Holding Company Expansion and GSE Portfolio Growth**

After reorganizing in 1997, the private-sector holding company embarked on an acquisition strategy to significantly expand its presence in the guaranteed student loan market. The holding company's strategy was to vertically integrate and thereby gain control of the entire student loan life cycle. Origination in particular was important to the

company's privatization strategy, because it allowed the company to capture an important Federal interest payment subsidy embedded in the Federal student loan program. Previously, originators, mostly banks, captured part of this subsidy by charging a premium when selling loans to Sallie Mae.

After Treasury provided guidance to the holding company that GSE funds should not be used to finance the purchase of companies that originate loans or for other prohibited investments, the holding company engaged in a series of acquisitions, the largest of which was the USA Group in 2000 for \$770 million. The holding company dramatically increased its non-federally guaranteed student loan business as well, primarily through rapid internal growth. The holding company also acquired mortgage banking operations, thereby expanding its non student loan business.

There was a backwards trend during the wind down period when the GSE actually continued to grow for several years as management exploited the benefits of the GSE which became more valuable as the Russian bond crisis of 1998 halted Sallie Mae's securitization program. Sallie Mae resisted divesting approximately \$150 million of real and personal property from the GSE after the 1997 reorganization even though congress required it to do so "as soon as practicable." Sallie Mae put this off until March of 2001, one of its many contentious readings of the wind down provisions. Treasury discovered that the holding company had used GSE funding benefits for other non-GSE uses in 2001, such as GSE funding of goodwill, commercial aircraft leases, and prohibited investments. The GSE divested itself of these assets at Treasury's insistence.

During the wind down, Sallie Mae managed GSE operations via agreements with non-GSE affiliates. This arrangement effectively gave the holding company, SLM Corporation, additional control over GSE activities and complicated the process by which the GSE board controlled its own management. OSMO had very little power to rein in the holding company or enforce the statutory requirements. A lesson learned is that greater enforcement powers and additional milestones would have been appropriate.

### **Non-GSE Debt Issuance**

During the wind down, market conditions were favorable for the holding company to issue debt because interest rates and credit spreads were very low. This helped minimize the difference between the low GSE cost of funds and the higher costs of the holding company. While the company's overall cost of funds did increase 30 to 40 basis points relative to U.S. Treasuries during the wind down, the cost was manageable.

The holding company was also able to issue ABS at favorable rates, via both the GSE and non-GSE subsidiaries. Nearly \$117 billion of ABS were issued by Sallie Mae during the wind down period, backed by both federally guaranteed student loans and private loans. OSMO's view is that, while the rich nature of the federally insured loan asset facilitated ABS issuances and a successful GSE wind down, the privatization experience is not unique to student loans and could potentially apply to other underlying assets.

Holding company debt and ABS provided good substitutes for GSE borrowing, especially because loans financed by these instruments were not subject to the 30 basis point offset fee. The offset fee continued to apply to certain loans financed by GSE debt during the wind down, providing an incentive to move these assets out of the GSE sooner rather than later. However, during the same period, the low interest rate environment meant that many student borrowers refinanced via the Federal consolidated loan programs. This volume of loan consolidations increased ABS prepayments and complicated the wind down. Sallie Mae was at the cutting edge of developing new exotic ABS structures to finance the longer-term (up to 30 years) variable-rate consolidated loans. Because of their more complicated structures, these securitization transactions are typically accounted for on-balance sheet. In the period 2003 to 2004, approximately \$34 billion of these types of ABS were issued. Additional consolidated loans securitized via more traditional structures were accounted for as off-balance sheet transactions.

Congress provided the wind-down period to allow time for the safe and sound transfer of SLMA operations and assets and to give the private company time to develop alternative financing sources to fund these transfers. Since the Act restricted new SLMA debt issuance to maturities earlier than September 30, 2008, it was incumbent on the holding company to obtain financing that extended beyond that date. In August 2002, for the first time, the holding company issued private corporate debt that matured beyond September 2008. In October 2002, for the first time, non-federally insured loans were sold out of the GSE and packaged into asset-backed securities. SLM Corp also tried unsuccessfully to obtain a bank charter to provide an alternative source of funds for its private loans and cross-selling opportunities.

Central to the privatization of the GSE was replacing Federal agency debt with non-agency debt in an economical manner. While not every effort to expand its investor base and to raise alternative funds bore fruit, Sallie Mae was ultimately successful in issuing equity, corporate debt and ABS, due to its own innovation and solid business practices. Exogenous factors, such as the 1998 Russian bond crisis and historical low interest rates in the 2000s also played a role in both complicating and increasing the ease of the refunding the GSE debt with alternative funds.

### **The Cut Over**

The Act allowed the GSE subsidiary to continue purchasing student loans until September 30, 2007 - one year prior to its final statutorily required dissolution. When the holding company began to purchase student loans in the secondary market, the GSE had to cease. This important milestone in the privatization was referred to as the cut over.

In January 2002, Sallie Mae announced publicly that it intended to complete the wind down in 2006, two full years before the statutory deadline. This accelerated time line was due in part to pressure from Treasury. Two years later, in April 2004, Sallie Mae informed Treasury that it planned to complete the wind down by mid 2005. It moved even faster. First it completed the cut over on July 1, 2004, more than three years ahead of the deadline. This early cut over was a result of the holding company's success in developing non-GSE financing. With the arrival of the cut over transition Sallie Mae

crossed the Rubicon on its way to full privatization, and the GSE entered into a true “runoff” mode. It completed the dissolution on December 29, 2004, nearly four years ahead of the deadline.

In OSMO’s view, the legislation provided too few benchmarks that would recognize steps toward actual privatization. Alternative approaches, such as a phased-in cut over, perhaps based on a percentage of prior year activity may have been more efficient and facilitated planning for a smooth wind down. Interim benchmarks and necessary approvals would have provided more clarity and flexibility for unforeseen events.

### **Sallie Mae’s Earnings Growth**

Earnings growth was key to the successful privatization of this GSE. Sallie Mae’s business growth and its ability to originate loans offset the cost of losing the remaining GSE special benefits. By year-end 2004, when Sallie Mae became a fully private-sector company, the market value of its equity was nearly \$23 billion – more than a three-fold increase from five years earlier. The total market of federally insured student loans outstanding grew to \$328 billion by year-end 2004 from \$200 billion at year-end 2000. According to the College Board, private student loan origination increased more than 400% from 1996 to 2003. These types of loans were a significant part of Sallie Mae’s earnings growth during the GSE wind down.

### **The Defeasance Trust**

Congress required that SLMA set up a defeasance trust to pay any GSE obligations that had not yet matured when SLMA was dissolved. Treasury had to approve the collateral and the trustee. At first, Sallie Mae wanted the trustee to actively manage the trust, reinvest idle cash and substitute collateral for maximum returns. This raised operating risk and other issues. Congress had put strict limits on the allowed collateral and Treasury concluded that only U.S. Treasuries were acceptable. Because of the mismatches in maturities between existing U.S. Treasury securities and the GSE bonds there were periods when the trust would be holding cash, if not reinvested, that would be idle and not earning interest. Funding a GSE payout on a certain date with a Treasury strip that matured at an earlier date could be seen as over-collateralization, and that problem was most significant for a GSE bond that matured in 2022. SLMA had established a pre-existing trust in 1993 which defeased certain SLMA securities with maturity dates beyond the wind down deadline. This trust did not meet the statutory requirements for the defeasance trust so it had to be restructured.

To resolve these problems and other issues: (1) the NY Fed agreed to be Trustee, (2) two subtrusts were established so that a portion of the idle cash could be released to SLM Corporation in 2012, (3) there was a limited provision for reinvesting other idle cash, (4) the trustee of the 1993 Trust replaced the collateral with Treasuries and assigned its duties to the NY Fed and (5) restrictive provisions were made for the early release of certain Trust collateral to SLM Corporation in exchange for retirement of all or a portion of the SLMA obligation that matures in 2022.

### **Treasury Safety and Soundness Oversight**

As part of the Privatization Act, Congress gave Treasury increased oversight responsibility for the GSE, SLMA, including the responsibility to study and report on the GSE's safety and soundness during the wind down. Treasury created the Office of Sallie Mae Oversight (OSMO) to carry out these examinations. The GSE paid for this oversight through an annual assessment. Treasury's enforcement tools were limited to moral suasion, reporting to Congress or taking the GSE to court for certain limited compliance provisions.

OSMO conducted annual examinations of the GSE and pressed it to make changes in its activities. From 2000 through 2005, it issued an annual report of examination to the Secretary with copies provided to the Secretary of Education and Sallie Mae. It argued for enhanced internal controls regarding the statutory requirements for separating the holding company and the GSE to ensure the holding company did not use GSE benefits for non-GSE purposes. Enhanced internal controls were an important safeguard to prevent non-GSE assets from being financed by the GSE.

The statutory capital requirement for the GSE became outdated from a safety and soundness perspective because the GSE engaged in higher risk activities such as originating private student loans and commercial aircraft leasing. During the same time accounting standards for certain capital and debt instruments became more complicated for financial institutions. Because of securitization accounting, the GSE could effectively create even greater leverage with off-balance-sheet financing of student loans while holding more risky assets, such as securitization residuals, on balance sheet. Treasury insisted that the capital of the GSE reflect the increased risk, the minimum capital level set by Congress notwithstanding. Treasury also pressured the holding company to provide a prudent, realistic wind down plan for dissolving the GSE by the deadline.

Traditional regulatory tools such as cease and desist authority, monetary penalties, and management removal would have enabled Treasury to apply its oversight more effectively. Sallie Mae tended to test the boundaries of the statutory firewalls against non-GSE use of GSE benefits. The holding company's management at times challenged Treasury's statutory right to obtain certain information and Treasury was hampered in enforcing the delivery of information.

## **GSE Mission Successes and Failures**

### **Legislative Successes**

It is clear that the Sallie Mae legislation, from its creation to its privatization, enhanced the student loan market over time, for both private and Federal student loan products, and it is now a robust market sustained by a variety of private-sector companies. Given that the GSE's mission was to enhance access to education by serving as a secondary market for student loans, it follows that Congress, in passing legislation to privatize Sallie Mae, was implicitly saying that a GSE was no longer needed for this function. The normalization of Sallie Mae has been a success. As Sallie Mae moved to a fully private-

sector company it remained highly leveraged while its cost of funds increased. The primary reason for this increase was the removal of the implicit Federal backing from the company's debt. In short, market discipline was improved.

### **Legislative Failures**

Shareholders' interests were more important to the business plan that Sallie Mae as a shareholder-owned entity set for itself than the GSE mission. That an entity left to its own devices considers its self-interest first is not exactly a novel idea.

Recognizing this fact helps to explain why it is such a challenge to use shareholder-owned GSEs to develop, implement and maintain public policy goals. Throughout SLMA's life as a GSE, shareholder interests were the driving force in management's decision-making process, outweighing congressional mission objectives - for example, take Sallie Mae's venture into commercial leases. The GSE facilitated the long-term financing of over \$1 billion of commercial assets that included commercial aircraft, rail cars, offshore drilling rigs, satellite transponders, and hydro-electric plants, through leveraged lease arrangements. The GSE tried to justify this non-mission activity as supporting its GSE purposes by disclosing in its public financial statements, "SLMA maintains a portfolio of tax-advantage assets principally to support education-related financing activities." While these investments provided Sallie Mae an initial tax break, by 2002 several contracts were non-performing and over \$100 million of write offs charges were expensed.

SLMA's non-mission activities went beyond its investment portfolio. In many cases, the economic substance of the payments by SLMA to banks reflected impermissible loan origination activity by Sallie Mae via a "storefront" as documented in our analyses.

There is a view that the GSEs are valuable as instruments of public policy because they "reduce interest rates." Our review indicates that the GSE subsidy is mostly captured and controlled by the company, not passed on as lower interest rates. In short, it means that the GSE buys and hold loans that other institutions would have funded with similar terms, including various award programs. To the extent that a GSE passes a portion of its subsidy out of the company, it is to increase its market share over private competitors. Further, the passing of a portion of GSE subsidy, if any, is not targeted to those in need.

### **Conclusion and Legislative Recommendations**

GSE legislation should include workable mechanisms to hold the GSE accountable to its mission. GSE history, however, invites speculation on how well a meaningful containment mechanism can be implemented.

As a market matures, it becomes increasingly difficult to limit a GSE to mission-related activities in that market in the face of shareholder pressure to increase the value of the company. GSEs facing this pressure have an incentive to use their congressionally-conferred advantages to compete unfairly with other non-GSE participants in the market or to enter new markets. For this reason, GSE legislation should include workable mechanisms that provide a GSE exit strategy.

## **SECTION I – The Decision to Privatize**

**Chapter 1 – Why Did Sallie Mae Want to Privatize**

**Chapter 2 – Policy Arguments**

**Chapter 3 – Privatization Act Negotiations**

**Chapter 4 – Final Legislation**

**Chapter 5 – Proxy Fight**



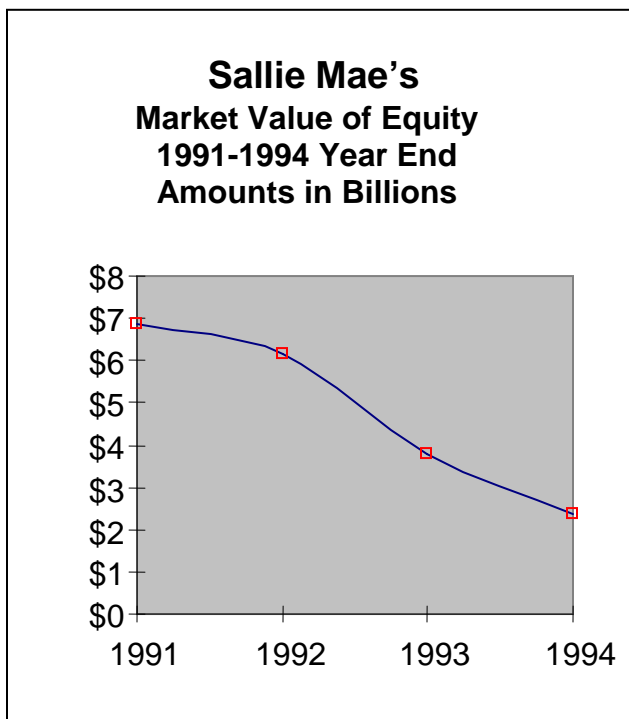


## Chapter 1 - Why Did Sallie Mae Want to Privatize

*“Once one agrees to share a canoe with a bear, it is hard to get him out without obtaining his agreement or getting wet.”* Congressional Budget Office.<sup>1</sup>

The fact that SLMA wanted to privatize made it politically possible to enact legislation to do so. If Sallie Mae was like a bear riding in a canoe with the Federal government, it had become an unwilling passenger. This brings up the question of why this company would not merely agree to get out of the canoe, losing its GSE charter and special privileges, but work very hard at it.

Congress had created Sallie Mae in 1972 to provide a secondary market for student loans at a time when students had difficulty finding banks with funds to lend. Sallie Mae bought loans and advanced funds to increase the liquidity in this market. Sallie Mae was consistently profitable as a GSE, growing from assets of \$100,000 in 1972 to \$53 billion in 1994. Despite its resounding success, for many years SLMA toyed with the idea of dropping its GSE charter.<sup>2</sup> By 1994, negative investor reaction to its political risk energized Sallie Mae in its drive to fully privatize.



### Dropping Market Value

Beginning in 1992, the prospect and then the reality of legislative change caused Sallie Mae's share price to drop. During the early 1990s its share price dropped by 66%, while the wider stock market gained value. SLMA's total market value declined from \$7 billion at year-end 1991 to \$2.4 billion at year-end 1994. By the end of this period SLMA's stock was only trading at 1.3 times the fair value of its net assets,<sup>3</sup> indicating that the market was pricing SLMA primarily at its liquidation value, with virtually no value given to its servicing ability, customer base or name recognition.

<sup>1</sup> From CBO's Report "Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mae," May 1996, p. 44.

<sup>2</sup> Edward Fox, SLMA's first CEO said that Sallie Mae had been unable to get the attention or agreement of Congress or the Reagan Administration in the 1980s. Interview of Edward Fox, Oct. 13, 2005.

<sup>3</sup> Fair value of earning assets and liabilities per note 8 of SLMA's financial statements at December 31, 1994.

In the early 1990s the political risk became clear as the Clinton Administration and Congress pushed to change the student loan program that SLMA and private lenders participated in, charge SLMA alone a GSE user fee (the 30 basis points “offset fee”), and set up a program where the Federal government made loans directly to students. The Student Loan Reform Act in 1993 was the tipping point. These changes had a dramatic negative impact on the market value of SLMA’s equity.

Sallie Mae stated that “The market reaction reflects in large part Sallie Mae’s narrowly defined business.”<sup>4</sup> In addition to the loss of market value caused by government actions, SLMA wanted to expand into other lines of business beyond the areas allowed by its charter. Until the 1993 legislation, the trade-off for the charter restrictions was the GSE funding advantage. SLMA could raise funds at levels close to those of Treasuries. With the 30 basis point offset fee that Congress imposed on Sallie Mae for loans acquired after 1993, the funding advantage would become smaller. The advent of asset-backed securitization offered an attractive funding substitute. Privatization offered a way out of the risks of remaining a GSE.

In summary, SLMA wanted to privatize because of (1) uncontrolled political risk, (2) a desire for more freedom to adapt to changing technology and business realities, which included a diminished GSE funding advantage and (3) SLMA’s opportunistic spirit and its view that privatization was now feasible.

### **Part 1 - Political Risk**

Political risk includes the risk that Congress or a government agency will take an unexpected action that negatively affects the business. SLMA experienced an ongoing stream of such actions, including changes to the guaranteed loan program, changes in SLMA’s capital requirements, and, each time a new administration came into office, changes to its board of directors. Further, in the early 1990s, Congress was considering increasing the regulatory oversight of SLMA and the other GSEs. As a GSE, SLMA also had to consider Congressional reaction to its strategic business decisions. Even though SLMA did not have a Federal safety and soundness regulator, Congress provided oversight and restrained management. For example, SLMA once purchased a depository institution, intending to use it to acquire student loans more efficiently. In 1986 Congress went so far as to prohibit SLMA from owning a bank and required it to divest the institution. Congress “slapped our wrists” according to Marianne Keler, who was an associate general counsel with SLMA at the time. She said that this was a stark reminder that SLMA could not simply conduct business as it saw fit, without considering Congressional oversight.<sup>5</sup>

### **Threat of Increased Regulation**

In response to the worries of Congress after the savings and loan crisis in the 1980s, Treasury, CBO and GAO issued a series of reports in the early 1990s, making

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<sup>4</sup> Sallie Mae, *The Restructuring of Sallie Mae, Rationale and Feasibility*, March 1994, p. 12.

<sup>5</sup> Interview with Marianne Keler, Sept. 1, 2004; Congressional Budget Office, *Controlling the Risks of Government-Sponsored Enterprises*, April 1991 [CBO, *Controlling the Risks of GSEs*, April 1991], pp. xxxviii-xxxix, 259.

recommendations to improve the safety and soundness of the GSEs and thereby reduce the potential risk to the government.<sup>6</sup> These reports consistently recommended strengthening safety and soundness regulation that would give regulators enforcement powers similar to banking regulators.

GAO and others noted that there was no safety and soundness regulator for SLMA, and no required level of capital.<sup>7</sup> It recommended a single regulator for all GSEs for safety and soundness as well as charter and program issues.<sup>8</sup> The regulator would establish capital requirements for all the GSEs, including SLMA, based on their risks, using computer modeling for capital needed during stressful economic periods. The total capital requirements would be a combination of a leverage ratio of fixed percentages of outstanding obligations, both on and off-balance sheet, with the capital needed under the stress tests.<sup>9</sup> The regulator would have strong enforcement authorities, similar to those for bank regulators. They would include removal of officers, cease and desist orders and civil money penalties.<sup>10</sup>

The level of monitoring that GAO recommended was vastly different than what SLMA had been accustomed to. It would have meant that the regulator could have access to all GSE operations and all books and records - systems and personnel, regular reports on internal controls, financial performance and business strategies. Very alarming for SLMA were the triggers for increased regulatory monitoring: Rapidly expanding business volume, entry into new activities and issuing or purchasing new types of debt instruments.<sup>11</sup>

SLMA opposed any further oversight, saying that “increased regulation will, over time, stifle creativity and impede the ability of Sallie Mae to manage its risk and quickly and creatively respond to programmatic initiatives requested or supported by our congressional overseers. We do not want to begin to manage our business ‘for the regulators.’ That style of management has not served other industries well[.]”<sup>12</sup>

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<sup>6</sup> Treasury, *Reports on Government Sponsored Enterprises*, May 1990 and April 1991; GAO, *Government-Sponsored Enterprises: The Government’s Exposure to Risks*, GAO/GGD-90-97 August 1990; Congressional Budget Office, *Controlling the Risks of Government-Sponsored Enterprises*, April 1991; GAO, *Government-Sponsored Enterprises, a Framework of Limiting the Government’s Exposure to Risks*, May 1991.

<sup>7</sup> GAO also noted that it had authority to audit every GSE except for SLMA. GAO, *GSE Report*, May 1991, pp. 6, 41.

<sup>8</sup> GAO, *Government-Sponsored Enterprises, a Framework of Limiting the Government’s Exposure to Risks*, May 1991 [GAO, *GSE Report*, May 1991], pp. 7-8, 44. This was in contrast to Treasury’s position that those functions should be separate.

<sup>9</sup> GAO, *GSE Report*, May 1991, pp. 8-10, 23.

<sup>10</sup> GAO, *GSE Report*, May 1991, p. 39.

<sup>11</sup> GAO, *GSE Report*, May 1991, p. 333-34.

<sup>12</sup> GAO, *GSE Report*, May 1991, p. 32, quoting, Letter dated March 7, 1991, from Timothy G. Greene, EVP and General Counsel of SLMA, to Jill K. Ouseley, Director, Division of Market Finance, Department of the Treasury.

The political risk, however, was most evident in SLMA's core business, the Federal Family Education Loan Program or FFELP.<sup>13</sup> Every four or five years Congress reauthorized the Federal student loan program and therefore, every four or five years there was a risk that there would be changes to the program that would hurt SLMA.

### **1992 Higher Education Amendments**

President George H.W. Bush signed the Higher Education Amendments of 1992<sup>14</sup> to reauthorize the student loan program, raise loan limits and create a program of unsubsidized student loans for middle class students. It also set up minimum safety and soundness requirements for SLMA, including a capital standard, converted all of SLMA's common stock into voting stock, and created a pilot "Direct Loan" program.

The pilot direct loan program empowered the Department of Education to make student loans directly to students, without going through banks. Direct lending had always been a contender as an alternative to the guaranteed student loan program. As far back as hearings on legislation to create SLMA there were proposals for a student loan bank to be run by the government. In 1979 hearings on reauthorizing the student loan programs, the CBO testified on the benefits of direct loans versus loans through private lenders:

Providing the loan capital and managing the program directly would cost the federal government less than the current practice of paying private lenders to provide loans. But Federal lending intrudes into private capital markets, and the Congress must weigh the costs and benefits of this intrusion.<sup>15</sup>

There was disagreement in 1992 about whether the direct loan program would save money for the government or cost more. After some debate, Congress determined that having a pilot program would allow it to evaluate the program and then decide if it should be implemented on a broader scale. The law called for a five-year test period and a limit of \$500 million.

The direct loan pilot program was controversial at the time and the first Bush Administration threatened to veto it. SLMA also objected strongly to the pilot and became a target for Senator Paul Simon who said that the legislation was "not a bankers' assistance bill or a Sallie Mae assistance bill, it's a student assistance bill...."<sup>16</sup> Senator Durenberger pointedly criticized SLMA. "To be blunt, we can no longer afford to squander billions of dollars a year ..." he argued. "Those billions of dollars belong in the classroom, not in six and seven figure salaries at Sallie Mae."<sup>17</sup>

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<sup>13</sup> As part of the Higher Education Amendments of 1992, the "Guaranteed Student Loan Program," (GSLP) was renamed the "Federal Family Education Loan Program" (FFELP).

<sup>14</sup> P.L.102-325, signed July 23, 1992.

<sup>15</sup> CBO Testimony of David Mundel, before the Education, Arts and Humanities Subcommittee of the Senate Committee on Labor and Human Resources, Oct. 10, 1979.

<sup>16</sup> Higher Education Amendments of 1992 (P.L. 102-325), Conference Report, 138 Cong. Rec. S. 9262 (June 30, 1992), pp. S9266, S9267.

<sup>17</sup> Higher Education Amendments of 1992 (P.L. 102-325), Conference Report, 138 Cong. Rec. S. 9262 (June 30, 1992), p. S9272.

Senator Simon singled out SLMA again on the day President Bush signed the bill. Regarding the pilot program he said, "... we particularly ran into the opposition of the Student Loan Marketing Association, Sallie Mae, which we created to help students. They became a barrier." He sounded a warning to SLMA, saying "... I think as we move along we are going to have to take a look at Sallie Mae and what we have created there."<sup>18</sup>

The real risk to SLMA was not the pilot program itself, but the threat that the program might become permanent and thus a serious competitor. The threat from direct lending weighed heavily on SLMA's shareholders. SLMA's stock price fell 40 percent and the market value dropped by over \$2.5 billion from the end of 1992 through the passage of the Student Loan Reform Act in August 1993. SLMA saw this as the market reacting to its narrow business, where over 80 percent of its income was from student loan activities. Because of its charter, SLMA was unable to diversify. When the Clinton Administration took office following the 1992 election, the threat of a permanent direct lending program became real.

### **Student Loan Reform Act of 1993**

The financial environment changed for SLMA when Congress enacted the Student Loan Reform Act of 1993.<sup>19</sup> First, the legislation imposed an "offset" fee on SLMA based on new federally guaranteed student loans that SLMA acquired for its portfolio after August 10, 1993. The fee, 0.30%, or 30 basis points, reduced the spread that SLMA received from student loans.<sup>20</sup> The fee applied to SLMA only and not to any other student loan holder. The legislation also implemented a lender-paid origination fee, a reduction in government's coverage of credit defaults, and a reduction to loan yield. However, these provisions applied to all participants in the guaranteed student loan program. SLMA calculated that overall these provisions would reduce the life-of-loan yield by about 0.40% for all holders.<sup>21</sup> SLMA was able to mitigate some of that loss by increasing the efficiency of its operations, but also began to explore securitization as a more efficient means of using capital and improving its returns.<sup>22</sup>

More ominous for SLMA, at the Clinton Administration's urging, the pilot Direct Loan program was made permanent as the Federal Direct Loan Program (FDLP) in the 1993 legislation, with plans to expand it dramatically. Direct loans, it was argued, would simplify the way loans were delivered. The FFELP delivery system was complex and multilayered, involving five kinds of loans, more than 7,500 educational institutions,

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<sup>18</sup> The Higher Education Amendments, July 23, 1992, Remarks of Sen. Paul Simon, 138 Cong. Rec. S10158.

<sup>19</sup> Student Loan Reform Act, Subtitle A of the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66), Aug. 10, 1993.

<sup>20</sup> The financial impact to SLMA was somewhat mitigated by applying the 30 basis point offset fee to only certain types of federally insured loans rather than the level of GSE debt. Per SLM Corporation's 10-K filings, the maximum impact on overall on-balance sheet student loan spread was only 15 basis points in 1999. The impact dropped to 10 basis points by 2002. The limited asset-side application of the "offset" fee also rationalized the earmarking of the funds collected for the Department of Education's purposes.

<sup>21</sup> SLMA Annual Report 1993, p. 7.

<sup>22</sup> SLMA Annual Report 1993, p. 7.

about 7,800 commercial lenders, 35 secondary marketers and 46 state or nonprofit agencies. Direct lending would eliminate the interest payments the Education Department makes to lenders while students attend schools and during a grace period. It would also eliminate the special allowance payment to lenders to subsidize the yield on student loans. The Treasury Department would raise loan capital by issuing securities and the Department of Education would service and collect the loans. Direct lending would eliminate the need for commercial lenders, guaranty agencies and secondary markets.<sup>23</sup>

Thus, the Administration championed the FDLP and ultimately supported the privatization legislation that SLMA sought, in part to ensure a smooth transition from guaranteed FFELP to FDLP for both the Government and SLMA.<sup>24</sup> President Clinton initially wanted a complete move into direct lending, but ultimately settled for a compromise under which FFELP and FDLP would coexist.

The final legislation authorized the Department of Education to replace up to 60 percent of new loan volume in the guaranteed student loan programs with direct lending by 1998. The Department of Education could increase the proportion of direct loans above that level if it determined that a higher percentage was warranted by the number of schools that wanted to participate in the program.

Bankers reacted negatively to the direct lending program, as student loans were among their more profitable loans at the time. “The direct lending concept,” ridiculed Donald Ogilvie, the American Bankers Association’s executive vice president, “combines the efficiency of the Post Office with all the charm of the IRS. It will not deliver the level of access, service and efficiency that the (system) currently provides.”<sup>25</sup> SLMA began massive lobbying and public relations campaigns to counter direct lending.<sup>26</sup> SLMA argued that a direct loan program would be more costly for taxpayers, schools and students than the existing guaranteed student loan program and that the resulting restructuring of the student loan delivery mechanism could seriously undermine the availability of student loans.<sup>27</sup>

However, even as it lobbied to discredit the idea of direct lending, SLMA signaled to its shareholders that a serious change in its business model was likely in the offing, given the new student loan environment. SLMA reported in its 1993 Annual Report, the Federal legislation passed that year would significantly change the market it served. During 1993 “The prospect and then the reality of that legislative change caused the market value of shareholders’ investment in the franchise to decline 35 percent.”<sup>28</sup> “The people who

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<sup>23</sup> *Direct Student Loans Would Save Government \$4.7 Bln, GAO Says*, Kleinbard, David, Bloomberg, Nov. 25, 1992.

<sup>24</sup> By 1998, during the Reauthorization of the Higher Education Act, there was a political consensus that both the FDLP and FFELP programs should be allowed to coexist.

<sup>25</sup> Fumento, Michael, *End Bank Loans to Students? If Government Takes Over, It Could Cost Billions*, Investor’s Business Daily, June 29, 1993.

<sup>26</sup> Boot, Max, *Behind the Student Loan Deal*, Christian Science Monitor, August 5, 1993, p. 5.

<sup>27</sup> SLMA, Information Statement, Feb. 12, 1992, p. 18.

<sup>28</sup> Sallie Mae 1993 Annual Report, p. 4.

own the company lost \$3 billion,” said SLMA’s CEO, Lawrence Hough.<sup>29</sup> SLMA told its shareholders that it would continue to explore changes in its charter to remove remaining attributes of a GSE and reposition SLMA as a private, state-chartered corporation.

As we see it, Sallie Mae was initially given the federal imprimatur of a GSE charter to jump-start the creation of a secondary market for federally guaranteed education loans. Today we share a role as one of a broad array of choices, each a viable source of capital support for educational credit. The job for which we were chartered is being phased out and it is time to recognize that the founding statutory structure is no longer a requirement for the future. For taxpayers, our charter transformation would mean removal of the so-called “implicit” guarantee associated with GSE liabilities, through an orderly process to protect existing bondholders ... For current and prospective customers in the higher education industry, we are eager to extend our core ... strengths to address ideas which respond ... to the many needs the market has identified.<sup>30</sup>

The 1993 legislation made it clear to SLMA that there was a real possibility that the FFEL Program, its main line of business, would be significantly reduced if not eliminated. Schools would have to choose between the two programs. The 1993 Federal Budget estimated that direct loans would eventually be 60% of the market. As it turned out, actual results only reached half of that projection. However, at the time, SLMA considered this trend to be particularly dangerous to its long term existence if it had to continue within the confines of its GSE charter.

### **1994 Elections**

Even though some political risk for SLMA was reduced when a majority Republican Congress that opposed Direct Loans came into office in 1994, SLMA had become committed to the goal of privatizing. There remained a political risk in the future that Congress or the Administration would again target SLMA specifically as they did in passing the offset fee that applied only to SLMA. This risk was too great and too unpredictable to ignore. With its shareholders demanding higher returns, and with the incentives of stock options for its officers, SLMA began setting its sights on becoming something more than a GSE operating only in the secondary market.

Although SLMA was adroit at working with Congress, its political risk had slipped out of its control and privatizing held the promise of reducing that risk. But political risk was not the only reason for what became SLMA’s full court press to drop its GSE status. It wanted very much to be free of the business limits imposed by its GSE status.

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<sup>29</sup> Howard, Maria Osborn, *Student Loan Agency works to Debunk Myth of Need*, Richmond Times Dispatch, Nov. 28, 1993.

<sup>30</sup> Sallie Mae 1993 Annual Report, p. 8.

## **Part 2 – GSE Limitations on SLMA’s Business**

Prior to privatization, many banks sold SLMA student loans at a premium when the loans went into repayment (generally six-months after the borrower is no longer a student). For the originating bank, this business model worked well because it provided a low-maintenance, virtually risk-free asset while the borrower was in school and a ready buyer for the loan when it went into repayment. With a growing number of secondary market participants this was increasingly a loan seller’s market.

SLMA wanted to lower its acquisition cost for student loans by either originating loans itself, which its GSE status prohibited, or negotiating lower premiums. As a private company, SLMA would be able to originate loans for its own portfolio without having to purchase them from other lenders. And if it wanted to buy loans its negotiation position would improve, because it could threaten to directly compete in the bank’s market unless the bank became SLMA’s “partner.” Having the freedom to originate loans for its own account was an attractive financial incentive to privatize.

A core competency of SLMA was and is servicing the highly regulated and specialized federally guaranteed student loans. SLMA’s large servicing scale provided it a competitive advantage in the form of lower unit servicing costs. This was a competency that SLMA was interested in expanding, into the health care industry, for example. Some within SLMA in the early 1990s thought the servicing business was undervalued, and the company should spin it off as a separate, totally private, non-GSE business in order to increase shareholder value.

SLMA also thought it could increase share value for its investors through revenue diversification. The GSE benefits balanced against its charter restrictions were no longer as attractive given the possibility of growth as a publicly held conglomerate. Being a mono-line business with significant political risk was less desirable than the possibility of diversifying into other, unlimited kinds of business.

### **GSE Funding Advantage Lessened**

The time was ripe for privatizing, given outside developments that were occurring in the markets in which SLMA operated. Competition for loans was increasing from lenders, state secondary markets and other entities with access to international capital markets. SLMA’s GSE charter limited how it could respond to this competition. Further, new funding sources for student loans were being developed, which reduced the relative value of SLMA’s GSE funding franchise, especially given the offset fee imposed on SLMA in 1993. The ability to securitize student loans via asset-backed securities (ABS) began to develop in the early 1990s. ABS provided a life-of-loan financing for student loans, which resulted in less interest rate risk than holding loans via unsecured financing.<sup>31</sup>

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<sup>31</sup> While this life-of-loan financing has similarities to Fannie Mae’s issuance of mortgage-backed securities (MBS) there are significant differences in the nature of and accounting for the cash flows to Sallie Mae from its ABS versus the cash flows to Fannie Mae from its MBS. The guaranteed credit and yield on the underlying assets gives Sallie Mae (or any other issuer of similar ABS) a distinct advantage over other classes of ABS (e.g., credit card receivables or auto loans). The student loan ABS market was made even more effective in 2000 when guaranteed lender yields on FFELP loans were indexed to commercial paper (CP) instead of Treasury 13-week bills. See further discussion in Section II, Chapter 2.



When SLMA finally issued its first student loan asset-backed securitization (ABS) in 1995 it found that securitization offered a good alternative to GSE borrowing. According to Marianne Keler, EVP and General Counsel of SLMA:

“When we did our first securitization deal, we had no idea how much capital would be required by the rating agencies ... We ended up needing maybe a quarter of the capital that we initially thought ... It turned out to be a much more efficient funding vehicle than we thought possible. ... When you think about it now, with 20/20 hindsight you say, of course, what better asset could there be than a student loan that is ... backed by the Federal government?”<sup>32</sup>

GSE status was not necessary for securitizations, and asset backed securitization was expected to become a wide-spread vehicle for student loan funding. Other actors in the secondary market also had access to this source of funding. According to Ms. Keler, SLMA’s first securitization deal was done through a state-chartered subsidiary for loan servicing operations, SLM Financial Corporation, not through the GSE itself:

“...when we did the first ABS transaction, we told our investors and rating agencies that after privatization, if we were to privatize, we would be moving that loan servicing facility off to the private side of the company, so there would be no implicit GSE support behind the servicing component. In the student loan world, really all the risk is in the servicing: Are you properly complying with the Higher Ed Act requirements? We wanted to be sure that there was not even the slightest notion or taint of the implicit GSE backing to our securitization deals... Otherwise people would say, ‘The reason you’re getting such good pricing on your securitization deals is because the market thinks that the Federal government is implicitly going to backstop any servicing errors that a GSE sub is committing.’”

Ms. Keler described the creation of this entity as valuable experience for management, because it was management’s first experience of preparing the SEC disclosures necessary for the ABS securitization.

“Before that we were doing financial deals with disclosures that never went through any review. It is a very critical step for management to take to go through SEC scrutiny. Our business so closely mirrored the securitization product itself that it wasn’t that big of a leap from getting SEC sign-off on the securitization deal to getting SEC scrutiny of our 10-K. It was a comfort factor for our investors, our board, to know that we could do this.”<sup>33</sup>

### **Part 3 - Opportunistic Spirit**

An explanation of why Sallie Mae wanted to privatize would not be complete without recognition of Sallie Mae’s opportunistic or entrepreneurial spirit, which included alertness to opportunities, and a will to act on insight. These attributes are evident throughout Sallie Mae’s history. While external factors were motivators to privatize and contributors to its success, Sallie Mae’s corporate culture was also an important catalyst.

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<sup>32</sup> Interview with Marianne Keler, Sept. 1, 2004

<sup>33</sup> Interview with Marianne Keler, Sept. 1, 2004

Sallie Mae's urge to privatize was not only about carrots and sticks, but also an outcome of its preparedness to make judgments in the face of uncertainty and adjust strategy accordingly.

Almost from the company's inception, SLMA's management was culturally oriented toward privatization, and in the early 1980s had tried to interest the Administration in privatizing, to no avail. "Even before the advent of direct lending and the offset fee," Ms. Keler said, "the idea of privatizing the company was something that just made sense to SLMA. It was because we felt that at some point our mission would be accomplished and to the extent that it is accomplished, the screws would be tightened."<sup>34</sup>

As its thinking on privatization progressed, in 1991 SLMA prepared an internal memo that envisioned the creation of a private holding company, with the GSE as a wholly-owned subsidiary, as a way to shift SLMA's GSE functions to a private company.<sup>35</sup> This would allow the activities of the GSE to gradually wind down while ensuring continuity of a national secondary market. The memo laid out the central features of the holding company model and noted that legislation would be needed for many features.

By 1993, with the offset fee and the direct loan program as realities, the company now saw privatizing as the preferred strategic business option as well. SLMA's 1993 annual report reflects that the company had begun to think seriously about dropping its GSE status:

As we position the corporation for a future of expanded opportunity, we will continue to explore changes in Sallie Mae's charter to remove remaining attributes of a government-sponsored enterprise (GSE) and reposition Sallie Mae as a private, state-chartered corporation. ... We are now moving through the charter transformation process, reviewing its potential merits and methods with leaders in the Administration and the Congress... We are encouraged that the interest in this proposition is significant and the audience is positive.<sup>36</sup>

The political risk, the offset fee, and the threat of more regulation, had become too great for SLMA. The limitations that went along with GSE status kept SLMA from expanding into new areas of business. The GSE funding advantage itself had diminished due to the offset fee and the development of the ABS market. For all these reasons SLMA's resolve to privatize stiffened. It had a strong desire to control and drive the change necessary to move into the marketplace without GSE limits. SLMA began trying in earnest to convince the Administration and Congress that privatization was not only feasible, but good public policy.

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<sup>34</sup> Interview with Edward Fox, Oct. 13, 2005; Interview with Marianne Keler, Sept. 1, 2004.

<sup>35</sup> Sallie Mae Interoffice Memorandum from Marianne M. Keler, VP and Assoc. General Counsel to Timothy G. Greene, EVP and General Counsel, *Privatization Issues and Possible Legislative Approach*, April 22, 1991.

<sup>36</sup> SLMA Annual Report 1993, p. 8.

## Chapter 2 – Policy Arguments

Privatization offered SLMA a way to expand its business and escape the confines of GSE regulation. It also offered a way for the Federal government to eliminate the perception that it might step in if necessary to prevent the collapse of this GSE. But there were reasons why the government might resist. The offset fee on SLMA's portfolio, perhaps as much as \$50 million per annum,<sup>37</sup> would be lost – an important budget consideration. The Federal government would want to make sure that the secondary market for student loans would remain stable and survive without the GSE. Congressional committees with oversight over SLMA would be giving up control over a large entity affecting schools and students nationwide. Banks competing with SLMA would pressure their legislators to prevent privatization. The Administration was focused on its direct lending plan and might not be willing to make the effort to facilitate privatization of an organization that was already very profitable.

The Clinton Administration ultimately supported the privatization as part of its efforts to reform the Federal student loan programs. Congress, too, was persuaded by SLMA. It saw the benefits of privatization as a way to reduce the government's risk exposure.<sup>38</sup> In 1995 it began to hold hearings on privatization legislation to effect the change. Some competitors opposed the privatization of SLMA (e.g., banks that originated FFELP loans), and some of SLMA's shareholders opposed a change in SLMA's business model if it privatized (see Section I, Chapter 5 on the SLMA Proxy Fights).

### Persuading the Administration

President Clinton had criticized SLMA's profits that rose by 172 percent during the period between 1986 and 1991, while he said its costs went down by 21 percent. "This is a group that helps us get college loans," he said, "It should not be a big profit-making operation."<sup>39</sup>

The Direct Student Loan Program was one of President Clinton's top priorities.<sup>40</sup> After he proposed to establish a permanent Federal direct loan program in February 1993,

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<sup>37</sup> The actual offset fee was only \$23 million in 1995. Because the offset fee applied to certain loans (Stafford and Plus were included and Consolidated loans were excluded) acquired after August 10, 1993, the per annum amount was expected to grow as the portfolio seasoned and grew. The \$50 million per annum estimate here is based on the actual offset fee in 1999, which is deemed to be representative of a forecast per annum results of a reasonable budget model.

<sup>38</sup> At the request of Congress, in the early 1990s, during the time period of this chapter, Treasury, CBO, and GAO issued a series of reports regarding the risk to the government from GSEs. While the reports generally found SLMA to be less risky than most other GSEs, several reports suggested privatizing SLMA as a means of eliminating potential government exposure. CBO went so far as to propose various structures for implementing such a privatization.

<sup>39</sup> Fumento, Michael, *End Bank Loans to Students? If Government Takes Over, It Could Cost Billions*, Investor's Business Daily, June 29, 1993.

<sup>40</sup> Darcy Bradbury, Deputy Assistant Secretary of the Treasury, Testimony before the House Subcommittee on Postsecondary Education of the Committee on Economic and Educational Opportunities and the

SLMA's stock lost 40 percent of its value.<sup>41</sup> In March 1993, SLMA's CEO and its General Counsel met with the White House to object to the Administration's direct loan proposal and start discussions on SLMA's conversion to a private corporation. SLMA's CEO, Lawrence Hough urged quick action to remove any cloud over SLMA's stock.

Through these discussions the Administration began to see privatizing SLMA as part of a plan to overhaul the student loan system. It was an olive branch to encourage SLMA to go along with the direct lending plan that it opposed. The privatization idea would reassure SLMA investors that SLMA would have enough capital to ensure student loan availability during a transition to direct lending.<sup>42</sup> Treasury began to see the benefit of privatizing and credited the coming Federal direct student loan program for creating an environment that no longer required a GSE to serve as a secondary market and warehousing facility for guaranteed student loans.<sup>43</sup>

SLMA predicted that there would be plenty of loans for it to buy over the next five or six years. If direct lending succeeded, SLMA believed it could buy portfolios. If direct lending failed, SLMA's business would be the same.<sup>44</sup> CEO Hough said that regardless of whether direct lending was successful and expanded, SLMA's core business of providing liquidity for student lending would be a "wealth of opportunity for the company for the next four to eight years." It was exploring new areas in student administration, registration, financial aid, tasks requiring "high paper processing," data processing, and health care processing. These fee based businesses would have a lower return for the company, but would be less risky than its asset based business.

In March 1994 SLMA offered new arguments to support a restructuring.<sup>45</sup> It said that the taxpayer would be relieved of the implicit liability associated with GSE indebtedness. SLMA pointed to the government's public policy goals in financing of higher education and its goal of maintaining the long term value of the franchise for its investors. It argued that the best way to meet those objectives was to restructure into a private, general purpose corporation. It painted its proposal as a win-win process. Taxpayers, investors, schools, students and SLMA's employees would all benefit. In addition, during a transition period, SLMA would remain a lender of last resort. Seeing a life cycle for successful GSEs was consistent with the Clinton Administration theme of "reinventing government." Restructuring would allow SLMA to compete in the areas of greatest need, providing education credit finance.

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Subcommittee on National Economic Growth, Natural Resources and Regulatory Affairs of the Committee on Government Reform and Oversight, May 3, 1995.

<sup>41</sup> Fumento, Michael, *End Bank Loans to Students? If Government Takes Over, It Could Cost Billions*, Investor's Business Daily, June 29, 1993.

<sup>42</sup> Sherry, Mike, "So Long, Sallie Mae?" Education Daily, April 28, 1993.

<sup>43</sup> Treasury, Office of General Counsel, *Proposed legislation to privatize Sallie Mae*, May 28, 1993.

<sup>44</sup> Memorandum from Darcy Bradbury, Treasury Deputy Assistant Secretary, to Frank N. Newman, Undersecretary for Domestic Finance, Nov. 30, 1993. To sweeten the negotiations, SLMA offered in November 1993, to prepay its floating 15 year notes with the Federal Financing Bank. These notes for \$4.76 billion were not due until 1995 and provided that SLMA could prepay at par.

<sup>45</sup> Sallie Mae, *The Restructuring of Sallie Mae, Rationale and Feasibility*, March 1994, attached to Letter from Timothy G. Greene, EVP & General Counsel, SLMA, to Frank N. Newman, Undersecretary of the Treasury for Finance, Mar. 8, 1994.

By August 1994, the Administration supported privatization. “While we are not yet ready to recommend specific actions for Congress to take on the future of Sallie Mae we are in agreement on the principal consideration that ought to guide us,” the Secretaries of Education and Treasury wrote to Congress, “The most promising approach now under consideration is . . . to restructure Sallie Mae from a GSE that has certain ties to the Federal Government into a completely private enterprise.”<sup>46</sup>

SLMA welcomed the letters, saying “We are encouraged that such a possibility can now be thoughtfully evaluated. We look forward to further dialogue with the Administration, Congress, and our shareholders.”<sup>47</sup> Lawrence Hough said that dealing with the Treasury’s concerns is key to any privatization and the question has been “can you actually do this, can you create a path” to privatization, “and the letter represents the conclusion that, yes, you can create a path.”<sup>48</sup>

### **Persuading Congress**

In order to privatize SLMA, Congress had to be convinced that there were good reasons to make the effort to do so.<sup>49</sup> SLMA argued that there were several public policy reasons for privatization.<sup>50</sup> Its primary mission – to provide liquidity for student loans – was accomplished. The capital markets had become more efficient and were no longer purely local. The student loan industry had become more sophisticated with specialization of functions, such as servicing and information processing. Securitization provided more volume for loans of all kinds.

Mission Accomplished. “Sallie Mae is a successful public/private partnership that has accomplished its mission,” testified SLMA’s CEO Lawrence Hough. “For all intents and

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<sup>46</sup> Letters from Richard Riley, Secretary of Education, and Lloyd Bentsen, Secretary of the Treasury, to William Ford, Chairman of the House Education and Labor Committee, and Sen. Edward M. Kennedy, Chairman of the Labor and Human Resources Committee, Aug. 23, 1994. These letters responded to a request from the two chairmen for a study of the future of SLMA as direct lending was phased in. Letters from Rep. William Ford, Chairman, House Education and Labor Committee and Sen. Edward M. Kennedy, Chairman, Senate Labor and Human Resources Committee to Secty Richard Riley and Secty Lloyd Bentsen, Nov. 16, 1993.

<sup>47</sup> SLMA press release, *Sallie Mae Welcomes Administration’s Statement on Corporate Rechartering*, Aug. 24, 1994.

<sup>48</sup> Crenshaw, Albert B., *Sallie Mae’s Crash Course in Private Enterprise*,” Washington Post, Sep. 5, 1994, p. 14.

<sup>49</sup> In 1985 the CBO had weighed privatization of SLMA as a way to control Federal risk exposure. Privatizing would eliminate the relatively small but unrecognized subsidy and the end of private leveraging of the Federal guarantee. Competition in the student loan secondary market would increase if agency status were removed. The disadvantages would include the possibility of a higher cost of funds for GSL lenders and the possibility that a private Sallie Mae would neglect the GSL market. Privatization might bring losses to current holders of GSE debt who acquired it at a price reflecting the market’s valuation of the government’s implicit guarantee. The CBO said that fairness would suggest that the guarantee would be withheld from future securities. CBO, *Government-Sponsored Enterprises and Their Implicit Federal Subsidy: The Case of Sallie Mae*, Dec. 1985, pp. 42-43..

<sup>50</sup> Sallie Mae, *The Restructuring of Sallie Mae, Rationale and Feasibility*, March 1994, attached to Letter from Timothy G. Greene, EVP & General Counsel, SLMA, to Frank N. Newman, Undersecretary of the Treasury for Finance, Mar. 8, 1994.

purposes, Sallie Mae has conducted itself as a fully private corporation for the past decade or more.” Mr. Hough went on to say:

Since the FFELP market is mature, with a very healthy set of liquidity choices for its participants, Sallie Mae's mission -- to ensure a broad base of liquidity for and access to student loans -- is accomplished. The FFELP market no longer needs a government sponsored enterprise (GSE).<sup>51</sup>

Mr. Hough argued that since SLMA had achieved its mission of ensuring a broad base of liquidity for and access to student loans, the life cycle of this GSE was complete and unnecessary borrowing that is perceived to be backed by the Federal government should be reduced.

SLMA described how the volume of student lending had grown significantly since the 1970s, as student lending changed from being a “loss leader” for commercial banks to a large volume program with strong competition and specialization. In 1993 more than \$17.9 billion in loans was originated to 5.8 million borrowers. Almost 70 percent of loans were sold to the secondary market by FY 1992, compared to less than 30 percent in 1981. SLMA said the growth of the secondary market improved the funding options for student loan originators.

Efficient Capital Markets. The financial markets had undergone a dramatic change, according to SLMA, lowering functional and geographical barriers to funding and increasing competition. “As a result,” said SLMA, “lending markets are no longer local in nature and segmented from the broader capital markets.” New funding options included collateralized debt and asset-backed securities (ABS), with access to long-term funds in domestic and foreign markets. Better information about borrower repayment performance allowed better default risk assessment of different borrower groups. Capital could flow better between regions because of the lower barriers to interstate banking. Competition, technology and innovation created a global financial market capable of providing funds efficiently for virtually all segments of the market.

Specialization and Securitization. SLMA pointed to functional specialization and asset-backed securitization as two recent trends that were having a strong impact on the student loan market. The functions of servicing, origination, and information processing technology, were becoming specialized, not only for student loans, but for all consumer lending. With the increased volume and economies of scale, the student lending business was becoming more competitive. Asset-backed securitization was a trend that promised to increase the base of investors. Securitization could take an asset such as a mortgage or car loan and package it into a pool of assets. Securities were issued on the pool, backed by the assets. SLMA expected securitization, in the form of taxable, SEC-registered

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<sup>51</sup> Joint Hearing of 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, May 3, 1995.

offerings to become a widespread vehicle for funding student loan credit. SLMA foresaw that it would bring in different investment sources.

FFEL Program Changes and FDL Program Transition. In 1993, Congress made substantial changes in the FFEL program - reducing yield, adding origination fees and reducing insurance coverage - all making FFELP loans less attractive to lenders and investors. More importantly, Congress introduced a program for Federal Direct Lending (FDLP) with the goal of providing 60 percent of new student loans by 1998. Congress imposed an offset fee on SLMA's new originations and allowed the Secretary of Education to require SLMA to be a lender of last resort if necessary.

In order to effectively meet the government's public policy goals of financing higher education, and providing stability in the student loan markets, while at the same time maintaining long term value for investors in the face of changes to the student loan program, SLMA argued that privatization was key.

No Need for a GSE. In early 1994 SLMA was arguing that direct lending would cause the FFELP market share to fall, perhaps to zero, and with it the liquidity and financing needs of FFELP lenders. Securitization offered banks liquidity that did not exist when SLMA started. SLMA's opportunities would shrink as direct lending grew. If SLMA became a government contractor servicing direct loans, as the Department of Education wanted, there was no need for it to have GSE status to do so. If it were limited to being a government contractor, a large portion of the company would effectively be liquidated.

GSE Life Span. SLMA argued that although Congress did not provide a sunset for GSEs, it also did not envision their expansion and perhaps perpetual existence, and therefore set limitations on their activities.

“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. In the case of Sallie Mae, whose mission has been accomplished and whose original business may gradually disappear, the question of how to complete the life cycle can no longer be deferred.”<sup>52</sup>

Restructuring SLMA as a state-chartered corporation was the only alternative that had any appeal to SLMA, compared with maintaining the status quo or even changing SLMA's charter to allow new activities. Keeping the status quo to SLMA meant that it would slowly lose its ability to attract qualified personnel and it would forego investments in its servicing operations. If SLMA's investors experienced losses because SLMA was substantially reduced, other GSEs might lose value due to the increased risk premium investors would demand. Similarly, if Congress redirected SLMA into other lines of business, SLMA predicted that its earnings might suffer. Redirection might not represent a good use of SLMA's skills and might not save time or money. Changing the

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<sup>52</sup> Sallie Mae, *The Restructuring of Sallie Mae, Rationale and Feasibility*, March 1994, pp. 13-14.

mission might also signal that Congress is unwilling to privatize SLMA. SLMA said this could lead to a further decline in share prices.<sup>53</sup>

Thus, SLMA itself embraced privatization as a natural end to the GSE life cycle and as the best choice for its shareholders as well. It developed its structural and political blueprint for privatization.

### **Opposition to Privatization - Persuading the Industry**

SLMA tried to convince its competitors that privatization was a good idea by pointing out that as a private entity it would have no GSE cost of funds advantage. The reorganized company would not have the current GSE portfolio to support new borrowing. SLMA intended to stay in the education field “for some time.”<sup>54</sup>

Bankers worried about SLMA competing for loan originations and opposed privatization. They pointed to SLMA’s history of efforts to make loans directly to students, such as its purchase in 1984 of a North Carolina thrift that it said was to provide supplementary capital for non-federal loans. Bankers claimed that having access to insured deposits was outside SLMA’s charter and sued to stop it. They also pointed to SLMA’s joint venture in 1990 with the College Board and Teachers Insurance and Annuity Association to offer one-stop shopping for college loans. After bankers object strongly, SLMA dropped both of these plans. However, despite the banks’ efforts, SLMA did not give up on trying to enter the loan origination business. In 1994, SLMA agreed with Chase Manhattan Bank to take over all functions of Chase Manhattan’s student loan business. Bankers said that this amounted to de facto lending. SLMA said that Chase would keep legal liability for the loans, and claimed that it, SLMA, was not the originator of the loans. Bankers also foresaw a loss of profits from the Federal government’s direct lending program, and expected SLMA to bid aggressively for portfolios with the Chase deal as a prototype.<sup>55</sup>

SLMA’s management tried to allay their fears by saying it would stay in the secondary market rather than enter the primary, origination market for student loans. The banks were unconvinced. They worried about competition from this large corporation with no restraints on its activities. They predicted that interest rates would rise on non-Federal student loans.

The Consumer Bankers Association opposed privatization, seeing it as a way to free SLMA from its charter restrictions and turn it into another large, non-bank competitor. Although SLMA insisted that its business was the secondary market, and that it would lose valuable partnerships if it competed directly, banks were worried. “I don’t want to be paranoid, but there are certain restrictions placed on them by GSE status that would be lifted,” said Joe Belew, president of the Consumer Bankers Association. “Sallie Mae

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<sup>53</sup> Sallie Mae, *The Restructuring of Sallie Mae, Rationale and Feasibility*, March 1994, pp. 17-18.

<sup>54</sup> Sallie Mae, *The Restructuring of Sallie Mae, Rationale and Feasibility*, March 1994

<sup>55</sup> Racine, John, *Sallie Mae Unleashed? Future of Student Loan Marketing Association*, American Banker, Jun. 13, 1994, p. 4.



would become a full-blown, efficient, well-funded competitor. A move towards privatization does not preserve the status quo.”<sup>56</sup>

Critics were complaining that SLMA should not have let the stock be beaten down as much as it was, and that management had not done a good job of looking out for its stockholders’ interests. Elliot Schneider, analyst for Gruntal & Co., Inc. in New York, said that going private would be an abdication of SLMA’s public mission and that the company faced political risks since Congress might limit SLMA’s activities as a private company.<sup>57</sup>

Investors and many analysts feared that privatization would cause interest rates to rise on non-Federal student loans. After privatization, consumers would bear the costs of Securities and Exchange Commission registration fees, local and state taxes, and fees for credit ratings. Wall Street traders worried about privatization since GSEs pump billions of dollars in debt, equity and securitizations – with the implicit support of the Federal government -- through their trading floors. “I consider privatization a worry,” said Thomas O’Donnell, a senior analyst at Smith Barney who followed the GSEs for a number of years. “It’s not a good idea. The benefits are uncertain and the negatives are unclear.”<sup>58</sup>

Despite the words of caution from Wall Street, SLMA had succeeded in getting the attention and support of the Administration and Congress to make privatization a reality. What follows is a discussion of the negotiations with the Administration and Congress to arrive at legislation that Congress would pass and the President would sign.

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<sup>56</sup> De Senerpont Domis, Olaf, *White House Plans to Take Sallie Mae Private*, American Banker, Aug. 25, 1994, p. 3.

<sup>57</sup> Crenshaw, Albert B., *Sallie Mae’s Crash Course in Private Enterprise*, Washington Post, Sept. 5, 1994, p. 14.

<sup>58</sup> Grassano, Bill, *Privatizing Sallie Mae; Wall Street, investors, the public and Congress are set to square off on the touchy issue of privatizing GSEs*, Investment Dealers’ Digest, June 19, 1995, p. 16.



## Chapter 3 - Privatization Act Negotiations

While privatization had been discussed for years, no action had been taken.<sup>59</sup> In the mid 1990s, SLMA finally succeeded in bringing together a consensus that privatization legislation should be enacted. Developing this consensus was a lengthy, iterative process involving SLMA, the Administration and Congress, as well as industry groups. SLMA took steps to change the direction of events that threatened its survival. Congress was costing it money by imposing an offset fee and setting up a Federal loan program that competed directly with it. Proposals were also starting to circulate on how to cut SLMA's GSE ties with the Federal government. SLMA was pressed to try to take control of the direction of these proposals.

### AT&T Break-Up Model

In April 1991 the Congressional Budget Office suggested privatization of SLMA as one way to reduce any perceived risk to the government.<sup>60</sup> It noted that there was a lack of urgency for establishing a regulator for SLMA because the risk to the government was insignificant, even without a Federal regulator. Since CBO saw it as hard to credibly sever all Federal responsibilities if no explicit guarantee existed, it suggested making the implied guarantee an explicit one and then withdrawing it on a schedule. Even with that plan, the markets might see the large new entity as too big to fail, as if it still had an implied Federal guarantee.

To get around the problem of size, CBO described a plan modeled on the break-up of AT&T to divide the firm into several independent entities and require SLMA to divest itself gradually by distributing shares in each of the newly created private firms to its existing shareholders. The new entities would not have any of the normal GSE attributes, such as a line of credit at Treasury or SEC exemption. The new, smaller entities would not be too big to fail, and would therefore be free of the implied guarantee. Under this plan the market value of the stock in the new entities would offset the lower value of the original stock. A variation on this plan would have the government terminate the spin-off short of complete dissolution if it wanted to have a standby presence in the secondary

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<sup>59</sup> During the 1980s SLMA tried to interest the Reagan Administration in privatization, but was unable to get the Administration's attention. Interview with Edward Fox, SLMA CEO, Oct. 13, 2005.

<sup>60</sup> CBO, *Controlling the Risks of GSEs*, April 1991, pp. 260-262.

After the savings and loan crisis in the 1980s Congress called for studies from Treasury, GAO and CBO on the risks posed by the GSEs. The thrust of these studies was that a regulator for all the GSEs was needed with the enforcement powers of bank regulators. The reports all agreed that although SLMA had no regulator or capital requirements, it had a triple A credit rating. Its risk was low because it reduced interest rate risk by matching asset funding to its liabilities. Nevertheless, there was a consensus that private markets did not effectively discipline GSE risk taking because Congress had not shown any willingness to allow a GSE to fail and creditors to suffer losses. GAO reasoned that Congress would step in to bail out a GSE because a GSE failure would be likely at times of crisis. Congress would also want to prevent the insolvency of GSE creditors such as federally insured banks and thrifts that held GSE securities. Treasury, *Reports on Government Sponsored Enterprises*, May 1990 and April 1991; GAO, *Government-Sponsored Enterprises: The Government's Exposure to Risks*, August 1990; GAO, *Government-Sponsored Enterprises, a Framework for limiting the Government's Exposure to Risks*, May 1991.

market. The government might wish to purchase the residual elements of the firm and operate it directly as a fully owned Federal entity. Such an arrangement would eliminate the ambiguity of the GSE structure.

CBO saw that privatization would benefit the primary student loan market by increasing competition, would relieve shareholders of GSE restrictions, and would relieve taxpayers of the contingent liability for SLMA debt. However, CBO was not convinced that the substantial legal and administrative costs from such a restructuring would be offset by these benefits.

SLMA disputed whether CBO's AT&T break-up model was appropriate. It viewed the analogy of AT&T to SLMA as inapt because of AT&T's size, monopolist practices and the nature of its business. AT&T was the largest corporation in the U.S. in 1980, at the time of its break-up, employing over one million people. Its local telephone service was a monopoly and it used those profits to subsidize its telephone equipment and long distance businesses. SLMA described itself as very different, being in two highly competitive markets, financial services and transaction processing, where there were no fixed cost barriers to entry. It questioned the cost advantage it had over other large servicers, and doubted that it would be able to use its specialized student loan transaction processing in other markets.<sup>61</sup>

### **Holding Company Concept**

With the pressure building to establish more regulation for the GSEs, and the possibility that Congress might use the AT&T model for privatization, SLMA began to think about a privatization alternative that it could support. In April 1991, Marianne Keler, an associate general counsel at SLMA, prepared a memo suggesting the concept of a holding company with SLMA as a wholly-owned subsidiary as a way to shift SLMA's GSE functions to a private company.<sup>62</sup> SLMA preferred this structure to the proposal by CBO to split the GSE into several private firms. Even though there were lengthy negotiations and counterproposals, most of the features laid out in this memo ultimately found their way into the final legislation.

Ms. Keler argued that preserving the GSE in a state-chartered holding company structure would allow the activities of SLMA to be gradually wound down and would ensure continuity of a national secondary market if Congress allowed limited privileges and benefits on the condition that the company kept education credit as its primary business.

The memo sketched out the central structures of the holding company privatization model and noted that legislation would be needed for many features. Most, but not all of the features she proposed found their way into the final legislation.

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<sup>61</sup> Sallie Mae Internal Memorandum to file, *Sallie Mae/AT&T Comparison*, from Timothy G. Greene, EVP and General Counsel, June 9, 1994.

<sup>62</sup> Sallie Mae Interoffice Memorandum from Marianne M. Keler, VP and Assoc. General Counsel to Timothy G. Greene, EVP and General Counsel, *Privatization Issues and Possible Legislative Approach*, April 22, 1991.

### Holding Company

- Creation of a state-chartered holding company and one or more state-chartered wholly-owned operating subsidiaries
- Shareholders of the holding company would have equal rights in all respects, including voting, and the SLMA board would be the initial board of the holding company
- Upon the conversion, the holding company would be the only SLMA shareholder

### Shareholders

- SLMA shareholders would vote within two years to go private based on a plan developed by the Board and management, with the board unable to take a position on the vote
- SLMA shareholders would exchange their shares for shares of the holding company, and SLMA would be a wholly owned subsidiary of the holding company
- SLMA would preserve a role for presidential appointees but the board would be smaller, and could include required appointments of people from the education and finance sectors, with the chairman elected by the majority

### Wind Down and Transfer

- SLMA would cease doing new business and would extinguish its existing obligations with a wind down as fast or slow as management saw fit
- SLMA's portfolio would be frozen, with gradual unwinding in proportion to the decline in the rest of the balance sheet
- All new business would be conducted by a state-chartered affiliate, capitalization and borrowing would occur at the holding company level
- Assets could be transferred from SLMA to the holding company or affiliates as long as the AAA status or minimum required capital of SLMA was not jeopardized
- No SLMA liabilities could be transferred to the holding company or affiliates without approval of holders of 50 % or more of any affected issue

### GSE Attributes

- SLMA would retain its Federal charter, subject to new GSE regulation Congress might adopt, such as AAA rating and increased reporting
- As long as the new corporation's assets consisted primarily of student loans, student loan financings and academic facilities financings, the GSE would retain limited benefits including:
  - Exemption from state qualification requirements
  - Exemption from anti-trust laws
  - Continuation of cost of carry exemption for tax-exempt portfolio up to average shareholders' equity
  - Tax credits for financing underserved markets

If there were no wind down, and SLMA continued as a regulated GSE within the holding company structure as an interim step toward full privatization, Ms. Keler noted that

Congress might want to limit the affiliates and ultimately regulate the entire structure similar to banks and broker dealers. However, if SLMA ceased new business, the government's risk would be frozen and no further regulatory expansion would be justified, regardless of the length of the wind-down.

The benefits of this plan, according to Ms. Keler, were that it would put the control of the corporation in the hands of its owners, eliminate artificial limits on business activities and diversification, encourage innovation, avoid government regulation, limit the government's implicit risk on SLMA's liabilities and allow Congress to apply new regulation to the federally chartered entity, consistent with its approach to the other GSEs.

## **NEGOTIATIONS WITH THE ADMINISTRATION**

In 1993 The Clinton Administration was concerned with its restructuring of the student loan program. It wanted its Federal direct loan program to succeed. SLMA saw the direct loan program as a serious threat to its survival. At the same time, investors seemed to see the same threat, and SLMA's shares lost substantial value.<sup>63</sup> In early 1993 SLMA met with the White House to object to the direct loan proposal that President Clinton had made. In those first meetings it brought up the concept of converting SLMA into a private corporation. The Clinton Administration appeared to see a trade off for its support of privatization if SLMA eased its resistance to the Federal direct loan program.<sup>64</sup>

Over the next two years SLMA and a White House working group that included Treasury hammered out a proposal to present to Congress. They adopted the holding company concept that SLMA proposed, with additional oversight from Treasury. They agreed that shareholders should approve a reorganization plan, since at the time SLMA management was dealing with a dissident shareholder group that was unhappy about SLMA's loss of value. If shareholders did not approve, the GSE would dissolve. They agreed that a trust should be established to provide for holders of GSE debt that remained after the GSE dissolved. SLMA even agreed that Treasury should have enforcement authority over all the affiliated companies under the holding company (though this fell away during the legislative process). They disagreed on the amount of required capital, use of the name "Sallie Mae" and an exit fee to repay the taxpayers for prior GSE benefits.

## **NEGOTIATIONS WITH CONGRESS**

It took several years for Congress to pass the Student Loan Marketing Association Reorganization Act of 1996. Both the House and the Senate held hearings. Congress had changed from being a majority of the same party as the President to being a Republican majority. The Democratic Administration supported privatization, and SLMA had to convince the Republican Congress too, that privatizing was good policy.

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<sup>63</sup> SLMA's shares had only recently converted to a single class of voting common stock. Higher Education Act Amendments, Pub. L. 102-385, Sec. 431, July 23, 1992.

<sup>64</sup> Sherry, Mike, *So Long, Sallie Mae?* Education Daily, April 28, 1993.

### 1995 Legislation

Several congressmen, representing areas with large numbers of SLMA employees, wrote to Administration officials to endorse privatization and de-link it from the success of direct lending. The congressmen encouraged the Administration to propose legislation to privatize SLMA, supporting the Administration themes of reinventing and downsizing government. They also worried that delay in privatizing would deter investment in the company and thereby hurt it.<sup>65</sup>

In 1995 the direct loan program expanded from a pilot program with 104 schools to 1,500 colleges, universities, community colleges and trade schools. The government expected to make money on the program by borrowing at low rates and lending at higher ones, just as private lenders did. It also believed it would save administrative costs. Although there was strong opposition to the program in the new Republican Congress, proponents in the industry said it was faster for students to obtain loans this way than through the banks. Changes could be made overnight with direct loans, compared with the bureaucratic headaches in using a private lender. Schools using direct loans had only one form to use rather than many. Proponents said that free market competition had not fixed the problems. Government competition was a “wake up call,” according to Susan Conner of USA Group, a company that guaranteed and serviced student loans.<sup>66</sup> USA Group began to deliver loans faster and give application updates. Lenders such as Citigroup, Chemical Bank and Bank of America created a common electronic lending system. SLMA and USA Group worked on a similar system.<sup>67</sup>

The debate continued on the benefits of direct lending. James Appleberry, president of the American Association of State Colleges and Universities supported direct lending saying, “The facts are it is working.” The University of Maryland, meanwhile, withdrew from the direct loan program, saying that it had worked out improvements with commercial lenders, including SLMA, “that we feel offer basically the benefits of direct lending.” Education’s Leo Kornfeld, argued against a cap on direct lending proposed by Senator Nancy Kassebaum, saying that more schools wanted to sign up than there was room for. He noted he had been hearing that private lenders were losing billions in Federal subsidies and were “putting pressure on institutions” to leave the program. “We’ve been told over and over the lobbyists are in full force,” he said, “This is a matter of survival.”<sup>68</sup>

As Congress and the Administration debated the extent of direct lending, SLMA’s stock gyrated. Privatization became a top priority for SLMA.<sup>69</sup>

The Department of Education decided to apply the offset fee to SLMA’s entire portfolio, including loans in securitizations. SLMA notified it that it would bring a lawsuit to

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<sup>65</sup> Letters to Vice President Al Gore, Jr. and Education Secretary Richard Riley, from Congressmen Sam Gibbons, Paul Kanjorski, Edward Markey, Chet Edwards and Pete Peterson, Feb. 10, 1995.

<sup>66</sup> USA Group was later acquired by the holding company, SLM Corp., during the privatization.

<sup>67</sup> *Direct Student Lending Due to Expand*, Washington Post, Feb. 19, 1995, p. H02.

<sup>68</sup> Kelly, Dennis, *More Tussles Over Scope of College Loan Direct Lending*, USA Today, Mar. 9, 1995, p. 6D.

<sup>69</sup> *Washington Post*, April 17, 1995, p. F37.

challenge the Department's decision regarding securitizations. SLMA argued that the offset fee was unconstitutional, and that the Department's application of the offset fee to securitized loans was unconstitutional.<sup>70</sup>

### **Administration Proposal**

Treasury worked with Education, OMB, the Domestic Policy Council, the National Economic Council, SLMA and Congressional staff to propose legislation to allow SLMA to restructure as a private entity and gradually wind down the operations of the GSE. On May 2, 1995, Treasury's Darcy Bradbury set out the features that the Administration wanted before a joint hearing of House committees, and some, but not all, of these proposals were incorporated.<sup>71</sup> She listed the benefits to the government of privatizing SLMA:

- The amount of debt that carried the perception of government support would be reduced.
- The government would show its commitment to enabling a public-private partnership to become private when government support for the activity is no longer needed.
- The government would show financial markets that it respects the interests of private bondholders and shareholders.
- By freeing a GSE to operate in the market once it has fulfilled its purpose, the government would support efforts to create new GSEs in the future, when appropriate.

Ms. Bradbury outlined the Administration's proposal for a privatization plan:

- Board authorization. SLMA's Board could authorize a reorganization to make SLMA a subsidiary of a state-chartered holding company.
- Approval of plan. The reorganization plan would be subject to approval by Education and Treasury followed by approval by SLMA shareholders.
- Transition restrictions. In the period after reorganization, SLMA's new businesses and new debt would be restricted.
- Limits on transfers. During this transition period, excess SLMA capital could be transferred to the holding company subject to specific limitations for the first three years and approval of Treasury and Education during the remaining transition period, and compliance with SLMA's capital requirements after the distribution.
- Exit fee. As an exit fee to recognize the benefits SLMA has received because of its GSE status, the government could participate in the financial success of the

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<sup>70</sup> SLMA, press release, *Sallie Mae will pursue litigation against Department of Education over proposed fee on securitized assets*, April 12, 1995.

<sup>71</sup> Testimony of Darcy Bradbury, Deputy Assistant Secretary of the Treasury before a joint hearing of the House 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 [Joint Hearing], May 3, 1995.



holding company, for example through the issuance of stock warrants, and the rest of the legislation must be revenue neutral.

Leo Kornfeld, a senior advisor at the Department of Education, testified that privatization was appropriate when the special privileges bestowed upon a GSE were no longer necessary to perform the functions for which they were created. “GSE privileges should be viewed as temporarily conferred by the Government for limited purposes,” he said, “and not as a permanent property right of the GSE owners and management.”<sup>72</sup>

He noted that the new direct loan program raised the question of whether the functions assigned to SLMA under the FFEL program would be necessary in the future. Students should be protected, since they would have a continuing need for loans beyond what the direct loan program could provide. Orderly privatization with a transition period over time would help protect students.

The offset fee imposed on SLMA for loans it held in its portfolio was estimated to add \$251 million to the Department of Education’s budget over the next five years. Mr. Kornfeld argued that, to avoid a PAYGO<sup>73</sup> issue under the Budget Enforcement Act, legislation should provide that SLMA paid the equivalent amount to the Federal Government.

Mr. Kornfeld argued for an exit fee to compensate the Federal government for the financial benefits that SLMA enjoyed as a GSE. These included low borrowing rates, better financial leverage than private institutions and exemption from state and local taxes. The exit fee would prevent SLMA from having an unfair competitive advantage based on resources it accrued as a GSE. On the other hand, in order to secure the ratings necessary to succeed as a financial institution SLMA would have to meet certain capital requirements.

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<sup>72</sup> Testimony of Leo Kornfeld, Senior Advisor to the Secretary of Education before the House Joint Hearing, May 3, 1995.

<sup>73</sup> The Budget Enforcement Act of 1990 required budget neutrality. Congress used a pay-as-you-go (PAYGO) rule beginning in 1993 to compel new spending or tax changes to not add to the Federal deficit. New proposals must either be "budget neutral" or offset with savings derived from existing funds. As formulated in the Senate, the PAYGO rule generally has prohibited the consideration of any revenue or direct spending legislation that would cause (or increase) an on-budget deficit for any one of three applicable time periods: (1) the first fiscal year covered by the budget resolution; (2) the first five fiscal years covered by the budget resolution; and (3) the next five fiscal years after that. CRS Report for Congress, *PAYGO Rules for Budget Enforcement in the House and Senate*, RL32835, May 3, 2005, p. CRS-2.

### **SLMA Privatization Arguments**

Lawrence Hough, SLMA's CEO and President, strongly favored privatization. He testified<sup>74</sup> before the two House subcommittees that there were three main compelling reasons to privatize SLMA: SLMA had accomplished its mission, privatizing would reduce the government's liability, and privatization would complete the GSE life cycle.

Mission accomplished. Mr. Hough testified that SLMA had accomplished its mission of ensuring liquidity for and access to student loans. Over \$80 billion in private capital was invested in FFELP loans and SLMA was instrumental in fostering that expansion. There were at least 42 secondary market participants and many banks that purchased loans, and securitization was presenting more liquidity. The FFELP market was mature and offered many choices. "The FFELP market no longer needs a government sponsored enterprise."

Reduce Federal liability. Mr. Hough's second argument was that privatizing SLMA would reduce unnecessary borrowing with Federal backing. He said that although SLMA's \$52 billion in debt did not carry a Federal guarantee, "investors who hold these bonds generally understand them to carry the 'implicit' backing of the U.S. Government." He went on to state it more clearly:

Sallie Mae's \$52 billion debt is part of what you have all heard referred to as 'off balance sheet' federal liability – the piece of the overall taxpayer exposure which is not included in the national debt statistics. Sallie Mae's privatization cleanly severs what has been for over two decades an implicit link back to the taxpayer.

GSE life-cycle complete. His third point was that in order for SLMA to complete its "GSE life cycle," it needed to relinquish its GSE status. It needed to successfully complete the transition that its management and Board of Directors had been considering for several years. In preparation for a possible privatization, he said SLMA had worked to create a strong financial balance sheet and credit standing, and this accomplishment was not due to SLMA's GSE status.

GSE bondholders. The privatization legislation should protect existing bondholders, Mr. Hough insisted. SLMA had worked with Treasury for a year to make sure that privatization would not affect the status of the GSE debt, and everyone had agreed to that principle.

Continued student loan business. SLMA would stay in the student loan business, and proposed to be available as the lender of last resort during the transition period if the Department of Education found it necessary. Mr. Hough said that in its new ventures SLMA would continue its core competencies of providing services to student lenders. At the same time, privatization would allow it to expand beyond FFELP loans, to service other types of loans and offer data processing services to the health care industry.

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<sup>74</sup> Testimony of Lawrence A. Hough, President and CEO of SLMA before the House Joint Hearing, May 3, 1995.

Budget scoring. If SLMA was privatized, Federal budget scoring rules required an offset for the loss of revenue from the 30 basis point “offset fee” Congress had imposed on SLMA. Mr. Hough pointed out that the 30 basis point fee was itself an offset fee set to meet a budget target. He complained that no credit was given for the principal benefit to the government – reduced Federal liabilities. Mr. Hough asked Congress to approve a privatization plan without more fees that the shareholders would support. He argued that SLMA shareholders had already paid a heavy fee in the form of a loss of \$4 billion of investment value.<sup>75</sup>

Banks were beginning to worry that privatization would transform SLMA from a partner into a strong competitor for student loan originations. As a GSE, SLMA could not originate. Mr. Hough tried to mollify the banks, saying SLMA would not be a threat to banks. “The company has grown to its current size because of its relationships with banks,” he assured them. “That’s a nice marriage, and to disrupt it with a run at loan originations runs counter to logic.” The bankers weren’t convinced. The Consumer Bankers Association and the American Bankers Association asked Congressman McKeon to include in the privatization legislation a ban against SLMA lending directly to students. Mr. Hough worried that shareholders might not agree to such a restriction.<sup>76</sup>

Many in Congress seemed to favor privatization but were concerned about the details. “Details can bring this whole process to a crashing halt,” Mr. Hough agreed, leaving the company “trapped without a future.”<sup>77</sup>

### **Legislation Introduced**

Shortly after the hearings, on May 11, 1995, Rep. Howard R. McKeon introduced a bill to privatize SLMA.<sup>78</sup> This bill reflected SLMA’s preferences, and the final legislation included more Administration proposals. The bill allowed SLMA’s board to adopt a plan to restructure the common stock of SLMA so that a newly formed holding company would own all of the stock and the common stock of SLMA would be converted to common stock in the holding company. Shareholders would have 18 months from enactment to approve of this reorganization plan or the reorganization legislation would have no effect. The dissolution would happen within ten years, by December 31, 2004.

Separate entities. SLMA and the holding company would maintain separate books and records, funds and assets, and management.

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<sup>75</sup> Robert E. Torray, an investment manager for owners of 1,484,400 SLMA shares, testified that SLMA’s stock closed at the end of 1994 with a loss of \$4.4 billion in market value, exceeding by almost 50% all of its earnings over 21 years. He said the market had rendered a harsh judgment on the issue of continuing SLMA as it was rather than privatizing. Privatizing would allow SLMA to get out of its straight jacket and use its resources to diversify. Testimony of Robert E. Torray, President and CEO, Torray Fund, before the House Joint Hearing, May 3, 1995.

As SLMA’s stock value had dropped, a group of dissident shareholders had organized to propose alternative plans for SLMA such as dividing SLMA into parts and selling off some divisions.

<sup>76</sup> Cahill, Joseph B., *Privatized Sallie Mae wouldn’t be home free*, *American Banker*, May 25, 1995, p. 4.

<sup>77</sup> Connor, John, *SLMA Chief Warns Against Onerous Privatization Conditions*, *Dow Jones News*, May 3, 1995.

<sup>78</sup> H.R. 1617, *Consolidated and Reformed Education, Employment, and Rehabilitation Systems Act (CAREERS Act)*, introduced May 11, 1995.

Names. The name of the holding company or any subsidiaries could not contain the name “Student Loan Marketing Association,” but could contain the name “Sallie Mae,” or variations on it.

Three year transition. SLMA would continue to have GSE attributes for three years, and could issue GSE debt for that period. SLMA would have to use its best efforts to transfer property to the holding company and could pay dividends to the holding company as long as it maintained the required 2.25 percent capital.

Stock warrants. At reorganization, the holding company would issue 100,000 stock warrants to Treasury, entitling it to purchase stock at the average price for the 20 days prior to enactment of the legislation, plus 10 percent of that average price.

Trust. The bill provided for a trust for the benefit of GSE bondholders, and SLMA would determine the form and substance of the trust agreement. The assets funding the trust would include non-callable obligations of or guaranteed by the United States, as well as triple A rated assets, including student loans, as to which the holding company would agree to take all actions necessary to maintain the triple A rating.

Safety and soundness. Treasury was authorized to monitor SLMA’s safety and soundness through review of information and records on SLMA’s policies, procedures, or systems for monitoring and controlling financial risk. This included risk to SLMA resulting from the activities of any of its affiliates if they were likely to have a material impact on SLMA’s condition.

No enforcement powers. Treasury did not have the right to approve of the trust, to conduct safety and soundness audits, or enforce any provisions.

Exit fee and budget neutrality. As mentioned above, eliminating the offset fee through privatization presented a budget problem. The Senate Budget Committee’s Chairman Pete Domenici suggested that an exit fee of up to \$535 million might be needed.<sup>79</sup> The Senate Budget Committee assumed that a significant fee could be leveled on SLMA upon privatization in return for years of financial benefits it had enjoyed. “However,” said Senator Jim Jeffords, “questions have arisen concerning its ability to provide such a fee. Instead, the focus is now on budget neutrality and determining a way to ensure that privatization not cost the Federal government.”<sup>80</sup> To solve the problem, Congress set the deadline for SLMA to dissolve at a time beyond the current ten-year budget cycle. That way, the offset fee could be included in the current budget cycle without interfering with budget neutrality.

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<sup>79</sup> Hammonds, Keith H., *The “Exit Fee” for Sallie Mae*, Business Week, June 12, 1995, p. 46.

<sup>80</sup> Testimony of Senator Jim Jeffords before the Senate Subcommittee on Education, Arts, and Humanities of the Committee on Labor and Human Resources, June 20, 1995.

SLMA’s CEO assured Congress that he believed that the budget neutrality problem could be solved. “This is a burden to be borne by Sallie Mae alone. We are not asking others to share in this.” Testimony of Lawrence A. Hough, SLMA President and CEO, before the Senate Subcommittee on Education, Arts, and Humanities of the Committee on Labor and Human Resources, June 20, 1995.

Shareholder dissent. Privatization did not have unanimous support at SLMA. During this period a group of shareholders led by ex-COO, Albert L. Lord, wanted to slow down the march to privatizing that Lawrence Hough, the current CEO, wholeheartedly supported. “The management and board are proceeding down the trail of privatization without explaining what they are doing,” Mr. Lord warned. “This will become a government issue, and when that happens, the shareholders will be left out of the equation.”<sup>81</sup> Lord’s group managed to elect 8 directors to SLMA’s board in 1995, a group that became known as the Committee to Restore Value at Sallie Mae, or the CRV. The CRV ultimately supported privatization too, but was initially cautious. It objected to what it called management’s haste. Paul Carey, a member of that group said that although they were philosophically committed to privatization, “the company is not ready yet.”<sup>82</sup> The proxy battle between the CRV and Hough’s supporters on the board is the subject of Chapter 5 of this section.

### **Administration Proposal**

The Administration considered the Direct Loan Program as a top priority and in support of that it had studied options for SLMA’s future, including privatization. It decided that privatization would be a major benefit to both SLMA, in lifting restrictions on its business, and the government since it would reduce the government’s implicit guarantee, demonstrate a commitment to privatize an activity when government support was no longer needed, show respect for private bondholders and shareholders, and allow for new GSEs to be created and then be freed to operate in other markets once their purposes were fulfilled. It believed however, that the government, not a GSE, should decide whether a GSE should continue, especially if the GSE had outlived its purpose.<sup>83</sup>

Deputy Assistant Treasury Secretary Darcy Bradbury testified<sup>84</sup> before the Senate and proposed that the legislation terminate SLMA’s GSE status whether or not the shareholders voted to reorganize into a state-chartered corporation. She also testified in favor of the government having enhanced oversight.

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<sup>81</sup> Grassano, Bill, *Privatizing Sallie Mae; Wall Street, investors, the public and Congress are set to square off on the touchy issue of privatizing GSEs*, Investment Dealers’ Digest, June 19, 1995, p. 16.

On May 26, 1995, the dissident group sued management, charging that it closed the polls early at the annual meeting where board seats were being voted on. SLMA countersued on May 30, accusing the dissidents of soliciting votes in a misleading manner. Hammonds, Keith H., *The “Exit Fee” for Sallie Mae*, Business Week, June 12, 1995, p. 46.

<sup>82</sup> Crenshaw, Albert B., *The Problems of Privatization at Sallie Mae*, Washington Post, May 22, 1995, p. F25.

<sup>83</sup> Treasury Memorandum to Karen Dorsey from Jill Ouseley, HR 1617, *Careers Bill, Comment on Sallie Mae Provisions*, (undated )

<sup>84</sup> Testimony of Darcy Bradbury, Deputy Assistant Secretary of the Treasury before the Senate Subcommittee on Education, Arts, and Humanities of the Committee on Labor and Human Resources, June 20, 1995. See Appendix 4 to this report.

Ms. Bradbury testified that the key elements of the Administration's privatization proposal were:

- The SLMA Board of Directors would be authorized to propose a reorganization - - to be voted upon by SLMA's shareholders -- under which the GSE would become a wholly-owned subsidiary of an ordinary state-chartered holding company whose other subsidiaries could engage in other businesses;
- If the shareholders choose not to proceed with a reorganization, SLMA would prepare a plan for its orderly liquidation that would ensure that the GSE would meet its ongoing capital requirements and have adequate assets to transfer to a trust to ensure payment of outstanding GSE debt obligations.
- After the decision by the shareholders, SLMA would enter a wind down period during which new business activities of the GSE would be restricted and new debt issued by the GSE would be restricted as to purpose and maturity;
- During the wind down, excess capital of the GSE could be transferred to the new private holding company or paid out to shareholders subject to continued compliance with the GSE's statutory capital requirements;
- The GSE would be protected from the financial failure of the holding company or its other subsidiaries in the event of reorganization;
- The GSE would cease to exist at a certain point in time and its remaining assets and liabilities would be liquidated;
- The bill would be deficit-neutral; and
- As a form of "exit fee," to recognize the benefits Sallie Mae has received because of its GSE status, the legislation would enable the United States to participate in the success of the company, for example through the issuance of stock warrants.

The Administration also wanted strong oversight authority of the relationship between the GSE and, if applicable, the new private company during the wind down period. The Administration wanted legislation to provide that:

- The reorganization plan and other actions of the GSE during the wind down period be subject to certain reviews by the Departments of Education and Treasury;
- The government's financial safety and soundness oversight and enforcement authorities over the GSE be enhanced and the minimum capital ratio of the GSE be increased gradually during the wind down period;
- The Secretary of the Treasury be authorized to collect an annual assessment to pay the Treasury's reasonable costs and expenses for carrying out its oversight responsibilities over the GSE during the wind down; and
- The new company and any of its non-GSE subsidiaries be prohibited from using the name Student Loan Marketing Association, Sallie Mae, or any variation on that name in securities offerings in order to prevent confusion in the financial markets.

Enhanced Oversight. The Administration wanted the legislation to provide for Federal oversight of the relationship between the GSE and the new private company during the wind down period. The reorganization plan should be subject to review by the

government. The government's safety and soundness oversight and enforcement powers over the GSE needed enhancement to allow Treasury and Education to approve a reorganization plan and distributions from the GSE until it dissolved. It believed that the minimum capital ratio should gradually increase during the wind down period. It also wanted authority to assess SLMA for reasonable costs of financial safety and soundness oversight.

### **1996 Reorganization Act**

The House first passed privatization legislation in September 1995, as the Student Loan Marketing Association Reorganization Act of 1995, part of the Careers Act of 1995. The Senate held hearings on privatization in June 1995, and passed privatization legislation in October 1995 as part of the Job Training Bill. A House Senate Conference Committee reconciled the differences between versions of the Careers Bill in August 1996 and included provisions to privatize Sallie Mae but the conference report was not brought before the House or the Senate for final action.

The House approved of H.R. 1720, the portion of the Careers Bill that had to do with SLMA's privatization, on September 24, 1996, but the Senate did not act on that bill. It came up once again as part of H.R. 3610, the 1997 Omnibus Budget Reconciliation Act. The House passed it on September 28, 1996, the Senate on September 30, and the President signed the Student Loan Marketing Association Reorganization Act of 1996 on September 30, 1996. The next chapter outlines the provisions of the final legislation.





## Chapter 4 – Final Legislation

Following years of negotiation between Sallie Mae, Congress and the Administration, on September 30, 1996, the Student Loan Marketing Association Reorganization Act of 1996 (the Act or the Privatization Act) was signed into law. The Act amended section 439 of the Higher Education Act of 1965 and added a new section, 440. In general, the Act contemplated the complete dissolution of the Student Loan Marketing Association, and set forth two alternatives for accomplishing the dissolution. To this end, the law required SLMA to propose a plan of reorganization to its shareholders under which their shares would convert to equal shares in a new state-chartered holding company. If the shareholders approved the plan, the business would be reorganized and the GSE would gradually be phased out by September 30, 2008. If the shareholders rejected the plan, sunset provisions of the legislation would be activated under which the GSE would be liquidated by July 1, 2013. Either way, SLMA the GSE would eventually cease to exist.

### Reorganization Principles

Under the reorganization option, it was envisioned that the company would be restructured into a state-chartered, SEC-registered holding company, which would own the GSE and other non-GSE subsidiaries. Shares of SLMA's stock would convert to shares of the holding company. The GSE would be phased out by September 30, 2008, following a transition or "wind-down" period during which its operations would gradually be transitioned to non-GSE affiliates. Congress provided the wind-down period to allow time for an orderly transition of SLMA's business activities, and to give the private company time to develop alternative financing sources. The wind down period also had budget implications.<sup>85</sup>

Given this opportunity, shareholders voted overwhelmingly to approve the reorganization plan on July 31, 1997. Following the shareholder vote, the sunset provisions were no longer operative, and the reorganization provisions, which were laid out in section 440, became controlling. Pursuant to the Privatization Act, a Delaware-charter corporation, SLM Corporation, ultimately became the parent company of SLMA. Under section 440, all SLMA employees were required to become employees of the private-sector company on the date of the reorganization. Thereafter, all SLMA's operations would be contracted to the holding company or another third party.<sup>86</sup> Also, certain property was required to be transferred to the holding company "as soon as practicable" after the reorganization.

According to the statute, during the wind-down period, SLMA would continue to have all its GSE rights, privileges and obligations. These privileges included exemptions from state and local taxes and from SEC registration and reporting concerning its securities, as

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<sup>85</sup> The offset fee imposed on SLMA in 1993 was included in long term government budget projections. The 10+ year wind down period allowed offset fee revenue to remain in the budget until the GSE was phased out. See further discussion in Chapter 3 of this section, footnote 9.

<sup>86</sup> Although the law provided for third parties to manage the GSE's operations, in practice holding company affiliates performed these functions throughout the wind down period.

well as access to the agency debt market for funding. SLMA was permitted to continue issuing agency debt while the holding company developed its own financing sources outside of the GSE. However, the issuance of new agency debt was restricted to maturities shorter than September 30, 2008. The Act provided that all existing GSE debt, as well as debt issued during the wind down period, would retain its GSE attributes until its maturity, so as not to disadvantage investors in SLMA bonds. During the period prior to the dissolution, SLMA was subject to various limitations on its business and activities. SLMA could pay dividends to the holding company, but only after certifying to Treasury that after doing so the GSE would remain in compliance with minimum statutory capital requirements.<sup>87</sup>

Conversely, the private-sector affiliates were not entitled to any of the GSE's benefits, nor were they subject to the activity limitations and restrictions applicable to SLMA. This meant that the holding company could enter into new lines of business through its private-sector subsidiaries, but could not utilize the GSE benefits in doing so.<sup>88</sup>

The Act allowed the GSE subsidiary to continue purchasing student loans until September 30, 2007, that is, one year prior to its final dissolution. However, the law required that when the holding company began to purchase student loans, SLMA had to cease. This requirement was one of only a few interim milestones in the privatization act.<sup>89</sup> SLMA had wanted a phased-in transition of student loan purchases rather than an instantaneous cut over; however, Congress did not agree to that.

### **Firewalls between the GSE and private-sector affiliates**

In addition to making the general statement that the holding company was not entitled to any GSE benefits, the statute required specific firewalls between the private-sector company and the GSE, so the former could not exploit the GSE. The Act required separate operation of the GSE versus the private-sector affiliates, and placed restrictions and prohibitions on transactions between the two parts of the company. The law dictated that: (1) GSE funds and assets be kept and accounted for separately and be used only for GSE purposes, (2) the GSE keep a headquarters physically separate from the private company, (3) no presidential-appointed director of the GSE could serve on the holding company's board of directors, (4) one officer of the GSE had to be solely an officer of the GSE, (5) transactions between the GSE and its private-sector affiliates be conducted as arms' length transactions, (6) the GSE was prohibited from extending credit to the private-sector affiliates, and (7) any GSE funds collected by the holding company on behalf of the GSE had to be immediately deposited into a GSE controlled account. The law also prevented the holding company from transferring its ownership of the GSE's

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<sup>87</sup> The Act also increased SLMA's minimum leverage capital ratio to 2.25% from 2%, effective 1/1/00.

<sup>88</sup> A provision in the Federal Deposit Insurance Act, however, restricted the holding company's ability to affiliate with an insured depository institution prior to the GSE's dissolution [12 U.S.C. § 1828(s)(4)(A)-(E) (as amended in 1998)].

<sup>89</sup> The holding company actually assumed loan purchase operations from the GSE on June 30, 2004, more than three years ahead of the deadline.

shares or causing the GSE to be liquidated or put into bankruptcy without the approval of Treasury and the Department of Education.

### **Increased Safety and Soundness Oversight by Treasury**

As part of the Privatization Act, Congress increased Treasury's authority and responsibility to provide safety and soundness oversight to SLMA during the transition. This expanded authority included an obligation on the part of SLMA to obtain, maintain and provide information to Treasury on request concerning financial safety and soundness of the GSE. It also gave Treasury the authority to make inquiries regarding financial risk posed by "associated persons," which covered the GSE's private-sector affiliates. The law allowed Treasury to charge SLMA for the cost of this additional oversight through an annual assessment. The law also provided that Treasury or the Department of Education could enforce compliance with the provisions of the Act by suing SLMA in US District Court, but did not provide the other enforcement powers that are now generally seen as essential to safety and soundness regulation.

### **Exit Fees**

SLMA effectively paid a total of \$42 million in privatization-related monies to the DC Control Board for DC Public Schools. The law required that SLMA issue warrants to the DC Control Board equal to 1% of its outstanding shares that could be exercised to purchase stock of the holding company at any time prior to September 30, 2008. The strike price for the warrants was set at the average price of SLMA's stock for the 20 day period leading up to the enactment of the law. The Control Board ultimately received \$37 million in proceeds from the sale of SLM Corporation common stock warrants issued to it on August 7, 1997<sup>90</sup>, the effective reorganization date. The Act also allowed the GSE to assign the "Sallie Mae" name to the holding company as a trademark, for a fee of \$5,000,000, also payable to the DC Control Board for DC Public Schools, with certain restrictions on its use as outlined below<sup>91</sup>.

### **Use of "Sallie Mae" Name**

While allowing the GSE to assign the Sallie Mae name to the holding company, the law placed restrictions on how the name could be used by non-GSE affiliates. Primarily, the law prohibited any private-sector affiliate from using the name in connection with any issuance of debt securities. It appears that Congress was concerned that there be no confusion in the market place as to which bonds were GSE bonds and which were issued by private-sector affiliates. The law also required certain disclosures to be made for three years after the dissolution of the GSE whenever holding company debt is issued or whenever the "Sallie Mae" name is used in ads or other promotional materials.

### **Dissolution of the GSE and Defeasance of Remaining SLMA Bonds**

Under the reorganization provisions the GSE had to be dissolved by September 30, 2008. However, the law allowed it to be dissolved before that, provided that the company gave Treasury and the Department of Education notice of its intention to do so. The notice had to be given at least 60 days prior to the planned dissolution date, because the law gave the

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<sup>90</sup> Pursuant to 20 U.S.C. 1087-(c)(9)

<sup>91</sup> 20 U.S.C. 1087-(e)(3)

Department of Education 60 days to object to the dissolution on the ground that the GSE was still needed for purposes of providing liquidity to the secondary market for student loans.

On the dissolution date, the law required that an irrevocable trust be created to defease any GSE debt obligations that would not mature until after the dissolution. The trust was to be established and fully funded on the day the GSE was dissolved. The form and substance of the trust had to be acceptable to Treasury. Treasury also had to determine that the cash flows from the collateral deposited into the trust would be sufficient to pay all scheduled principal and interest due on the remaining GSE obligations. Collateral in the trust was limited to cash and noncallable obligations backed by the full faith and credit of the United States.

## Chapter 5 - Proxy Fight

In 1996, the year of the SLMA Reorganization Act, a struggle for control of SLMA intensified between a group of directors backing existing management and an opposition group of directors calling itself the Committee to Restore Value at SLMA (CRV). Tensions between the CRV and the management group had been simmering since a contested director election in 1995 had put the CRV on the board. The Higher Education Act required that SLMA's board of directors be composed of 21 persons, 7 appointed by the President of the United States, and 14 selected by the shareholders.<sup>92</sup> The CRV gained control of 8 of the 21 seats on the board in 1995 largely due to shareholder discontent over the decline in value of SLMA's stock in the early 1990s. While the CRV was a minority on the overall board, they represented a majority of the board members elected by shareholders.

While both the management group and the CRV supported the privatization legislation, they disagreed over the direction the company should take following privatization. There were also serious personality clashes between management and certain CRV members. Several CRV members were former executives from SLMA. At the core of the difference in business direction was the issue of whether or not the privatized SLMA would compete directly with banks by originating its own guaranteed student loans. Management and its backers on the board (13 directors, including all 7 presidential appointees) favored a privatization strategy in which SLMA continued in its secondary market role ("partnering" with banks), and diversified its revenue through expanding servicing operations, consulting and other technology oriented subsidiaries. Many of the elected board members who backed management's vision were representatives of the banking industry.

The CRV, on the other hand, favored shifting the company to a direct origination model during the privatization process and competing directly with banks and other lenders for loans in the primary market. The CRV also saw value in diversifying revenue sources through many of the same fee revenue businesses that management advocated. The core difference was the origination versus secondary market issue, which was often framed at the time as "partnering versus competing with banks."

The legislation, which became law on September 30, 1996, permitted SLMA's board to adopt a plan to reorganize the company, and required the board to submit such a plan for shareholder approval within 18 months, by March 31, 1998. If shareholders did not approve the plan by then, the legislation directed that the GSE be liquidated by 2013 (the "sunset" provision<sup>93</sup>). The board of directors announced its intention to bring a reorganization plan to shareholders for a vote by mid 1997, well ahead of the deadline. The simmering tension on the board regarding the future of the company quickly

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<sup>92</sup> 20 U.S.C. § 1087-2 (c)(1).

<sup>93</sup> 20 U.S.C. § 1087-2 (s)

mounted. Both groups saw the shareholder vote on privatization as an opportunity to solidify (in the case of management) or seize (in the case of the CRV) control over the board of directors and the future of the company.

After much debate between the opposing groups at the board committee level, the board of directors adopted management's plan of reorganization on January 24, 1997, by a 13 to 8 vote. All of the 7 directors appointed by the President voted to support management's plan. The CRV, with its majority of the elected directors, unanimously voted against the plan.

Embedded in management's reorganization plan was the election of a slate of directors that would have greatly weakened, if not eliminated, the CRV dissenters. Initially, management included two members of the CRV on its slate, but required that they support management's plan of reorganization and not voice public dissent. The two CRV directors were given a week to consider if they wanted to be a part of management's slate of directors. In early February 1997, both CRV directors withdrew their names from the management slate, and, having failed to sway SLMA's board, began formulating an argument to take the matter directly to the shareholders.<sup>94</sup>

In accordance with the reorganization plan, the board created a new company chartered under Delaware state law on February 3, 1997.<sup>95</sup> The company was initially a subsidiary of the GSE, however, if shareholders approved the reorganization plan, the new entity, via a stock conversion, would become the parent holding company and the GSE would become a subsidiary, ultimately to be phased out entirely. The plan now needed only the approval of the shareholders.

Management scheduled a special meeting of shareholders for Thursday, May 15, 1997, at 10 am to vote on the reorganization. Holders of record as of March 17, 1997, were entitled to vote. SLMA had approximately 23,000 shareholders<sup>96</sup> at that time. However, as mentioned above, embedded in management's proxy was the election of a slate of directors that largely eliminated the dissenters. At the time it was clear that shareholders were in favor of reorganizing the company as opposed to liquidating it under the sunset provision. Management made the reorganization and the new slate of directors into a package. A vote against management's slate of directors was effectively a vote against reorganization. Given that there was clearly some shareholder support for the CRV, management also scheduled a meeting for the dissident shareholders for 2 pm on May 15th, but noted that the meeting was advisory in nature. If the reorganization plan was adopted at the 10 am meeting, management stated that it would be implemented without regard to the results of the 2pm meeting or vote.

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<sup>94</sup> SLMA Board of Director minutes for meeting held January 24, 1997, page 52.

<sup>95</sup> SLM Holding Corporation, 10-Q filing with the SEC for the second quarter of 1997.

<sup>96</sup> Per SLMA's April 9, 1997 Proxy Statement/Prospectus at page 1. Ownership of the privatized SLMA is now far more concentrated. In its Form 10-K for the year 2004, SLM Corporation disclosed that as of March 4, 2005, the number of holders of record of the company's stock had fallen to only 741 holders. Item 5, page 20.

The CRV was outraged by management's actions, and campaigned to expose to shareholders what they saw as management's self-serving approach to reorganizing the company and entrenching itself and its supporters on the board in the process. The CRV prepared and mailed its own proxy statements to shareholders and scheduled a separate shareholder meeting for May 9<sup>th</sup>, a week earlier, hoping to be able to claim a majority of shareholder support before management even held its meeting. The CRV proposal required that the vote on the holding company's board of directors be held separate from the reorganization vote. The CRV also solicited votes in support of amending the holding company's by-laws and certificate of incorporation in ways it said would improve shareholders' rights. Management filed a lawsuit seeking a temporary restraining order that would have prevented the CRV from holding its meeting. The lawsuit was not successful.

As it turned out, both the CRV and management's May meetings were held, but neither group was able to claim the support of a majority of shareholders. There were approximately 52 million eligible voting shares outstanding, which meant that just over 26 million votes were needed to claim victory. The CRV reported that their meeting garnered approximately 38 million votes in total, 23 million of which favored the CRV and 15 million favoring management. Management claimed that at their meeting 42 million votes were cast, but they were split roughly 50/50, giving each side about 21 million votes. With neither side able to claim a majority in May, the contest was a stalemate.

At this point, management and the CRV began to negotiate. On May 27, 1997, they reached a settlement agreement outlining a mutual understanding of the procedures to be used to obtain shareholder approval of the privatization plan and a slate of directors. The parties agreed to cancel all shareholder meetings previously held regarding privatization, and void all proxies solicited to date.

The necessary documents were filed with the SEC and another shareholder meeting was called for July 31, 1997. At this meeting shareholders would have the opportunity to cast two separate votes: one on the plan of reorganization, and a second for a slate of directors to run the new holding company. The Privatization Act required a majority vote on the plan to reorganize the GSE.<sup>97</sup> The parties agreed, however, that the board slate receiving the highest plurality of votes cast, as opposed to a majority, would be appointed as the directors of the holding company's board as soon as possible after the vote.

In the interim between the May settlement agreement and the July proxy contest, the CRV gained momentum. One of the presidential appointees renounced her past board votes against the CRV, left the management camp, and was named as a nominee for the holding company board on the CRV board slate. The CRV recruited several other influential board members who had sizable investments in the company's stock. The CRV announced that if its slate of directors was selected it would appoint Albert Lord, SLMA's former CFO and COO, who had left the company in 1994, as the CEO of the new company. In the final week before the July vote, Institutional Shareholder Services,

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<sup>97</sup> 20 U.S.C. § 1087-3 (b).

a large shareholder advisory firm, abandoned its previous support of management and recommended a vote for the CRV slate.

Meanwhile, the management group seemed to be in some disarray. SLMA's then-CEO and board member Lawrence Hough, announced that regardless of the outcome of the proxy fight, he would resign, citing the need for new management with non-GSE experience to lead the holding company. In addition, since the presidential appointees that had supported SLMA's management were not eligible to serve on the holding company board, management had to recruit new directors for its slate. Management recruited several nominees who held no SLMA stock at the time the proxy solicitations were mailed, which did not help their cause. Management's slate also included representatives of several large banks that some shareholders viewed as potential competitors to a privatized SLMA. Senior management at the company also began to split, with the Treasurer and the Controller publicly supporting the CRV slate before the shareholder vote.<sup>98</sup> The CRV fully exploited the apparent weakness in management's slate, sending letters to shareholders detailing these issues in the days leading up to the July vote.

The shareholder meeting was held as planned on July 31, 1997, garnering significant shareholder participation. Approximately 43 million or 83% of all eligible shares were voted. As expected, shareholders approved the reorganization by a wide margin, with 99% of votes cast favoring the reorganization plan.<sup>99</sup> The vote on a slate of directors to run the privatized company was much closer, but the CRV slate of directors ultimately prevailed and gained control of the company. The CRV received over 25 million votes, or roughly 58% of the votes cast by shareholders.<sup>100</sup> Management's slate received approximately 18 million votes.

In early August, the company was reorganized with SLM Holding Company (subsequently renamed SLM Corporation) as the parent and SLMA as a wholly owned GSE subsidiary. Albert Lord was installed as the CEO and vice chairman of the holding company. Edward Fox, SLMA's first CEO who had retired in 1990, assumed the position of Chairman of the Board under the CRV slate. Previous senior management was replaced, and the process of vetting the remaining management team took place. A large percentage of SLMA's management turned over after Albert Lord was appointed CEO.<sup>101</sup> Mr. Lord headed the company as vice chairman and CEO throughout the wind down of the GSE, before resigning as CEO in May 2005.<sup>102</sup> Mr. Lord then assumed the Chairman role and Mr. Fox retired from the board.

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<sup>98</sup> CRV proxy statement, July 10, 1997

<sup>99</sup> SLM Holding Corporation, Third quarter 1997 Form 10-Q, page 33.

<sup>100</sup> While only 48% of all eligible shares were voted in favor of the CRV, management and the CRV had agreed notified shareholders that the slate receiving the highest plurality of votes would win. Therefore, the CRV was the clear winner despite not receiving a majority vote.

<sup>101</sup> "It was a very difficult time," said Marianne Keler, SLMA VP and General Counsel, "It was like a civil war here." Keler Interview, Sept. 1, 2004.

<sup>102</sup> The GSE was dissolved on December 29, 2004.



**Lessons Learned - SLMA's Proxy Fight**

The decline in the value of SLMA's stock from 1991-1994 was linked, at least in part, to the political developments discussed in chapters 1 & 2 of this section. These external events pushed SLMA in the direction of shedding its GSE charter. Also, SLMA's stock may have under performed, in part, due to shareholder uncertainty regarding the future of the company.

Congress established a sunset provision to phase out SLMA in case the shareholders voted against reorganization. Since a majority of the holders of SLMA stock had to approve, in effect shareholders that did not vote were counted as voting against reorganization. In different circumstances, Congress might consider approval by a plurality. It is impossible to know what would have occurred at SLMA over the ensuing years if the shareholder vote had triggered the sunset provision. There was concern at the time that if the sunset provision was triggered, it might have resulted in a sudden and untimely flight of quality management and other unforeseen difficulties in liquidating the GSE. This provision did, however, have the positive effect of giving the shareholders a choice in how the GSE would be phased out (privatization vs. liquidation), and thereby engaged them in the process.

It is conceivable that privatizing a GSE increases the likelihood of a proxy battle given the business opportunities, uncertainties, and complexity in winding down a GSE. Competing visions for the future of a privatized GSE emerge in the process, increasing the likelihood of such a contest. Uncertainty surrounding the proxy fight, in turn, conceivably affected shareholders' views regarding reorganization.



## **SECTION II – Business Summary**

**Chapter 1 - Overview of the Student Loan Market**

**Chapter 2 - Overview of Key Sallie Mae Business History**



## Chapter 1 – Overview of the Student Loan Market

In conducting our review, we considered the questions “was the success of SLMA’s privatization experience unique to the education credit market because of federally insured student loans? And how would the experience apply to other underlying assets?” This chapter provides some context for considering these questions by discussing why the full privatization of SLMA was economically viable in the education credit market. It discusses the unique nature of federally insured loan asset, and its importance in the SLMA privatization experience, which facilitated a successful GSE wind down, but in OSMO’s view was not essential to the successful privatization of SLMA.

### Part 1 – Overview of Federal Insured Student Loans - 1990-2004

#### 1993 Enactment of the Federal Direct Loan Program

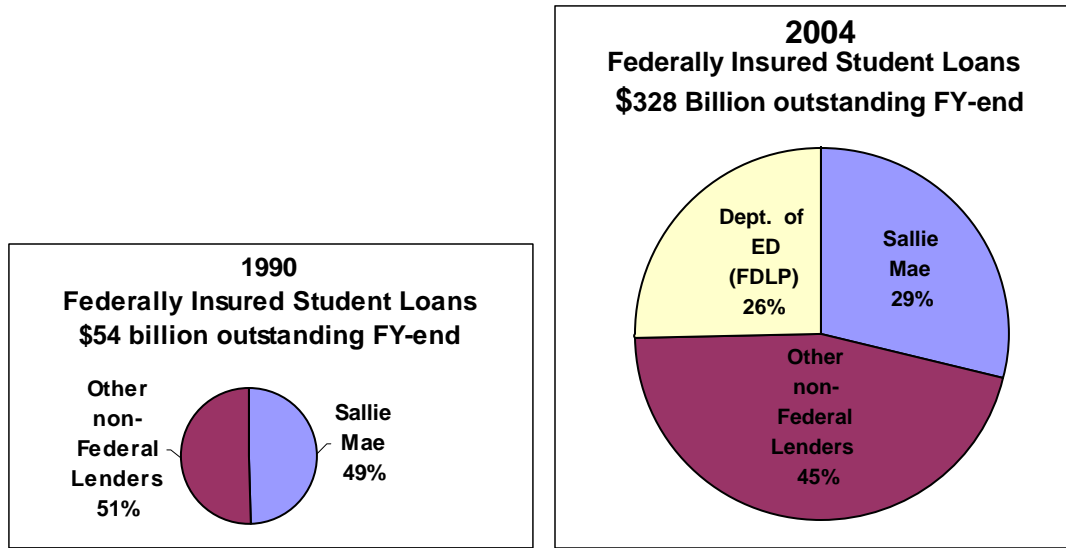
In recent years, the higher education credit market has grown at a rate greater than the overall U.S. economy. As of 2004, this credit market is significantly supported by the emergence of Federal financing of student loan and by private-sector financing via the securitization market, as SLMA’s GSE role diminished. These changes in the credit market help explain why the SLMA privatization was appropriate public policy and in part why SLMA wanted to privatize. The consequences of a fully private secondary market for student loans may not yet be fully understood, but the preliminary evidence is that dissolution of the GSE (SLMA) has had no negative impact on the availability of credit in this market. Further, the emergence of strong competitors to both SLMA and Federal financing for both federally insured student loans and non-federally insured student loans should prove beneficial to the stability and resilience of the education credit market in the long run.

The following two pie charts<sup>103</sup> illustrate (1) the rise of the direct Federal student lending program, and (2) the overall growth in federally insured education credit to \$328 billion outstanding by fiscal year-end 2004 from \$54 billion outstanding in 1990. In 1990 SLMA dominated the ownership of FFELP with nearly half the market. The Department of Education, via its direct student loan program (FDLP) became a serious competitor in 1994, taking away market share in subsequent years<sup>104</sup>. By 2004 SLM Corp. ownership of all federally insured student loans (FFELP and FDLP) had declined to a 29 percent share. The next largest holder of federally insured student loans at year-end 2004 was the Department of Education with a 26 percent share.

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<sup>103</sup> The two pie charts sizes are proportional to dollars outstanding. Outstanding Perkins, HEAL and dollar-in-default loans are excluded from pie charts and outstanding amounts.

<sup>104</sup> The FDLP stated as a pilot program in 1992, and its authorization was expanded in 1993 legislation.



**Other Secondary Market Participants**

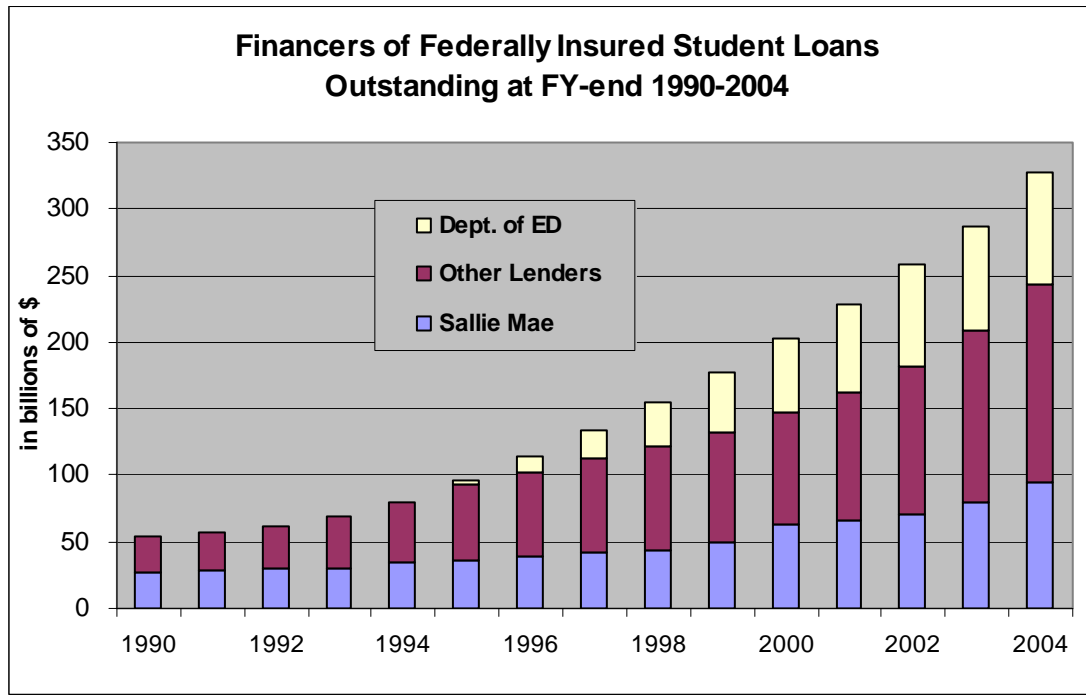
In 1976, four years after SLMA was created, Congress authorized the creation of specialized student loan secondary market organizations throughout the country. In general, these organizations were created as not-for-profits to serve a particular state or region. Some financed part of their activity by issuing tax-exempt bonds, some used advances from SLMA. Most provided extensive outreach and counseling programs.

The following table shows the market share distribution in 1995. These so called “state secondaries” were competitors to SLMA holding 19 percent of the market at fiscal year-end 1995. Although still relatively small individually, compare to SLMA, these institutions’ access to tax-advantaged funding made them viable competitors.

| Estimated Share of FFELP Loans Outstanding<br>For Federal FY end - \$ in billions |             |             |
|---|-------------|-------------|
| Holder/Manager (excludes Sallie Mae's warehousing advances)                       | 1995        |             |
|   | Dollars     | Pct.        |
| SLMA  | \$31        | 33%         |
| <b>Other non-Federal Holders:</b>   |             |             |
| State Secondaries Lenders:  | 18          | 19%         |
| Student Loan Corp. (CitiGroup Subsidiary)   | 6           | 6%          |
| Next Top Four   | 10          | 10%         |
| Other   | 29          | 31%         |
|   | <u>44</u>   | <u>48%</u>  |
| Other non-Federal Holders   | <u>62</u>   | <u>67%</u>  |
| Total FFELP Outstanding   | <u>\$93</u> | <u>100%</u> |

The share of FFELP loans held by the non-for profit state secondaries is not readily available for periods subsequent to 1995 but is expected to have declined significantly from 19 percent because SLM Corp. and other private-sector companies have purchased many of these companies, particularly the larger ones.

The following graph shows overall market growth for the federally guaranteed insured student loan programs (FFELP and FDLP) for the period 1990 to 2004, as well as the shifting market share among types of holders.



### Significant Overall Growth after 1993

While the 1993 Reauthorization of the Higher Education Act made the Department of Education (FDLP) a competitor to SLMA and other lenders (FFELP), it also expanded eligibility and borrowing amounts under both student loan programs (FDLP and FFELP). This was positive for all lenders, and had a dramatic impact on loan origination volumes. All ships rise in a rising tide. These increases were at least part of the reason SLM Corp. achieved significant growth during the GSE wind down period despite losing overall market share. During the eight year period ending in December 2004, SLM Corp.'s holdings of federally insured loans increased at an annualized compounded rate of nearly 12 percent. At the same time however, overall loans outstanding, including FDLP, increased by over 14 percent annually.

### New Private-Sector Competitors

During the GSE wind down period, ABS (asset-backed securities) provided SLM Corp and its non-Federal competitors greater access to the capital markets without GSE funding. SLMA faced competition from numerous sources.<sup>105</sup> Some newer competitors built business models based on marketing campaigns, via mailings and internet advertising, often geared towards encouraging borrowers to consolidate their "Stafford"

<sup>105</sup> The Student Loan Corporation, a subsidiary of Citibank, increased its overall market share slightly to approximately 7 percent outstanding at year-end 2004 up from 6 percent at year-end 1995.

FFELP loans. This resulted in loan run-off for SLM Corp. After consolidation, these companies would outsource the loan servicing function, and finance the loans via ABS. SLM Corp. managed to slow its loan run-off to these competitors through legislative and legal means as well as through its own aggressive marketing campaign. These newer participants viewed SLM Corp. as a competitor not a partner<sup>106</sup> as had some banks.

### **Private-Sector Acquisitions of State Secondary Participants**

While it lost market share in the overall Federal student loan market as Federal direct lending grew, SLM Corp. maintained its FFELP market share (FDLP loans excluded) during the GSE wind down. In part this was due to acquisitions of specialized student loan companies, the so called “state secondaries.” SLMA’s 11.7 percent growth in FFELP loans was approximately the same as the growth rate of approximately 11.5% in the overall market of FFELP loans (compounding annually for the eight year period ended December 2004). By purchasing three specialized student loan companies, at the end of 2000 SLMA held 43 percent of the FFELP market (FDLP loans excluded). This share declined to 39 percent by year-end 2004. The largest remaining state secondary is the Pennsylvania Higher Education Assistance Agency (PHEAA) with an estimated market share of 2 percent as of year-end 2004. In 2005, SLM Corp. sought to acquire PHEAA’s student loan business from the State of Pennsylvania for \$1 billion in a controversial proposal that was rejected by PHEAA<sup>107</sup>, and ultimately withdrawn by SLM Corp. in September 2005.

### **SLM Corp.’s “Preferred Channel Origination”**

SLM Corp. has changed its business model from one that relied on purchases of loans in the secondary market, to a direct origination model where it controls the marketing and origination processes and originates loans directly or uses brand name conduits. SLM Corp. refers to loans acquired in this manner as “Preferred Channel Originations.” In 2004 Preferred Channel Originations accounted for \$18 billion or 78 percent of managed student loan acquisitions (excluding loans acquired through business acquisitions).<sup>108</sup> Of these Preferred Channel acquisitions \$5.6 billion came through Sallie Mae brand names.

## **Part 2 - The Nature of FFELP Student Loans**

### **Valuing Student Loans**

A financial asset, loan or bond that pays an interest rate above the current market rate for credit of similar quality, will price at a premium to the principal amount. If the premium is relatively large, the price is considered “rich.” Loan prices are generally quoted as a

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<sup>106</sup> College Loan Corporation (CLC) of San Diego, California sued SLM Corporation and SLMA in September 2002. In its complaint, CLC claimed that although SLMA was prohibited from originating loans, it made arrangements with lenders to provide marketing and other services for lenders who would originate loans subject to a commitment to sell the loans to SLMA after origination. These conduit lenders, with the assistance and participation of SLMA [and SLMA affiliates], compete directly with CLC in the marketplace to originate FFELP loans. *College Loan Corporation v. SLM Corp., et al.* (E.D.Va.) Civil Action No. 02-1377-A, Sept. 6, 2002.

<sup>107</sup> PHEAA, Press Release, *PHEAA Board of Directors Reject Unsolicited Takeover Bid*, Dec. 27, 2004.

<sup>108</sup> SLM Corporation’s 10-K, 2004,



percentage of the principal (e.g., a loan selling at 102 means a 2 percent premium, or a premium of 200 basis points).

There are a variety of interest rate and co-insurance terms to student loans originated under the federally guaranteed student loan programs based on year of origination, type of product, and repayment status. Further, the rate borrowers pay is not necessarily what lenders receive. Lenders receive the greater of what borrowers pay or a guaranteed rate, with the government making up the difference (for example the guaranteed yield to a lender for most Stafford loans held in repayment status is the weekly average commercial paper rate plus 234 basis points). Another consideration in pricing student loans is their smaller average balances, which make them, relative to mortgage loans, more expensive to service (e.g., a \$30 fixed expense has a 30 basis point impact on the value of a \$10,000 loan but only a 3 basis point impact on the value of a \$100,000 loan).

### **FFELP Loans are “Rich”**

In general, many federally guaranteed student loans sell at premiums from 3 to 8 percent. In general, these premiums are large when compared to other types of financial assets. For a typical FFELP ABS transaction, SLM Corp. would sell \$100 of student loans and receive \$102 in cash plus future residual cash flows or “residuals.”<sup>109</sup> Given the market value of the residuals, which is disclosed publicly, the total premium may be calculated for a given pool of student loans. For example a securitization transaction executed in March 2002 by the Student Loan Corporation (a Citibank subsidiary and competitor of SLM Corp.) indicates a premium of 5 percent in the pricing of this portfolio of student loans.<sup>110</sup>

### **FFELP Loans Facilitated the Wind Down**

SLMA’s management has attributed the nature of the FFELP loans, particularly the two guarantees (the guaranteed yield and the guaranteed credit) that make predicting cash flows more reliable, as facilitating securitization of these assets, which in turn was a positive factor in the GSE wind down. In general, securitizing assets that are guaranteed as to yield and credit by the Federal government is far easier and less costly than securitizing other performing assets, because they need fewer enhancements such as additional collateral or private-sector insurance.

Securitization challenges, however, can still arise even with Federal guarantees, such as the challenge of securitizing the long-term variable-rate Consolidated loans, for which Sallie Mae had to develop sophisticated ABS structures. Overall, Sallie’s Mae’s ability to readily securitize its portfolio of FFELP student loans assets played an important role

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<sup>109</sup> The present value of the estimated residual cash flows “residuals” is recognized under GAAP as “retained interest in securitized receivables” see, Appendix, Vexing Accounting, for further discussion.

<sup>110</sup> In this case, the student loan portfolio price, which was sold into a trust by the Student Loan Corporation (STU), is calculated by dividing the sum of the cash proceeds received by STU and the market value of future receivables booked by STU (\$259.7 million and \$12.6 million, respectively) by the principal amount of loans and other assets provided (\$258.2 million). The relatively high premium of 5 percent is explained by the attributes of the underlying consolidated loans, which have higher average balances, longer duration, and in some cases high fixed rate yields than other student loans. Source: Student Loan Corporation, financial statements for 2002.

in its ability to quickly and smoothly replace its GSE debt. However, OSMO's analysis indicates that the wind down could have been accomplished absent the Federal guarantee on those assets for the reasons outlined below.

### **But FFELP Loans Were Not Essential to Privatization**

OSMO's analysis indicates that the Federal guarantee for SLMA's FFELP loan portfolio was not an essential factor in the privatization of the GSE. First, much of the GSE's portfolio of FFELP loans was not as "rich" as FFELP loans held by originators because the GSE paid some level of premiums to originators when it bought the loans in the secondary market. SLMA, as the GSE, was not allowed to originate loans. Second, while FFELP loans acquired in the secondary market at fair value may be securitized more readily, if the market is effective and efficient at pricing assets, the overall business should be no more profitable than securitizing non-federally guaranteed financial assets acquired in the secondary market. Theoretically, the market should adjust to less valuable assets by pricing them at a discount.

Nonetheless, in Sallie Mae's case the bulk of acquisitions during the wind down were not purely originations, nor were they purely secondary market transactions. It acquired most of its FFELP loans during the wind down through negotiated forward purchase commitments in which banks originated loans for Sallie Mae using Sallie Mae's platform. Therefore, it appears that some of the premium associated with the rich FFELP asset was captured by the originator and some was captured by Sallie Mae.<sup>111</sup>

While a government guarantee makes it easier to securitize assets, it is not a prerequisite for doing so. For example, SLM Corp. was readily able to securitize its private education loans. During the wind down period the GSE transferred to non-GSE subsidiaries over \$10 billion in private loans. The non-GSE affiliates in turn securitized \$7 billion of these private loans in two years. Structuring the cash flows from the underlying assets to meet a certain credit rating threshold, as measured by the credit rating agencies, can be accomplished without Federal guarantees. Other enhancements, such as over-collateralization, larger subordinated tranches, and private-sector insurance, can support the securitization structure. Of course, making such enhancements to the ABS makes the transaction more costly for the issuer. The large and deep universe of ABS and MBS supported by non-federally guaranteed assets makes it clear that non-guaranteed assets can be securitized, at some price. In summary, the lesson learned is that the SLMA privatization experience, while facilitated by government guaranteed loans, is not unique to student loans and could potentially be applied to other underlying assets.

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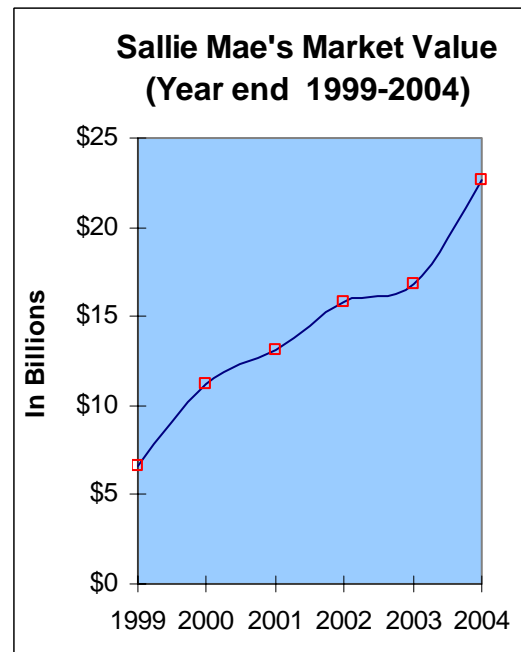
<sup>111</sup> See discussion of Sallie Mae's "Preferred Channel" acquisitions, 2004 Form 10-K, page 10 and its discussion of "Competition" 2004 Form 10-K, page 13.

## Chapter 2 - Overview of Key Sallie Mae Business History

### Growth was Key to the Successful GSE Wind Down

As SLMA, the GSE, wound down from 1997 to 2004, the holding company, SLM Corporation made acquisitions of its competitors and firms in related fields in order to: (1) achieve more vertical integration, (2) grow its student loan portfolio, (3) build its capacity to originate student loans for its own account, and (4) expand beyond its traditional education-related secondary market activity into new lines of business such as debt collection.

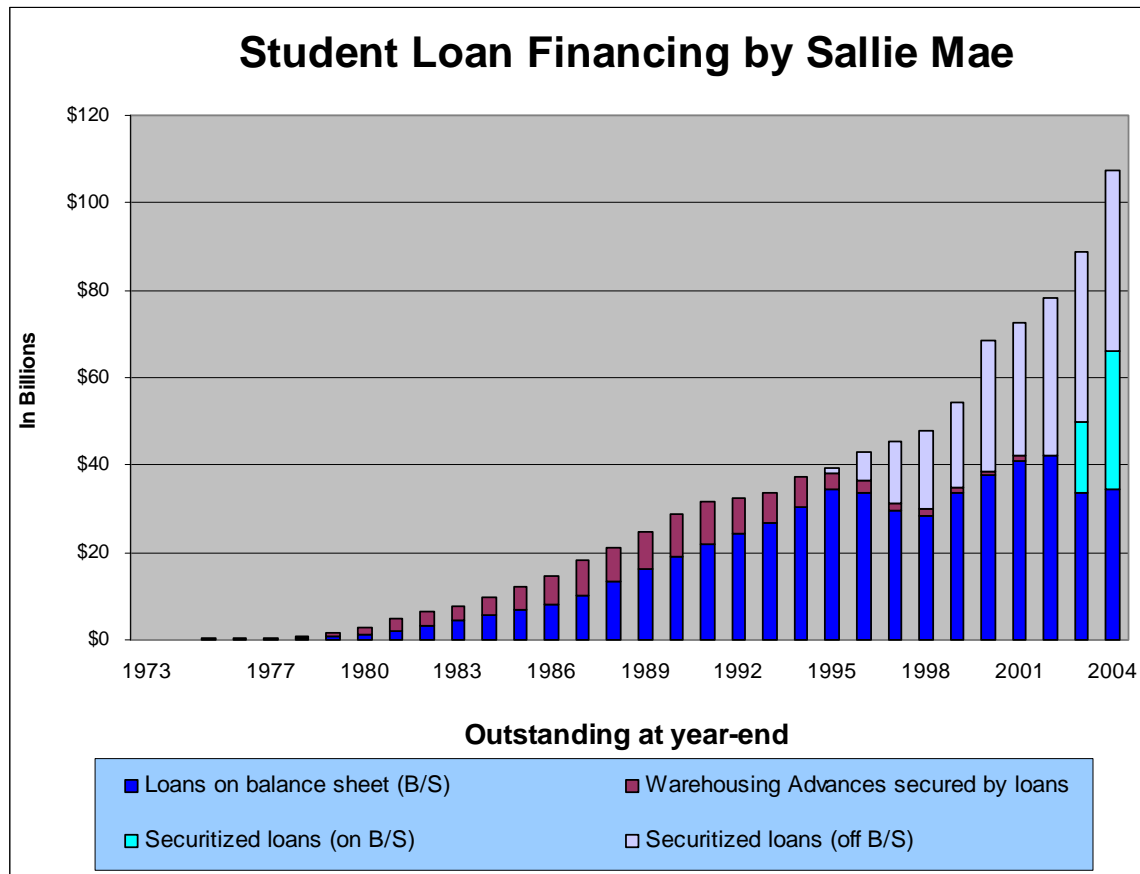
By year-end 2004, when Sallie Mae became a fully private-sector company, the market value of Sallie Mae's equity was \$22.6 billion – more than a three fold increase from five years earlier. In a May 2005 study by Boston Consulting Group of the top global financial firms, Sallie Mae ranked the highest among U.S. companies and third in the world in shareholder returns in the five years from 2000 to 2004.<sup>112</sup> The following chart illustrates Sallie Mae's stock performance in the five year period ending December 31, 2004. Clearly, full privatization of Sallie Mae was beneficial to shareholders. See further discussion in Section III, Chapter 2.



### Part 1 - History of Sallie Mae's Financial Assets and Business Models

At its core, Sallie Mae's business has been about acquiring, financing, and servicing student loans in a profitable manner. Important to Sallie Mae's story of the growth in its core business are the types of student loans it held, and its methods of acquisition and financing, which have evolved over the years. A graph follows that presents Sallie Mae's portfolio from 1973 to 2004 as it transformed from the GSE's monoline business into a larger and more diversified company. The chart contains all of Sallie Mae's advances, federally insured loans (including "HEAL" loans), and non-federally insured student loans, "private loans," which are further discussed in Section III. The graph shows the strong growth that Sallie Mae achieved, particularly during the GSE wind down period (1997 to 2004).

<sup>112</sup> Dayal, Ranu, et al., *Succeeding with Growth: Creating Value in Banking 2005*, BCG Report, May 10, 2005.



### Pre-Privatization - Monoline Business

From 1973 to 1995, before the privatization of the GSE began, Sallie Mae's business can generally be described as a monoline financial company. Sallie Mae held student loans under the Federal Family Education Loan Program or FFELP.<sup>113</sup> During this period, Sallie Mae acquired FFELP loans, particularly Stafford loans, shortly after students left school, and held the loans until the borrowers paid them back or defaulted.

Sallie Mae also made secured loans to banks and public sector agencies. These loans, known as warehousing advances, were generally collateralized by student loans guaranteed under FFELP. In the 1973 to 1976 period, these advances were the dominant part of the business. From 1977 to 1982, outstanding warehouse advances nearly equaled outstanding student loans purchased. In the 1973 to 1983 period, before SLMA issued non-voting tradable stock, it resembled the business model of the FHLBanks: stock that essentially did not trade at other than par value, and a significant business line of making secured advances to depository institutions.

<sup>113</sup> There are four major loan types under both FFELP and FDLP: Subsidized and Unsubsidized Stafford loans, Parent Loans (called PLUS Loans), and Consolidated loans. Sallie Mae also held up to \$3 billion of loans under another federally insured program, HEAL, which was initially administered by the Departments of HHS. The HEAL program was integrated into the FFELP in 1998.

**Mid Years - Mature GSE Financing**

Between 1983 and 1995, most of Sallie Mae's profits arose from holding FFELP loans financed with GSE debt.<sup>114</sup> Sallie Mae's equity traded on the New York Stock Exchange. Its structure as a business began to look more like Fannie Mae than the FHLBanks. Sallie Mae developed channels for acquiring loans and modern technology for its partners to use to originate loans for Sallie Mae to buy. SLMA became a highly sophisticated counterparty in derivative instruments and an issuer of complicated GSE debt obligations, known as structured notes.

Beginning in 1984, Sallie Mae was the first American company to trade in interest rate and currency swaps with financial entities in other countries. Swaps were a highly innovative instrument at the time, and the fact that Sallie Mae entered into that field was a sign of its willingness to be creative and take risks.

This innovation was followed by "structured GSE debt," which is a traditional GSE debt instrument embedded with a derivative or multiple derivatives. The market risk that arises from the "structured note" is balanced by SLMA with an offsetting derivative. All the GSEs became the great counterparties in the over-the-counter (OTC) derivative market, with counterparty attributes similar to an exchange. Like a prudent broker-dealer or exchange, SLMA balanced its trading book of embedded derivatives and stand-alone derivatives (i.e., its "long positions" were offset by its "short positions"). It made a profit with this activity by making a small spread (5 to 30 basis points) on billions of dollars in notional amounts of derivatives, as opposed to taking a speculative position.<sup>115</sup> In effect SLMA began enhancing the market for OTC derivatives and options. SLMA's structured GSE debt activity is also analyzed in Section IV, GSE Mission and Other Policy Discussions.

**Privatization Years 1997 to 2004 – Evolution to a Private-Sector Finance Company**

The Privatization Act, by which SLMA became a subsidiary of SLM Corporation in 1997, made possible Sallie Mae's transformation from a monoline GSE into a private sector financial company.<sup>116</sup> Sallie Mae's transformation allowed it to enter previously

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<sup>114</sup> At December 31, 1995, SLMA held \$31 billion of FFELP loans, \$4 billion in warehousing advances, \$2.5 billion in HEAL loans, and \$900 million in private loans. SLMA also managed another \$1 billion in FFELP loans that were financed off-balance sheet via securitization.

<sup>115</sup> Though this activity was low market risk for SLMA, the 1994 failure of Orange County, California, was due to the decline in market value of its holding of "structured GSE debt" (mostly debt instruments called inverse floaters). This raised the concern that some holders of "structured GSE debt" were not sophisticated enough or "suitable."

<sup>116</sup> During the wind down Sallie Mae used the names "SLM Holding Corporation" and "USA Education, Inc." SLM Holding Corporation was formed on February 3, 1997, as a wholly owned subsidiary of SLMA. On August 7, 1997, SLMA was reorganized into a subsidiary of SLM Holding Corporation. In connection with Sallie Mae's acquisition of substantially all of the assets of USA Group, Inc., effective July 31, 2000, SLM Holding Corporation was renamed USA Education, Inc. In this transaction the GSE acquired the student loan portfolio and the non-GSE subsidiaries acquired the other assets of USA Group. Approximately two years later, on May 16, 2002, USA Education, Inc. changed its name back to SLM Corporation, which remains the name specified in Sallie Mae's state-charter. Sallie Mae's New York Stock Exchange ticker symbol remained "SLM" throughout these changes.

forbidden lines of business, as well as to integrate vertically, through non-GSE subsidiaries. Unlike Fannie Mae, Sallie Mae serviced a majority of the loans it held in its portfolio, as well as serviced loans for others. Sallie Mae developed a core competency in servicing FFELP loans, which also involves complying with extensive Department of Education regulations. Sallie Mae developed non-student loan fee based businesses such as debt collection and developed its non-GSE funding by issuing asset-backed securities and corporate debt. The Privatization years are discussed more fully in Section III.

## **Part 2 - The Asset-Backed Securities (ABS) Market Development**

A significant development in the financial markets that enhanced Sallie Mae's ability to privatize was the development of the market for asset-backed securities. Asset-backed securities are created by bundling assets, such as student loans, into pools, and establishing trusts, which then issue securities backed by the cash flows from a pool of loans sold to the trust.

Sallie Mae completed its first ABS transaction in October 1995 through a state chartered subsidiary for loan servicing. "Securitization turned out to be a very efficient funding vehicle."<sup>117</sup> Sallie Mae's initial ABS experience (1995-1996) was valuable in developing its confidence in its ability to privatize using the ABS market and in gaining experience in SEC registration and disclosures. Sallie Mae developed its capacity to work with the rating agencies and the U.S. Security and Exchange Commission. Sallie Mae's size, name recognition, and efficiency provided advantages over its smaller competitors in terms of lower costs for issuance and servicing ABS. However, the development of the ABS market ultimately resulted in a more competitive environment for Sallie Mae as its competition also had access to this market.

During the GSE wind down period Sallie Mae issued \$120 billion of ABS. The ABS market is central to the history of the GSE wind down. Highlights of Sallie Mae history in the ABS market during this period include:

- In 1998, following the Russian bond crisis, Sallie Mae's ABS program was sidelined for over a year as the pricing made it an inefficient funding vehicle. This highlighted the need for contingency planning showing that even a well considered business plan may not always pan out.
- Sallie Mae did not anticipate the large prepayments in its traditional student loan ABS and the additional complexity of financing new long-term consolidated loans.
- Sallie Mae was at the cutting edge of developing new ABS structures to finance the longer-term consolidated loans. It was a major issuer of "auction rate" ABS and the innovator of the more exotic "reset rate" ABS.

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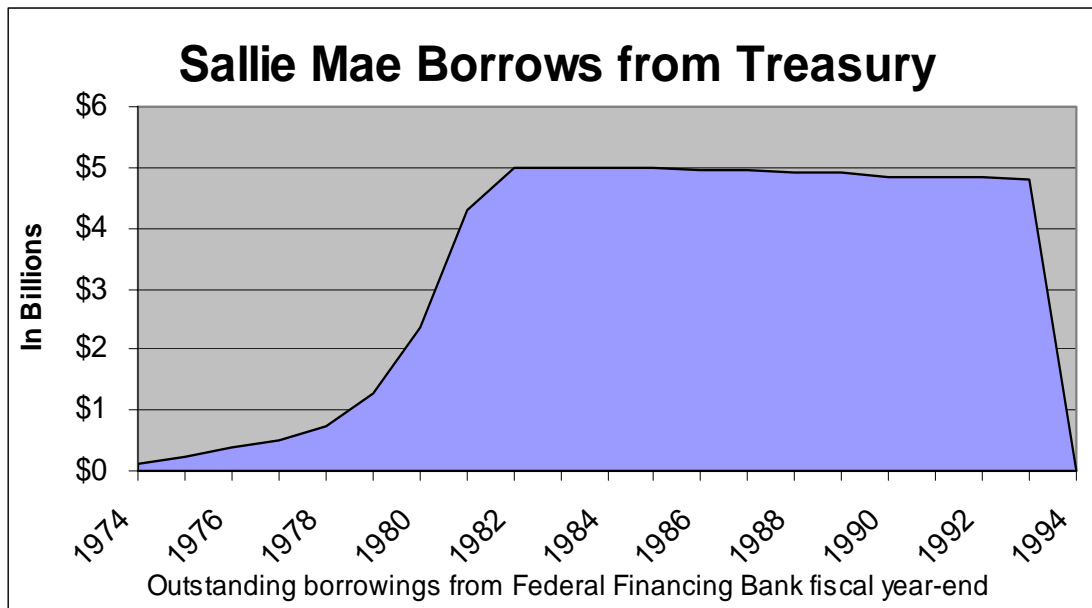
<sup>117</sup> "When we did our first securitization deal," said Marianne Keler, "we had no idea how much capital would be required by the rating agencies, even though we have very sophisticated finance guys here. We ended up needing maybe a quarter of the capital that we initially thought we would have to put up." Interview with Marianne Keler, Sept. 1, 2004.

- The accounting for ABS, which can be either on or off-balance-sheet depending on the structure, is challenging to many users of financial statements including Sallie Mae's management and Board.

### Part 3 – Other Key Business History 1973-to 1994

#### Borrowings from Treasury

In its early years, SLMA met all of its modest debt needs through the sale of rolling, short-term guaranteed debt obligations to the Federal Financing Bank (FFB), an arm of the U.S. Treasury created in 1974 to fund loans guaranteed by the Federal agencies. However, the statutory authority for Sallie Mae to borrow from the FFB ended on September 30, 1984, when the Department of Education could no longer guarantee SLMA's debt.<sup>118</sup> This termination presented a serious problem for Sallie Mae since it had been rolling over its FFB debt on a three month basis. To solve the problem, on September 30, 1980, the Department of Education and Treasury agreed that although Sallie Mae would not be able to borrow after 1984, its loans could be at a variable rate and have 15 year terms. On March 9, 1981, Sallie Mae agreed to discontinue further FFB borrowing at the time that outstanding debt reached \$5 billion, which it did in January 1982. The following chart illustrates the build-up and plateauing of Sallie Mae's FFB borrowings.



Sallie Mae could borrow from FFB at a variable rate equal to 91-day T-Bills plus 12.5 basis points, a rate significantly better than it could borrow funds in the capital market. As a sweetener for Treasury's support for privatization, Sallie Mae paid off the remaining outstanding \$4.7 billion of notes in three installments between January and March of 1994, more than two years prior to final maturity of most of the notes.

<sup>118</sup> 20 U.S.C. 1087-2(h)(2)

**Key Legislation - Expansion of Stock Issuance and other Powers**

In the 1980s legislation passed that let Sallie Mae expand in its business and sell shares to a larger market. In 1980, Congress allowed Sallie Mae to sell non-voting stock to the public, beyond the limited market for its voting stock, which continued to be restricted to educational and financial institutions participating in the guaranteed student loan program.<sup>119</sup> In 1981, Congress expanded Sallie Mae's mission and authorized the company to deal in non-insured loans and to undertake other activities deemed necessary by the board to support the needs of students generally.<sup>120</sup>

**First GSE Debt Issuance 1981 and 1982**

As its ability to borrow by using FFB was winding down, Sallie Mae needed to issue debt on the capital markets. In May 1981, as a first step in its transition to issuing GSE, or agency, debt to the capital markets, Sallie Mae began offering discount notes. It sold its first \$250 million issue of three-year floating notes through an underwritten offering in February 1982.

**First Public Stock Issuance 1983 - Listing on the NYSE 1984**

In 1983, Sallie Mae made successful equity offerings in preferred stock and non-voting common stock. The stock offering had an effect beyond creating more equity. "Summing it up, we wanted more equity," Sallie Mae's Chairman Edward A. McCabe explained, "but we also wanted to substantially broaden our shareholder base beyond the banks and schools that held our voting stock. With just plain people in a sizeable number now holding our shares — in addition to the banks and schools — we're much more the private company and less vulnerable than before — less vulnerable to government tinkering."<sup>121</sup> In April of 1984 Sallie Mae's stock was accepted for listing on the New York Stock Exchange.

**Non-voting Stock Converted to Voting Common Stock 1992**

On July 23, 1992, by Act of Congress,<sup>122</sup> all of the outstanding voting and non-voting common shares automatically converted to a single new class of unrestricted voting common shares. Sallie Mae's non-voting common stock became equal in all respects to the voting common stock and was transferable without restriction.<sup>123</sup>

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<sup>119</sup> Pub. L. No. 96-374.

<sup>120</sup> Pub. L. No. 97-35; 20 U.S.C. 1087-2(d)(1)(E).

<sup>121</sup> Sallie Mae, *The History of Sallie Mae, 1972-1986* (1987), p. 88

<sup>122</sup> Higher Education Amendments of 1992

<sup>123</sup> A more expanded discussion of the history of the GSE from 1973 to 1992 is in an Appendix.



## **SECTION III– The Wind Down, 1997 – 2004**

**Chapter 1 – Privatization Successes and Problems**

**Chapter 2 – Planning and Implementing the Wind Down**

**Chapter 3 – The Defeasance Trust**

**Chapter 4 – Impact of Privatization on Sallie Mae’s Cost of Funds**

**Chapter 5 – Safety and Soundness of Sallie Mae**



## Chapter 1 - Privatization Successes and Problems

Sallie Mae dissolved the GSE and fully privatized nearly four years ahead of the 2008 date required by statute. The development of the asset-backed securities (ABS) and the securitization market was expected to play a key role in facilitating the transition, and it ultimately did. External events, however, impacted the privatization in unexpected ways.

- Sallie Mae's ABS program got off track for a year as a result of market pricing following the 1998 Russian bond crisis. OSMO had concerns that Sallie Mae might simply declare it could not meet the 2008 requirement and seek a legislative extension of the date.
- After resuming its ABS program, another unexpected development was that the market was not receptive to Sallie Mae's initial financing plan. Sallie Mae anticipated that it could shrink its balance sheet to \$10 billion by the date of the GSE dissolution by funding most of its loans with ABS. It would issue relatively little of the more expensive long-term non-secured debt. In fact, Sallie Mae's balance sheet was approximately \$80 billion on the date of the GSE dissolution, December 29, 2004. Approximately \$40 billion of non-secured holding company debt was outstanding.
- Also unexpected were the historical low interest rates in the early 2000s, which were advantageous to the accelerated GSE dissolution date. This condition facilitated SLM Corporation's program to issue the needed non-secured notes.

The privatization process was not without other issues, some foreseen by Congress and some that would have been nearly impossible to identify in advance. Reviewing both the problems and successes in this process is instructive. This chapter provides a summary of the successes and problems encountered during the privatization of Sallie Mae.

### Successes

First and foremost, Sallie Mae was the driving force behind privatization. Having the impetus come from Sallie Mae itself so that it was intimately involved in negotiating and crafting the legislation made it easier for the Administration and Congress to act. The company saw an opportunity to increase shareholder value through vertical integration of its student loan business and diversification into other businesses, both of which it could not do as a GSE. Due to the then recently created Federal Direct Loan Program, Sallie Mae saw a diminishing opportunity to create further value for shareholders if it remained a GSE. The private-sector holding company, SLM Corporation, ultimately was able to successfully change its business model and grow into other businesses, reducing its dependence on FFELP (the Federal student loans program funded by the private sector).

The legislation gave the company's shareholders a choice between dissolution of the company and going private through a holding company process over a number of years to allow the ongoing business to grow while the GSE shrank and to not disrupt the student loan market. The shareholders overwhelmingly supported reorganizing through a holding company and were committed to the privatization process. The statutory

transition period allowed SLM Corp to choose the best time to refinance, based on the market. Ultimately, the shareholders of GSE did quite well after they became shareholders of the non-GSE. In the eyes of the equity market, the privatization created shareholder value, even as it eliminated a perceived liability from the government's books.

The secondary market for student loans, which the GSE was originally chartered to foster, continued to grow and thrive without the GSE. Student lending continued to expand throughout the privatization. A major achievement was the fact that there was no market disruption when the GSE stopped buying and securitizing federally guaranteed student loans at the same moment that the holding company took over purchasing them – the cutover.

GSE debt of nearly \$50 billion in 1996 was effectively run off or refinanced by non-GSE borrowing, with approximately \$117 billion of student loan ABS issued, nearly \$40 billion of private-sector holding company debt issued, and additional borrowings under an asset-backed commercial paper program. The Federal guarantee of both the credit and the yield of the underlying student loan asset facilitated the process and helped minimize the cost of this refinancing. However, in OSMO's view the guarantees were not essential to privatization. The lesson learned is that the privatization experience is not something unique to student loans and could potentially apply to other underlying assets.

The statutory firewalls that Congress inserted between the GSE and its non-GSE affiliates proved to be a necessary element of legislation and promoted a weaning of the company from the GSE.

### **Problems**

Congress chose not to give Treasury the full enforcement powers customary to a safety and soundness regulator when it made Treasury responsible for safety and soundness oversight. Treasury's tools were limited to moral suasion, reporting to Congress, or taking SLMA to court for certain limited compliance provisions.

Traditional regulatory tools (including cease and desist authority, monetary penalties, management removal) would have enabled Treasury to apply its oversight more efficiently.

SLM Corp tended to test the boundaries of the statutory firewalls against non-GSE use of GSE benefits. Treasury was hampered in enforcing its interpretation of firewalls because of weak enforcement tools.

SLM Corp's management at times challenged Treasury's statutory right to obtain certain information and Treasury was hampered in enforcing the delivery of information.

As the GSE took on more risky activities and investments, the statutory minimum leverage capital ratio alone was insufficient to ensure its safety and soundness during the wind down. The lack of a capital standard based on risk provided an incentive for

management to concentrate its riskiest assets in the GSE during the wind down. Risk based capital standards are widely accepted as prudent tools in the regulation of financial institutions. In 2001, Treasury was ultimately able to convince SLMA to voluntarily agree to a risk-based capital standard over the wind down period. However, a safety and soundness regulator should be able to enforce a prudent capital standard, unilaterally if necessary.

Congress could have clarified that there should be coordination between Treasury, as the wind down regulator, the Department of Education, and banking agencies such as OTS and the FDIC if situations arose that affected them all. During the wind down period Sallie Mae sought a Federal charter as a depository institution and it was difficult to coordinate a clear response from the regulators on this.

The legislation provided too few benchmarks that would recognize steps toward actual privatization. For example, the instantaneous cessation of secondary market activity by the GSE, “the cutover,” had some advantages but was difficult to implement and verify. Treasury required the GSE president to provide a statement that it was accomplished. Alternative approaches, such as a phased in cutover, perhaps based on a percentage of prior year activity may have been more efficient and facilitated planning for a smooth wind down. A better approach would be to provide more clarity on interim benchmarks and necessary approvals, accompanied by some flexibility for unforeseen events.

The shareholder proxy fight in 1996 over the future direction of the company was acrimonious and potentially could have been problematic for the wind down, but clarified the positions of each faction, encouraged them to make better proposals to shareholders, and may ultimately have given clear support for the new management team.

### **The Defeasance Trust**

The Privatization Act required SLMA to establish a trust to ensure that any GSE bonds still outstanding when the GSE dissolved would be paid in full. The bonds were referred to as “remaining obligations” and the trust as the “defeasance trust.”

There were issues that arose from this statutory provision. First, SLMA wanted to structure the trust to minimize its cost, while Treasury’s goal was certainty and safety regarding payments on the remaining GSE debt. Second, the statute did not provide any guidance on who should be trustee. SLM Corp at one point suggested using a bank with which they would have an ongoing relationship outside of the trust. OSMO was concerned that under such an arrangement SLM Corp might have ongoing influence over the trustee. Finally, there was an existing trust created more than a decade earlier that contained GSE debt not maturing until after the GSE would be dissolved. This trust did not meet the statutory requirements for the defeasance trust and had to be restructured.

Despite these issues, Treasury and SLMA were able to negotiate a structure for the defeasance trust that provided certainty, cost effectiveness, and was satisfactory to all parties. The existing trust was rolled into the defeasance trust and modified to conform to the requirements of the Privatization Act. The New York Federal Reserve Bank agreed

to serve as a trustee. All of these issues negotiated in a relatively short period of six to nine months during 2004. Refer to Chapter 3 of this section for additional discussion of the defeasance trust, including possible alternatives and policy implications.

## **Chapter 2 - Planning and Implementing the Wind Down**

This chapter discusses the actual wind down, both its planning and implementation. The story of the wind down really is about two simultaneous, but somewhat distinct, progressions: that of shrinking the GSE's balance sheet to zero and thereby weaning the company from it, but also the process of building a private-sector version of the business that could survive and thrive without GSE benefits.

Sallie Mae viewed the wind down as an opportunity to reinvent its business from a relatively narrow one of competing for guaranteed student loans in an increasingly competitive secondary market, to a vertically integrated company that originated loans for itself (and thereby controlled its acquisition costs), and entered totally new lines of business.<sup>124</sup> Sallie Mae saw itself as moving from a commodity business to franchise. Growth, vertical integration, and revenue diversification were building blocks for privatizing the business. To a large degree, the company followed through on its basic idea for transforming the company. However, during the first several years following the passage of the wind down legislation and the proxy battle, there was a great deal of management turnover and the specific planning as to how the company would give up the GSE and accomplish its transformation goals suffered.

### **A. Planning the Wind Down of SLMA**

Once the shareholders voted for reorganization in 1997, the Act called for the GSE to be dissolved by 2008 following a transition period, during which it would transfer its assets and operations to the Holding Company or its affiliates. The GSE could continue to borrow while the Holding Company built up its business outside of the GSE. The statute, however, prohibited the GSE from extending credit to the Holding Company, and included other "firewall" restrictions designed to deny the Holding Company access to the GSE benefits. After the reorganization, all employees of the GSE became employees of the holding company, and the management and other personnel service needs of the GSE were outsourced to the holding company. Certain real and personal property were transferred to the holding company.

### **Evolution of a Wind Down Plan**

During the first several years following reorganization, Sallie Mae's management was slow to formalize its plan to wind down the GSE. Management did not develop a formal GSE wind down plan until late in 2000, and only then at the behest of Treasury. By this time, Sallie Mae had already purchased several student loan companies and was building the private-sector business it envisioned through acquisitions. However, specific plans

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<sup>124</sup> Several privatization strategies were the subject of the 1997 proxy fight discussed in section I, chapter 5. The primary issue in the competing plans was whether or not the company should originate its own loans and thereby compete with the banks that currently supplied loans to Sallie Mae. Ultimately, the origination idea won.

to eliminate its reliance on the GSE's cheap funding and other benefits were less developed. The vast majority of Sallie Mae's assets, including most new student loans being acquired, were still financed by the GSE. This was permitted under the Act, but had to end at some point, and management did not seem to be planning for that.

In November, 2000 SLMA's senior managers first presented a formal wind down plan to its board of directors (the 2000 Plan). The plan outlined progress in developing access to alternative funding sources after reorganization. It also contained projections for gradually refinancing GSE debt, primarily with asset-backed securitization over a seven year period. The plan projected GSE-funded assets to increase through 2003 and then gradually decline, culminating in a final \$6 billion asset transfer from SLMA to SLM Corporation on the statutory dissolution date, September 30, 2008. Management estimated that securitization would increase from \$6 billion in 2002 to \$18 billion in 2005, and then stabilize at \$20 billion per year through 2008. It estimated that by the end of the wind down ABS funding would exceed 80 percent of Sallie Mae's total funding. ABS issuance at the time had been sporadic due to unsettled market conditions, and had never exceeded \$11 billion in one year. The development and stabilization of this market was key to the success of the wind down plan.

Planning the wind down was complicated by a provision in the Act that prohibited the holding company from purchasing federally guaranteed student loans in the secondary market, until the GSE had ceased such purchases. OSMO and Sallie Mae referred to this event as the "cutover," and viewed it as a significant milestone in the wind down. For the cutover to occur, the holding company would have to develop the capacity to finance all new loan purchases independent of the GSE. Under the statute the cutover had to occur by September 30, 2007, one year before the dissolution date. In the 2000 Plan, management projected that the cutover would wait until the last possible date under the statute.

OSMO reviewed the initial wind down plan as part of its 2001 safety and soundness examination and found it inadequate in several areas. OSMO was concerned with the projected deterioration of the GSE's asset quality in the 2000 Plan, and the lack of an adequate capital standard commensurate with its projected risk profile (OSMO's findings with regard to risk-based capital adequacy are discussed further in chapter 5 of this section). OSMO was also concerned that the GSE's assets were not projected to begin declining until 2004, creating a situation in which GSE asset dispositions might be too concentrated later in the wind down to allow for unforeseen events. Further, the plan did not analyze the consequences of delaying the cutover until the statutory deadline.

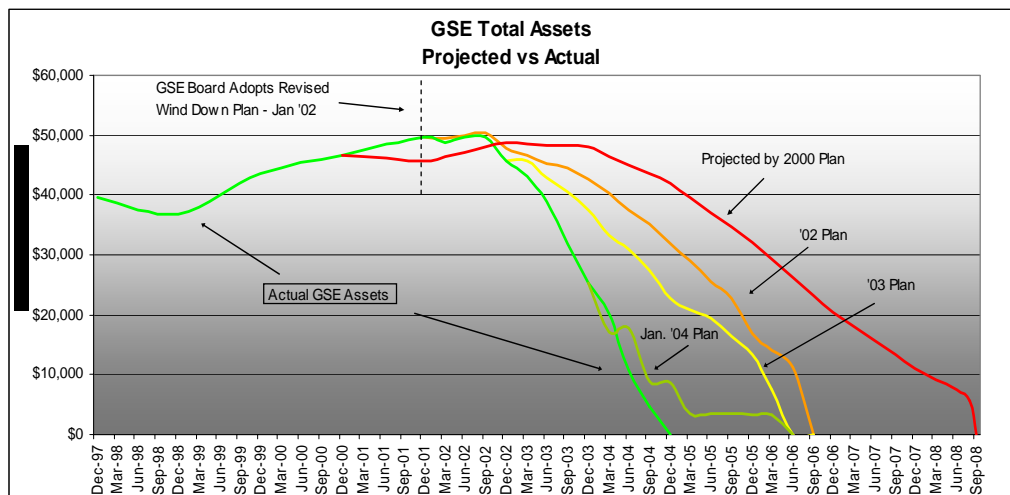
OSMO notified SLMA's board of directors of its concerns with the 2000 Plan in its May 2001 Report of Examination. OSMO's findings led to extensive discussions between Treasury and SLMA's management and board of directors, and ultimately, SLMA agreed to a more prudent wind down plan. The revised plan, approved by SLMA's board in January 2002 (the 2002 Plan), largely alleviated OSMO's concerns. Key elements of the 2002 Plan were: (1) an agreed upon standard tying capital to risk; (2) a commitment to



divest riskier and non-mission GSE assets within specific time frames; and, (3) an accelerated wind down target of September 30, 2006.

The 2002 Plan also made projections of both the GSE and holding company balance sheets, whereas the 2000 Plan focused solely on the GSE. The 2002 Plan set quarterly benchmarks, requested by Treasury, to provide a gauge to measure the actual progress toward the wind down. Management agreed to review the wind down plan annually and adjust assumptions as necessary to achieve a safe and timely wind down.

With the adoption of the 2002 Plan, management began to demonstrate a commitment to accelerating the wind down. During its two subsequent examinations OSMO noted that the company generally met or exceeded the quarterly benchmarks that Sallie Mae had adopted, and management became more aggressive in developing non-GSE funding sources. Management made significant progress toward the Wind Down during 2002 and 2003. It took advantage of favorable market conditions to accelerate the level of non-GSE debt issuance, and dramatically increased asset-backed securitization activity. Management presented updated wind down plans in January 2003 and January 2004, each slightly more aggressive in terms of completing the wind down than the previous one. The following graph illustrates the total GSE assets projected by the different versions of the plan, as well as the actual path by which the assets declined during the wind down. It is clear that beginning in 2002, management made a serious commitment to winding down the GSE, and followed through.



During the wind down period the overall company grew somewhat faster than management had projected. The holding company, with its many subsidiaries including SLMA, the GSE, significantly expanded its presence in the guaranteed student loan market through acquisitions, increasing its operations to include virtually the entire student loan life cycle, from marketing and origination through final collection. The holding company also dramatically increased the non-federally guaranteed (private) student loan portion of its business, primarily through rapid internal growth. While the additional growth added financing stress to the wind down, it did not keep the wind down from wrapping up ahead of schedule.

As the major financial issues of the wind down appeared to be increasingly manageable, in 2003 OSMO shifted its focus to SLMA's planning for the transfer or termination of GSE contracts that extended beyond the projected dissolution date. Of particular interest were the GSE's derivative contracts and loan purchase commitments. OSMO recommended that management expand the formal wind down plan to address all transition issues associated with the wind down. Management and the board concurred and adopted a comprehensive wind down plan in late 2003 addressing legal, contractual and trust related issues, in addition to financial projections.

The wind down gained momentum in 2004. The GSE's total assets declined from nearly \$50 billion in mid 2002 to only \$10.8 billion in mid 2004, with nearly 60 percent of that in cash and short-term assets. In April 2004 management informed Treasury of its plans to further accelerate its target dissolution date for the GSE by six months, to March 31, 2005. As 2004 wore on, management expressed a desire to complete the dissolution by the end of 2004.

### **The Cutover**

On July 1, 2004, the "cutover" occurred, with a non-GSE affiliate assuming all loan purchase operations.<sup>125</sup> This was a critical milestone in the GSE wind down that put the GSE in a pure runoff mode. All new asset flow was now being financed entirely outside the GSE. The early cutover was a result of the holding company's success in developing financing outside of the GSE. In negotiating the legislation, SLMA had wanted a phased-in transition of student loan purchases rather than an instantaneous cutover. Congress, however, did not agree to that. While the instantaneous cutover was a challenge in planning the wind down, it ultimately did not derail the wind down.

### **Completed Wind Down**

Remarkably, by the fall of 2004 the GSE wind down was largely complete, despite the slow start in planning. The refinancing of nearly \$50 billion of GSE-funded assets essentially took place during a three year period from January 2002 to December 2004. The primary task remaining in the final months of 2004 was developing a trust that would defease the GSE bonds that would remain after the GSE was dissolved. The development of the trust is covered in detail in the next chapter. The balance of this chapter discusses how Sallie Mae's private sector business grew and evolved during the wind down, as the GSE was phased out.

## **B. How the Private Sector Business Evolved During the Wind Down**

### **Loan Origination versus Secondary Market Activity**

During its life, the GSE had always purchased loans in the secondary student loan market, but was not authorized by its charter to originate student loans for its own account. As competition to hold student loans increased, this left the GSE with less and

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<sup>125</sup> See letter dated July 16, 2004, from Assistant Secretary Wayne Abernathy to SLMA's Chairman of the Board Duane W. Acklie regarding the cutover.

less control over the price at which it could acquire the loans. Banks and other originators would fund loans and hold them during the period when the student borrower was in school, a period during which the government paid the interest due on the loan. When students left school they had to repay their loans. Once the loans went into repayment status, the originators would generally sell them to Sallie Mae or another secondary market player, for a relatively rich premium, given the guaranteed nature of the assets.

In 1998, SLM Corporation had extensive discussions with Treasury about its plans to begin originating federally insured student loans for its own account. Treasury stressed that the statute banned the GSE subsidiary from directly or indirectly funding such loan origination activity. SLM Corporation management represented to Treasury that its origination program would be conducted and funded separately from the GSE. In a legal memorandum dated March 31, 1998, management stated that the origination program would “not be funded with proceeds from debt issued by the GSE and ... loans made under the program [would] not be sold to the GSE.” This was an important step in building a portion of the business that would be critical for the private-sector company’s success.

### **Building Origination Capacity through Acquisitions**

In 1999, SLM Corp purchased Nellie Mae Corporation, a regional student loan lender. In the Nellie Mae acquisition, SLM Corp management represented to Treasury that “no loans originated by [Nellie Mae] will be transferred to the GSE.” The Nellie Mae acquisition was a significant step in developing the private-sector capacity to originate loans, and was the first of several large acquisitions that would have been problematic under the GSE charter.

The Nellie Mae acquisition was followed by the purchase of Student Loan Funding Resources and the USA Group in 2000. The USA Group transaction was by far the largest purchase, at a price of \$770 million. The Holding Company also acquired several debt collection services and two mortgage banking operations, thereby expanding its non student loan product lines. The timing of significant acquisitions of student loan companies is outlined in the table below.

| <b>SLM's Business Acquisition Activity (in millions)</b> |  |  |                               |  |
|--|--|--|-------------------------------|--|
| Date   | Company Acquired                       | Fair Value of Assets Acquired (mostly loans) | Goodwill and Intangible Costs |  |
| July-99  | Nellie Mae                             | \$2,787                                      | \$90                          |  |
| July-00  | Student Loan Funding Resources         | 3,634  | 51                            |  |
| July-00  | USA Group                              | 7,537  | 443                           |  |
| October-03   | Academic Management Services           | 1,400  | 38                            |  |
| September-04   | Arrow Financial Services               | 165  | 142                           |  |
| September-04   | Student Loan Finance Association       | 1,600  | 3                             |  |
| October-04   | Southwest Student Services Corporation | 5,549  | 305                           |  |
|  |  | <b>\$22,672</b>                              | <b>\$1,072</b>                |  |

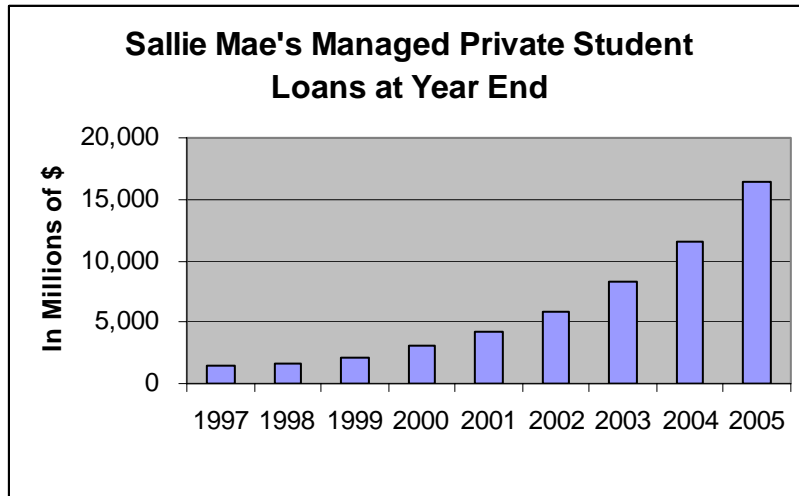
Throughout the wind down, the company continued to purchase loans from lender partners as it always had done through negotiated forward purchase commitments and opportunistic spot purchases, and it gradually gained more leverage to negotiate the premiums it paid for the loans. The company also grew its portfolio through acquisition of other student loan holders. SLM Corp also continued to steadily build its own origination capacity. By the end of the wind down it was one of the largest originators of guaranteed student loans in the country. The company originated loans under a variety of brand names, many of which Sallie Mae acquired through the purchase of competing student loan companies. In developing its origination capacity, SLM Corp's task was to get its brands on the "preferred lender lists" maintained by the financial aid offices of colleges. It assembled a large sales force for this purpose. In the case of some schools, the company was so successful that its brands dominated the school's preferred lender list. For example, Sallie Mae, Nellie Mae, Student Loan Funding Resources, and other company brands might all appear on the same preferred lender list as distinct choices for the students of a given school, but, in fact, they were all brands of SLM Corporation.

### **SLM Corp's Student Loan Growth**

Focus on building its origination business while continuing to buy large quantities of loans in the secondary market resulted in significant growth in Sallie Mae's loan portfolio during the wind down. SLM Corporation's average managed student loans grew at approximately 13%, compounded annually, during this time. In the seven years ended in 2004, SLM Corp's managed student loans outstanding increased \$44 billion to \$107 billion, partly due to its acquisitions. Six of the student loan companies SLM acquired held roughly \$22 billion of student loans at the time of their purchase. Although this growth is impressive, the company actually lost some of its market share in guaranteed student loans during the wind down. There was strong growth in the overall student loan market exceeding the company's growth in these assets. Nonetheless, the company's ability to grow in a profitable manner during the wind down eased the impact of relinquishing the GSE and its benefits.

The company's non-federally guaranteed student loan portfolio, its so-called private loan, grew significantly in the years following the reorganization. By December 31, 2004, when the GSE formally dissolved, Sallie Mae was managing \$12 billion in private loans. These loans are of lower credit quality than federally guaranteed student loans. Typically a student used private loans to supplement the limited amount of guaranteed student loans available to cover the balance of their tuition. Early in the wind down there were relatively few national lenders offering these loans. Having private loans available as a supplement to the guaranteed programs, gave Sallie Mae's sales force an additional selling feature in their struggle for a spot on the preferred lender list for the guaranteed program. However, from a risk management perspective, these loans are far riskier to the holder than federally guaranteed credit. Private loans are underwritten based on the student borrower's usually scant or non-existent credit history and therefore have far higher yields than FFELP loans. The challenge for a lender is to ensure that the additional yield it receives is adequate compensation for the risk it is taking and the capital it is attributing to the product.

The private credit activities were a significant part of SLM's plan to privatize the GSE. SLM Corporation was evolving, at least partially, into a finance company that engaged in underwriting, financing, and servicing specialty unsecured consumer credit, in addition to its guaranteed loan business, which was more commodity-like.



Management anticipates continued rapid growth in this area in both absolute amounts and as a percentage of total managed loans. The growth of the private credit portfolio in absolute amounts is shown in the chart on the left.<sup>126</sup>

Private credit loans represented less than 4 percent of total SLM Corporation managed student loans at year-end 1999. However, this grew to 11 percent by year end 2004 and grew to 13 percent by year end 2005.<sup>127</sup>

### Trade School and Consumer Loans

A subset of the private loans that was still riskier and relatively new to Sallie Mae was the trade school loan portfolio. SLM Financial Corp. ("SLMF"), a non-GSE subsidiary of SLM Corp, was founded in 1998 to serve a new market segment by offering unsecured consumer loans that were not federally or privately insured ("trade school loans"). These are loans made to students of computer training, truck driving, culinary, beautician and other technical, generally non-degree granting schools. SLMF also provided financing for part time education and distance learning, as well as financing for kindergarten through high school (K-12 loans). Initially, SLMF acquired these loans through banks and sold them to the GSE, which was authorized to hold private education loans. In addition, SLMF provided mortgage and non-educational consumer loans throughout the U.S. but did not sell these loans to the GSE.

In 2002, after reviewing the GSE's trade school loan portfolio as part of a safety and soundness study, OSMO objected to these loans being sold to the GSE on the grounds that they constituted a prohibited new business activity for the GSE, and they were, in substance, originations of loans by SLM Corp. While management did not concur with OSMO's analysis, it nonetheless removed the trade school loans from the GSE's portfolio and directed future loans to another non-GSE subsidiary.

<sup>126</sup> Source: SLM's Corp's annual 10-K filings.

<sup>127</sup> SLM Corp's 2005 10-K, pp 58-59.

### Fee Based Businesses

As part of Sallie Mae's effort to diversify its sources of revenue, it sought to increase its fee-based businesses. These businesses were primarily guarantee servicing and debt collections activities that had been acquired through purchases of other companies. The USA Group acquisition in particular, gave Sallie Mae a guarantee servicing capacity that it lacked previously.

The chart below summarizes the impact of the fee based activities on Sallie Mae's overall earnings, before taxes, and its share of core cash net income on an after tax basis.<sup>128</sup>

| <b>Growth in SLM's Fee-Based Businesses</b> |                            |            |            |                      |            |            |
|---|----------------------------|------------|------------|----------------------|------------|------------|
| Business                                    | <b>Contribution Margin</b> |            |            |                      |            |            |
|   | In Millions of Dollars     |            |            | % "Core Cash" Income |            |            |
|   | 2004                       | 2003       | 2002       | 2004                 | 2003       | 2002       |
| For Services to Entities with Reinsurance   |                            |            |            |                      |            |            |
| Agreements with Dept. of Education          | 59                         | 63         | 52         | 4%                   | 4%         | 5%         |
| For Debt Collection Business                | 174                        | 128        | 74         | 13%                  | 9%         | 7%         |
| <b>Total - Fee based Businesses</b>         | <b>233</b>                 | <b>191</b> | <b>126</b> | <b>17%</b>           | <b>13%</b> | <b>12%</b> |

Fee income grew steadily during the wind down, providing a source of non-GSE income that was 17% of total core cash net income by the end of the period. In March 2006, Sallie Mae was one of three companies to be awarded contracts from the Internal Revenue Service to collect unpaid Federal tax debt as a result of a provision in the American Jobs Creation Act of 2004.<sup>129</sup>

### Challenges Financing Student Loans through ABS

Beginning in 2001, falling interest rates combined with a quirk in the Federal consolidation loan program provided a strong incentive for borrowers to refinance their ten-year "Stafford" student loans into new long-term (up to 30-years) consolidated loans. Many borrowers saw the economic wisdom of refinancing their student loans and took advantage of the opportunity. This presented Sallie Mae with some unforeseen problems. Suddenly, loans that had already been removed from the GSE's balance sheet through sale to an ABS trust were being prepaid with the proceeds of new consolidation loans that were being sold in great volume to the GSE. The holding company did not yet have the capacity to finance the flow of consolidation loans. Essentially, assets that had already been refinanced with non-GSE debt from the perspective of the wind down were being put back on the GSE's balance sheet where they would have to be refinanced again. Another problem that arose from the consolidation phenomenon was that the structures previously used to finance Stafford loans in the ABS market wouldn't work for

<sup>128</sup> The before taxes contribution margin for the debt collection business is from SLM Corp's 2004 10-K, p. 57. The before taxes contribution margin for the guarantor servicing fees business is based on gross fees per SLM Corp's 2004 10-K, p. 59, times an estimated profit margin of 49 percent. SLM presents full "core cash" income statements each quarter on its web site. This topic is discussed in *Appendix 2, Vexing Accounting*. Core cash net income was \$868 million, \$926 million, and \$690 million for 2004, 2003, and 2002, respectively. A tax rate of 35 percent was assumed to calculate the percent of core cash net income.

<sup>129</sup> See Donmoyer, Ryan et. al., "Sallie Mae, 2 Companies, Win IRS Tax Debt Contract," *Bloomberg*, March 9, 2006. See also, Laffie, Lesli, "IRS to Outsource Debt Collection," *Journal of Accountancy*, January 2006.

consolidation loans with their much longer maturities. Investors in student loan ABS generally wanted shorter-term investments, without the “tail risk” embedded in the longer term asset pools.

Sallie Mae had always been a leader in developing financing structures. Once again it had to be creative to deal with the longer term consolidation loans. To finance consolidation loans outside the GSE, SLM began to use "auction rate" ABS and the more exotic "reset rate" ABS. It became a major issuer of both of these cutting edge ABS structures.

Auction rate ABS typically deal with the tail-risk issue by allowing future interest rates on certain tranches in the structure to reset based on periodic auctions of a spread-to-LIBOR yield. This gives characteristics of a shorter term security to the longer maturity tranches. However, the structure places more of the risk with the holder of the interest-only residual asset (SLM Corp in this case), and ultimately with the trust rather than the investor. This is because future interest costs are less certain than under a traditional structure where the spread to LIBOR is set at inception and remains constant. A failed auction will result in the interest rate defaulting to a much higher spread than the initial spread.

A “reset rate” ABS is similar, but more complicated, and requires certain tranches to be “remarketed” which can significantly alter the terms of the notes including interest rate, amortization features, or even the currency in which the notes are denominated. In general, the issuer retains even more risk in the more complicated ABS structures to make the notes more attractive to investors. In the case of reset rate notes, the issuer also retains more control over future decisions regarding the assets and their financing.

The development of these sophisticated term financing structures for consolidated student loans was important to the timely GSE wind down. Sallie Mae did not anticipate the large prepayments of its traditional student loan ABS and the additional complexities of financing the consolidated loans. During the wind down the company issued approximately \$120 billion of ABS, nearly three times the student loan portfolio the GSE held at the beginning of the wind down. A significant portion of this volume was due to the “recycling” of loans because of loan consolidation

### **Accounting Treatment for Securitized Loans**

In general, the accounting applied to Sallie Mae’s traditional ABS and its auction rate ABS is “gain on sale” accounting treatment. This treatment assumes the assets, and all risk associated with them, were truly sold to a trust so the assets are removed, or derecognized, from the balance sheet. A gain is recognized for the difference between the carrying value of the assets and the fair market value at the time of the sale. If the seller retains a residual interest in the cash flows from the trust, as Sallie Mae did, then a separate asset is recognized on the balance sheet equal to the present value of the expected residual cash flows.

The accounting of “reset rate” ABS, however, results in the related student loans remaining on balance sheet. This is because under the reset rate structure, the seller of the assets, SLM Corp in this case, retains too much control over the assets, thereby violating GAAP accounting’s “true sale” criteria for derecognizing the assets. The assets must continue to be carried on the balance sheet, and the liability associated with the issuance of notes by the trust is also booked as a debt of the company. The accounting for ABS, particularly the off-balance-sheet accounting, is challenging for many users of financial statements. These financial reporting issues and others relating to the impact on measures of capital and performance are discussed in more detail in Appendix B.

### Sources and Uses of Funds

As the company built its non-GSE loan portfolio through origination and diversified its sources of revenue through fee-based businesses, it began to have substantial activity outside the GSE and substantial income other than from GSE dividends to the holding company. The following chart presents SLM Corp’s sources and uses of funds during the wind down period in the context of the non-GSE balance sheet. Following the chart are additional observations about the key sources of funds and uses of funds (highlighted). In general, this discussion presents the timing and amounts of financial activities that transformed Sallie Mae from a GSE to a fully private-sector company.

| SLM Corporation's Non-GSE on Balance Sheet Financing and Investing Activities |                 |                 |                |                |                |              |              |              |
|---|-----------------|-----------------|----------------|----------------|----------------|--------------|--------------|--------------|
| Amounts in millions of dollars  | 2004            | 2003            | 2002           | 2001           | 2000           | 1999         | 1998         | 1997         |
| <b>Source (use) of funds:</b>   |                 |                 |                |                |                |              |              |              |
| Dividends received from GSE   | 2,654           | 2,401           | 22             | 231            | 349            | 205          | 707          | 414          |
| Non-GSE income  | 2,225           | 966             | 113            | 94             | 65             | 21           | 20           | (15)         |
| Non-GSE other comprehensive income, (loss)                                    | 224             | (114)           | (68)           |                |                |              |              |              |
| Net Increase (decrease) in borrowings outstanding:                            |                 |                 |                |                |                |              |              |              |
| Short-term borrowings   | 418             | 574             | 209            | 455            | 156            | 173          | (59)         | 281          |
| Long-term notes (greater than one year)                                       | 21,465          | 12,885          | 4,303          | 994            | 499            |              |              |              |
| Long-term on-balance sheet securitization debt                                | 19,423          | 16,346          |                |                |                |              |              |              |
| Preferred stock issued  |                 |                 |                |                |                | 165          |              |              |
| Stock issued - acquisition of USA Group                                       |                 |                 |                |                | 370            |              |              |              |
| Stock issued - employees purchases & options plans                            | 298             | 339             | 357            | 523            | 205            | 58           | 21           | 72           |
| Other liabilities (interest payables and derivatives)                         | 1,223           | 942             | 162            | 56             | 441            | 52           | 36           | 24           |
| <b>Total</b>  | <b>47,931</b>   | <b>34,340</b>   | <b>5,098</b>   | <b>2,353</b>   | <b>2,085</b>   | <b>676</b>   | <b>725</b>   | <b>775</b>   |
| <b>(Use) source of funds:</b>   |                 |                 |                |                |                |              |              |              |
| Dividends to shareholders of SLM Corporation                                  | (333)           | (278)           | (142)          | (126)          | (116)          | (99)         | (95)         | (94)         |
| Buybacks of SLM Corporation's stock   | (1,480)         | (953)           | (652)          | (953)          | (324)          | (342)        | (418)        | (472)        |
| (Net Increase) net decrease in assets:  |                 |                 |                |                |                |              |              |              |
| Federally insured student loans   | (35,854)        | (24,462)        | (1,459)        | (942)          | (538)          | (179)        | (2)          |              |
| Private Credit Student Loans and other loans                                  | (2,666)         | (874)           | (2,687)        | 24             | (6)            | 3            | (16)         |              |
| Investments   | (4,613)         | (4,214)         | (245)          | (65)           | (138)          | 67           | (72)         | (136)        |
| Cash & cash equivalents   | (0)             | 348             | (67)           | (20)           | (195)          | (37)         | (22)         | (7)          |
| Purchased Goodwill and intangible assets                                      | (474)           | (6)             | (20)           |                | (488)          | (87)         |              |              |
| Retained Interest in securitized receivables                                  | 159             | (2,398)         | (62)           |                |                |              |              |              |
| Investment in GSE   |                 |                 |                | (200)          |                |              |              | (100)        |
| Other assets (interest receivables and derivatives)                           | (2,670)         | (1,502)         | 237            | (71)           | (280)          | (2)          | (99)         | 33           |
| <b>Total</b>  | <b>(47,931)</b> | <b>(34,340)</b> | <b>(5,098)</b> | <b>(2,353)</b> | <b>(2,085)</b> | <b>(676)</b> | <b>(725)</b> | <b>(775)</b> |

Note: Loans sold by the GSE to non-GSE affiliates resulted in gains in the GSE financial statements but were netted out in the consolidated financial statements of SLM Corporation. Therefore, for the purpose of this analysis OSMA made mark-to-market adjustments to financial statements of SLM Corporation so that non-GSE affiliate incomes could be calculated by subtracting the GSE income from consolidated SLM Corp income. The mark-to-market adjustments increased the carrying value of SLM’s loans and net income before taxes by \$122 million, \$1,408 million, and \$1,329 million for the year ended 2002, 2003, and 2004, respectively.



### **GSE Dividends**

The dividends from the GSE to SLM Corporation in 1997 and 1998 appear to have paid for SLM Corporation's stock buybacks. Generally at that time, it was management's practice to dividend all capital in excess of the GSE's 2.25% statutory leverage minimum to the holding company. The drop in GSE dividends to SLM Corporation in 2001 and 2002 reflects the risk-based capital agreement between Treasury and the GSE board reached in late 2001. Dividends out of the GSE declined significantly in this period to build up the agreed upon GSE capital. The large dividends in 2003 and 2004 from the GSE to SLM Corporation were generally non-cash dividends of loans and other assets for the purpose of shrinking the GSE.

Non-GSE income increased significantly in 2003 and 2004 because the holding company moved large chunks of the GSE's earning assets to non-GSE affiliates. These transfers were both through arms' length purchases by the holding company and through dividends of assets from the GSE to the holding company. It is noteworthy that the holding company issued long-term debt to fund its asset purchases. The significant increase in non-GSE income in 2003 and 2004 are also the result of new fee-based lines of business previously discussed.

### **SLM Corporation's Capital and ROE**

One benefit of SLMA's GSE charter was that Congress established a minimum ratio of capital as a percentage of total assets that was markedly less than regulators required of banks and savings institutions. This ratio is generally called a "leverage capital" ratio. A company with a low leverage capital ratio is said to be "highly leveraged." That is, a high percentage of its funding comes from borrowing, not from equity investors. In general, a lower leverage capital ratio increases risk to bond holders but also increases returns on equity (ROE), as the earnings are spread over a smaller capital base. As a GSE, SLMA had always been highly leveraged. At least in part because of this capital disparity, it was more efficient for banks to sell student loans to Sallie Mae at a premium rather than hold the loans themselves. This leverage would also make it difficult for a bank to compete with SLMA in terms of price to purchase loans in the secondary market.

SLM Corporation, as an unregulated financial institution, initially maintained a lower leverage capital ratio than the GSE or a regulated depository institution. Normally very high leverage in a private company would put downward pressure on the company's credit rating. While the NRSROs did comment on SLM Corp's thin capitalization in their ratings analysis, they generally justified their high ratings by noting the guaranteed nature of the underlying assets. While SLM Corp's leverage capital ratio nominally increased during the wind down, its capital at year end 2004 included over \$1 billion of goodwill and intangible assets that are not eligible as capital under bank regulatory rules.

The following table presents the company's average capital level and managed leverage ratio<sup>130</sup> during the wind down. It also presents SLM Corporation's capital formation as a percentage of the average capital level, and presents how capital was deployed each year.

| <b>Sallie Mae's High Leverage, High ROE, and Large Stock Buybacks</b> |                                    |                           |                              |                                  |                                |       |                    |                |       |
|---|------------------------------------|---------------------------|------------------------------|----------------------------------|--------------------------------|-------|--------------------|----------------|-------|
| As Percentage of Average Capital by Year                              |                                    |                           |                              |                                  |                                |       |                    |                |       |
| Year  | Leverage                           |                           | Capital Formation            |                                  |                                |       | Capital Deployment |                |       |
|   | Average Capital -In Millions of \$ | Capital to Managed Assets | Compre- hensive Income "ROE" | Stock Issued & Options Exercised | Tax Benefits - Options & Other | Total | Divi- dends        | Stock Buybacks | Total |
| 1997  | 780                                | 1.4%                      | 69%                          | 9%                               | 1%                             | 79%   | -12%               | -87%           | -99%  |
| 1998  | 619                                | 1.1%                      | 80%                          | 3%                               | -4%                            | 80%   | -15%               | -68%           | -83%  |
| 1999 *  | 660                                | 1.1%                      | 65%                          | 34%                              | -3%                            | 95%   | -15%               | -52%           | -67%  |
| 2000 *  | 1,093                              | 1.5%                      | 44%                          | 53%                              | -4%                            | 93%   | -11%               | -30%           | -40%  |
| 2001 *  | 1,422                              | 1.7%                      | 52%                          | 37%                              | 5%                             | 94%   | -9%                | -67%           | -76%  |
| 2002  | 1,866                              | 2.2%                      | 38%                          | 19%                              | 3%                             | 60%   | -8%                | -35%           | -43%  |
| 2003  | 2,475                              | 2.7%                      | 55%                          | 15%                              | 5%                             | 75%   | -11%               | -39%           | -50%  |
| 2004  | 2,783                              | 2.5%                      | 69%                          | 11%                              | 2%                             | 82%   | -12%               | -53%           | -65%  |

\* Capital formation due to stock issuance activities were significant in three years as follows: \$165 million preferred stock issued, \$370 million stock issued-related to the acquisition of USA Group, & high-level of stock options exercised were incurred in 1999, 2000, and 2001, respectively.

As expected by the high-leverage business model, most of SLM Corporation's capital formation was generated by earnings that are reflected in an exceptionally high return on equity. It is also interesting that SLM Corporation deployed most of the capital it formed during the wind down into an aggressive stock-buy back program. The fully private-sector company remains highly leveraged, and has a single-A credit rating, which is well below the triple-A rating the GSE held.

### **Sallie Mae Stock Appreciated during the Wind Down**

Sallie Mae was able to improve its earnings despite an ever increasing competitive environment and an unprecedented business transformation. Its growth in market capitalization, which is rooted in its earnings improvement during the privatization, is an indication that shedding the GSE was beneficial to Sallie Mae's shareholders (see chart of Sallie Mae's Market Value 1999-2004 and discussion in Section II, Chapter 2). Despite losing some market share in the federally insured student loan market during the wind down, Sallie Mae's overall growth and diversification was a key to its successful transition to a fully private-sector company.

External events that took place during the wind down appear to have contributed to the increase in the value of SLM Corp's stock. Between 1999 and 2004 the following external factors were bullish for Sallie Mae:

1. The political shift in power to the Republicans in 2000. Many equity analysts espoused the view that Sallie Mae was a "Republican play," that is, Republican

<sup>130</sup> The leverage ratio is calculated by including student loans financed off-balance sheet and excluding the on-balance sheet value of "retained interest in securitized receivables." In effect, this reverses the accounting treatment for off-balance sheet securitizations, treating them simply as another form of financing rather than an asset sale for capital calculation purposes.

- policies on education tended to favor the FFELP over the FDLP, which was good for Sallie Mae. (See section I for additional discussion of political risk).
2. The impact of falling interest rates on student loans - Guaranteed student loans include a yield guarantee which ensures that student loan lenders receive the **greater** of a guaranteed interest yield (e.g., commercial paper rate plus 234 basis points) or the interest rate that the borrower is paying. Because borrowers' rates are either fixed or reset infrequently, holders of student loans can receive a yield above the guaranteed yield if rates fall, a feature known in the industry as "floor income." As rates fell significantly during the wind down, Sallie Mae benefited. The company reported "floor income" of \$335 million and \$474 million in 2001 and 2002, respectively. This "floor income" alone produced a 25 % return on overall equity during these years.
  3. The flight to quality. Following the 1998 Russian bond crisis and the attacks of September 11, 2001, investors shifted to US Treasury and GSE debt obligations. This flight to quality provided financial benefits to all of the GSEs with advantageous pricing of GSE debt obligations. During this time, Sallie Mae was still funding the majority of its balance sheet with GSE debt, so it too benefited from the flight to quality.
  4. Collapse of high tech stocks. Equity investors rotated their investments to sectors that favored "defensive" companies with better cash flows following the collapse in high-tech stocks in 2001. Sallie Mae's stock rallied significantly during this period.

### **Sallie Mae's Effort to Own a Bank**

SLM Corporation also explored the possibility of adding a bank charter during the wind down, as an alternative source of funds for its private loans and for cross-selling opportunities. Sallie Mae made various missteps in its efforts to acquire a bank during this period in the political, market, and regulatory arenas.

In 1998, Sallie Mae lobbied the conferees of the Reauthorization of the Higher Education Act to revise a 1996 amendment of the Federal Deposit Insurance Act that prohibited GSEs from affiliating with a depository institution. Chairman James Leach of the House Banking Committee wrote the Chairman of the Committee on Education and the Workforce in a letter dated September 18, 1998, and requested that the amendment be excluded from the Conference report. He opposed this amendment because it was within his committee's jurisdiction. The amendment that subsequently passed included Treasury's recommended language authorizing the Secretary to approve any affiliation, requiring a two-year wind-down of the GSE, and authorizing the Secretary to impose additional terms and conditions on the affiliation.

In 2002, at Sallie Mae's request, a letter was sent from Treasury to SLM Corporation regarding Treasury's read on the statutory provisions that also authorized Treasury to extend, up to two years, the GSE early dissolution requirement if the GSE affiliated with

a depository institution.<sup>131</sup> The market reacted negatively to stories that Sallie Mae might buy a large thrift, because the smaller earnings growth of a thrift institution could dilute Sallie Mae's earnings growth rate. By 2003, Sallie Mae changed its focus from buying an existing depository institution and requested Treasury's approval of an affiliation between SLMA and a de novo savings bank.<sup>132</sup> SLM Corporation submitted a draft business plan, and had several pre-filing meetings with the Office of Thrift Supervision (OTS) regional office in Atlanta, but ultimately abandoned its pursuit of the savings bank charter, since its preliminary de novo thrift application was unacceptable by OTS without an amended business plan.

In 2005, subsequent to the completion of the wind down, the FDIC and the Utah Department of Financial Institutions approved SLM Corporation's application for an industrial bank charter. Sallie Mae Bank began to originate and fund private loan and guaranteed consolidation loans.<sup>133</sup>

### C. Conclusions

Sallie Mae was reluctant at first to let go of its cheap GSE funding during the wind down period, preferring to wait until the very last moment to give it up. As it diversified and vertically integrated its business through acquisitions and new business ventures, it grew more confident and ambitious, moving its deadline for full privatization forward several times. Treasury supported and even pressed for these accelerations of the wind down.

Between 1997 and the end of 2004 Sallie Mae's success was affected by events such as the political shift of Congress from Democratic to Republican in 2000, establishing a legislature much more sympathetic to Sallie Mae. Lower interest rates over the last several years caused many student borrowers to consolidate their loans at the lower rates, and thereby remove those higher interest rate loans from Sallie Mae's portfolio and ABS. Sallie Mae responded wholeheartedly to the changing market conditions, using creative structures such as auction rate and reset rate ABS to finance its assets. Important events such as the Russian bond crisis in 1998, the terrorist attacks of September 11, 2001, and the collapse of high tech stocks all affected the wind down in different ways.

Sallie Mae's stockholders did very well as the wind down unfolded. Sallie Mae stock appreciated during the wind down and Sallie Mae's capital and ROE were hardly affected by the changeover from GSE leverage requirements to the new private company.

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<sup>131</sup> Letter sent by Roberta K. McInerney, Assistant General Counsel – Banking and Finance, on July 12, 2002 regarding Treasury's statutory discretion and responsibilities under a 1996 amendment to section 18 of the FDIC Act, 12 U.S.C. § 1828 (s)(4).

<sup>132</sup> Letter dated June 24, 2003 from Marianne M. Keler, General Council, to Philip Quinn, Director of OSMO. See also OSMO's Report of Examination dated October 2003, page 13.

<sup>133</sup> See SLM Corporation's 2005 10-K, p. 15. See also Oberbeck, Steve, "New Salt Lake City bank specializes in education loans," *Knight Ridder/Tribune Business News*, December 2, 2005

## Chapter 3 - The Defeasance Trust

As Sallie Mae wound down its GSE operations it began to discuss the terms of the defeasance trust required by the statute. Over the years SLMA had issued GSE debt. Investors purchased what they expected would be GSE debt until the bonds matured. Congress chose to protect the interests of these bondholders so that their investment would not be negatively affected by privatization. A “Privatization Trust” was Congress’ solution. The trust would “defease,” or nullify, the GSE’s obligations on bonds that would mature after SLMA dissolved, while protecting the bondholders’ interests. Essentially SLMA was required to put sufficient cash and other assets into a trust for the sole purpose of ensuring timely payment to the bondholders.

The Privatization Act set out several requirements for the Privatization Trust.<sup>134</sup> The Privatization Trust had to be an irrevocable trust and satisfactory in form and substance to the Secretary of the Treasury, SLMA and the trustee. It had to irrevocably transfer all remaining obligations of SLMA to the trust and to pay those obligations it had to make an irrevocable deposit into the trust of money or direct noncallable obligations of the United States or a U.S. agency whose payment is backed by the full faith and credit of the United States. The trust funds were to be held solely for the benefit of holders of the remaining obligations. The funds were to mature as to principal and interest in such amounts and at such times as the Secretary of the Treasury determined to be sufficient, without considering any significant reinvestment of interest, to pay the remaining obligations in accordance with their terms. If SLMA had been unable to provide money or qualifying obligations in the necessary amount, the statute required the holding company, SLM Corp, to transfer money or qualifying obligations to prevent a deficiency. In addition, the statute required the trustee to apply all money, obligations, or financial assets deposited into the trust to payment of the remaining obligations assumed by the trust.<sup>135</sup>

### Remaining Obligations

The statute defined “Remaining Obligations” as debt obligations of SLMA outstanding as of the dissolution date.<sup>136</sup> In all there were 44 bonds amounting to \$1.9 billion, and all of the debt was at fixed rates of interest. This was fortunate as variable rate obligations would have been more difficult to defease. Part of the debt was in a previous defeasance trust set up in 1993 for tax and accounting purposes. This 1993 trust presented several unexpected problems.

### The 1993 Trust

In 1993 SLMA created a defeasance trust (the 1993 Trust) for accounting reasons to remove obligations from its balance sheet. Although it was called a defeasance trust, the 1993 Trust did not extinguish all of SLMA’s legal ownership since the GSE remained liable as a guarantor. SLMA called this an “accounting defeasance” rather than a “legal defeasance.” Since the GSE remained liable for these obligations, they met the definition of “remaining obligations” in the

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<sup>134</sup> 20 U.S.C. §1087-3(d)(1).

<sup>135</sup> 20 U.S. §1087-3(d)(2).

<sup>136</sup> 20 USC §1087-2(i)(4).

statute. Treasury insisted that all remaining obligations, including the bonds in the 1993 Trust, had to be defeased by the Privatization Trust if SLMA was going to dissolve. The 1993 Trust accounted for approximately \$466 million of the debt to be defeased.

Sallie Mae at first took the approach that the 1993 Trust was adequate as a defeasance trust. Treasury disagreed because the 1993 Trust was not initially funded with sufficient assets, relying instead on earnings from reinvestments of cash balances, and indeed, the initial assumptions for earnings appeared very optimistic, given subsequent market conditions. To be acceptable, the 1993 Trust would have to satisfy Treasury as to its form and substance and that meant it could not rely on earnings, there could be no significant reinvestment of interest, and the trust would be for the sole benefit of the bondholders.

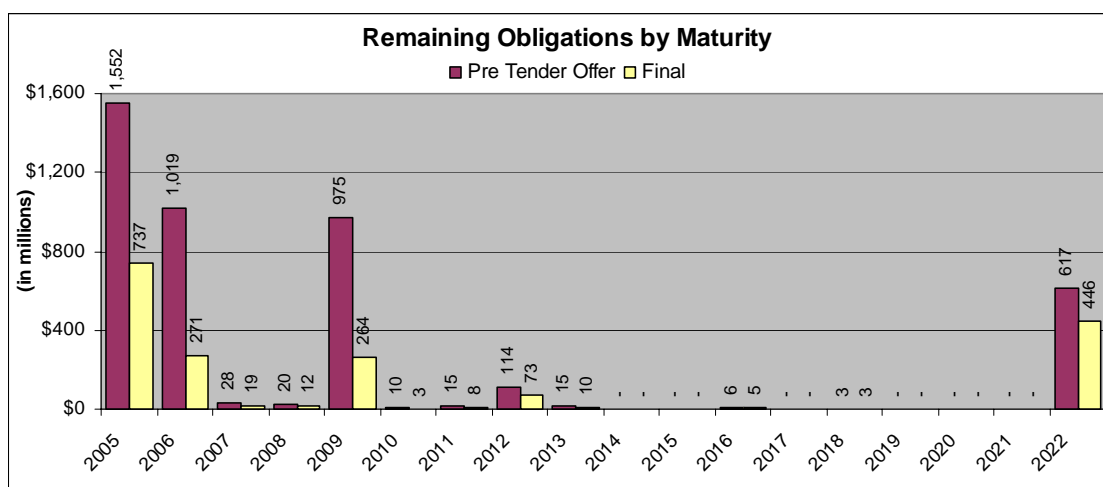
The 1993 Trust also provided for reinvestments and for an investment manager to make the deposits earn as much as possible. This arrangement was unacceptable for the Privatization Trust because of Treasury's obligation to determine that the funds were sufficient, without considering any significant reinvestment of interest. If the trust relied on a reinvestment strategy with an investment manager to fund the trust, Treasury would also have to rely on that reinvestment strategy to determine that the assets were sufficient. Too much would be unknown. Treasury's view was that the trust had to be completely planned with sufficient assets at inception to pay all obligations. The motto was "Set it and forget it." Allowing an investment manager to take chances with the assets was unacceptable.

SLMA wanted the 1993 Trust collateral to be used in the Privatization Trust. However, the assets collateralizing the 1993 Trust included Israeli bonds and Ref Corp bonds. Neither of these met the statutory requirements of being noncallable U.S. or agency obligations.

Since the 1993 Trust was irrevocable, SLMA could not simply dissolved it and transfer the assets and liabilities to a newly created Privatization Trust. At first, Treasury suggested that in the worst case, SLMA could provide separate collateral in the Privatization Trust to cover the obligations in the 1993 Trust as well as other remaining obligations. This would mean the obligations of the 1993 Trust would have double collateral – in both the 1993 Trust and in the Privatization Trust. Treasury suggested that SLMA management should explore ways to bring the 1993 Trust in line with the Privatization Trust requirements. SLMA then proposed that Deutsche Bank, the Trustee of the 1993 Trust, resign as trustee and SLMA assign the duties of trustee to the NY Fed. Later, SLMA developed this idea into a plan to merge the two trusts.

### **Tender Offer**

To reduce the size of the Privatization Trust, SLMA made a tender offer to buy back \$4.3 billion in bonds that would mature after the planned dissolution date. The tender offer, launched July 28, 2004, bought back \$2.2 billion, or 52 percent of the targeted bonds. Certain other bonds were short term and did not have to be bought back as they would mature before dissolution. By the time the trust was funded in December 2004 there were 36 bonds on the balance sheet and 9 bonds in the 1993 Trust (one bond was partially in both, for a total of 44 bonds). These amounted to approximately \$1.9 billion in face value. The following chart shows the Remaining Obligations by maturity both before the tender offer and as defeased by the final trust in December 2004.



### The Trustee

In 2003 SLMA requested that the NY Fed consider acting as the trustee for the Privatization Trust. OSMO liked the idea of the NY Fed as trustee for several reasons. It was already the fiscal agent on SLMA's bonds, which were in the Fed's book entry system. Retaining this arrangement would minimize operational adjustments in the market. There was not much risk that the NY Fed would go out of business before the last bond was paid off in 2022. The NY Fed would not have a conflict of interest that a private bank trustee doing business with SLM Corp might have. The NY Fed's internal requirements suited Treasury, since it could not accept securities that were not on its Fedwire system and that meant that it could not handle such securities as Israeli bonds. The NY Fed was also reluctant to make reinvestments or allow substitutions of securities to optimize the defeasance after the initial deposit of assets to the trust.

On the other hand, there were reasons why it might not work for the NY Fed to be the trustee. The market might have the perception that the GSE debt was still "government-backed" in some way. Until the NY Fed decided it had the legal authority to be trustee, Treasury worried that a long approval process might delay the trust. The NY Fed was not enthusiastic about being the trustee, and it looked as if it might refuse to be trustee on grounds of its own policy interests. Treasury was also concerned that if it did become trustee, the NY Fed might impose strict conditions that could create a risk for Treasury.

A less appealing alternative was to use Deutsche Bank, the trustee for SLMA's existing 1993 Trust. That plan would have required that the 1993 Trust would be folded into the Privatization Trust, with additional protections for the current bondholders. Treasury was concerned that the extensive business relationship between Deutsche Bank and SLM Corp might influence the bank to act in SLM's interest in the future rather than the bondholders', as had happened in other cases, not involving Deutsche Bank.

When the NY Fed reviewed SLMA's plan to merge the 1993 Trust into the Privatization Trust, it was worried that a merger of trusts was unusual and requested a legal opinion to make sure this would work. Rather than provide a legal opinion, SLMA suggested that the merger take place prior to Deutsche Bank's resignation, and then the terms of the merged trust would be those

required by Treasury. After that merger, Deutsche Bank could resign and the NY Fed would accept the trusteeship. This proved to be unnecessary since the NY Fed agreed to be Trustee. It also agreed not to charge any trustee fees beyond the fees it was already charging as fiscal agent, which was a boon for Sallie Mae.

### **Unacceptable Proposals**

At first SLMA proposed a trust that included unacceptable provisions, apparently modeled on the terms of the 1993 Trust. It set up an investment manager to optimize the earnings of the trust assets. It provided that SLM Corp would be a beneficiary and approve of the trustee's actions. As it offered succeeding drafts it continued to include SLM Corp. as a beneficiary and to set up investments that Treasury and the NY Fed could not accept. It took several rounds of negotiation over several months before SLMA dropped that provision and arrived at an agreement with Treasury and the NY Fed.

### **Mismatched Securities**

A sticky problem for Sallie Mae, was that there were a number of bonds outstanding whose maturities did not match available Treasury securities. This was important because the collateral that the GSE had to put up had to be “money or direct noncallable obligations of the United States or any agency thereof for which payment the full faith and credit of the United States is pledged.” In effect, this meant Treasury securities. Treasury securities are issued on schedules with known maturity dates, so, to fund the trust, SLMA would need to purchase Treasury securities maturing on or before the date when the trust obligations were due. Unfortunately for SLMA, the dates did not match for certain of the bonds. That meant that SLMA would have to purchase Treasury bills maturing early and let the cash payment sit in the trust until the bond matured and the trustee paid it. The foregone earnings from this idle cash are illustrated by the chart on the following page. Because of the mismatches, Sallie Mae would be providing more equity than it would need if the Treasury securities could be matched to the due dates for the bond payments.

To deal with this problem, SLMA at first suggested designating an investment manager to reinvest the idle funds to maximize earnings that might revert to SLM Corp at the end of the trust. In fact, SLMA suggested that SLM Corp be paid the extra earnings on a regular basis. This plan was unacceptable to Treasury because it was not for the “sole benefit of the bondholders” as the statute required. It was also operationally risky.

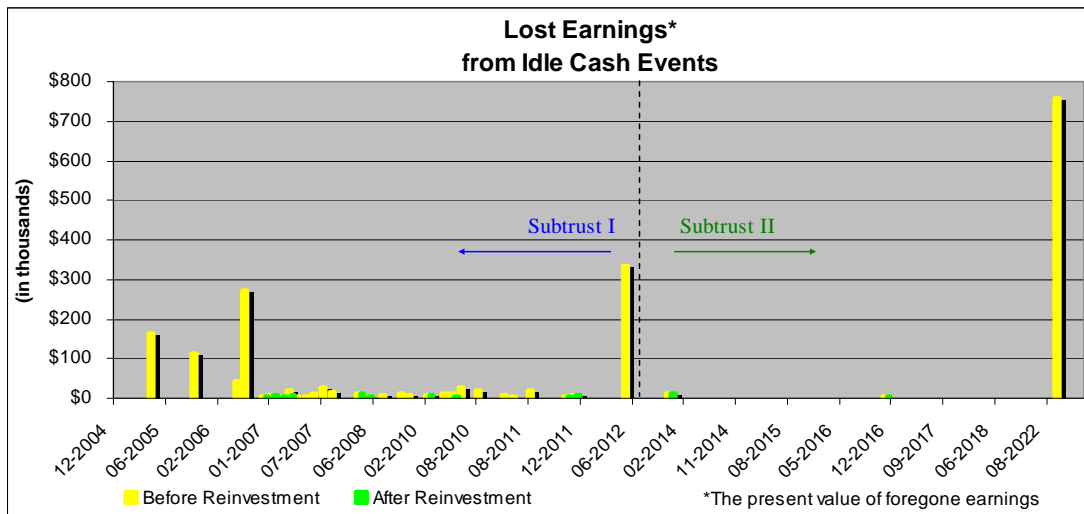
### **Subtrusts**

SLMA then suggested that separate subtrusts be set up for each maturing bond and as all bondholders on a particular subtrust were paid, any remaining collateral for that bond would be transferred to SLM Corp. This approach would allow the mismatches to be isolated from the other bonds. This idea was acceptable to the NY Fed and to Treasury, but not in the number that SLMA initially suggested - 44 separate trusts.

After looking at the cash flows and the lost interest from uninvested equity, OSMO noticed that most of the costs were in two groups: one that matured by October 2012, and another that matured in 2022. OSMO suggested that there be two subtrusts rather than 44 as SLM had wanted. OSMO also proposed allowing there to be nine distinct reinvestments of idle cash (eight



in subtrust I and one in subtrust II) as a compromise to lower the amount of foregone interest to SLM Corp. SLMA and the NY Fed eventually agreed to this approach and it was implemented in the final trust. The impact of this solution is illustrated in the following chart.



### Merger of 1993 Trust

There was a practical problem of how to incorporate the obligations that were being paid through the 1993 Trust into one Privatization Trust. SLMA's lawyers proposed to briefly merge the 1993 Trust into the Privatization Trust with Deutsche Bank as the single trustee. Both the NY Fed and Deutsche Bank agreed. The merger would take place on the same day as the appointment of the NY Fed as the trustee for the combined Privatization Trust.

### Redemption of Collateral

Treasury and the NY Fed agreed that SLM Corp could buy GSE bonds in the open market that were defeased by the Trust, and in limited circumstances, submit those bonds to the NY Fed and have the associated collateral released to it. This recognized that SLM Corp was responsible for funding any deficiencies if SLMA was unable to provide sufficient assets for the Trust. It also recognized that SLM Corp was the holding company with 100 percent ownership of SLMA. Redemption of collateral would allow the NY Fed to release collateral to SLM Corp if it bought back 100 percent of an outstanding bond.

Allowing redemption meant that the final dissolution of the Trust might be pushed forward from its latest possible date in August 2022. One bond matures at that time, and another extends to June 2012. A year after obligations of the Trust have been extinguished, either as scheduled or because of early redemption, the statute that established and governs SLMA, is repealed.<sup>137</sup>

<sup>137</sup> 20 U.S.C. 1087-2.

Repeal of Section. Pub. L. 104-208, div. A, title I, Sec. 101(e) (title VI, Sec. 602(d)), Sept. 30, 1996, 110 Stat. 3009-233, 3009-289, provided that this section [20 U.S.C 1087-2] is repealed effective one year after date on which all obligations of trust established under section 1087-3(d)(1) of this title have been extinguished, if reorganization occurs in accordance with section 1087-3 of this title; or date on which all obligations of trust established under subsec. (s)(3)(A) of this section have been extinguished, if reorganization does not occur in accordance with section 1087-3 of this title. Notes on Section 1087-2.

**Form and Substance Letter**

To assure that all documents were accepted by all the parties, the parties agreed to a pre-closing ahead of the actual closing. At the pre-closing the NY Fed, SLMA and SLM Corp. reviewed and signed the merger documents and the trust documents. Treasury reviewed the Privatization Trust documents and signed a letter saying that the form and substance of the trust were satisfactory.

**Sufficient Funding Letter**

Treasury had to review the obligations and assets that were to go into the Privatization Trust to be sure that the funding was sufficient to pay the bondholders without looking to reinvestment proceeds. The list of obligations had been in flux over the course of several months of negotiations and when it was nearly final problems turned up. Some of the bonds were definitive securities, where the owners were not known. These bonds could not be easily repurchased by SLMA, and when they matured, if no one presented a claim, payments on these bonds would eventually escheat to the state.

The list of assets for paying these obligations was also in flux. Treasury learned that there were unacceptable securities in the 1993 Trust, including Israeli bonds and Ref Corp bonds. SLMA had to replace these securities with Treasury securities before they were acceptable. On the day of closing, December 29, 2004, Deutsche Bank wired the securities to the NY Fed and the NY Fed faxed a list of the securities to Treasury for review.

**Final Signing Ceremony**

Treasury completed its review and notified Wayne A. Abernathy, Assistant Secretary for Financial Institutions, that he should sign the letter finding the funding to be sufficient. At a ceremony on December 29, 2004, officials from Treasury, SLMA and SLM Corp gathered for the final signatures approving the Privatization Trust, effectively cutting the ties of SLMA as a government sponsored enterprise

**Possible Alternatives and Policy Considerations**

The structuring of the SLMA defeasance trust was greatly facilitated by the fact that all remaining GSE obligations were simple fixed rate or zero coupon bonds, which had known cash flows. If any had carried floating rates pegged to an index, defeasing the cash flows would have been more complex. Also, there were virtually no embedded options in the remaining obligations. Only one bond had a call provision, and prior to the execution of the trust, the decision was made to call the bond on the first possible date.

There are different structures or techniques that can be used to offset, or defease, a known liability. Most of these techniques involve either matching cash flows or matching the durations of a group of assets with those of the liabilities. Academics have studied the different structures and opined on their strengths and weaknesses.<sup>138</sup> In general, cash flow matching structures are the most certain and once structured do not require ongoing management. However, they are

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<sup>138</sup> Neglected Complexities in Structured Bond Portfolios. Kevin J. Maloney and Dennis E. Logue. The Journal of Portfolio Management, Winter 1989. Mr. Logue was a director of the Student Loan Marketing Association during the privatization.

generally more expensive to implement. Duration matched structures, on the other hand, have lower upfront costs and are more efficient overall. The drawback with this technique is that it requires ongoing rebalancing and may experience cash flow shortfalls necessitating future cash infusions. In short, it must be actively managed.

Given the statutory language and the desire for certainty, Treasury considered cash flow matching techniques rather than duration matching as the appropriate form of defeasance trust in the case of SLMA. While exact cash flow matches were not available in the market, the assets were structured such that cash equal to or greater than the amount needed to fund each liability payment was available at or prior to the date the liability became due. In this way Treasury ensured the trust would always have sufficient cash to pay the principal and interest payments on the remaining GSE bonds, even assuming no reinvestment would occur. This technique is referred to by Maloney and Logue as a “pure dedication” strategy. While no reinvestment of imprecisely matched cash flows was necessary to meet the obligations, the trust documents did allow for limited reinvestment of certain cash balances. This, in effect, created additional protection for the trust by generating extra cash.

Costs associated with idle cash due to the structure were minimized through the use of two subtrusts and a limited provision that allowed SLM Corporation to purchase certain GSE bonds in the open market, submit them to the FRB for retirement, and have excess collateral associated with the bonds released. Also, at the conclusion of the defeasance trust, any remaining assets will revert to SLM Corporation.

While a relatively simple cash flow matching strategy could be effectively implemented in the case of SLMA, if the remaining obligations had been more complex (i.e, floating rate liabilities and option-embedded structured notes) a more complex defeasance trust would likely have been needed. In a more complex scenario, a strategy involving a duration matched portfolio and active rebalancing might have been appropriate. However, in such a scenario it would be necessary to develop a clear investment policy statement for the portfolio manager/trustee, and it would be necessary to explicitly designate the entity responsible for any cash flow short fall. Additionally, it would be prudent in a more complex scenario to require the trust to be overfunded from inception to reduce the likelihood of a cash flow shortfall.



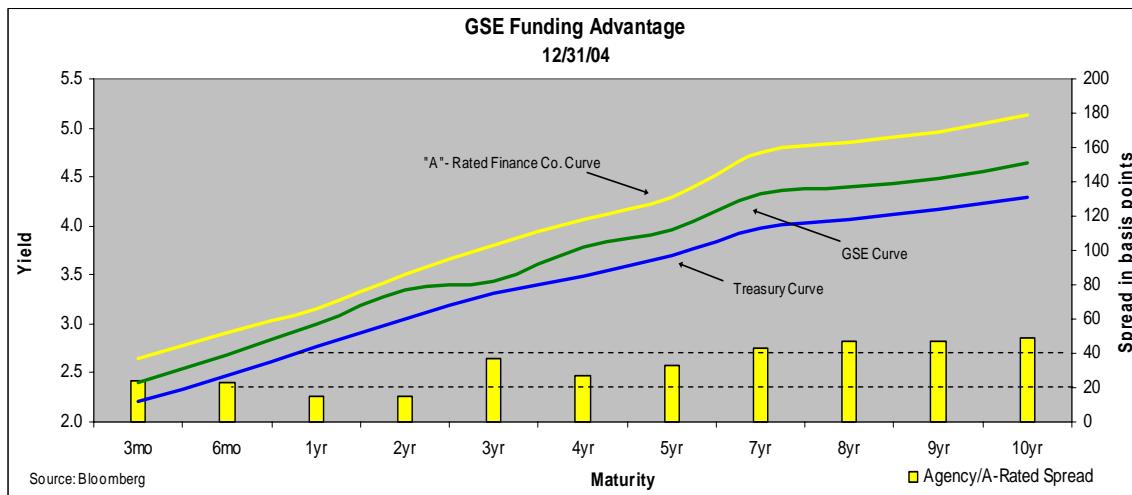
## Chapter 4 - Impact of Privatization on Sallie Mae's Cost of Funds

### Overview

One major advantage GSEs have over fully private-sector financial institutions is lower borrowing costs. The interest rates GSEs pay to borrow money in the bond markets are well below the rates paid by most private-sector companies, and just above those paid by the U.S. Treasury.

This phenomenon is widely believed to be due to a perception in the bond market that there is “an implied Federal guarantee” on the GSE’s debt. This perception persists despite explicit disclaimers on the bond documents and consistent statements to the contrary by GSE and U.S. government officials. Nonetheless, bond market investors apparently remain convinced that the government would not allow a GSE to fail, and willingly lend money to the GSEs at favorable rates. These rates are referred to in the bond market generally as “Agency” rates, although the term apparently has no legal significance.

The Congressional Budget Office (CBO) in 2004 estimated that the overall interest rate on debt issued by the housing GSE’s (FNMA, FHLMC, and the FHLBs) is approximately 41 basis points lower than comparable private-sector companies.<sup>139</sup> This funding advantage is apparent when looking at the yields investors demand to invest in various types of debt. The following graph depicts the relative borrowing costs of Treasury, Agency, and A-rated<sup>140</sup> financial corporations at different maturities.



<sup>139</sup> Congressional Budget Office, *Updated Estimates of the Subsidies to the Housing GSEs* (April 2004).

<sup>140</sup> Credit rating as assigned by a Nationally Recognized Statistical Ratings Organization, or NRSRO, generally referred to as “credit ratings” agencies. As a fully private-sector company, Sallie Mae’s credit rating is now single A.

When SLMA was faced with relinquishing its GSE status and moving to a fully private-sector business model, one of the anticipated consequences was an increase in its cost of funding. However, since this type of transition had never occurred before it was unclear exactly how and when this cost would be felt by the company. In privatization analysis that SLMA prepared in 1994, the company assumed that the private corporation's debt cost would be 30 basis points higher than the GSE's, and assumed that the incremental cost of securitization transactions over GSE funding would be 15 basis points. The preliminary assumption was that approximately half of the private sector company's funding would come from securitization. Still, given these assumptions the company's management felt that the benefits gained from privatization would offset or even outweigh the cost.

Congress designed several provisions to facilitate the funding transition. The statute explicitly stated that the GSE could continue to issue debt during the wind down period (subject to certain maturity restrictions), and that all existing and interim debt issued by SLMA would continue to have GSE attributes until it matured.<sup>141</sup> The law provided for a ten year wind down period to allow the company to transition its funding at a deliberate pace. The statute assured continued market acceptance of SLMA's debt by requiring that any GSE debt still outstanding on the day SLMA dissolved be defeased with U.S. Treasury securities to ensure payment of all principal and interest on those bonds.

This chapter reviews how the company's actual cost of funds changed during the wind down relative to Treasuries, agencies, and fully private sector bonds. The chapter also analyzes the overall impact of this change on the company and how it conducted its business.

### **Part 1 – Positive Interest Rate Environment and “Floor Income”**

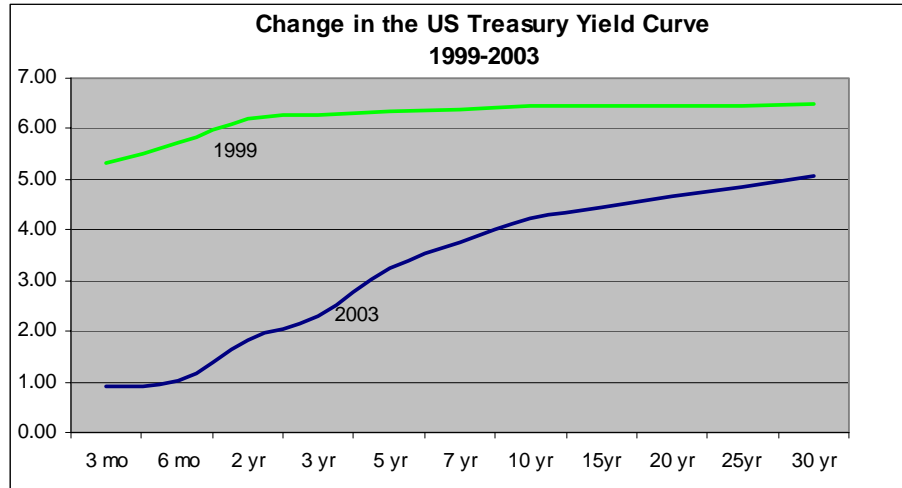
In looking at how Sallie Mae's cost of funds changed during the wind down, it is important to note that the overall interest rate environment from 1996 through 2004 turned out to be very favorable for achieving the wind down. In particular from the period from 1999 to 2003, interest rates, particularly short-term rates, fell to historic lows. As shown below, during this time the short end of the Treasury curve fell by more than 400 basis points, while the long end fell by a significant amount as well. This was a very favorable environment in which to hold and finance student loans, given their credit quality and guaranteed yield. The historically low long term rates later in the wind down allowed the holding company to lock in long term financing at very favorable levels.

The decline in short term rates in 2001 and 2002 also triggered massive amounts of so-called “floor income” which is essentially income that results from an embedded long

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<sup>141</sup> 20 U.S.C. 1087-3(c)(7) states, in part, that, “Nothing in this section shall modify the attributes accorded the debt obligations of the Association by section 429, regardless of whether such debt obligations are incurred prior to, or at any time following, the reorganization effective date or are transferred to a trust in accordance with subsection (d).”

floor position for holders of FFELP loans.<sup>142</sup> SLMA reported a windfall profit from floor income of \$335 million and \$475 million for 2001 and 2002, respectively.<sup>143</sup> To put this amount into perspective, SLMA's offset fee payments to the government for the 10 years that offset fees were levied was less than \$400 million. In general, the extra cash from the floor income allowed Sallie Mae to buy back older, higher coupon debt and other liabilities that were outstanding (e.g., certain derivatives economically linked to net interest income) and which helped maintain its net interest spread even as it was shedding the GSE funding advantage.



### Level of Interest Rates May Impact Credit Spreads

In general, the market's perception of credit default risk determines the availability and cost of funds to both governments and private-sector entities. In the bond market, a common indicator of credit default risk is a credit rating assigned by a credit ratings agency (i.e., AAA, AA, A, BBB, etc.). Credit spread analysis looks at the differences in yield, or cost of funds, for similar maturities among entities with different credit ratings, often using Treasury securities as a benchmark.

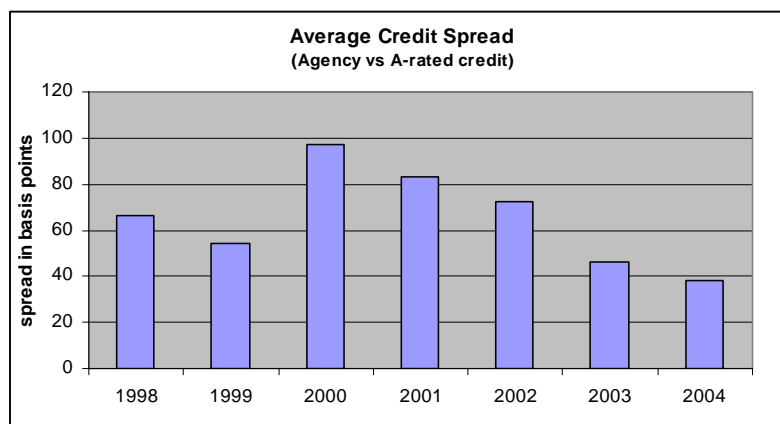
Comparison of spreads between entities with different credit ratings over a period of time, while useful, should be viewed in context because absolute spreads are impacted not only by changing perception of risk but also by the level of interest rates. Credit spreads can also be analyzed on a relative basis, given the level of rates. Further, credit spread between companies of the same credit rating often vary due to specific events involving a particular company that cause the market to view its debt differently than that of its peers.

<sup>142</sup> Under FFELP, the government guarantees lenders an average yield that is completely independent of the interest rates that borrowers must pay. If borrowers are paying less than a certain rate—right now, the cost of commercial paper (just over 4%) plus 2.34%—then the government pays the lender the difference (so called “SAP” payments). If the student is paying more than the SAP formula would provide, which occurs in a falling rate environment, the lender gets to keep the extra profits, known as floor income (also called the asymmetrical “SAP”). See the glossary for Sallie Mae's explanation of “floor income.”

<sup>143</sup> Page 32 of SLM Corp's 2002 Form 10-K. Non-GAAP measures of income.

The following chart shows an average<sup>144</sup> of the absolute spread between yields on bonds of A-rated finance companies versus so-called “Agency” or GSE debt, and gives a sense of how those spreads changed during the wind down.

Credit spreads widened in the year 1998 due to the Russian bond crisis, and in 2000 during the “flight to quality” when investors, shunning many other asset classes in times of market turmoil, flocked to Treasury and Agencies securities as a safe haven. As is often the case, however, when



interest rates fall, as they did in 2001 and 2002, absolute credit spreads tightened which generally reduced the absolute differential between the cost of Agency debt and lower rated corporate debt. From a relative point of view, however, a 40 basis point spread when bonds are trading at 2 percent (as 2 year Treasuries were in 2003) is much larger than a 40 basis point spread when bonds are trading at 6 percent (as 2 year Treasuries were in 1999). In general, the interest rate environment for the period 1998 to 2004 benefited Treasury and Agency issues relative to lesser rated credit.

## Part 2 – Changes in Sallie Mae’s Funding Costs and Strategy During Wind Down

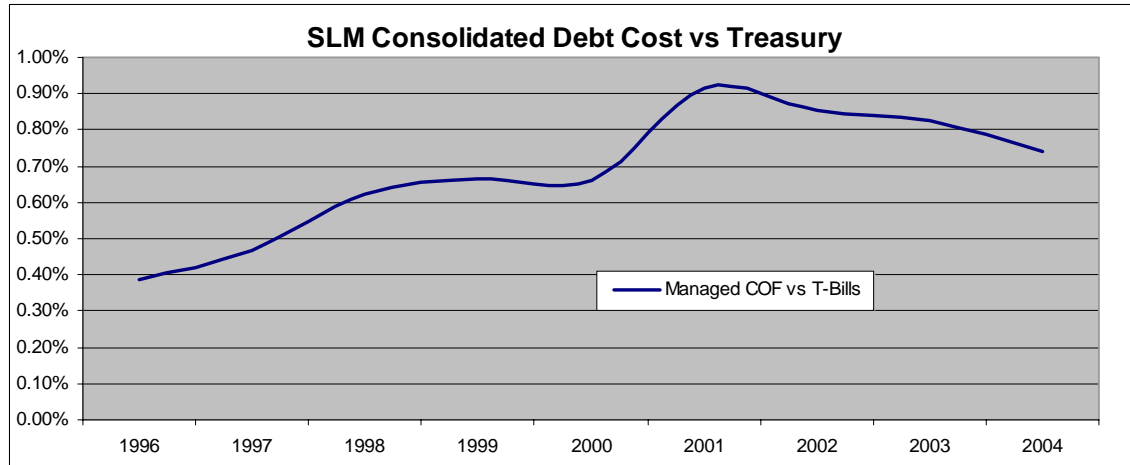
In the case of Sallie Mae, its cost of funds did indeed widen, relative to Agency and U.S. Treasury costs over the course of the wind down. The graph below shows Sallie Mae’s overall debt costs by year, as a spread to the average 91-day Treasury bill.<sup>145</sup> It shows the cost of funding the company’s total “managed”<sup>146</sup> book of assets.

<sup>144</sup> The chart is based on the average of fifteen different maturities at each year end. While spreads on individual maturities vary, the pattern is generally similar to the graph.

<sup>145</sup> Historically, guaranteed student loan yields were based on this index, so SLMA viewed its debt cost in this context. As the wind down progressed, SLM Corp gradually began viewing its cost of funds in terms of a spread to Libor. Also, beginning with loans originated in 2000, lender yields were based on a commercial paper index which is more closely correlated with Libor.

<sup>146</sup> Managed assets include all assets funded through ABS structures. The graph reflects managed cost of funds through a non GAAP measurement of the cost of on-balance sheet funding AND cost of off-balance sheet funding. This is a more robust measure of SLM Corporation’s cost of funds than simply looking at the GAAP cost of funds. It is also appropriate in the context of the wind down because it was the company’s strategy to replace a large part of its GSE funding with ABS funding.

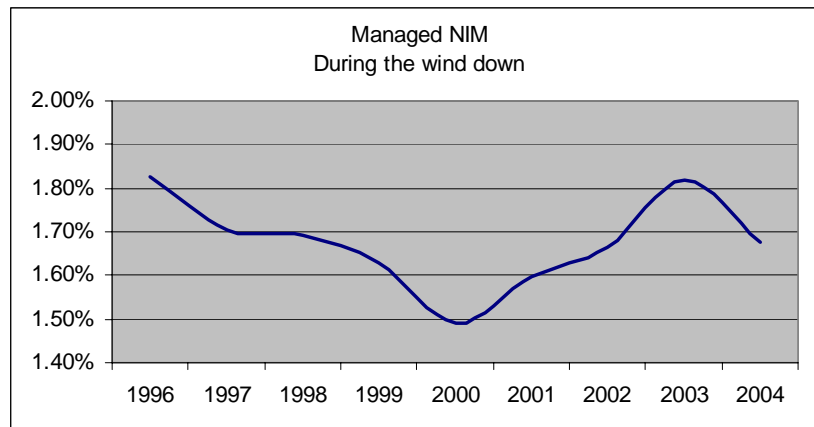




For the purposes of analyzing the company’s overall cost of funds, the managed number is more relevant than the cost associated with only on balance sheet activities, as Sallie Mae migrated to a much higher proportion of off-balance sheet financing as part of its wind down strategy. This strategic shift is discussed further later in Part 4 of this chapter. The financial reporting of the cost of funding the company’s “managed” book of assets versus the financial reporting under GAAP is discussed in Appendix 2, Vexing Accounting.

### Net Interest Margins

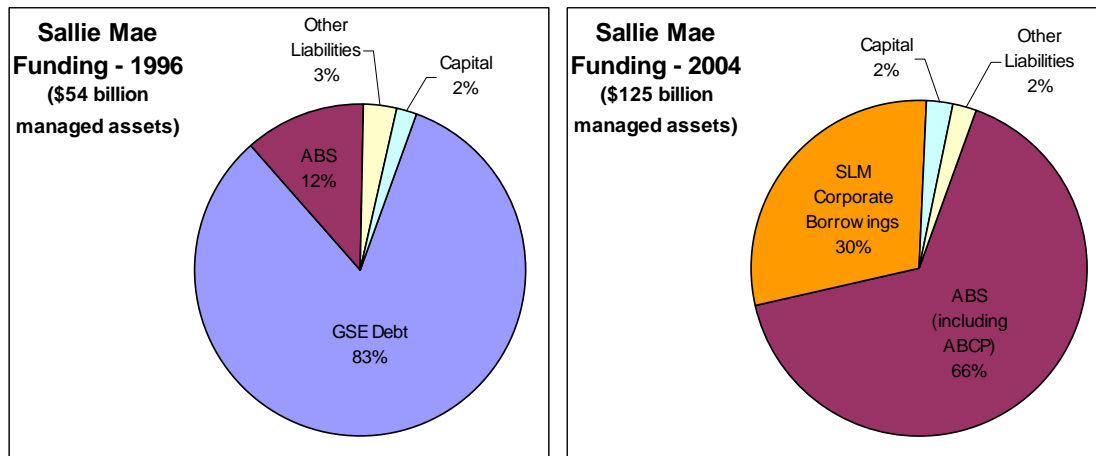
Although there is an impact on the company’s managed net interest margin over the wind down period, the relationship between the increasing cost of funds and the change in net interest margin is not as direct might be expected. During the wind down period managed net interest margin declined by only 15 basis points -- from 1.83% in 1996 to 1.68% in 2004 -- however, most of the decline came in the early years when the company was largely still financed with GSE debt. As the graph below shows, the recent trend in net interest margin was up for 3 of the last 4 years of the wind down, when some of the heaviest refinancing activity was taking place. In Part 4 of this chapter, there is analysis regarding why this counterintuitive result may have occurred.



### Sallie Mae's Funding Strategy

Sallie Mae's strategy to overcome the increased cost of funds hurdle had several facets and evolved during the wind down period to take advantage of market conditions. The company planned to use asset-backed securitizations for a much larger portion of its overall funding. While asset-backed securitizations were more expensive than funding with GSE debt, they were cheaper than alternative sources of funding (e.g., private sector corporate debentures). In addition, by securitizing the loans and removing them from the balance sheet, Sallie Mae was relieved of the 30 basis point offset fee that Congress had levied on Stafford loans held by the GSE. The company also planned to compensate for the increased funding cost through diversification into higher yielding asset classes (e.g., private credit student loans) and new areas of the student loan business that generated fee revenue rather than net interest margin (refer to Section III, Chapter 2 for further discussion of fee based revenue).

This strategy led to a dramatic shift in the company's financing. The following graph illustrates the overall change in funding sources from 1996 to 2004.



At year-end 1996, the year of the Privatization Act, Sallie Mae had \$47.6 billion of on-balance sheet assets, and managed \$6.3 billion more in student loan ABS for total managed assets of \$53.9 billion. As the graph shows, the assets were 83% financed with GSE debt, 12% by ABS, and the balance with other liabilities and capital. From the earlier graph, we can see that Sallie Mae's average cost of all managed financing was roughly 39 basis points above the 91 day T-bill.

Contrast this with December 31, 2004, two days after the completion of the GSE wind down when SLM Corp had \$84.0 billion of on-balance sheet assets, and \$41.1 billion in off-balance sheet student loan trusts for a total of \$125.1 billion in managed assets. These assets were 66% financed with ABS certificates,<sup>147</sup> and unsecured corporate debt, was only 30% of total funding. The average cost of SLM Corp's managed financing for 2004 was roughly 74 basis points above the average 91 day T-bill rate.

<sup>147</sup> Includes both on and off balance sheet ABS. See Appendix regarding Vexing Accounting for a description of why some ABS are reported on the balance sheet and others are not.

While a variety of factors can impact the observed spread between Treasury securities and SLM debt cost, the 35 basis point increase (74 basis points less 39 basis points) is one indication of how much the company gave up in funding costs relative to Treasuries during the wind down. Since the results of 2004 reflect some level of GSE funding, debt costs for 2005 may increase still more relative to Treasuries. While the 35 basis point widening in the accounting debt spread is slightly less than the 41 basis point funding advantage estimated by CBO, it is not inconsistent with that estimate given the other factors that impacted the company's funding costs and the residual effect of GSE funding in 2004. Of these other factors, the shift to an ABS-dominated funding model was the most important part of minimizing the funding impact.

### **Part 3 - Success with Asset-Backed Securities**

Securitization proved to be a very effective strategy for Sallie Mae in narrowing the difference in the cost of funds between the GSE and the holding company's debt. From 1995 until the completion of the wind down in 2004 the company as a whole, including the GSE, executed 59 ABS transactions, issuing nearly \$117 billion of student loan ABS. This was despite the fact that issuance of ABS was side tracked for a year following the Russian bond crisis, which resulted in unfavorable pricing in ABS versus GSE funding. Sallie Mae's ABS transactions were rated primarily at a triple-A level.<sup>148</sup> Because of the guaranteed nature of the underlying FFELP student loans, approximately 96.5% of the certificates issued by the ABS trusts were given AAA ratings with out the need for significant structural credit enhancements that were required of non-guaranteed student loans. The other 3.5% were subordinated to the AAA tranches and generally received A ratings. Overall ABS funding costs were initially 25 to 35 basis points over Libor, and contrary to the expectations of some investors<sup>149</sup> declined steadily during the wind down.

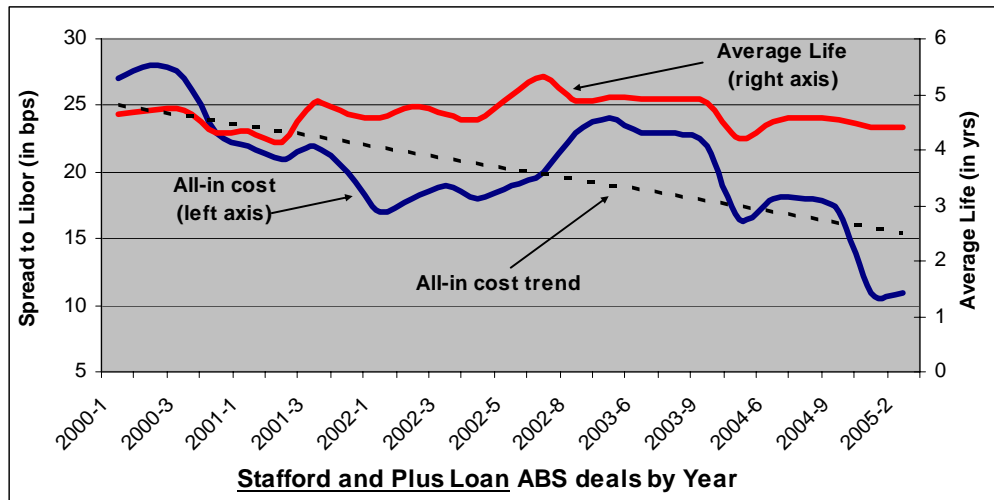
Each of the following three graphs shows how pricing and average life for a distinct type of ABS transaction evolved during the wind down. Federally guaranteed Stafford loan ABS were the first and most consistent type of ABS transaction issued by the company during the wind down. Consolidation loan ABS began appearing suddenly and in large sizes in late 2002, in response to a wave of student loan refinancing triggered by very low interest rates. The company first issued private credit ABS in late 2002 and this category remained a relatively small portion of the company's overall ABS activity.

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<sup>148</sup> In contrast, when the holding company issued corporate debt it earned a single A rating and therefore had higher funding costs. This is discussed more below.

<sup>149</sup> Jack Remondi, Sallie Mae's EVP for Finance during the wind down period remarked that it was difficult to convince investors that student loan ABS was a good investment. He said that costs for these ABS went down as Sallie Mae opened new markets internationally. Interview with Jack Remondi, July 27, 2005.

### ABS Funding Costs Declined For Traditional Student Loans

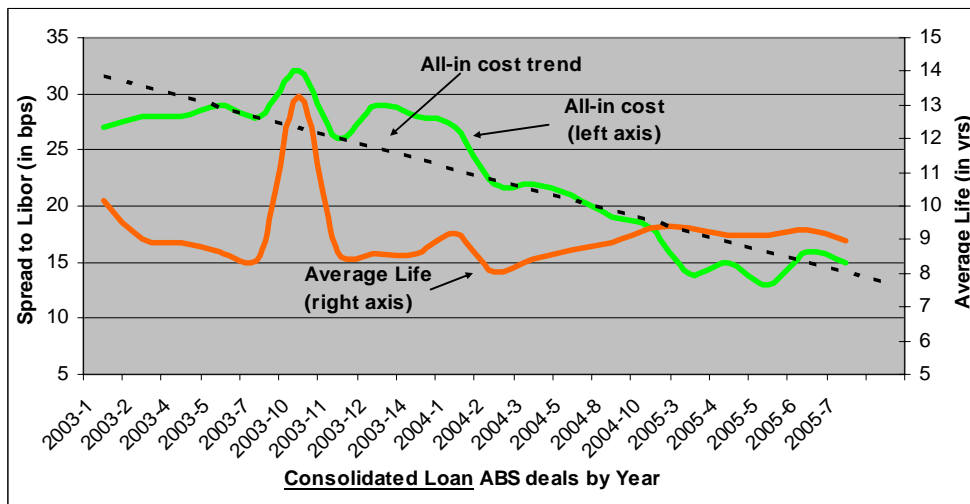


First Stafford Loan ABS done in 1995<sup>150</sup>

Number of deals through 2004: 37

Total securities issued: \$69 billion

### ABS Funding Costs Declined For Long-Term Student Loans



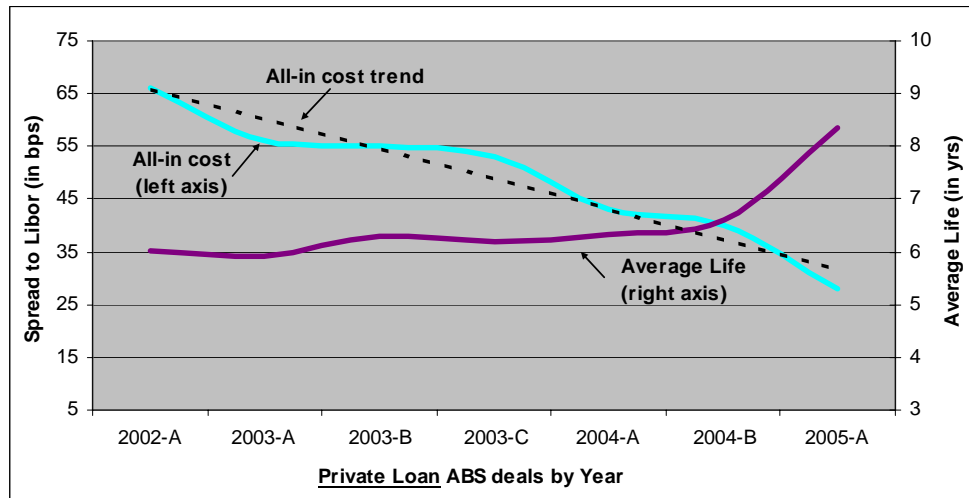
First Consolidated Loan ABS done in 2002

Number of Deals through 2004: 16

Total securities issued: \$41 billion

<sup>150</sup> SLMA issued fourteen Stafford loan ABS between 1995 and the end of 1999. Because average life and spread data wasn't available for the period before 2000, the graph only shows from the year 2000 on.

### ABS Funding Costs Declined For Private-Credit Student Loans



First Private Loan ABS done in 2002  
 Number of Deals through 2004: 6  
 Total securities issued: \$7 billion

The charts above show a dramatic decline in the cost of ABS funding costs for the three major types of student loans. This decline was due to several factors. First, Sallie Mae and others in the student loan industry aggressively promoted the product globally to investors such as Central Banks and were successful in gaining broad market acceptance, increasing the demand for student loan ABS among various groups of investors. Second, the overall spreads that investors demanded from asset-backed securities generally tightened a considerable amount, which also benefited the issuers of student loan ABS.

In the second quarter of 2004, SLM Corporation closed its first asset-backed commercial paper program. It was a revolving 364-day multi seller conduit that allowed SLM Corp to borrow up to \$5 billion secured by student loans. Under this facility, \$4.2 billion was outstanding at year-end 2004. This program provided SLM Corp a valuable liquidity source, which is more critical after shedding the GSE.

ABS funding was critical to the wind down, because it was a non-GSE source of funding that was immediately available early in the wind down before the holding company had the wherewithal to issue its own unsecured debt in any significant size or at a reasonable cost. Thus the ABS market helped to ease the transition to non-GSE funding sources.

### Part 3 - Corporate Debt Issuance

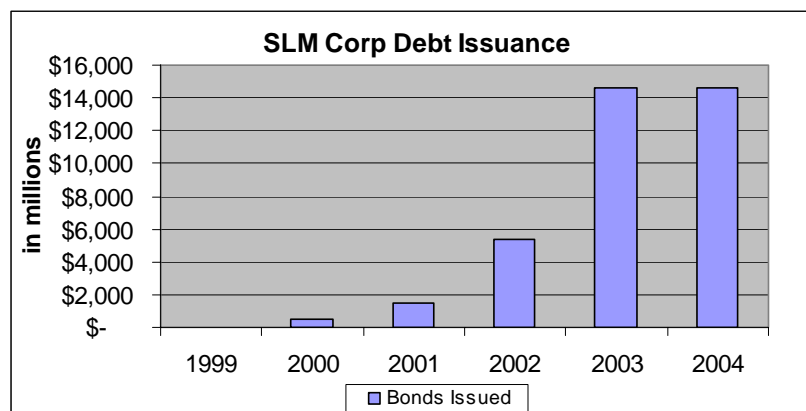
Although the private sector Sallie Mae now relies far less on unsecured corporate debt than it did as a GSE, it is instructive to look at its cost for this portion of its funding, and see how those costs evolved over the course of the wind down. In particular, OSMO was interested in how the market viewed holding company debt relative to its private sector peers and whether there is any confusion in the market as to whether SLM Corp debt should still trade similarly to the old “Sallie Mae” (GSE) debt. While unsecured

corporate debt now accounts for less than a third of the company's funding, it is still a significant factor in the company's overall cost of funds.

Upon passage of the Privatization Act, management began developing its strategy of diversifying the company's funding sources. While ABS was going to be the primary source of funding, it was well understood that various types of corporate debt would also be needed to successfully wind down the GSE. A necessary step was for the holding company, SLM Corp, to be assigned a "stand alone" credit rating by an NRSRO, and in 1999, the credit rating assigned was single A. While several notches below the GSE's rating of triple A (the highest rating), the holding company's rating was nonetheless an investment grade rating that would allow it to raise funds independent of the GSE.

SLM Corp issued its first unsecured debenture in October 2000. The first issuance was a 2 year, \$500 million floating rate note that matured well before the wind down was expected to be complete. The issue priced at 22 basis points above 3 month Libor or approximately 44 basis points higher than the GSE's cost for similar debt. This was the holding company's only issuance in 2000. In 2001, the holding company went to the market five times with 1 to 3 year issuances totaling \$1.5 billion that were all floating rate and all matured prior to the GSE dissolution deadline. Spreads to Agency debt on these issues ranged from roughly 40 to 60 basis points higher than similar GSE debt, depending on maturity and timing of each issuance.

OSMO viewed 2002 as a critical year in the evolution of the holding company's debt issuance. In April 2002 the company issued its first senior unsecured bond with a maturity date beyond the expected GSE dissolution date (by this time the company had publicly announced that it planned to dissolve the GSE by September 2006). The bond was a \$1.5 billion 5-year note issuance. This was followed in August 2002 with a 10-year \$600 million dollar issuance. These issues were well received by the market, pricing at approximately 45 and 42 basis points above the Agency benchmarks at the time, respectively. Overall, the holding company issued nearly \$6 billion on non-GSE debentures in 2002, paving the way for much heavier issuance for the next two years, as shown below.



The holding company significantly accelerated its unsecured debt issuance in 2003 and began to diversify the types of debt it issued to include foreign denominated securities that were swapped back to dollars at issuance. This was a significant step in expanding the investor base for the holding company's debt to a global market. In 2003, the company also launched a relatively small program known as "Ed Notes" that targeted retail investors with small weekly issuances and \$1,000 minimum investment. The Ed notes product competes with certificates of deposits offered by insured depository institutions.

Between its first issuance in October 2000 and the conclusion of the wind down at year end 2004, the holding company issued nearly 500 discrete debt instruments, totaling approximately \$37 billion. However, many of the company's bond issues were relatively small Ed Note issuances, with only 91 of the 500 exceeding \$25 million.

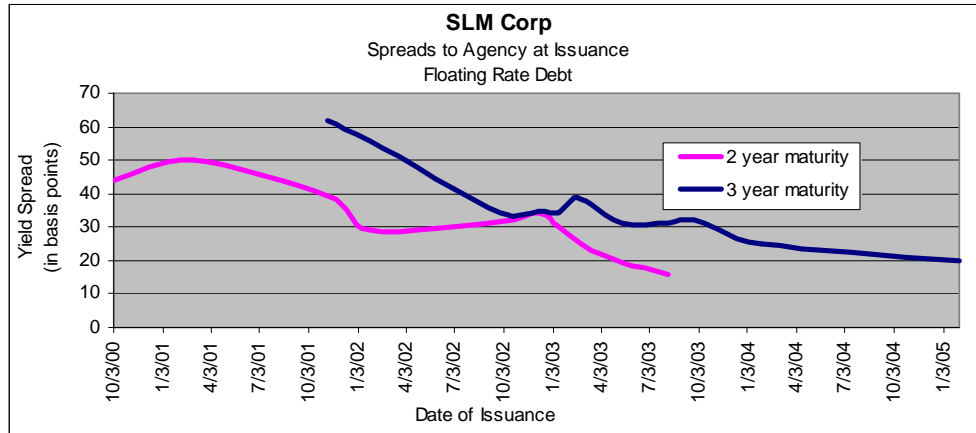
To get a sense of how SLM Corp's debt priced versus GSE debt and other private sector financial institutions, OSMO studied a judgmental sample of SLM Corp bonds in terms of how they priced at issuance and how they traded over time versus debt of the other groups. We selected only dollar-denominated, bullet maturity bonds with no embedded options, in sizes of \$100 million or greater. Twenty of the twenty-five bonds in the sample were \$500 million or greater. The sample OSMO focused on consisted of the following:

| Tenure  | # of bonds | Coupon        |       | \$ Amount      | % of all issuance<br>2000-2005 |
|---------|------------|---------------|-------|----------------|--------------------------------|
|         |            | Floating      | Fixed |                |                                |
| 2 year  | 5          | x             |       | 1,800,000,000  | 4.2%                           |
| 3 year  | 9          | x             |       | 6,720,000,000  | 15.6%                          |
| 5 year  | 6          |               | x     | 5,150,000,000  | 12.0%                          |
| 10 year | 4          |               | x     | 3,350,000,000  | 7.8%                           |
| 30 year | 1          |               | x     | 750,000,000    | 1.7%                           |
|         | 25         | Total Sampled |       | 17,770,000,000 | 41.4%                          |

OSMO found that, on average, the holding company bonds were issued and traded generally in a range of 30 to 50 basis points wider than comparable Agency securities, and tended to tighten somewhat as the wind down progressed. This result is consistent with the CBO estimate of the GSE funding advantage being roughly 41 basis points. OSMO did find some variation in trading levels depending on the maturity of the bond, and other unrelated market events which is to be expected. On average, in market trades after issuance, SLM Corp bonds tightened from their issuance levels.

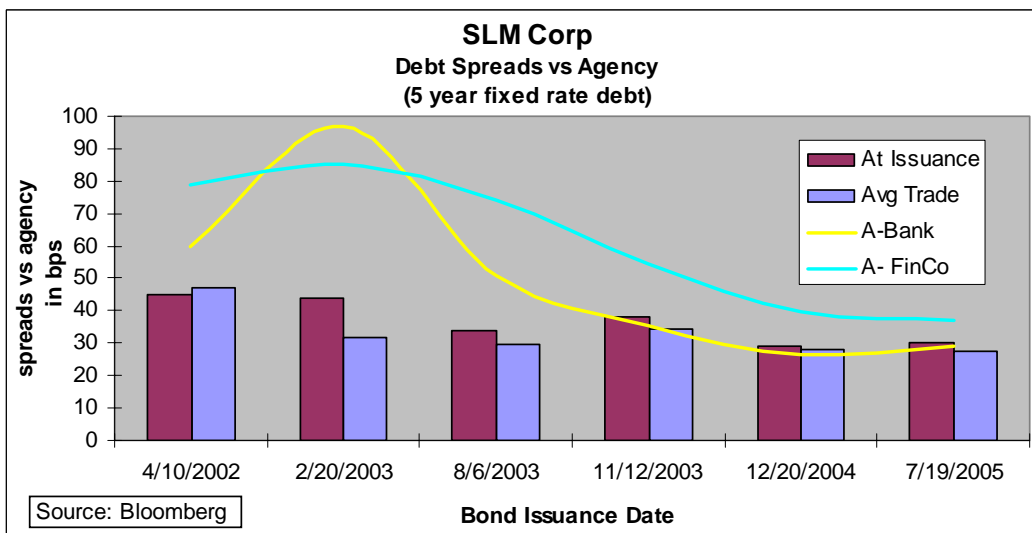
### **Floating Rate Securities**

The graph below compares SLM Corp's two and three year floating rate debt to the similar Agency debt. Most of the bonds were issued at 30 to 40 basis points above Agency rates, and the spreads tended to improve over time as the wind down progressed. The most recent issues, however, may reflect deterioration in Agency spreads resulting from ongoing regulatory issues at the remaining GSEs as well as improvement on the part of SLM Corp.



**Fixed Rate Securities**

OSMO also looked at the yield spreads between SLM Corp’s fixed rate bonds and Agency benchmark bonds both at issuance and trading spreads over the life of each bond. The graph below presents yield spreads for six different 5 year bonds issued by SLM Corp between 2002 and 2005. It shows that over time, the spreads at issuance generally tightened and that trading spreads were generally tighter than issuance spreads.

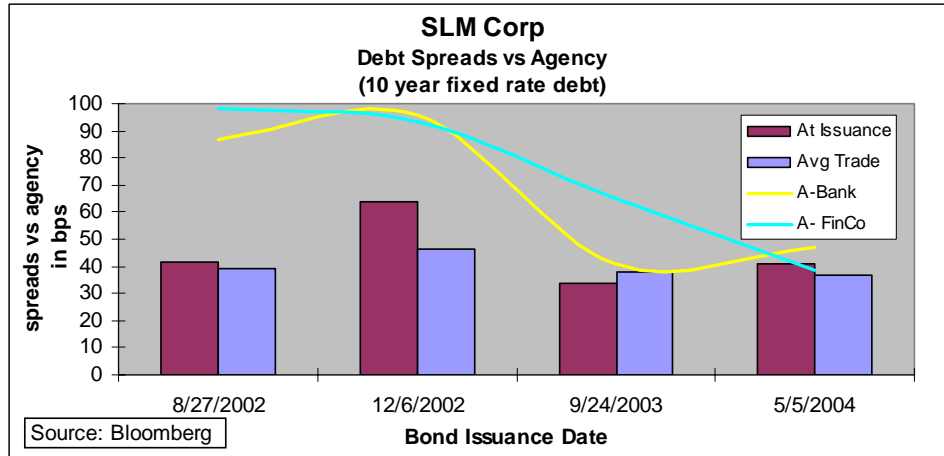


More interesting, however, is the comparison of SLM Corp debt early in the wind down relative to the theoretical levels expected at that time for A-rated banks and finance companies. In 2002 and early 2003, SLM Corp was able to issue fixed rate debt at spreads 15-30 basis points more favorable than predicted for a single A rated bank or finance company based on a theoretical model.<sup>151</sup> This anomaly did not persist for long, however, and by 2003 spreads on SLMA debt began to come in line with theoretical

<sup>151</sup> The theoretical model was Bloomberg’s fair value model for corporate bonds. This model has certain weaknesses in that it is not always possible to identify the underlying data that was used to derive the fair value at a given point on the curve for a given credit quality. This is especially true when looking back at historical fair value curves. Still, it is one theoretical indicator, although not necessarily a conclusive one.



levels. Sallie Mae management expressed the opinion that this anomaly had more to do with specific issues that were negatively impacting banks and finance companies at the time, but did not taint SLM Corp in the eyes of the market. The pattern observed in the five year bonds also held for ten year bonds as can be seen below.

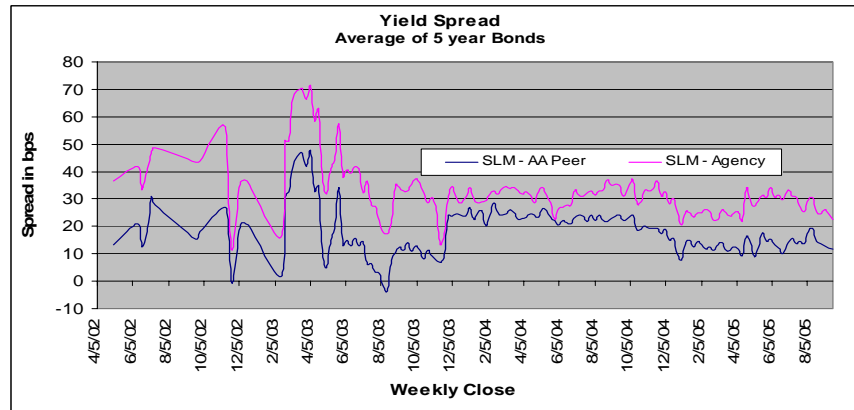
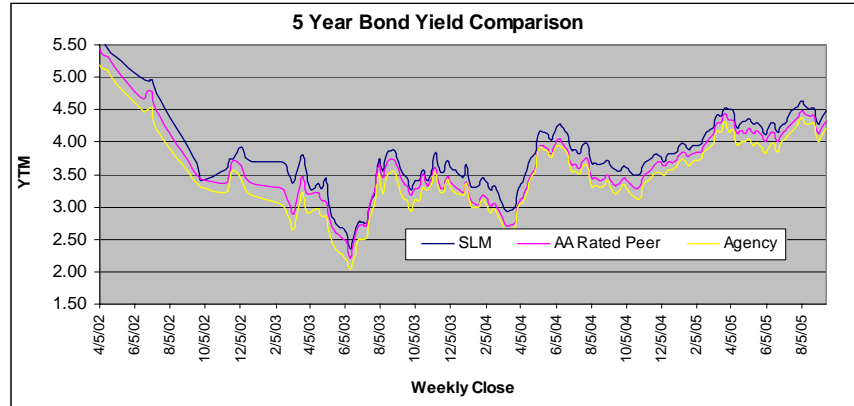


### Further Comparison to Peers

During the wind down, SLM Corp's management often gauged its cost of funds by tracking the debt costs of a group of mainly AA-rated banks, specifically, Bank of America, Wells Fargo, and Bank One (later merged with JPMChase). OSMO analyzed how SLM Corp's bonds traded relative to this peer group, using data from settled trades in the NASD's "Trace" data base and using Bloomberg's generic pricing function which is an indicator of where the bonds were trading on a given day, based on an amalgam of dealer quotes, according to Bloomberg.

SLM Corp's 5 year fixed rate bonds generally traded 10 to 20 basis points wider on average than the peer group and tended to tighten a bit as the wind down progressed. This comparison did not show the disparity noted above when comparing issuance levels and average trades to theoretical levels. Below are graphs showing the average yields and yield spreads for SLM Corp 5 year fixed rate bonds, comparable benchmark Agency bonds, and bonds issued by SLM's chosen peer group of AA-rated banks. In the earlier part of the graph (mainly 2002) SLM's longer term, fixed rate bonds were still new in the market and traded somewhat sporadically. Accordingly, the spread relationships are more volatile during this period.

**SLM Corp Five Year Bond Yield  
Versus Agency and Peer During and Post Wind Down  
(April 2002 – Aug. 2005)**



Beginning in 2003, trades became more frequent as issuance picked up and volume outstanding increased. Early volatility notwithstanding, there are no dramatic changes in yield spread before and after the completion of the wind down in December 2004. Nor is there any conclusive evidence of a halo effect from the GSE early in the life of the bond which would have caused the bond to trade relatively better than its peer.

In 10 year fixed rate bonds, Sallie Mae’s trading spreads were also wider on average than its peer group, which is to be expected given the peer group’s higher credit ratings. Presented below is trading data for a pair of ten year fixed rate bonds versus slightly higher rated peer bonds.

**SLM Corp Ten Year Bond Yield  
Trading Level versus Peers During Wind Down  
(Oct. 2002 – Aug. 2005)**



WFC = Wells Fargo  
Source: Bloomberg

Average Spread over time: 14.9 basis points

**SLM Corp Ten Year Bond Yield versus Bank of America  
(Dec. 2002 – Aug 2005)**



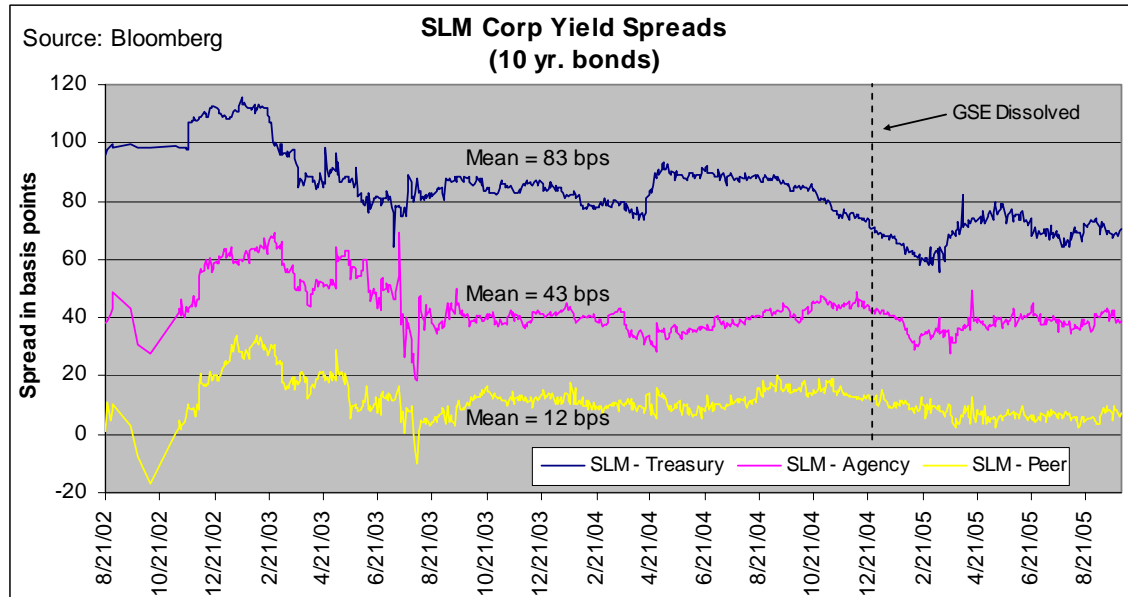
BAC = Bank of America  
Source: Bloomberg

Average Spread over time: 12.1 basis points

In the case of the first bond, SLM Corp's yield on a ten year bond compared to its peer group, there is a favorable spread relationship during the first several months after the bond was issued, where the SLM bond trades very near or even through its higher rated peer. However, this relationship soon reverts to a more normal level and trades at an average of 15 basis points wider than the Wells Fargo bond. The thin market for the SLM bond early in its life is likely skewing the normal relationship.

The following graph provides a more general look at how SLM Corp's 10 year bonds traded versus Treasuries, Agencies, and a group of bonds issued by the company's chosen peer group. From this view, it appears that the market does demand about 40 basis points more to invest in SLM Corp's ten year debt than it does to invest in Agency

(GSE), debt. It also shows that on average the risk premium demanded by the market to invest in SLM Corp debt instead of AA-rated bank debt is about 12 basis points. The graph also shows the same pattern of SLM Corp's debt tightening to other investments over time.



## Part 4 – Additional Observations on Funding Costs and Strategy

### Net Interest Margin Impact

The company's net interest margin declined during the wind down, but by less than the increase in funding cost. Much of the differential is likely due to the company's shifting a larger portion of its assets into higher margin, higher risk assets. In particular, the company grew its higher yielding non-guaranteed or "private" loan portfolio significantly during the wind down as a percentage of its overall student loan portfolio. These higher yielding assets result in a larger gross margin than do guaranteed assets, an expected result of taking on increased risk.<sup>152</sup> This shift in asset composition is discussed in chapter 2 of this section.

### Management's Estimates

During the wind down, management periodically presented comparative cost of funds data to SLM Corp's board of directors. In a presentation made in January 2005, just after the completion of the wind down, management estimated that during 2004, SLM Corp's long-term (maturity greater than one year) unsecured debt cost approximately 45 basis points more overall than similar GSE debt would have cost. This estimate is slightly higher than the indications OSMO found, and likely to be more of an "all-in" cost figure,

<sup>152</sup> On a risk adjusted basis, management has acknowledged that the private credit has a lower return on equity due to the higher capital required to support this type of lending. Also, assumptions regarding the loan loss reserve required for these assets affect the reported margin.

taking into account certain registration and other issuance costs which the holding company incurs, but the GSE did not.<sup>153</sup>

Management has stated that while the company's overall funding costs increased as a result of the wind down, the relief from the 30 basis point offset fee on Stafford loans coupled with the ability to enter new lines of business, offset much of the downward earnings pressure from the cost of funding increase. Also, its ability to control the origination of the loans it holds, gave the company the ability to significantly reduce the premium it had paid as a GSE to acquire the loans through other lenders. This change had a positive impact on the company's margin. In addition to the asset mix changes discussed above, new fee-based lines of business, such as debt collection and guarantee servicing, created new sources of non-margin based revenue that also buoyed the company's earnings as margins tightened.

Although margins in the lending business did tighten as a result of privatization, management was able to report steady earnings growth, which buoyed the stock throughout the later years of the wind down. Today investors in the company still appear enthusiastic about the company's prospects for growth in both its core portfolio business as well as its newer fee-based businesses.

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<sup>153</sup> This is because the GSE could issue debt without registering it with the SEC and GSE debt required less marketing than does SLM Corp debt.



## Chapter 5 - Safety and Soundness of Sallie Mae

Safety and soundness regulation for GSEs is a relatively recent development in the history of financial regulation. Following the savings and loan crisis in the 1980s, Congress passed the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) to strengthen regulation and thereby help stabilize financial institutions. Congress became worried that not only thrift institutions, but government sponsored enterprises, holding hundreds of billions of dollars in obligations, might fail. Therefore, in FIRREA, Congress directed both Treasury and GAO to prepare reports on the risk taking and capital adequacy of a number of GSEs, including Sallie Mae.

Congressional thinking seemed to focus on the public missions of the GSEs and their importance to the economy. Providing effective safety and soundness regulation would reduce the risk of insolvency and failure of the GSEs.<sup>154</sup> As it created GSE regulators, Congress gave most of them powers very similar to the Federal bank and thrift regulators. In linking effective Federal regulation to reducing the risk of GSE failure Congress took care to point out that the debt of the GSEs is not the responsibility of the Federal government.

For the first 20 years of its existence, SLMA had virtually no safety and soundness oversight. While it was subject to various reviews regarding its compliance with certain aspects of the student loan program, none of the reviews comprehensively looked at the company's operations or its level of capitalization. In an April 1991 report on GSEs, Treasury concluded that "The financial safety and soundness oversight of Sallie Mae is nonexistent."<sup>155</sup> Following a series of government prepared reports on the safety and soundness of the GSEs,<sup>156</sup> in 1992 Congress gave the responsibility for safety and soundness oversight for SLMA to the Treasury Department through an amendment to the Higher Education Act.<sup>157</sup> The legislation did not give Treasury the authority to assess SLMA for the cost of oversight, in contrast to most other GSE regulatory designs. Treasury developed a function within Domestic Finance to meet its responsibilities using its existing resources. From 1992 until 1997, Treasury's oversight program for SLMA consisted largely of certain reporting obligations and certifications, rather than traditional on-site examination activities.

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<sup>154</sup> 12 U.S.C. § 4501. Congressional findings in the Act creating the Office of Federal Housing Enterprise Oversight (OFHEO).

<sup>155</sup> Report of the Secretary of the Treasury on Government-Sponsored Enterprises. April 1991, page 46.

<sup>156</sup> Treasury, *Report on Government Sponsored Enterprises*, May 1990

GAO, *Government-Sponsored Enterprises: The Government's Exposure to Risks*, August 1990

Treasury, *Report on Government-Sponsored Enterprises*, April 1991

CBO, *Controlling the Risks of Government-Sponsored Enterprises*, April 1991

GAO, *Government-Sponsored Enterprises, a Framework of Limiting the Government's Exposure to Risks*, May 1991

<sup>157</sup> Higher Education Act of 1992, 12 U.S.C. § 1087-2(r).

## **OSMO's Approach to Safety and Soundness Studies**

The concept of safety and soundness oversight is clear when it applies to the oversight of a federally insured depository institution. Under Federal banking law, an unsafe and unsound banking practice can pose risks to the deposit insurance fund and is therefore a basis for terminating an institution's deposit insurance coverage.<sup>158</sup> That concept is not as clear for GSEs. If a GSE operates in an unsafe and unsound manner, the risk to a national interest is not as direct as with banks. Given that there is explicitly no Federal backing of the GSE's bonds, the purpose for safety and soundness oversight may lie in Congress's desire to ensure the stable functioning of the markets the GSEs serve.

OSMO adopted a risk-focused examination approach for assessing the safety and soundness of SLMA consistent with that of other Federal bank and government-sponsored enterprise regulators. The objective of a risk-focused examination is to effectively evaluate the safety and soundness of a financial institution, including the assessment of risk management systems, financial condition, and compliance with applicable laws and regulations, while focusing resources on the highest areas of risk.<sup>159</sup> OSMO's assessed SLMA's management, oversight by its board of directors, the adequacy of its records and internal controls, and the various risks faced by the company, including credit risk, market risk, operations risk, corporate governance, technology management, and progress toward privatization.

OSMO also developed examination communication standards, including the need for transparency, familiarity, and an ethical understanding. These standards were intended to ensure that examination procedures were documented, findings and concerns were communicated to management and the board of directors in a timely fashion, and examiners treated confidential information appropriately. OSMO required examiners to be free from financial conflicts of interest.

In September 2000, the Secretary of the Treasury directed OSMO to issue annual Reports of Examination regarding SLMA to be provided simultaneously to the Secretary, SLMA, and to the Secretary of Education.

During its examinations, OSMO encountered significant safety and soundness issues. These include findings relating to capital adequacy, liquidity, internal controls, corporate governance and financial reporting.<sup>160</sup> As OSMO dealt with these issues, it had few enforcement tools to persuade SLMA to accept its recommendations. What follows is a discussion of the major safety and soundness issues that OSMO dealt with during its oversight of Sallie Mae's wind down.

### **A. Capital Adequacy**

A critical factor in the safety and soundness of an institution is its level of capital. Capital provides a cushion to absorb unexpected losses, as opposed to reserves that

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<sup>158</sup> 12 U.S.C § 1818(a)(2)

<sup>159</sup> See the FDIC's *Manual of Examination Policies*

<sup>160</sup> Wind-down planning, a recurring issue in OSMO's examinations, has been covered previously and is not discussed here.



absorb expected losses in certain asset classes. A financial institution's level and formation of capital also serves as a check on its asset growth rate.

**Riskier business needed more capital.**

As the GSE's assets shifted from low risk federally guaranteed loans to higher risk assets such as non-guaranteed or private student loans and interest-only residuals (a trend that was projected to continue throughout the wind down), Treasury insisted that the GSE's capital be commensurate with its risk profile.

The legislation that led to the privatization of SLMA recognized the need for some minimum level of capital to be retained in the GSE. The law essentially required that the GSE maintain a minimum ratio of equity to assets (adjusted for certain off-balance sheet items) of 2.25% during the wind down.<sup>161</sup> Prior to January 2000, the minimum was 2.00%. In practice, management maintained the actual level of capital very near the minimum. As OSMO analyzed the risks inherent in the GSE wind down, it became apparent that the statutory minimum leverage capital ratio alone was insufficient to ensure the safety and soundness of SLMA during the wind down. The lack of a capital standard based on risk, rather than equity to assets, provided a financial incentive for management to concentrate its riskiest assets in the GSE during the wind down.

Early versions of the GSE wind down plan targeted the statutory minimum as the desired level of capital for the GSE. OSMO viewed the statutory minimum as the floor for the appropriate level of capital, but not a ceiling. This view was consistent with other Federal regulators of financial institutions. The statutory minimum, while perhaps sufficient for a going concern based on a federally guaranteed student loan business, was insufficient to meet established safety and soundness standards, given the riskier conditions introduced by management's wind down plans.

An internationally accepted notion in the regulation of financial institutions is that the appropriate level of capital varies above some minimum level, and is largely dependent on the risks inherent in the institution's business at any point in time, a so-called "risk-based" approach.<sup>162</sup>

Following the issuance of the original wind down plan in 2000, OSMO reviewed SLMA's current and projected capital adequacy from a safety and soundness perspective.

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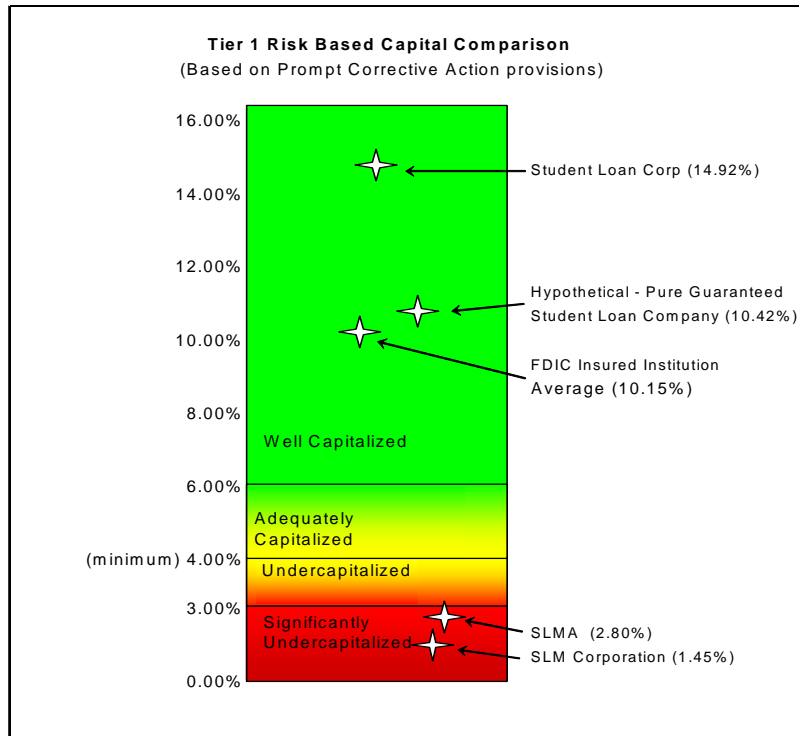
<sup>161</sup> See USC 1087-2(r)(15) for the precise calculation of the capital ratio.

<sup>162</sup> The *International Convergence of Capital Measurements and Capital Standards* or the "Basel Accord" was the original risk-based framework developed by the Basel Committee on Banking Regulations and Supervisory Practices and endorsed by the central bank governors of the Group of Ten (G-10) countries in July 1988. The Basel Committee met at the Bank for International Settlements in Basel, Switzerland. The concepts set forth in the Basel Accord served as the underpinning for the risk-based capital methodology and requirements of the U.S. Federal banking regulatory agencies for over a decade. The Basel Accord was recently updated in a document titled, *International Convergence of Capital Measurements and Capital Standards: a Revised Framework*, which is commonly referred to as "Basel II." The updated standard was published by the Basel Committee in June 2004, and is being phased in by the agencies. The agencies will require the ten largest U.S. Banks to adopt the Basel II framework, while it will be optional for certain other U.S. banks.

OSMO looked to guidance from the Federal banking regulatory agencies<sup>163</sup> (the agencies) for guidance in performing this assessment. The agencies had adopted risk-based capital calculations as part of their regulatory regime for estimating appropriate capital for safe and sound operation. These calculations applied to financial institutions in general and presented a standard for assessing SLMA’s capital. Per the FDIC’s Manual of Examination Policies:

A financial institution is expected to maintain capital commensurate with the nature and extent of risks to the institution and the ability of management to identify, measure, monitor, and control these risks. ... The types and quantity of risk inherent in an institution's activities will determine the extent to which it may be necessary to maintain capital at levels above required regulatory minimums ....

OSMO’s analysis showed that, at that time, SLMA was undercapitalized from a risk-based perspective, and the projected balance sheets in the 2000 plan would result in further undercapitalization if left unchanged. The following graph depicts the relative level of the GSE’s, and the holding company’s, risk-based capital at that time, compared to other financial institutions and one of its peer student loan companies. The categories signifying the adequacy of the capitalization are taken from the agencies’ prompt corrective action regulations.



While the 2000 plan projected that SLMA would comply with the minimum statutory

<sup>163</sup> The Comptroller of the Currency (OCC), the Federal Reserve Board (Fed), the Federal Deposit Insurance Corporation (FDIC) and the Office of Thrift Supervision (OTS).

equity to assets, or leverage ratio, it ignored the GSE's increasing risk profile that resulted from the planned changes in asset composition. Specifically, management planned to significantly increase the GSE's unsecured private education loans and interest-only residual assets during the wind down. Given a shift to higher risk assets, the risk-based capital position would continue to deteriorate, other things being equal.

Based on its analysis, OSMO concluded that the minimum statutory capital ratio was insufficient by itself, from a risk-based perspective, to ensure the safety and soundness of the GSE as the wind down progressed. OSMO further concluded that projected capital levels based on risk for SLMA during the wind down period could put the financial safety and soundness of the GSE at risk.

### **Preferred Stock Issue**

The analysis of SLMA's capital was further complicated by \$214 million of redeemable preferred stock that SLMA had issued. The stock was held by outside investors (not the holding company), and under law it had to be redeemed at par upon SLMA's dissolution. Management included this preferred stock as capital in its projected capital ratio.

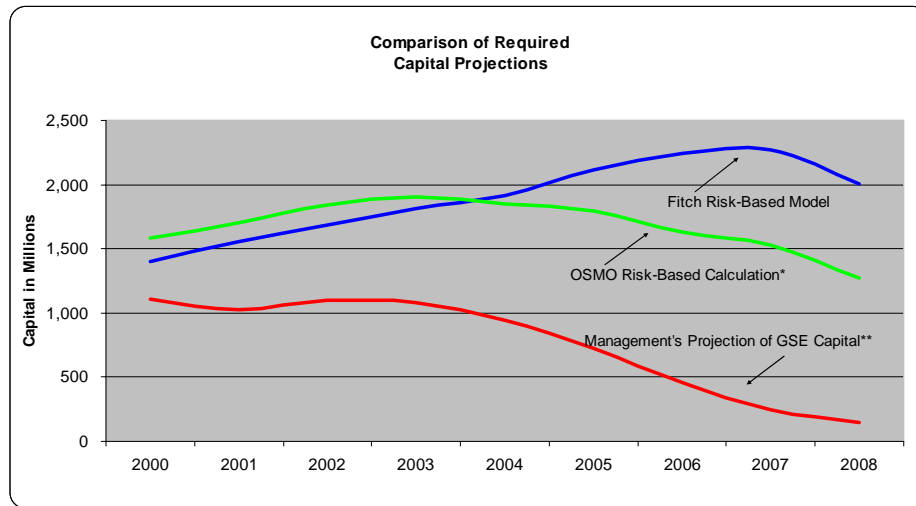
OSMO analyzed the preferred stock and concluded that, given the mandatory redemption by a specific date, it resembled subordinated debt rather than equity and should not be included in the measurement of capital. Given the mandatory redemption, it did not serve the purpose of being available as capital to absorb unexpected losses. Further, since the overall equity account would shrink as the GSE shrank, allowing this preferred stock to count as capital would have eventually resulted in the preferred stock being the only capital needed to meet the statutory leverage ratio late in the wind down. That is, the required leverage capital late in the wind down was projected to be less than the preferred stock. Excluding the preferred stock from the capital calculation, of course, exacerbated the risk-based capital shortfall.

### **Disagreement over Risk-Based Capital**

Management's wind down plan at that time (the 2000 Plan) did not provide any of its own analysis of SLMA's capital adequacy based on risk. OSMO presented its analysis and suggested that management review each of its assets and provide its own definitive calculation of capital under the Basel Accord or another relevant risk-based standard. Management declined, citing the statutory leverage ratio as the only relevant measure. Management disagreed with OSMO's conclusions regarding capital, taking the position that it was "inappropriate" for OSMO to apply any capital standard other than the minimum statutory leverage ratio.

OSMO communicated its conclusions to SLMA's board of directors in its 2001 Report of Examination. In response, SLMA's board of directors acknowledged that risk-based capital analysis was a "useful tool in assessing overall safety and soundness" of SLMA. The board requested that Treasury work with management and the board's audit committee to develop an agreed upon analytical framework for risk-based capital, taking into account the unique nature of the wind down.

During the summer and early fall of 2001 OSMO met with SLMA management and members of the board's audit committee to reach a consensus on an appropriate measure of capital based on risk. Progress was slow and faltering. In addition to its analysis under the Basel standard, OSMO developed a risk-based capital analysis using a model developed by Fitch Ratings.<sup>164</sup> As illustrated below, the Fitch model, too, showed SLMA as undercapitalized, both currently and as forecast.



Management continued to insist that only the minimum statutory leverage standard was relevant and declined to perform internal risk-based analysis of its own. OSMO's position was that if management did not provide an appropriate capital analysis that supported its argument, OSMO would look to established industry and regulatory standards.

Discussions ultimately culminated in a meeting between SLMA's senior management and members of its board of directors, and senior Treasury officials on October 5, 2001. At that time, Treasury made clear its view that SLMA was undercapitalized, given its increasing risk, and directed SLMA to provide an acceptable plan to correct the undercapitalization by November 5, 2001. In the event that an agreement could not be reached by then, Treasury made it clear that it would fulfill its obligation to report to Congress on what it considered an unsafe and unsound practice at SLMA.

A flurry of activity by SLMA management ensued, and ultimately SLMA agreed to meet a risk-based capital standard for the balance of the wind down that was acceptable to Treasury.<sup>165</sup> This standard was incorporated into the January 2002 wind down plan, discussed in the previous section that SLMA's board of directors adopted. SLMA agreed to certify to Treasury quarterly, prior to any dividend being paid, that the standard was being met and would continue to be met if a dividend was paid to the holding company.

<sup>164</sup> NRSRO - Nationally Recognized Statistical Ratings Organization, a designation assigned by the SEC. Fitch is one of three NRSROs that assign ratings to debt issued by public companies.

<sup>165</sup> The agreed upon standard was that SLMA would meet the Tier 1 risk-based capital standard of 4%, required by the Federal banking regulatory agencies.

SLMA quickly came into compliance with the risk-based standard by shifting many of its riskier assets (private credit loans, leveraged leases, and interest only residuals) to the holding company and retaining several quarters' earnings rather than paying dividend payments to the holding company. The agreement did not require the GSE or the holding company to issue any new equity.

### **Effect of Risk-Based Capital Standard**

The practical effect of the agreement was a shift of risk away from the GSE and toward its fully private affiliates. This shift provided additional transparency to investors, serving to impose the discipline of the market on the holding company as investors and debt rating agencies tended to scrutinize the holding company's financial statements more closely than the GSE's. It also forced considerably more discipline into the wind down planning process, in that management now had to systematically plan to start financing the riskier assets with non-GSE debt instead of deferring this activity until late in the wind down. The GSE continued to comply with this agreement throughout the wind down, and became increasingly well capitalized from a risk-based perspective through dissolution.

### **B. Liquidity**

During the wind down, OSMO monitored the overall liquidity of the company as the GSE was phased out. The "liquidity" of a financial institution is generally defined as "the ability of a company to meet its short-term obligations, to convert assets into cash or obtain cash, or to roll-over or issue new short-term debt."<sup>166</sup> The wind down of SLMA depended on developing liquidity at the private holding company so it could consistently raise funds independent of the GSE to refinance the existing assets and fund ongoing operations and growth.

Ultimately, the holding company was successful in raising the necessary funds without a large adverse impact on overall funding costs, as discussed in the previous chapter, but there were lapses along the way. The initial financing concept for the privatization was that securitizing student loans would largely "replace" GSE funding. However, securitization alone would not meet all of the company's funding needs. For example, a securitization generally must be of sufficient size (say \$1 billion) to get efficient execution in the market. This means that a company must have the capacity to fund, on its books, a fairly significant pipeline of loans to feed its securitization vehicle. Further, disruptions in the securitization market can alter the timing of securitization activity, requiring additional on-balance sheet funding flexibility. The 1998 Russian bond crisis, which occurred early in the wind down, demonstrated this point.

### **Russian Bond Crisis**

In late summer 1998, the Russian government was nearing default on some of its debt. This followed financial crises in several East Asian economies. Market participants were concerned about "contagion" in other sovereign securities and fled to the safety of U.S. Treasury securities. This drove up the price of Treasuries relative to other classes of

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<sup>166</sup> From the Federal Reserve's *Bank Holding Company Supervision Manual*. Short-term debt is considered to be debt maturing in a year or less.

securities (driving down the yield on Treasuries), which caused a widening of credit spreads. This widening of credit spreads adversely affected the economics of student loan securitizations and brought SLMA's ABS transactions to a halt for a full year. Initially, certificates issued by a student loan trust generally paid a floating rate of interest based on 91 day Treasury bills, which was effectively the same as the underlying student loan pool.<sup>167</sup> To the extent that investors in the ABS certificates were funding their investments with Libor-based funding they would be subject to what is known as "basis" risk. If the spread between the two indices (the so-called TED<sup>168</sup> spread) widened, the ABS certificates would offer relatively lower yields, increasing the risk to the certificate holders. This risk was often managed in ABS transactions using basis swaps.

Before the Russian bond crisis, this risk was considered manageable, given the historical relationship between T-bill and Libor rates. Following the Russian bond crisis, investors began demanding a higher premium to accept the risk. Alternatively, it cost the issuer more to hedge this risk out of the transaction (the cost of basis swaps increased). These events made it more expensive for SLMA to securitize student loans, effectively foreclosing this option for a period of time. After a year of issuing no ABS, SLMA reentered the market with ABS securities that had an increasing share of the tranches indexed to LIBOR, which was more attractive to investors and cheaper to hedge. This change however, reallocated the basis risk in the transaction, shifting more of it to the trust or the issuer.

Ultimately, the TED spread issue with student loans was solved by a legislative change to the program that was championed by lenders. The yield that lenders were guaranteed to receive on FFELP loans was changed, effective January 1, 2000, from a floating rate based on T-bills to a floating rate based on commercial paper. This "fix" still left some basis risk in a securitization transaction, in that the student loan assets now paid a commercial paper based floating rate, while ABS certificates paid a floating rate based on Libor. However, the basis risk in the transaction was significantly reduced since the spread between commercial paper and Libor is historically very stable, and was easier and cheaper to hedge.

The student loan ABS market overcame the events of late 1998 and continued to develop in the early 2000s, becoming increasingly stable and liquid. SLM Corp enjoyed market recognition as the benchmark issuer in the sector, as its student loan ABS were the most desirable to investors. Sallie Mae's ABS therefore priced slightly better than its competitors, largely due to name recognition among investors and the company's reputation for quality servicing of the underlying loan pools. As the securitization market developed, management focused on developing a variety of other funding sources to enhance liquidity.

### **Short Term Commercial Paper**

One of the first sources of stand alone liquidity for the holding company was a

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<sup>167</sup> Differences between the two in a falling rate environment only strengthened the transaction and worked to the issuer's advantage. See discussion of "floor income."

<sup>168</sup> Treasury Eurodollar spread. Libor is the London Inter Bank Offer Rate.

commercial paper program supported by series of bank credit facilities. Early in the wind down the holding company relied heavily on this short term facility for its funding its loan origination activities. It would frequently sell overnight or other very short term commercial paper and then roll it over with investors at maturity. This strategy proved somewhat problematic following the events of September 11, 2001, when high levels of uncertainty among market participants caused reluctance to simply “rolling over” the company’s short term paper. The holding company lacked the liquidity to simply redeem all the outstanding commercial paper en masse on its own, and was reluctant to draw down the bank lines backing the commercial paper.

During this period, management of the company approached Treasury to explore using the GSE to temporarily fund holding company operations. Treasury objected to such a use of GSE funding, citing statutory prohibitions on the GSE extending credit to the holding company. Treasury further pointed out that the company had short term bank credit facilities specifically to provide a liquid backup to its commercial paper program. This arrangement was similar to other private sector issuers of commercial paper. Management viewed the market disruption as an extremely unusual event and sought to use the GSE benefit as a means of avoiding a potential liquidity issue in the holding company’s commercial paper program. After Treasury objected, management was able to work out a solution outside of the GSE and a liquidity disruption was averted.

### **Long Term Corporate Debt**

It was clear by this point in the wind down that longer term unsecured corporate debentures issued by the holding company would be a key part of the overall funding strategy. This meant that the holding company’s ability to achieve an investment grade credit rating,<sup>169</sup> independent of the GSE was important to a successful wind down. In 1999, the holding company sought such a rating and was assigned a single-A rating by the three major NRSROs, a rating it maintained throughout the wind down. Following the events of September 11<sup>th</sup>, management began to issue unsecured debentures in a more structured manner, staggering maturities over a significantly longer time horizon. While this was a more expensive funding strategy than rolling over short-term debt, it was essential to the company’s long term liquidity and stability.

While the holding company issued significant amounts of unsecured corporate debt in 2003 and 2004, its primary source of liquidity for funding student loans remained the student loan ABS market. During 2003 the consolidated company issued \$31 billion of ABS, and through July 2004 issued another \$20 billion. In 2004 the company also launched a \$5 billion asset-backed commercial paper program through a syndicate of banks, providing another source of liquidity.

### **Student Loan Asset**

A positive factor contributing to SLM Corp’s liquidity was the fact that its primary asset was the government guaranteed student loan, which is considered low risk and liquid by the market. This not only aided in developing securitization, but also was a significant

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<sup>169</sup> Ratings from the NRSROs of BBB or higher are generally considered “investment grade,” as opposed to ratings of BB or lower, which are considered “junk” bond ratings.

factor in the rating agencies' consideration of SLM Corp's credit standing.<sup>170</sup> Even though the company was relinquishing its GSE status, the government guarantee on its primary asset, the Federal student loan, remained unchanged.

As the percentage of SLM Corp's funding taking place outside of the GSE grew, its overall funding costs increased moderately. However, the increase in cost of funds was manageable, and over time converged with SLM Corp's completely private peers. See Section III, Chapter 4 for a discussion of the impact of privatization on the overall company's cost of funds.

### C. The Need for Sound Internal Controls

Another important component of safety and soundness that OSMO found inadequate was the company's internal controls. The agencies define internal control as:

a process, brought about by an institution's board of directors, management and other personnel, designed to provide reasonable assurance that the institution will achieve the following internal control objectives: efficient and effective operations, including safeguarding of assets; reliable financial reporting; and, compliance with applicable laws and regulations.<sup>171</sup>

During its 2002 examination, OSMO found a pattern of noncompliance with statutory requirements for transactions between the GSE and its private affiliates.<sup>172</sup> The pattern of issues, and management's responses, led OSMO to conclude that systems of internal control were not functioning effectively. If internal control systems had been adequate they would have prevented, or at a minimum detected, the compliance issues. In particular, SLMA's internal audit function had not detected the statutory compliance issues.

A key part of a financial institution's internal control system is its internal audit function. When properly structured, the internal audit function can provide directors and senior management with vital information about weaknesses in the systems of internal controls so prompt remedial action can be taken.<sup>173</sup> High profile corporate failures resulting from poor internal controls, such as Enron and MCI WorldCom, make clear the importance of an effective, independent internal audit function.

OSMO found that SLMA's internal audit function was inadequate, in large part, because it wasn't organizationally independent. The internal audit function was outsourced to a third party that reported directly to SLMA's CFO. This internal audit arrangement did

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<sup>170</sup> See, Moody's Investors Service Global Credit Research Dec. 2003 analysis of SLM Corporation, p. 2; and Standard & Poor's Financial Institutions analysis of USA Education, Inc., Mar. 8, 2002, p.1.

<sup>171</sup> See the *Interagency Policy Statement on the Internal Audit Function and its Outsourcing* published Dec. 22, 1997 by the Fed. FDIC, OCC, and OTS.

<sup>172</sup> See OSMO's *2002 Report of Examination*, beginning on page 8.

<sup>173</sup> See the *Interagency Policy Statement on the Internal Audit Function and its Outsourcing*, published December 22, 1997 by the Fed. FDIC, OCC, and OTS.



not meet best practice standards for independence, as the CFO had significant operational responsibility for areas to be audited.

To assess SLMA's internal audit arrangement, OSMO looked to banking agency standards as well as to the Institute for Internal Auditors (the IIA), a widely recognized authority on internal audit.<sup>174</sup> Based on those standards, OSMO strongly recommended that the audit committee hire a full-time internal audit manager to oversee the internal audit contract in accordance with best practices. Given the size and complexity of the company and the compliance issues raised by OSMO, the benefit of an independent internal audit manager outweighed the costs. OSMO recommended that the internal auditor report functionally to the Audit Committee and only administratively to the CEO.

Management did not concur, stating that it believed its existing internal audit function was organizationally independent, but did not cite any authoritative guidance. The board of directors, however, saw the value of an independent internal audit manager and directed that one be hired. An internal audit manager was hired and given the appropriate reporting lines.

During this period, SLM Corp's external auditor, PriceWaterhouseCoopers (PWC), also noted numerous internal control weaknesses involving the company's financial reporting processes. This increased pressure on management and the board of directors to address internal control issues in a holistic way. The passage of the Sarbanes-Oxley Act in 2002, with its requirement that management certify certain internal controls by year end 2004, was also effective in convincing management that internal controls needed a comprehensive review. The process of documenting and remediating internal controls was undertaken and continued throughout the wind down.

#### **D. Board of Director Oversight/Corporate Governance**

The Higher Education Act required that SLMA's board of directors be composed of 21 persons, 7 appointed by the President of the United States, and the balance selected by the shareholders. The appointed directors served at the pleasure of the President. Upon reorganization in 1997, SLMA became a subsidiary of a holding company, SLM Corp, which had its own board consisting of 15 directors all elected by shareholders. SLM Corp, as the sole shareholder of SLMA, elected 14 of the GSE's 21 directors. Insiders came to refer to SLM Corp's board of directors as the "big board," and SLMA's board as the "little board," reflecting the fact that the company's overall strategy and policies were set by SLM Corp's board.

The GSE board could still set policy for the GSE, though, and retained control of dividend payments from the GSE to the holding company. Early in the wind down the

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<sup>174</sup> The IIA's view is that to achieve the necessary independence, the internal auditor "...should report functionally to the audit committee. For administrative purposes, in most circumstances, the [auditor manager] should report directly to the chief executive officer." The banking agencies' had reached similar conclusions. See the position paper presented to the U.S. Congress by the IIA, dated April 8, 2002, entitled *Recommendations for Improving Corporate Governance*.

GSE was the primary source of income for the holding company, so OSMO viewed the GSE board's control of the dividend as important. However, since the holding company elected two thirds of the GSE's board, the GSE board was not independent. The statute also provided that the President would designate the chairman of the GSE's board. This provided some measure of independence to the GSE's board, despite the fact that the holding company's elected directors were in the majority. At all times, at least three of the holding company board's 15 directors sat on the GSE's board as well. At no time did any of the presidential appointees to the GSE's board sit on the holding company board.

In 2001 following the change of the administration, all the presidential appointees were replaced. This kind of wholesale of change to a board can be more disruptive than a staggered approach, as a full third of the new board has no background with the board.

#### **E. Financial Reporting and Disclosure**

Upon reorganizing the company in 1997, the newly created state chartered holding company registered its stock with the SEC, triggering certain reporting requirements. The GSE subsidiary remained exempt by statute from SEC registration and disclosure requirements, as it had been since its creation. Although the consolidated financial statements incorporated all of the activity of the GSE, it was not possible for a user to determine what business was taking place inside the GSE and what was a purely private activity. Prior to the reorganization, management had posted GSE-only supplemental statements on its website, but these were often not posted in a timely way and their content was not necessarily consistent with SEC registrant disclosures. After reorganization, management continued to post these statements on Sallie Mae's web site.

In its 2001 examination OSMO raised the issue of untimely and inadequate GSE disclosures with management and the board of directors. OSMO found that management had repeatedly failed to release timely public financial statements for SLMA, and that SLMA lacked a formal, board-approved policy for public disclosure of its financial condition and performance. OSMO made two recommendations: (1) the board adopt a policy specifically addressing the timeliness of SLMA's public disclosures, and (2) management and the board should address the content of public disclosure, as the wind down was significantly altering the makeup of SLMA's balance sheet. OSMO expressed its view that timely and accurate public disclosures of information can play a role in creating and maintaining market discipline. Management acknowledged that in certain instances it had not provided timely financial disclosures, and agreed to implement new procedures and address staffing issues to improve the timeliness.

A year later, management had not fixed the problems. OSMO argued that SLMA had a responsibility to ensure the timely release of financial information to the public, especially because of the increasing differences between the holding company's financials and those of SLMA, resulting from the phase-out of the GSE.

Meanwhile, the Bush Administration was making public its view on GSE disclosures generally. During testimony before a Congressional subcommittee on July 16, 2002, Treasury's Undersecretary for Domestic Finance Peter Fisher testified, "The

Administration believes that all GSEs should comply with the same corporate disclosure requirements of the Securities Exchange Act of 1934, as interpreted and applied by the Securities and Exchange Commission.” The Administration took this position because it would subject the financial disclosures of the GSEs to SEC staff review, and because the SEC serves as the central repository of public financial reports. The Administration’s view was that GSEs should serve as role models for good public disclosures, not as exceptions to the rules.

On August 21, 2002, in a separate letter from Undersecretary Fisher, Treasury recommended that SLMA enter into an agreement with the SEC and OSMO to voluntarily register under section 12(g) of the Securities Exchange Act of 1934, or otherwise voluntarily file reports with the SEC.

The holding company’s board adopted a resolution on March 19, 2003, to include the financial statements of SLMA as an appendix to the holding company reports filed with the SEC. Beginning with the Form 10-K for 2002, the holding company began including this appendix with all its Forms 10-K and 10-Q. This was satisfactory to OSMO as it ensured timely GSE disclosures that were subject to SEC scrutiny and maintained in a central repository for financial statements. Upon dissolution of the GSE in December 2004, management of SLM Corp initially resisted filing the GSE’s final financial statements with the SEC, but eventually agreed to submit them to the SEC on a form 8K. OSMO viewed the final filing as important since GSE bonds were still outstanding in the defeasance trust, and such a filing would set a sound precedent of public financial disclosure for a GSE’s closing statements.

## **F. Treasury Enforcement Authority**

Through the Privatization Act Congress strengthened Treasury’s oversight authority and gave it limited authority to assess the cost to SLMA. This led to the creation of the Office of Sallie Mae Oversight in 1997 and the more formal oversight program. The statute did not, however, provide full enforcement powers. Treasury’s tools were limited to moral suasion, reporting to Congress, or taking SLMA to court if Treasury found SLMA had violated certain statutory provisions.

Traditional regulatory tools, including cease and desist authority, monetary penalties, management removal, would have enabled Treasury to carry out its oversight responsibilities more effectively. As detailed earlier in this section, SLM Corp often interpreted provisions of the Privatization Act to its benefit. Treasury was hampered in enforcing its interpretation of these provisions because of weak enforcement powers. Further, SLM Corp’s management at times challenged Treasury’s statutory right to obtain certain information and Treasury had difficulty in enforcing the delivery of information. More traditional, comprehensive enforcement powers would have been useful in these situations, enabling Treasury to carry out its oversight responsibilities more effectively.

### Summary of Safety and Soundness Lessons Learned

- GSE regulators should have the full range of enforcement powers.
- A prudent, well-defined plan is critical to winding down a GSE.
- The regulator must have clear authority to apply prudent capital standards.
- Financial reports and disclosures based on GAAP are important.
- Sound lines of communication with the board of directors must be established.
- Non-GSE liquidity development is critical in a wind down scenario and should be pursued and monitored early in the process. Contingency planning is necessary.
- GSEs should conform to best practices in developing internal control.
- In the absence of specific rules (i.e., capital), best practices in large financial institutions provide a reasonable benchmark to assess a GSE's operations.

## **SECTION IV – GSE Mission and Policy Discussions**

**Chapter 1 – Objectives, Successes and Failures**

**Chapter 2 – Public Interest Directors**

**Chapter 3 – Capital Policy**

**Chapter 4 – Market-Granted Subsidy**

**Chapter 5 – GSE Sunsets and Exits**



## Chapter 1 – Objectives, Successes and Failures

*“Trying to plan for the future without knowing the past is like trying to plant cut flowers.”* Daniel Boorstin, historian.

Understanding and applying lessons regarding how SLMA’s mission was established and carried out is important and practical to future GSE legislation and regulation. The ultimate dissolution of the SLMA charter, via a privatization process, was recognition that the public policy purpose for this GSE was no longer compelling. GSEs differ from both Federal agencies and private companies in that although they are created by Federal statute generally to fill some unmet need in the credit market and although they are instruments of Federal policy, they are owned and managed by the private sector. As such, SLMA’s board and management had a fiduciary duty to shareholders.

### Scope of Mission Discussion

In our review, we ask why the full privatization of Sallie Mae was appropriate public policy, and why using a GSE to direct capital to the education market is no longer a desirable public policy. The answers to these questions can support positions that either SLMA accomplished what was intended, its purpose became obsolete because of business and technology advances, or that Congress was acting to correct unintended consequences created by the SLMA charter.

This chapter discusses the objectives, successes and failures of what Congress intended when it established Sallie Mae and later expanded both its powers and its mission. It asks whether Sallie Mae accomplished its mission and what the consequences are for the secondary market for education related credit. It addresses the question of how well the GSE stayed within its legislative, mission-related limits. Finally, this chapter looks at the larger issue of the inherent conflict between the GSE’s need to drive value to shareholders versus its role as a tool of public policy.<sup>175</sup>

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<sup>175</sup> Section III, chapter 5 discusses mission-related issues encountered during safety and soundness examinations conducted by Treasury.

## Part 1. Reasons for Establishing and Modifying Sallie Mae

Stated Purpose for Creating SLMA To evaluate the mission of a GSE like SLMA, it is important to understand why Congress created such an entity and what powers Congress provided the entity to accomplish its purpose. Congress created SLMA in 1972 to provide liquidity to the higher education credit markets by making a secondary market in federally insured higher education student loans, and to enhance facilities credit to higher education institutions. Congress said its purpose in passing this legislation was:

to establish a private corporation which will be financed by private capital and which will serve as a secondary market and warehousing facility for student loans, including loans which are insured by the Secretary under this part or by a guaranty agency, and which will provide liquidity for student loan investments.<sup>176</sup>

Congress added that “In carrying out all such [authorized] activities the purpose shall always be to provide secondary market and other support for lending programs offered by other organizations and not to replace or compete with such other programs.”<sup>177</sup> In practice, this generally was taken to mean that Sallie Mae was not allowed to originate loans.

Beyond this stated purpose, Congress also demonstrated its intent and concerns throughout the legislative history, in the powers it granted and withdrew from the GSE, its level of oversight, and by the GSE structure itself.

Expansion In 1981, Congress effectively expanded Sallie Mae’s powers by authorizing the company to deal in non-insured loans, and to undertake other activities deemed necessary by the board to support the credit needs of students.<sup>178</sup> The “other activities” language in particular was very broad and Sallie Mae interpreted it to include a range of activities very different from providing liquidity to the secondary market for student loans.<sup>179</sup>

Restrictions In 1986, Congress pulled backed on Sallie Mae’s broad authority to undertake “any activity” by stating that Sallie Mae was not authorized to “acquire, own, operate, or control any bank, savings and loan association, savings bank or credit union.”<sup>180</sup> Later, in the legislation to privatize Sallie Mae, Congress was careful to restrict extensions of credit from the GSE to non-GSE affiliates, among other things.<sup>181</sup>

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<sup>176</sup> 20 U.S.C. 1087-(a).

<sup>177</sup> 20 U.S.C. 1087-2 (d)(1)(E)(i).

<sup>178</sup> Pub. L. No. 97-35; 20 U.S.C. 1087-2(d)(1)(E).

<sup>179</sup> An example is the GSE’s investments in commercial aircraft leases, which is noted later in this chapter. Based on disclosures made, Sallie Mae implied that if investment activity profited the company it could be deemed to support education.

<sup>180</sup> Pub.L. No 99-498; 20 U.S.C 1087-2(d)(1)(E)(ii).

<sup>181</sup> Privatization Act of 1996; 20 U.S.C. 1087-3 (c)(8)(C)((vii).



Lender of Last Resort An important public purpose of Sallie Mae was to act as a “lender of last resort,” making loans to borrowers whenever the Secretary of Education determined that borrowers “are seeking and are unable to obtain [FFELP] loans.”<sup>182</sup> Congress provided powers to the Secretary of Education to ensure enforcement of this provision. If the Secretary determined that the GSE had substantially failed to comply with the lender of last resort provision then it could more than triple certain fees that SLMA was required to pay to the Department of Education.<sup>183</sup>

Limited Oversight and Enforcement of Mission Other than providing the Department of Education lender-of-last-resort enforcement powers, for many years Congress did not authorize any Federal agency to oversee Sallie Mae’s mission or business operations.<sup>184</sup> In 1992, after the savings and loan crisis, Congress authorized Education and Treasury to enforce safety and soundness requirements such as statutory capital adequacy by requesting that the Attorney General bring an action for enforcement in Federal court.<sup>185</sup> Congress did not give Treasury or Education the broad powers that Federal regulators of depository institutions and the other GSEs held.

Public Interest Directors The Higher Education Act required that SLMA’s board of directors be composed of 21 persons, 14 selected by the shareholders and seven appointed by the President to “be representative of the general public.” Presumably Congress provided presidentially appointed directors to help balance the company’s profit-seeking motives with the spirit of its GSE mission.<sup>186</sup> The role and experience of the appointed directors is discussed further in the next chapter.

#### Divided Views on Missions

*People have only the foggiest notion of what GSEs are about.*<sup>187</sup>

It is challenging to precisely discern Congress’ purpose for establishing SLMA and the other GSEs.<sup>188</sup> SLMA’s mission went beyond the stated purposes in the enabling legislation. It was expanded by Congress to support the credit needs of students, to purchase non-federally guaranteed loans and to deal in construction loans for higher

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<sup>182</sup> 20 U.S.C. 1087-2(q).

<sup>183</sup> 20 U.S.C. 1087-2(h)(7)(B). This was the “offset fee,” normally 30 basis points, assessed on Sallie Mae’s portfolio of certain categories of federally guaranteed student loans.

<sup>184</sup> Congress retained some oversight for itself, requiring SLMA to send it written plans 30 days before it intended to undertake “other activities.” 20 U.S.C. 1087-2(d)(1)(E)(iii). OSMO is not aware of any plans ever submitted to Congress by SLMA. This provision was superseded by provisions in the 1996 SLMA Privatization Act. See 20 U.S.C. 1087-3(c)(6).

<sup>185</sup> 20 U.S.C. 1087-2(r)(13). In 1996, Congress added a similar provision with regards to wind down requirements. 20 U.S.C. 1087-3(g).

<sup>186</sup> 20 U.S.C. 1087-2(c).

<sup>187</sup> Shin, A, *Freddie Mac Feathers Ad Campaign With an Egg*, Washington Post, Aug. 29, 2005, quoting Bruce Haynes, advertising consultant to Freddie Mae.

<sup>188</sup> “The announced goals of a policy are sometimes unrelated or perversely related to its actual effects, and the truly intended effects should be deduced from the actual effects.” George J. Stigler, *The Theory of Economic Regulation*, 1975.

education facilities.<sup>189</sup> The opaqueness of Congressional intent has made it easy for the GSEs themselves to put their own spin on what their missions are.

Differing views on how GSEs should be used can cloud the discussion regarding the mission of a particular GSE. The view that a GSE is a privileged, but restricted, corporation chartered to bring stability to a targeted secondary credit market has often been reframed, sometimes by the GSEs themselves, to depict a broader mission.<sup>190</sup>

Broad or Narrow Purpose? As the primary GSE mission, to provide a secondary market, has been accomplished and numerous large-scale non-GSE institutions participate in the securitization market, the role of the GSE privileges become further blurred. Whether supporting another specialized lender, as opposed to developing a viable secondary market, constitutes a meaningful public purpose is something that Congress should carefully consider.

SLMA is a GSE that has now experienced a full life cycle. The answer to the question of when full privatization became appropriate depends upon the view of SLMA's original mission. If Sallie Mae's mission was very broad, for example, "to expand education credit," full privatization might never be deemed appropriate. On the other hand, if one sees Sallie Mae's mission as narrower, that Sallie Mae was meant to provide "seed money" to get the secondary market for educational loans up and running, full privatization of Sallie Mae may have been overdue. The secondary market for student loans had been functioning for years by the time Sallie Mae became private. Sallie Mae's privatization, or "normalization," may have been appropriate by 1990 when: (1) SLMA held half of the outstanding federally insured student loans, (2) increased efficiency in the student loan market reduced or eliminated the need for a GSE to support this market, and (3) SLMA was using a \$5 billion long-term loan from Treasury's Federal Financing Bank to compete with other student loan purchasers.<sup>191</sup>

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<sup>189</sup> 20 U.S.C. 1087-2(d)(1).

<sup>190</sup> For example, in an advertising campaign in 2005 Freddie Mac claimed that its mission is to "keep interest rates stable and low." Freddie Mac provided this message in a web cast and it has been taken up by Wikipedia, an online dictionary, which describes the GSEs' function, "to reduce interest rates for specific borrowing sectors of the economy, students, farmers, and homeowners."

The idea that a GSE's purpose is "to reduce interest rates" does not stem from any actual legislation, and is in conflict with the monetary policy role of the U.S. central banker, the Federal Reserve. Often missing from the GSE public relations efforts is the Congressional mandate that GSEs not compete against other companies that originate credit but do not have the GSE's privileges.

<sup>191</sup> SLMA's market share in the student loan market and its borrowing from the Federal Financial Bank is discussed in Section II.

## Part 2. Did Sallie Mae Accomplish the Legislative Intent for Establishing It?

*Sallie Mae ... has accomplished its mission. For all intents and purposes, Sallie Mae has conducted itself as a fully private corporation for the past decade or more.* Lawrence A. Hough, SLMA's CEO, May 3, 1995<sup>192</sup>

By 1996, there was a broad consensus that a GSE was no longer needed to fill the role for which Sallie Mae was created. SLMA testified to Congress that an effective private-sector secondary market had developed for FFELP loans, with at least 42 secondary markets and a number of banks who actively purchase loans from other lenders. This is consistent with OSMO's research. While Sallie Mae held 33 percent of student loans in 1995, the market share held by state-chartered entities that specialized in secondary market support was 19 percent. The top five banks held 16 percent.

Separately, a significant development in the market was the advent of asset-backed securities (ABS). Student loan ABS issuers tap many of the same capital market investors that support the annual securitization of tens of billions of dollars in credit card, automobile, and mortgage loans. The ABS market provides student loan lenders significant access to the capital markets, and thereby a diversification of funding sources, without the use of a GSE. When Treasury testified in support of the SLMA Privatization legislation in 1994 it agreed that the Sallie Mae mission had been accomplished.

GSEs Successes - The GSEs contributed importantly to the development of business processes and technology, particularly securitization and hedging techniques, which made the SLMA charter obsolete. For example, Sallie Mae was a pioneer in managing interest rate risk, and was a party to the first interest rate swap in 1981. The first pass-through mortgage-backed security was brought to market by Ginnie Mae (a government-owned corporation). In 1983, Freddie Mac, a GSE, widened the access to the capital markets by issuing the first collateralized mortgage obligation with structured tranches. Because of these developments, financial institutions in the U.S. now have broad access to the liquidity of world capital markets.

Major changes have occurred, however, since SLMA was created and even since the 1996 Privatization Act. In particular, technological innovations in risk and information management, global communications by internet, common electronic records, and the evolution of corporate governance practices have altered the business environment for all companies. Increased capital flows are providing more efficient sources of credit in the financial markets at both the consumer and wholesale level.

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<sup>192</sup> Joint Hearing of the House 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, May 3, 1995.

Sallie Mae's history in funding higher education<sup>193</sup> as a GSE, the market's development of alternatives to SLMA, and the transformation of SLMA to a fully private-sector corporation are measures of the full life cycle of a GSE, and a successful public policy.

**Lesson Learned:**

The Sallie Mae legislation, including the full privatization of Sallie Mae, was appropriate public policy based on what has ultimately become a fully private secondary student loan market sustained by a robust mix of players who now operate without a GSE. Market discipline with respect to Sallie Mae's non-GSE private-sector successor, SLM Corporation, has been improved.

However, also relevant to the evaluation of mission are Sallie Mae's investments in non-mission related assets (e.g., commercial aircraft leases), whether Sallie Mae competed with education-related lending programs offered by other organizations, and whether the GSE status was used to generate what amounted to arbitrage profits. These shortcomings are discussed in next two parts of this chapter.

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<sup>193</sup> SLMA privatization experience, while facilitated by government guaranteed loans, is not unique to student loans and could potentially be applied to other underlying assets as discussed further in Section II, Chapter 1.

### Part 3. Containing the GSE within its Mission Limitations

#### Questionable Mission Activities

Commercial Aircraft Leases In the 1980s, Sallie Mae began investing in commercial aircraft and other equipment leases known as “leveraged leases.” SLMA facilitated the long-term financing of over \$1 billion of commercial assets, including rail cars, offshore drilling rigs, satellite transponders, hydro-electric plants, and commercial aircraft through leveraged lease arrangements.<sup>194</sup> In a leveraged lease arrangement, equity investors like SLMA have concentrated credit exposure. This type of investment activity appeared to fall outside of the GSE mission to serve the education credit market.

Was Sallie Mae’s long-term funding of dozens of commercial aircraft leases non-mission activity? Was it an abuse of the GSE funding privilege – an example of corporate welfare? Sallie Mae argued that those investments were in the category of “other activities” to support the credit needs of students. The leveraged lease example illustrates the difficulty of holding the GSE accountable to a mission that is not clearly defined in its governing statute.

GSE Status Arbitrage In the 1990s, GSEs came to be viewed as preferred counterparties in the over-the-counter (OTC) derivative market. Their counterparty attributes were somewhat similar to those of a creditworthy broker-dealer or an exchange. SLMA and other GSEs entered into structured note transactions and profited via “spreads” in offsetting derivative positions. Like a prudent broker-dealer or exchange, SLMA balanced its trading book of embedded derivatives and stand-alone derivatives (i.e., its “long positions” were offset by its “short positions”). It profited from this activity by making a small spread (5 to 30 basis points) on billions of dollars in notional amounts of derivatives, as opposed to taking a speculative position.<sup>195</sup> In effect SLMA and other GSEs benefited from the superiority of their AAA credit rating versus that of their financial counterparties.<sup>196</sup> This was essentially an arbitrage of the GSEs’ credit ratings.<sup>197</sup>

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<sup>194</sup> SLMA began investing in commercial leveraged leases in the early 1980’s and ceased new activity in 1994.

<sup>195</sup> See Section II, Chapter 2 for additional discussion of structured note transactions.

<sup>196</sup> Structured notes received wide public attention after Orange County, California took losses on investments in them in 1994. Other examples of GSE status arbitrage include the FHLBanks in 1997, which were counterparty to the equivalent of approximately \$80 billion of long and short call options via structured notes and embedded swaps. While not transparent in its financial statements, it appears that Freddie Mac also engaged in GSE status arbitrage. In 2001, Freddie Mac’s derivative position doubled in nine months; it had \$1.1 trillion of derivatives when it held a mortgage portfolio of only \$0.5 trillion as of September 30, 2001. As of December 31, 2001, the notional amount of interest-rate swaps where Freddie Mac received a fixed rate and paid a variable rate increased to \$187 billion (versus a near zero amount prior to 2000). This swap activity is noteworthy not only for its sudden appearance but because these swaps could not hedge the fixed-rate mortgages that Freddie held. It appears these swaps were economically matched to other derivatives and Freddie Mac profited via the “spreads” in the offsetting derivative positions.

<sup>197</sup> Despite economic hedges, this activity is not entirely risk-free. While generally viewed as manageable, the GSEs are exposed to credit risk from the possibility that a counterparty to a stand-alone derivative could fail to perform. In general, this risk is managed by taking collateral and other operational procedures.

Was SLMA's structured note transactions non-mission activity or an incidental activity that supported education? This and other types of GSE status arbitrage activity appears to fall outside of SLMA's mission to serve the education credit market and demonstrates that a GSE, in order to drive value to shareholders, can expand its activities into those that only serve as profit makers.

### **Private-Sector Relationship Issues**

Unfair Competition Claims SLMA's competitors made an ongoing effort to hold SLMA accountable to the legislative decree that SLMA's "purpose shall always be to provide secondary market and other support for lending programs offered by other organizations and not to replace or compete with such other programs."<sup>198</sup> College Loan Corporation complained that SLMA used its privileged position to compete against it (see Section II, Chapter 1, New Private-Sector Competitors). In 2000 Citibank made similar claims to Treasury with regard to a SLMA acquisition.

OSMO raised a similar mission issue during its 2002 examination. It questioned whether SLMA was honoring the restriction against its being in the primary versus secondary market when it acquired certain private student loans. Based on its examination of SLMA's relationship with its funding bank partners, OSMO concluded that SLMA, in substance, was originating certain private loans. The funding banks did not take long-term possession of the notes signed by the student borrowers, nor did they assume the credit risk associated with the notes. The GSE unconditionally purchased the notes, generally within a month, even in case of the borrower's death. Further, the economic substance of the payments by SLMA to the funding banks reflected loan origination activity via a "storefront" rather than secondary market activity.<sup>199</sup> Subsequent to the dissolution of the GSE, a former member of SLMA's management and board conceded that SLMA was in effect "originating loans for a long time," but defended the practice saying "There were a lot of reasons why it was appropriate," and he said "Congress was aware of it."<sup>200</sup>

During the GSE wind down period, OSMO's examination scope included testing for compliance with certain "firewall" provisions between the GSE and non-GSE affiliates which were permitted to enter into non-GSE lines of business. OSMO raised issues regarding compliance with the firewall provisions that are summarized in Section III, Chapter 5. OSMO's Examination Reports provide additional perspective on the difficulty of regulating a GSE's non-public purpose activities.<sup>201</sup>

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<sup>198</sup> 20 U.S.C. 1087-2 (d)(1)(E)(i)

<sup>199</sup> In a true secondary market, a bank would sell its asset into the secondary market (i.e., to Sallie Mae) at its fair value. However, in practice that was not how these loans "sold" to Sallie Mae were priced. The loans were sold to Sallie Mae by its "storefront banks" at cost plus interest during the holding period rather than at fair value. This was, in effect, origination by SLMA.

<sup>200</sup> Interview with Edward Fox, October 13, 2005.

<sup>201</sup> A noteworthy "fire wall" issue is documented in OSMO Examination Report, September 2002, page 10. "Origination versus Secondary Market Activity." In 1998, after extensive discussions and documentation management represented that loans originated by non-GSE affiliates during the GSE wind down period would not be sold to the GSE. It undermines the statutory restriction on loans originated by the GSE, if a

Enforcement Difficulties During Sallie Mae’s life as a GSE there was a continuing difficulty when it came to enforcing mission principles and public policy aspirations. It is difficult to restrict the activity of a stockholder-owned company. SLMA’s management was pressured by market realities to attract investors to the GSE’s bonds and equity securities. The lack of mission activity regulation and the lack of even a consensus on what are permitted GSE activities made addressing the non-mission activity issue problematic. Many assets and intermediation activities are safe and sound from a financial point of view, but only some are consistent with the GSE mission.

GSE principles and aspirations must be accompanied by enforceable law if Congress wants to seriously commit the GSE to limitations. The purposes of the GSE limitations, however, are important to ensure that private profit-making motives do not overwhelm the public benefits. To prevent the original reason for creating any GSE from eventually becoming obsolete, Congress could prescribe the public purpose of the GSE in specific terms. This would enable regulators to appropriately contain mission expansion during the GSE’s life.

**Lesson Learned:**

GSE legislation should include workable mechanisms to hold the GSE accountable to its mission. Such mechanisms should make clear who is responsible for determining if a given activity is mission-related and should provide enforcement authority. GSE history, however, invites speculation on how well a meaningful containment mechanism can be implemented.

The GSE Monitoring Challenge Privatization ultimately resolved the problem of mission limitations for Sallie Mae. If a GSE is to remain a GSE indefinitely, a challenge is developing a regulatory mechanism that can detect and prevent inappropriate GSE mission expansion. It is also a challenge to ensure the independence of the GSE regulator. Treasury’s 1991 report on GSEs stated:

The problem of avoiding capture appears to be particularly acute in the case of regulation of GSEs. The principal GSEs are few in number; they have highly qualified staffs; they have strong support for their programs from special interest groups; and they have significant resources with which to influence political outcomes. ... even the most powerful and respected government agencies would find regulating such entities a challenge.<sup>202</sup>

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non-GSE affiliate originates loans and the GSE then purchases the loan. Nonetheless, OSMO subsequently found that the GSE had purchased loans originated by a non-GSE affiliate. In addition to the economic substance of the transactions, OSMO also cited that Sallie Mae had represented in SEC filings that this non-GSE affiliate “originates its loans.” While management ceased the activity and transferred the loans out of the GSE, it made a vexing claim about the origination activity in an August 30, 2002, response letter: “The term “origination” has many different meanings in the student loan industry.” Such a spin on the “mission” and “the meaning of origination” illustrates the challenge for regulators to restrain the use of non GSE funding benefits from those uses that only serve as profit makers.

<sup>202</sup> Treasury Report on Government-Sponsored Enterprises, April 1991, p. 8.

#### Part 4. Conflict – Shareholder Interest vs. Public Policy Interest

As SLMA brought stability and liquidity to the secondary market for student loans and as numerous institutions expanded that secondary market, SLMA began to reframe its public purpose role to include profit making itself as a public mission. SLMA characterized activities that appeared to be purely for-profit as activities that supported its public mission. In the late 1980s it ventured into commercial aircraft leases, as discussed previously. It disclosed to the public:

SLMA maintains a portfolio of tax-advantage assets principally to support education-related financing activities.<sup>203</sup>

The leasing transactions initially provided tax benefits and in short, they made economic sense to Sallie Mae, regardless of whether they carried out the GSE's public purpose. Based on Sallie Mae's history, it is clear that the interests of shareholders were most important.

#### Lesson Learned:

Shareholders' interests were more important to the business plan that Sallie Mae as a shareholder-owned entity set for itself than the GSE mission.

That an entity left to its own devices considers its self-interest first is not exactly a novel idea. Recognizing this fact helps to explain why it is such a challenge to use shareholder-owned GSEs to develop, implement and maintain public policy goals. While for-profit companies do well for shareholders by doing "good" for customers, their ultimate mission is corporate profits. The GSEs are no different.

GSE management knew that it served the company at the shareholders' pleasure, and knew the importance and duty of delivering growth to shareholders. "Since day one we have run this corporation as a business," said Edward Fox, Sallie Mae's first president and CEO.<sup>204</sup> He was even clearer about how management saw Sallie Mae's mission, saying, "Our duty is to shareholders and bondholders – not to subsidize education credit."<sup>205</sup> On the day of SLMA's dissolution as a GSE, CEO Albert L. Lord reflected that "In order for us to do what we do best required our mission to creep."<sup>206</sup>

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<sup>203</sup> Sallie Mae 1997 Information Statement, April 15, 1998, p. 16. It appears that not until 2001, when losses were incurred on the commercial aircraft leases, did Sallie Mae's financial statement disclose its leverage lease activities in a transparent fashion.

<sup>204</sup> Ross, Nancy L., "Sallie Mae Works A Risk-Free Arena," *Washington Post*, February 21, 1983.

<sup>205</sup> Mr. Fox made other similar statements 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, Aug. 12, 1982, p. 135.

<sup>206</sup> *Wall Street Journal*, Dec. 30, 2004.

Sallie Mae was not the only GSE to see Congress' public purposes as secondary. Freddie Mac's CEO Richard F. Syron noted that his company had not paid enough attention to the affordable housing mission and instead regarded it as a "tax" on what was otherwise "a profit-maximizing organization." Hilzenbath, David S., *Washington Post*, July 2, 2004.



SLMA's history demonstrates that a GSE, in order to drive value to shareholders, will expand its profitable activities. GSE benefits to shareholders are balanced against countervailing GSE costs, such as lost opportunities, regulatory overhead, and compliance with statutory provisions. GSEs strive to maximize return to shareholders and must weigh those economics. SLMA's history demonstrates that in order to drive value to shareholders it would also seek to shed the GSE charter when it perceives that its costs exceed its benefits.

GSEs - Ineffective Conduit of Federal Subsidy - Principle 1 There is a view that the GSEs are valuable as instruments of public policy because they subsidize a target credit by "reducing interest rates." This view needs examination. This view presumes that if a GSE's costs are low, the GSE will pass on its savings and borrowers will have lower cost loans. Private-sector companies' duties to shareholder and creditors are in conflict with such a "voluntary" mechanism to pass subsidy out of the company. Sallie Mae, as a GSE, firmly stated that its purpose was to drive value to stockholders, not to subsidize education.

An interview by George Will of General Motors Chairman and CEO, Rick Wagoner, illustrates the business realities of how a company sets its prices to consumers, and the separation of a company's costs and its product prices in the market place.

Q: ...people buying GM cars are paying a lot of money for a welfare state that you're running. Someone recently said you buy a Hyundai, they give you a satellite radio. You buy a General Motors car, or Ford, you're buying pensions, medical care and all the rest. That adds an enormous premium on the cost of a car.

A: That's really not true at all. Well, ***it adds to the cost. It doesn't add to the price. We price to the market.*** [Emphasis added]<sup>207</sup>

Suppose subsidies to the GSEs were increased by an exemption from all Federal taxes - what would happen? General Motors demonstrates that if only its costs rise, the company's shareholders lose - not the consumers. Likewise, if only the GSE subsidies increase, the company's shareholders win - it does not result in cash flows passing through to consumers. Principle 1 - the GSE subsidy is captured and controlled by the company. In short, it means that the GSE buys and hold loans that other institutions would have funded with similar terms.

GSEs - Ineffective Conduit of Federal Subsidy - Principle 2 To the extent that a GSE passes a portion of its subsidy out of the company by "reducing interest rates," its likely motivation is to increase its market share over private competitors that are not able to fully overcome the GSE's advantage. In this case, one policy question is, do the GSE advantages help to concentrate market power and risk without the usual discipline of market forces. This question is discussed in Chapters 3 and 4. A separate public policy question is does this passing of a portion of GSE subsidy help borrowers or sellers?

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<sup>207</sup> "This Week" (ABC News) on January 8, 2006.

Indeed, a seller-versus-borrower effect due to changes in interest rates is manifested in the rising prices in the housing market in general. On September 26, 2005, Federal Reserve Board Chairman Alan Greenspan stated “This enormous increase in housing values and mortgage debt has been spurred by the decline in mortgage interest rates, which remain historically low.”<sup>208</sup>

While a GSE may slightly lower interest rates for borrowers, one likely outcome is that the sellers (schools or the owners of the housing stock) increased their prices, and thereby captured the benefit for themselves.<sup>209</sup> Principle 2 - while lower interest rates are often thought to help the borrower, a resulting increase in prices can offset much or all of that benefit.<sup>210</sup>

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<sup>208</sup> Speech to the American Bankers Association Annual Convention, Sept 26, 2005.

A similar view on the drawbacks due to the seller-versus-borrower effect was expressed by the French central bank governor and member of European Central Bank’s governing council after the ECB raised its key interest rates for the first time in five years on December 1, 2005. “What is happening in the real-estate market is one example of how extraordinarily low interest rates do not have only advantages.” Christian Noyer, *Europe 1 Radio*, Dec. 2, 2005.

<sup>209</sup> Who captures government subsidies embedded in the student loans has been written on by Dr. Richard Vedder, Distinguished Professor of Economics, Ohio University, Athens, OH, *Why College Costs Too Much*, AEI Press, 2004. In testimony on April 19, 2005, before the U.S. House of Representatives, Committee on Education and the Workforce, Dr. Vedder testified that college tuition fees have risen faster than the overall rate of inflation every year since 1982. One factor in Dr. Vedder’s explanation is that the government’s broad-based low-interest student loans have allowed increases in education prices, rather than making education more affordable.

The student loan program was expanded in the early ‘80s to allow large numbers of middle-income students to get federally guaranteed loans, and Sallie Mae grew exponentially. Ross, Nancy L., “Sallie Mae Works A Risk-Free Arena,” *Washington Post*, Feb. 21, 1983

<sup>210</sup> Government quotas on the GSE may also be an ineffective solution. Rather than relying on the market place, a regulator can establish targeted goals for the GSE. This goal setting process however, does not ensure the pass-through of the GSE subsidy to needy people because the GSE may be able to meet the goals by charging market rates.

## Chapter 2 - Public Interest Directors

### Summary

The role of SLMA's public interest directors manifests the inherent tension within the GSE model – a publicly traded company obliged to make a profit for its shareholders and at the same time serve the public purposes that Congress required. The conflict of purposes resulted in disputes over the role of the public interest directors.

Congress might have avoided the confusion as to the proper role for the public interest directors, particularly during the wind down period, if it had clarified their role and strengthened their powers. In addition, Congress should evaluate the appropriateness of aligning and amending the board structure at the time when it amends the GSE's ownership structure.

Despite the inherent tension, the presence of public interest directors, who may have had a different mandate than elected directors, was a distinctly positive element and facilitated the wind down of SLMA.

### Background

The Higher Education Act required that SLMA's board of directors be composed of 21 persons, seven appointed by the President of the United States to represent the general public, and the balance elected by the shareholders.<sup>211</sup> The appointed directors served at the pleasure of the President. No specific duties or unique authority were ascribed to the presidentially appointed directors as opposed the elected directors. The President designated one of the directors to serve as the GSE Chairman.

Upon reorganization in August 1997, SLMA became a subsidiary of a holding company, ultimately named SLM Corporation, which had its own board of directors. As discussed in section I, chapter 5, the company underwent an acrimonious proxy fight prior to the reorganization date that resulted in the ouster of many of the previously elected directors. After the dust settled, there were two boards of directors: one for the holding company consisting of 15 directors elected by shareholders and one for the GSE still consisting of 21 directors as outlined in the statute. However, now that SLM Corporation was the sole shareholder of SLMA, it elected 14 of the GSE's 21 directors. Of these 14, six were SLM Corporation board members and another four were SLM Corporation officers. In practice, a number of holding company directors (never less than three and as many as seven) always served on the GSE board. The Privatization Act prohibited any presidentially appointed GSE director from serving on the holding company's board.

The Privatization Act required all SLMA personnel to be transferred to non-GSE affiliates upon reorganization. During the wind down, the GSE operations were managed

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<sup>211</sup> Congress split these 14 board members into two groups, seven members representing banks and seven representing schools.

via agreements with these non-GSE affiliates. This effectively gave SLM Corporation's management and board additional control over GSE activities, and complicated the processes for the GSE board to control the management of the GSE. The individuals designated as GSE officers by the GSE board held similar offices in the holding company. The Act required that at least one GSE officer be an officer solely of the GSE.

### **Public Interest Directors - Forcing Square Pegs Into Round Holes?**

While SLMA's board attempted to gain consensus on the fiduciary obligation of the GSE's appointed directors following Sallie Mae's reorganization, this was an issue that it never definitively resolved. Questions surrounding this issue included whether board "liability" differed between the presidential appointees and the elected board members, and whether those public interest directors had a unique fiduciary obligation to the GSE's bondholders. The GSE retained outside counsel from two different firms in 1997 to opine on this issue. It first hired Ronald Mueller of Gibson, Dunn & Crutcher, as outside counsel to the GSE, who had previously and subsequently advised Albert Lord, Vice Chairman of SLM Corporation. Mr. Mueller discussed his firm's legal opinion and the nature of the fiduciary duty owed by the presidentially appointed directors with the board.<sup>212</sup> The following month, the GSE Chairman unsuccessfully argued for separate counsel for the presidential appointees.<sup>213</sup>

SLMA then hired Arnold & Porter to review the question of whether the fiduciary obligations of the presidential appointees differ from those of the shareholder-elected members of the Board.<sup>214</sup> Robert Rosenbaum of that firm explained that it was his firm's opinion that, in addition to the fiduciary obligations which Board members have to SLM, the Board also holds a fiduciary obligation to the holders of the GSE's preferred stock and, perhaps, to the holders of the GSE's debt obligations. Mr. Rosenbaum also noted his legal opinion that the presidentially appointed Board members had an additional discretionary responsibility to communicate with the executive branch when it was in the best interest of the GSE to do so.<sup>215</sup>

The directors on the GSE board who were elected by the holding company appeared somewhat suspicious of the appointed directors and opposed meetings between senior Treasury officials and the presidentially appointed directors that excluded the elected members. The GSE board adopted a resolution that required the Vice Chairman, who was elected by the holding company, to approve in advance any non-meeting work in order for a board member to receive per diem payments.<sup>216</sup>

Treasury also considered the evolving nature of the role of the presidentially appointed GSE directors during this time, particularly as it related to director stock option awards in the reorganized company. In 1977 Treasury's Under Secretary for Domestic Finance, John D. Hawke, expressed the view that:

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<sup>212</sup> SLMA Board Meeting minutes, Sept. 18, 1997.

<sup>213</sup> SLMA Board Meeting minutes, Nov. 20, 1997.

<sup>214</sup> SLMA Board Meeting minutes, Jan. 22, 1998.

<sup>215</sup> SLMA Board Meeting minutes, May 20, 1998.

<sup>216</sup> SLMA Board Meeting minutes, Sept. 18, 1997.

It would be inconsistent with the objective of maintaining both the fact and appearance of independence of the public directors of the GSE if, after consummation of the reorganization, they were to continue to hold options to purchase stock, or to participate in the Sallie Mae Employees' Stock Purchase Plan, in the newly formed holding company.<sup>217</sup>

Treasury confirmed that view five years later, adding that "Such plans would inherently afford these directors certain insider treatment." Treasury concluded however that the Higher Education Act did not prohibit the purchase of SLM Corporation stock by a SLMA director.

It is the ongoing duty of all of SLMA directors to be objective and independent when overseeing SLMA's affairs, including the winddown. Further, presidentially appointed directors of SLMA are also representatives of the general public. It is the obligation of each SLMA director to evaluate his or her actions in fulfillment of their duties, based on all facts and circumstances.<sup>218</sup>

### **Other Related Controversies**

While corporate governance may be enhanced by public interest directors, they should have the skill and experience commensurate with the sophisticated needs of a GSE. The process of appointing the public interest directors to the GSEs has been controversial at times, with allegations that appointments are based on political connections rather than qualifications.<sup>219</sup>

Congress originally limited stock ownership and required that the 14 elected board members be split between education and lending institutions. In 1983, Congress moved SLMA away from this co-op-like entity by allowing the sale of non-voting stock to the public. In 1992, Congress permitted SLMA to operate as a publicly traded company by converting all stock to voting shares. Yet with both of the 1983 and 1992 amendments to SLMA's ownership structure Congress did not amend SLMA's board structure. In hindsight, if current practices in corporate governance were applied, the provision that two-thirds of the board be associated with institutions that have a business relationship with Sallie Mae would be inconsistent with the concept of an independent board that reflects all shareholders interests.

Over the past several years a consensus seems to be emerging that GSE directors should all be elected. Under proposed legislation, presidentially appointed board directors for

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<sup>217</sup> Letter from John D. Hawke, Treasury Under Secretary for Domestic Finance to SLMA, Apr. 18, 1997.

<sup>218</sup> Letter from Philip Quinn, Director, Office of Sallie Mae Oversight, Treasury, to SLMA Board, July 26, 2002.

<sup>219</sup> See, e.g., Barnett, Megan et. al., "Big Money on Campus," *U.S. News & World Report*, Oct. 27, 2003. The U.S. News & World Report cover story noted that two SLMA board members were connected to the Chairman of the Senate Education Committee, his wife (appointed) and his former chief of staff (elected). During the GSE wind down, SLMA's appointed directors included the wives of three congressmen and the wife of a cabinet secretary. See also, Day, Kathleen et. al., "Presidential Pals Populate Fannie, Freddie Boards," *Washington Post*, June 27, 2003.

Fannie Mae and Freddie Mac would be eliminated, and directors for the Federal Home Loan Banks would all be elected, although at least two would be public interest directors.<sup>220</sup>

SLMA reduced its number of board meetings to as few as three a year after reorganization. OSMO found this and possible deficiencies in the strategic planning an analysis by the GSE board to be a concern, and questioned whether the GSE board was exercising due care when performing its oversight responsibilities.<sup>221</sup> Insiders came to refer to SLM Corporation's board of directors as the "big board," and SLMA's board as the "little board," reflecting the relative importance they saw and the fact that the company's overall strategy and policies were set by SLM Corporation's board.

### **SLMA's Appointed Directors Provided Value**

Despite the foregoing issues, the history of SLMA's wind down also illustrates the benefits of appointed public interest directors. During the wind down, the GSE board could set policy for the GSE and retained control of dividend payments from the GSE to the holding company. Early in the wind down the GSE was the primary source of income for the holding company, but the GSE needed to maintain significant retained earnings to bear the cost of buying Treasury securities to defease the GSE obligations at the end of the wind down (i.e., risk-based capital requirements were not sufficient). The GSE board's control of the dividend was important.

In 2001, following the change of administrations, all the presidential appointees were replaced. In general, both sets of presidentially appointed directors appeared willing and able to provide a valuable check upon the strong-willed SLM Corporation management. In several instances where management did not concur with OSMO's examination findings and recommendations, SLMA's board was instrumental in working with management to implement acceptable solutions to the issues OSMO raised.

SLMA's Chairmen and Treasury's Oversight. During the wind down period there were three chairmen of SLMA, all presidentially appointed directors (one appointed by President Clinton and two appointed by President Bush). The chairman's ability to set the board's agenda provided a measure of independence to the GSE's board,<sup>222</sup> despite the fact that the holding company's directors were in the majority. Each GSE chairman had a distinguished station because he was appointed by the President and was not beholden to the holding company. In their discussions with OSMO, these GSE chairmen noted the unusual nature of their position. Their observations included:

- the fact that their power mostly lay in providing moral suasion,

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<sup>220</sup> The Federal Housing Finance Reform Act of 2005, H.R. 1461.

<sup>221</sup> OSMO Report of Examination May 2001, page 1.

<sup>222</sup> During the wind down period, one SLMA chairman, Colin Riley McMillan, heightened his independence by prodding SLMA's board to engage an attorney that had previously represented him in certain bank regulation matters. On September 10, 2002, the executive committee of SLMA's board voted unanimously to engage as counsel Gary Lax of the law firm of Jenkins & Gilchrist, P.C.

- they could not hire or fire GSE management, except through contract renegotiation, and
- they had no budget or statutory authority to communicate with Congress if they had concerns about the progress of the GSE winddown.

Nonetheless, these chairmen were valuable to Treasury's oversight. In general, they were focused on the public policy of prudently winding down the GSE business affairs. In several situations where GSE management was recalcitrant regarding Treasury's concerns, the chairman worked aggressively to improve the situation. A less independent chairman might have been more apt to side with management.

### **Recommendations**

The shortcomings of the GSE wind down structure related to the transfer of all GSE personnel out of the GSE, which complicated the processes for the GSE board to control the management of the GSE, the lack of power and resources for the GSE chairman, and possible alternatives (e.g., not transferring all GSE personnel, and authorization for the GSE chairman to report directly to Congress) should be considered in future GSE wind down legislation if they are applicable.

If Congress intends for a GSE to operate as a cooperative or in a co-op-like manner, it may wish to consider restricting the GSE's ability to issue non-voting stock. If Congress converts a co-op-like entity to one that is a publicly traded GSE, it should review the GSE board structure to ensure an independent board and the one-share one-vote principle, to better reflect all shareholders interests.



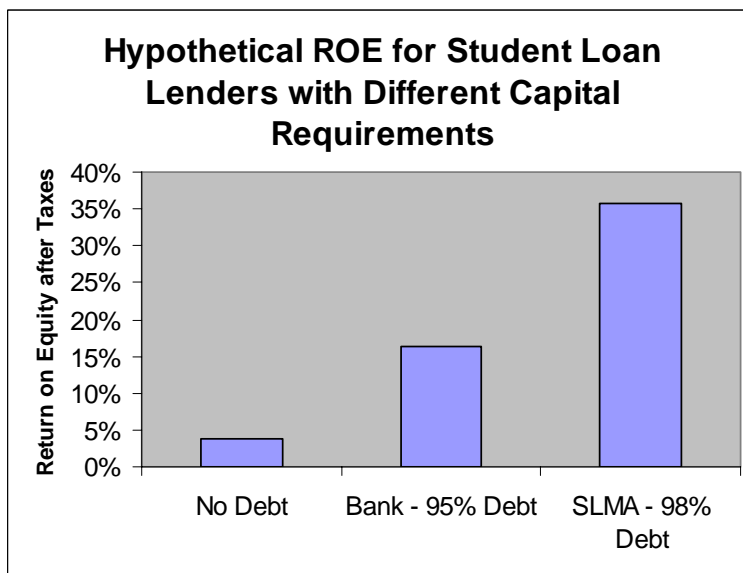


## Chapter 3 - Capital Policy

While any of a number of factors were instrumental, much of SLMA's success and growth was due to regulatory capital arbitrage. Sallie Mae and its partners were able to successfully use to their benefit the difference between SLMA's statutory capital requirement and the higher requirement for banks. This topic is important to an understanding of (1) the shortcomings of inflexible less stringent capital standards that do not adjust for the effects of new business risks and accounting conventions, and (2) how parity in capital requirements for similar activities leads to competitive equity across federally regulated financial institutions.

### GSE Capital Advantage

Congress established a minimum ratio of capital as a percentage of total assets ("a leverage capital ratio") for SLMA that was significantly less than what regulators required of banks and savings institutions. Because of this difference, it became more profitable for banks to sell student loans to Sallie Mae at a premium rather than hold the loans themselves and bear the cost of their regulatory capital requirement.



From a company's perspective, a lower leverage capital ratio increases risk to bondholders but also magnifies its return on equity (ROE). A lower minimum capital requirement provided SLMA a significant competitive advantage over banks as the chart on the left shows. The chart illustrates a hypothetical example of ROE for three different student loan lenders, assuming the same

yield on assets and cost of funds but with three different levels of debt-to-capital ratio: (1) with no debt, or no leverage, (2) at 95 % debt, or a 5 percent leverage ratio, which is considered "well capitalized" by bank regulators, and (3) at 98 % debt, SLMA's minimum statutory leverage ratio of 2 percent.<sup>223</sup> SLMA's less stringent statutory capital requirement made the GSE franchise more desirable to shareholders and management, as it facilitated higher returns on equity. SLMA's ROE prior to 2000 often

<sup>223</sup> The after tax ROE calculations assume a 1 percent return before taxes on the assets funded by debt (i.e., an interest rate spread of 1 percent), a 6 percent return before taxes on the assets funded by capital (i.e. overall assets funded by capital are earning 6 percent), and a 35 percent tax rate.

exceeded 40 percent. The ROE of the two publicly traded housing GSEs, Fannie Mae and Freddie Mae, often exceeds 25 percent, as Fed Chairman Alan Greenspan noted, far in excess of the average approximately 15 percent annual returns achievable by other large financial competitors.<sup>224</sup>

### **A Case for Rational and Prudent Capital Provisions**

Minimum levels of regulatory capital are buffers to absorb *unexpected* losses. These buffers are separate from accounting reserves, which are capital set asides for *expected* yet unrealized losses. Statutory provisions that permanently allow a GSE to hold less capital than a non-GSE for the same asset (i.e., taking the same risk) can distort normal market forces and beg rationalization. Given the lower risk of holding federal guaranteed assets, SLMA's special minimum capital requirement might have been rational at a time when existing markets were less willing to fund and hold student loans, assuming that SLMA held only federally guaranteed student loans.<sup>225</sup>

The statutory capital requirement became outdated from a safety and soundness perspective once SLMA began holding non-federally insured assets, engaged in higher risk activities such as commercial aircraft leasing, and accounting standards for certain capital and debt instruments became more complicated. Because of securitization accounting, SLMA could effectively create the condition of even greater leverage with off-balance-sheet financing of student loans, while holding the most risky securitization residuals on balance sheet (see the Appendix – Vexing Accounting). In 2001, at the behest of Treasury, the GSE agreed to maintain capital under a more stringent risk-based capital regime<sup>226</sup> that effectively was greater than the capital required under its minimum statutory leverage requirement. Under the risk based capital requirement, SLMA held capital commensurate with the risk associated with certain off-balance sheet activities and other risks.<sup>227</sup>

Once the market for student loans (or other assets for that matter) is developed and efficient, it does not appear rational to continue to allow a GSE participant in the market to have a lower capital requirement than everyone else (i.e., lower than the established and considered best practice capital standard). Minimum capital rules for federally insured financial institutions are established for the purpose of providing a prudent buffer for unexpected losses. Less stringent minimum capital requirements that are provided as

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<sup>224</sup> Testimony of Federal Reserve Board Chairman before the Senate Committee on Banking, Housing, and Urban Affairs, April 6, 2005.

<sup>225</sup> Section III, Chapter 5 provides further discussion of SLMA's capital condition. If SLMA held only student loans and met its minimum statutory leverage requirement, its risk-based capital position, as measured using "Tier 1" capital standards would be approximately the same as the average FDIC insured institution.

<sup>226</sup> Guidance was provided by OSMO that was based on "Tier 1" capital standards.

<sup>227</sup> The holding company, SLM Corporation, as an unregulated financial institution, maintained capital levels that were lower than those required under the risk-based capital regime of a depository institution. SLM Corporation's relatively low level of capital was often cited by credit rating agencies when analyzing why the holding company didn't warrant a higher credit rating than single A. The capital of SLM Corporation also includes assets not eligible as capital under bank and thrift regulatory rules such as, \$1.1 billion in goodwill. SLM Corporation's Capital and ROE during the GSE wind down period is discussed in more details in Section III, Chapter 2.

a franchise incentive appear to overextend and change the shape of that purpose. It is analogous to allowing less stringent accounting rules when measuring capital. To say that a GSE is well capitalized when applying a lower standard is like saying that a room is warmer after painting a new scale on the thermometer rather than changing the temperature.

### **Recommendations Regarding GSE Capital Standards**

In the Report of the Secretary of the Treasury on Government Sponsored Enterprises, May 1990, Treasury proposed as a major principle:

A GSE should be adequately capitalized, meet high credit and operational standards, and be subject to effective government supervision or congress should terminate all government ties with the GSE.<sup>228</sup>

Sallie Mae's case illustrates the point that the amount of capital needed for prudent business practices is complicated because of securitization accounting and other factors such as operational risks, quality of the assets (e.g., reserve accounting and illiquid instruments) and the classification of certain debt-like instruments as stock rather than debt. The subject is further complicated for all GSEs because of their mono-line nature, and the fact that the market views them as backed by the Federal government. GSE capital rules should result in prudent capital levels that are commensurate with the risks of a GSE's actual activities. The process of setting the GSE capital requirements should be flexible enough to contemplate the effects of new business risks, changing accounting conventions and new capital standards, such as the Basel II effort.

#### **Lesson Learned:**

Competition suffers when a GSE operates under looser capital rules that do not maintain a competitive equity across financial institutions. GSE capital rules should rationally relate to the prudentially established capital rules for similar activities for depository institutions.

Minimum capital rules for federally insured financial institutions are based on extensive experience and a rule making process that involves expert judgment and public input. These established rules may be considered "best practices." GSE capital rules should be able to coexist rationally with capital rules for non-GSE financial institutions that are federally regulated. If advantageous GSE capital standards are permitted for the purpose of furthering the GSE mission, the difference in minimum capital requirements for similar activities by depository institutions should be limited and subject to periodic review and revisions.

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<sup>228</sup>Treasury Report on Government Sponsored Enterprises, May 1990, page 7.



## Chapter 4 - Market-Granted Subsidy

In addition to advantageous capital rules, GSE's benefit from investors purchasing their debt at lower interest rates than required of comparable financial institutions without ties to government. This "market-granted subsidy" is demonstrated in the case of Sallie Mae. The company's cost of funds increased relative to U.S. Treasury costs and compared to financial institutions without ties to government as it moved from a GSE to a fully private-sector company (see Section III, ch 4). The market-granted subsidy to the GSEs portends a lack of market discipline.

*"The market perception of federal backing for GSEs weakens the normal relationship between the availability and cost of funds to the GSEs and the risk that these enterprises assume"* Treasury Report on GSEs, May 1990.

*"Typically in a market system, lenders and investors monitor and discipline the activities, including leverage, of their counterparties to assure themselves of the financial strength of those to whom they lend. However, market discipline with respect to the GSEs has been weak to nonexistent."* Fed Chairman Greenspan<sup>229</sup>

GSEs enjoy benefits not available to other private companies, as noted in the Introduction to this report. A private company that can issue debt that policy, regulation, and law treat very much like Treasury securities provides a basis for the market's perception of an implied government guarantee. Sallie Mae, as a GSE, enjoyed a lower cost of funds than companies with the highest corporate debt rating due to market perceptions resulting from its government relationship.

In 2004 Sallie Mae's overall debt costs, as a spread to the average 91-day Treasury bill, were approximately 35 basis points higher than in 1996 when the privatization process began. Since its 2004 results reflect some level of GSE funding until the GSE was completely phased out at year end, 2005 spreads may yet show additional widening. Corporate spreads to Treasury can also widen or tightened when overall interest rates rise or fall, respectively. Prior to 2006, specific SLM Corporation bonds in sizes of \$100 million or greater, traded 30 to 50 basis points wider than comparable GSE securities. This is consistent with CBO's 2004 estimate of the GSE funding advantage being roughly 41 basis points.<sup>230</sup>

While the widening of debt costs can be attributed to the fact that the company now has only a single A credit rating rather than the triple A rating it had as a GSE, the question is, "why is its credit rating lower?" Isn't SLM Corporation still fundamentally the same business, run by the same managers as when it was a GSE? The higher debt cost

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<sup>229</sup> Testimony of Federal Reserve Board Chairman Alan Greenspan before the Senate Committee on Banking, Housing, and Urban Affairs, April 6, 2005.

<sup>230</sup> Congressional Budget Office, Updated Estimates of the Subsidies to the Housing GSEs (April 2004).

theoretically should reflect a higher risk company. However, the diversified privatized company should be viewed as a safer investment than the monoline GSE and it has a level of capital as high as or higher than it had as a GSE. Offsetting these lower risk attributes however, is a higher mix of non-guaranteed student loans. It is difficult to precisely parse which has more impact on the company's risk profile.

The fact is, the underlying business might never have warranted a triple AAA rating given its level of capital, but was treated as such anyway by the market due to its perceived affiliation with the Federal government. This brings us back to the market's perception of Federal backing weakening the normal relationship between the availability and cost of funds to the GSEs, given their risk. Sallie Mae's case certainly seems to support the conclusion that it does.

**Lesson Learned:**

On balance, the primary reason Sallie Mae's costs of funds increased approximately 40 basis point as the GSE was dissolved is that now the company no longer has the "implied federal guarantee" of a GSE.

It may not be possible to fully determine why the market consistently paid a premium for SLMA's debt. We note however, that holders of the GSE's long-term debt when it dissolved had a basis for paying a premium since they were the beneficiaries of the statutorily required trust created to satisfy all SLMA remaining debt obligations. Sallie Mae's equity shareholders, on the other hand, realized an accounting and economic cost when it purchased the Treasuries that were needed to fund the trust.

Don't Rely on the Market. Sallie Mae's case supports the conclusion that the market discipline with respect to the GSEs has been weak. The authorized regulatory oversight of SLMA was not sufficient to compensate for this market weakness in the long-run. A lack of market discipline, the difficulties of overcoming this problem through oversight, and a rapidly growing GSE is a problematic combination. It may be preferable to develop policy solutions for such a combination before significant problems arise. In Sallie Mae's case, full privatization was the successful solution. The lack of market discipline with respect to the GSEs is another factor to consider when discussing GSE sunsets and exit strategies.

## Chapter 5 - GSE Sunsets and Exits

*The Treasury has for a number of years, in Democratic and Republican Administrations, believed that it is appropriate to wean a GSE from a 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.<sup>231</sup>*

### Summary

As discussed in Section I, the fact that SLMA wanted to privatize made it politically possible to enact legislation to do so. This chapter pulls together past discussions and proposals on GSE exit strategies and sunsets. If Congress creates a GSE or makes substantial changes to a GSE, such as modifying its ownership structure, we suggest that Congress consider legislation to provide a GSE exit strategy.

### Congress and Others Study Exit Strategies

When SLMA was created, the Senate initially wanted the statutory authority for SLMA to lapse after five years, effectively setting a sunset date for the GSE unless Congress acted to extend it. The idea of a GSE having a life cycle with an end was part of Congressional thinking at the time. However, the Senate eventually agreed to the House position that SLMA should continue until dissolved by Congress. Originally Congress also provided SLMA with Federal guarantees for debt it issued; however, the authority for these guarantees, and unlike the GSE's existence, was not indefinite and expired after a period of time.

Full privatization of Sallie Mae was considered by the CBO in 1985, ten years prior to the SLMA Privatization Act. CBO proposed privatization as a means for controlling the risk assumed by GSEs.<sup>232</sup> Sallie Mae too, considered full privatization in 1990 as a response to political risk and restrictions under its GSE charter. Sallie Mae considered full privatization as a means that might guard the interest of its shareholders and allow Sallie Mae to enter new markets or provide new services.

When Congress decided to terminate the GSE status of SLMA in the early 1990s it set up two alternative “sunsets” in the 1996 Privatization Act. It provided that unless SLMA reorganized itself into a private-sector company within 18 months with a plan to dissolve the GSE by September 2008, it faced the alternative of liquidating by July 2013.<sup>233</sup> While SLMA shareholders had some control over the timing of the GSE termination, it was Congress alone that had the authority to determine the end of a GSE. At the time, Treasury was concerned that if SLMA shareholders rejected the reorganization option

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<sup>231</sup> Statement of Darcy Bradbury, DAS for Federal Finance, U.S. Department of Treasury, 1995. See Appendix for full text.

<sup>232</sup> CBO, *Government-Sponsored Enterprises and Their Implicit Federal Subsidy: The Case of Sallie Mae*, December 1985.

<sup>233</sup> 1996 Privatization Act; 20 U.S.C. 1087-2(s).

there might be a flight of talented people from the GSE complicating the planning and execution of an orderly wind down of the GSE. This did not turn out to be an issue, as shareholders overwhelmingly supported reorganization over liquidation.

Congress has held hearings on GSE accountability to consider characteristics important to the GSE life cycle including: political controversy that might arise if government sponsorship is removed, the idea that an exit strategy be a part of any new GSE charter, and systematic mission regulation by federal examiners as a means of containing GSE mission creep.<sup>234</sup>

Freddie Mac, one of the giant housing GSEs, provides an example of a GSE that originally intended to privatize, but decided against it. Thomas R. Bomar, Freddie Mac's founding CEO, wrote:

I became Freddie Mac's first CEO in September 1970. It was my charge to create a market for trading conventional home mortgages. The objective was to stabilize and reduce the cost of housing credit. At its first meeting, the board informed me that Freddie Mac's purpose was to create the secondary mortgage market as established by Congress and, when this was accomplished, to put the corporation out of business as a government-sponsored entity. We never imagined that the GSEs would assume their massive and potentially economic disrupting size, and engage in activities never contemplated by Congress. In 1973, I was appointed by the president and confirmed by the Senate to be chairman of the Bank Board and chairman of Freddie Mac. The understanding continued that Freddie Mac was to be effective for its congressionally authorized purpose and then disengage as a federally supported entity. This purpose being clearly understood, Freddie Mac was never allowed to build up any sizable staff. Rather, its owners, at that time the Federal Home Loan Banks, carefully controlled its operations. Freddie Mac was intended from its inception to be a transitional vehicle carrying out activities that the private market could not perform at the time without government assistance. It never built up a large mortgage portfolio during its first years as it is not necessary to carry a large mortgage portfolio to generate a secondary trading market. Accumulating a large mortgage portfolio would have been inconsistent with the intent for which Freddie Mac was created. How times have changed!<sup>235</sup>

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<sup>234</sup> See, e.g., Statement of Thomas H. Stanton before a joint hearing of the Subcommittee on Capital Markets, Securities and GSEs and the Subcommittee on Government Managements, Information and Technology, U.S. House of Representatives, July 16, 1997.

<sup>235</sup> Bomar, Thomas R., *Freddie Mac Was Meant to Succeed, Die Young*, Wall Street Journal, June 13, 2005, OpEd, Mr. Bomar was Freddie Mac CEO, 1970-1973; and chairman of the Federal Home Loan Bank Board, 1973-1975.

Subsequent to Mr. Bomar's stewardship, Freddie Mac adopted a business strategy to grow the loans that it keeps on its books. This is another example of how running a GSE is about making business decisions in the best interest of the shareholders rather than the public.



**GSE Inflection Points**

Congress amended the GSE charters that allowed Sallie Mae and Freddie Mac to convert from co-op-like entities to publicly traded GSEs in 1983 and 1989, respectively. Issuing public shares monetizes the GSE's franchise value and creates expectations for growth from private-sector investors. For Sallie Mae the first public stock issuance was intended to have effects beyond creating more equity (See Section II, Chapter 2). Changes of such distinction or inflection points in the GSE's life cycle may be an appropriate time for Congress to contemplate the GSE's mission and perhaps provide for a GSE exit strategy, or at a minimum, provide for a review of the GSE's mission. Other examples of GSE inflection points might include Farmer Mac's receiving authority to issue GSE debt in 1996 or Fannie Mae being converted to a GSE from a government corporation in 1968.

Congress should provide for an exit strategy that kicks in when the life cycle of a GSE has run its course. An exit strategy would help avoid risk to the public from a GSE failure. The strategy could address the possibility that a GSE regulator might be predisposed to policies that lengthen the GSE's life cycle. An exit strategy could allow the company to provide value for shareholders long after the mission is accomplished, but as a private-sector company rather than a GSE. Providing for succession at the inception of a GSE, could avoid the controversy associated with removal of government sponsorship from an already established GSE.

**Lesson Learned:**

GSE legislation should include workable mechanisms to provide a GSE exit strategy when creating new or modifying existing GSEs. In particular, Congress should consider a GSE's mission, its oversight, and an exit strategy when legislation enables the GSE to change the nature or structure of the company.



## **Appendices**

### **Glossary**

### **Appendix 1 – Sallie Mae’s Early History**

### **Appendix 2 – Vexing Accounting**

### **Appendix 3 – Transcripts of Interviews**

#### **3-A. Interview with Edward Fox, Oct. 13, 2005**

#### **3-B. Interview with Marianne Keler, Sept. 1, 2004**

#### **3-C. Interview with Jack Remondi, July 26, 2005**

### **Appendix 4 – Treasury Testimony Regarding Privatization**

### **Appendix 5 – Master Defeasance Trust Agreement**

### **Appendix 6 – Treasury Determination Letters & Supplemental Memorandum**

### **Appendix 7 – Press Releases upon the Privatization of Sallie Mae**



## GLOSSARY

This appendix contains definitions of key terms that are used in this document.

**ABS** – Asset-Backed Security. A method of financing assets, involving sponsoring a trust and selling a pool of loans, without recourse, into the trust. The trust then sells interest-bearing certificates to investors. Cash flows from the pool of loans are used to make interest and principal payments to the investors, and to pay for loan servicing, administrative fees, and other costs. Any excess cash remaining after the trust pays these costs generally goes back to the issuer or another holder of the interest only residual.

**Borrower Benefits** – Borrower Benefits are financial incentives offered to student loan borrowers who qualify based on pre-determined qualifying factors, which are generally tied directly to making on-time monthly payments. The impact of Borrower Benefits on a lender’s yield is dependent on the estimate of the number of borrowers who will eventually qualify for these benefits and the amount of the financial benefit offered to the borrower. Lenders occasionally change Borrower Benefits programs in both amount and qualification factors.

**Consolidation Loans** – Under both the FFELP and the William D. Ford Federal Direct Student Loan Program (“FDLP”), borrowers with eligible student loans may consolidate them into one note with one lender and convert the variable interest rates on the loans being consolidated into a fixed rate for the life of the loan. The new note is considered a Consolidation Loan. Typically a borrower can consolidate his student loans only once unless the borrower has another eligible loan to consolidate with the existing Consolidation Loan. FFELP Consolidation Loan borrowers can reconsolidate their FFELP Consolidation Loan into a FDLP Consolidation Loan under certain conditions. The borrower rate on a Consolidation Loan is fixed for the term of the loan and is set by the weighted-average interest rate of the loans being consolidated, rounded up to the nearest 1/8th of a percent, not to exceed 8.25 %. In low interest rate environments, Consolidation Loans provide an attractive refinancing opportunity to certain borrowers because they allow borrowers to consolidate variable rate loans into a long-term fixed rate loan. Holders of Consolidation Loans are eligible to earn interest under the Special Allowance Payment (“SAP”) formula (see definition below).

**Consolidation Loan Rebate Fee** – All holders of Consolidation Loans are required to pay to the U.S. Department of Education an annual 105 basis point Consolidation Loan Rebate Fee on all outstanding principal and accrued interest balances of Consolidation Loans purchased or originated after October 1, 1993, except for loans for which consolidation applications were received between October 1, 1998 and January 31, 1999, where the Consolidation Loan Rebate Fee is 62 basis points.

**Constant Prepayment Rate (“CPR”)** – A variable in life of loan estimates that measures the rate at which loans in the portfolio pay before their stated maturity. The

CPR is directly correlated to the average life of the portfolio. CPR equals the percentage of loans that prepay annually as a percentage of the beginning of period balance.

**Credit Spread** – The portion of the yield spread between two bonds attributable to the difference in their respective credit ratings.

**Direct Loans** – Student loans originated directly by the US Department of Education under the FDLP.

**Exceptional Performer (“EP”) Designation** – The EP designation is determined by the U.S. Department of Education in recognition of a servicer meeting certain performance standards set by in servicing FFELP loans. Upon receiving the EP designation, the EP servicer receives 100 % reimbursement on default claims (99 % reimbursement on default claims filed after July 1, 2006) on federally guaranteed student loans for all loans serviced for a period of at least 270 days before the date of default and will no longer be subject to the two percent Risk Sharing (see definition below) on these loans. The EP servicer is entitled to receive this benefit as long as it remains in compliance with the required servicing standards, which are assessed on an annual and quarterly basis through compliance audits and other criteria. The annual assessment is in part based upon subjective factors which alone may form the basis for the U.S. Department of Education determination to withdraw the designation. If the designation is withdrawn, the two-percent Risk Sharing may be applied retroactively to the date of the occurrence that resulted in noncompliance.

**FDLP** – The William D. Ford Federal Direct Student Loan Program.

**FFB** – Federal Financing Bank. This is an independent agency whose operations are carried out in an office within the Department of Treasury that coordinates federally owned agencies’ fund raising activities in U.S. capital markets. It does this by acquiring debt from federally owned agencies so that they do not compete with each other, it acquires loan assets and it acquires loans guaranteed by federally owned agencies. It acquires agency debt at a yield of 12.5 basis points (1/8 percentage point above Treasury securities. FFB raises its funds through Treasury borrowing.

**FFELP** – The Federal Family Education Loan Program. This is the main federal student loan program that involves private lenders. It is the successor program to the Guaranteed Student Loan program or GSL.

**FFELP Stafford and Other Student Loans** – Education loans to students or parents of students that are guaranteed or reinsured under the FFELP. The loans are primarily Stafford loans but also include PLUS and HEAL loans.

**Fixed Rate Floor Income**—Sallie Mae and other lenders refer to Floor Income associated with student loans whose borrower rate is fixed to term (primarily Consolidation Loans) as Fixed Rate Floor Income.

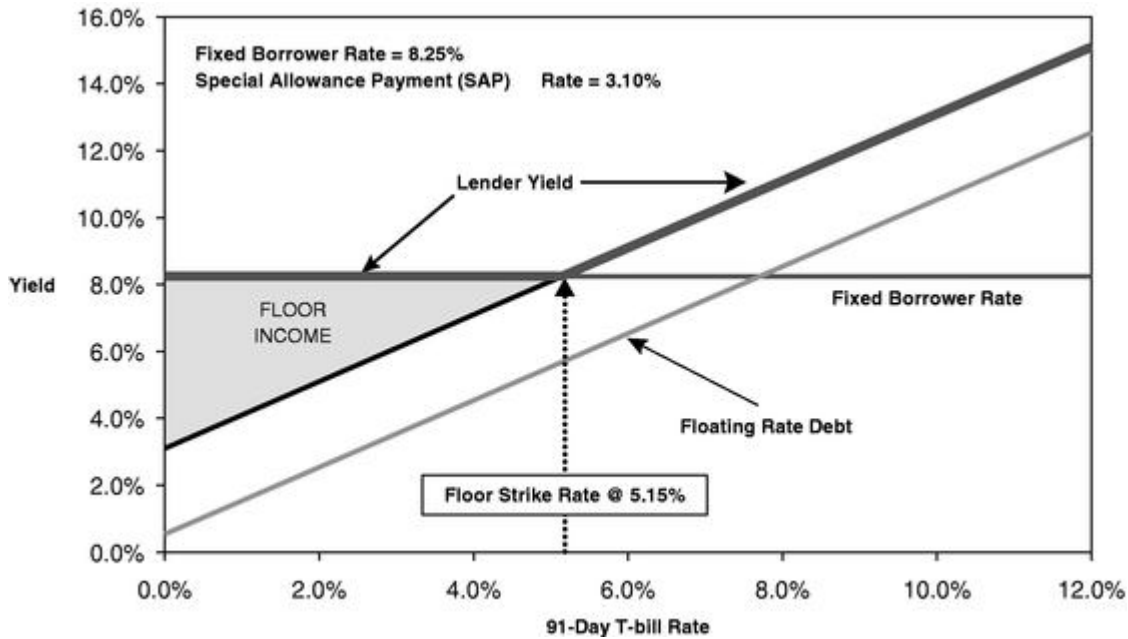
**Floor Income**—Sallie Mae’s portfolio of FFELP student loans generally earns interest at the higher of a floating rate based on the Special Allowance Payment or SAP (see

definition below) formula set by the DOE and the borrower rate, which is fixed over a period of time. Sallie Mae and other lenders generally finance their student loan portfolio with floating rate debt over all interest rate levels. In low and/or declining interest rate environments, when its student loans are earning at the fixed borrower rate and the interest on its floating rate debt is continuing to decline, Sallie Mae may earn additional spread income and refer to it as Floor Income. Depending on the type of the student loan and when it was originated, the borrower rate is either fixed to term or is reset to a market rate each July 1. As a result, for loans where the borrower rate is fixed to term, Sallie Mae may earn Floor Income for an extended period of time, and for those loans where the borrower interest rate is reset annually on July 1, Sallie Mae may earn Floor Income to the next reset date.

The following example shows the mechanics of Floor Income for a fixed rate Consolidation Loan:

|  |                              |
|--|------------------------------|
| Fixed borrower/minimum floor interest rate:                    | 8.25%                        |
| Floating rate special allowance payment formula:               | 91-day T-bill + <u>3.10%</u> |
| Floor strike rate (minimum floor strike rate less SAP spread): | 5.15%                        |

***Graphic Depiction of Floor Income:***



Based on this example, if the quarterly average 91-day Treasury bill rate is over 5.15 percent, special allowance payments will be made to ensure that the holder receives at least a specified floating rate based on the Special Allowance Payment formula. On the other hand, if the quarterly average 91-day Treasury bill is below 5.15 percent, the loan holder will earn the minimum floor rate of 8.25 percent from the student loan. The difference between the minimum floor rate of 8.25 percent and the lender's expected yield (i.e., the yield that the lender would have earned if the borrower's rate did not create a

floor) is referred to as Floor Income. Because the student loan assets are generally funded with floating rate debt, the net interest income is enhanced during periods of declining interest rates when the student loan is earning at the fixed borrower rate.<sup>1</sup>

**Floor Income Contracts** – SLM Corporation and other lenders sell floor under which, in exchange for an upfront fee, they will pay the counterparties the Floor Income earned on that notional amount over the life of the Floor Income Contract. Specifically, they agree to pay the counterparty the difference, if positive, between the fixed borrower rate less the SAP (see definition below) spread and the average of the applicable interest rate index on that notional amount, regardless of the actual balance of underlying student loans, over the life of the contract. The contracts generally do not extend over the expected life of the underlying student loans. This contract effectively locks in the amount of Floor Income lenders will earn over the period of the contract, but is subject to risk based on miscalculation of student loan CPRs. Floor Income Contracts are not considered effective hedges under Statement of Financial Accounting Standards (“SFAS”) No. 133, “Accounting for Derivative Instruments and Hedging Activities,” and each quarter lenders must record the change in fair value of these contracts through income.

**GAAP** – Generally Accepted Accounting Principles.

**GSE** – Government-Sponsored Enterprise. An entity chartered by Congress and given a public policy mission and certain benefits, but funded with private-sector capital. The Student Loan Marketing Association was a federally chartered government-sponsored enterprise and wholly owned subsidiary of SLM Corporation that was on December 29, 2004.

**HEA** – The Higher Education Act of 1965, as amended. Sections 438 and 439 of the HEA established SLMA, provides for its dissolution, oversight and other provisions.

**Interest Only Residual** - Interest-only residuals are a special type of receivable recognized by the issuer of an ABS based on the net present value of certain expected residual cash flows. Issuing an ABS involves sponsoring a trust and selling a pool of loans, without recourse, into the trust. The trust then sells interest-bearing certificates to investors. Cash flows from the pool of loans are used to make interest and principal payments to the investors. The trust also pays for loan servicing, administrative fees, and other costs. Any excess cash remaining after the trust pays these costs goes to the issuer. Since the issuer is entitled to this residual cash flow, GAAP requires that the issuer estimate the present value of this expected residual cash flow and recognize an asset in that amount. The asset would need to be written off the books at a loss, if after their recognition, anticipated residual cash flow fails to be realized.

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<sup>1</sup> The decline in short term rates in 2001 and 2002 triggered massive amounts of so called floor income. Sallie Mae reported over \$800 million of floor income in 2001 and 2002, which is discussed further in Section III, Chapter 4.



**LIBOR** - the London Inter-Bank Offered Rate. [add more description of what it is – use Bloomberg description?]

**Managed Loans** – SLM Corporation generally analyzes the performance of their student loan portfolio on a Managed basis, under which they view both on-balance sheet student loans and off-balance sheet student loans owned by the securitization trusts as a single portfolio. Under this analytical framework, the related on-balance sheet financings are combined with off-balance sheet debt and the portfolios are analyzed as one.

**Offset Fee** – SLMA was required to pay the U.S. Department of Education an annual 30 basis point Offset Fee on the outstanding balance of Stafford and PLUS student loans purchased and held by the GSE after August 10, 1993. The fee did not apply to student loans sold to securitized trusts or to loans held outside of the GSE. This fee ceased to apply when the GSE was dissolved on December 29, 2004.

**OSMO** – The Office of Sallie Mae Oversight. The office within the Department of Treasury that was charged with providing safety and soundness oversight during the wind down of SLMA.

**Preferred Channel Originations** – SLM Corporation’s Preferred Channel Originations are comprised of: 1) student loans that are originated by lenders with forward purchase commitment agreements with Sallie Mae and are committed for sale to Sallie Mae, such that SLM either owns them from inception or acquires them soon after origination, and 2) loans that are originated by internally marketed Sallie Mae brands.

**Preferred Lender List** – Most higher education institutions select a small number of lenders to recommend to their students and parents. This recommended list is referred to as the Preferred Lender List.

**Private Loans** – Education loans to students or parents of students that are not guaranteed or reinsured under the FFELP or any other federal student loan program. Private Education Loans include loans for traditional higher education, undergraduate and graduate degrees, and for alternative education, such as career training, private kindergarten through secondary education schools and tutorial schools. Traditional private higher education loans have repayment terms similar to FFELP loans, whereby repayments begin after the borrower leaves school. Repayment for alternative education or career training loans generally begins immediately.

**Privatization Act** – The Student Loan Marketing Association Reorganization Act of 1996.

**Reauthorization Legislation** – The Higher Education Reconciliation Act of 2005, which reauthorized the student loan programs provisions of the HEA and generally becomes effective as of July 1, 2006.

**Residual Interest** – When lenders securitize student loans, they often retain the right to receive cash flows from the student loans sold to trusts in excess of amounts needed to pay servicing, derivative costs (if any), other fees, and the principal and interest on the bonds backed by the student loans. The Residual Interest (which may also include reserve and other cash accounts), is the present value of these future expected cash flows, which includes the present value of Embedded Fixed Rate Floor Income described above. Lenders value the Residual Interest at the time of sale of the student loans to the trust and at the end of each subsequent quarter. (also see definition for “Interest Only Residuals).

**Retained Interest** – The Retained Interest includes the Residual Interest (defined above) and any retained servicing rights.

**Risk Sharing** – When a FFELP loan defaults, the federal government guarantees 98% of the principal balance (97% on loans disbursed after July 1, 2006) plus accrued interest and the holder of the loan generally must absorb the 2% (3% after July 1, 2006) not guaranteed as a Risk Sharing loss on the loan. FFELP student loans acquired after October 1, 1993 are subject to Risk Sharing on loan default claim payments unless the default results from the borrower’s death, disability or bankruptcy. FFELP loans serviced by a servicer that has EP designation from the U.S. Department of Education are not subject to Risk Sharing.

**Sallie Mae** – The nickname for SLMA and its private-sector successor, SLM Corporation.

**SLMA** – the Student Loan Marketing Association, a federally chartered entity with a mission of providing liquidity to the secondary market for federally guaranteed student loans.

**SLM Corp.** – SLM Corporation. A publicly traded, Delaware state-chartered, holding company. The private-sector successor to SLMA.

**Special Allowance Payment (“SAP”)** – FFELP student loans originated prior to July 1, 2006 generally earn interest at the greater of the borrower rate or a floating rate determined by reference to the average of the applicable floating rates (91-day Treasury bill rate or commercial paper) in a calendar quarter, plus a fixed spread that is dependent upon when the loan was originated and the loan’s repayment status. If the resulting floating rate exceeds the borrower rate, the U.S. Department of Education pays the difference directly to the lender. This payment is referred to as the Special Allowance Payment or SAP and the formula used to determine the floating rate is the SAP formula. We refer to the fixed spread to the underlying index as the SAP spread. SAP is available on variable rate PLUS Loans and SLS Loans only if the variable rate, which is reset annually, exceeds the applicable maximum borrower rate. Effective July 1, 2006, this limitation on SAP for PLUS loans made on and after January 1, 2000 is repealed.

**Title IV Programs and Title IV Loans** – Student loan programs created under Title IV of the HEA, including the FFELP and the FDLP, and student loans originated under those programs, respectively.

**Variable Rate Floor Income** – For FFELP Stafford student loans originated prior to July 1, 2006 whose borrower interest rate resets annually on July 1, lenders may earn Floor Income based on a calculation of the difference between the borrower rate and the then current interest rate. This may be referred to as Variable Rate Floor Income because Floor Income is earned only through the next reset date.

**Wind-Down** – The dissolution of the GSE under the terms of the Privatization Act (see definition above).

**Yield Curve** – a “yield curve”, also known as the “term structure of interest rates,” is a graphical representation of the relationship between the yields of a set of similar bonds and their maturity dates, at a given point in time. Generally, in a normal interest rate environment, the yield curve slopes up toward the right, as rates for longer term debt are generally higher than those for shorter term debt.

**Yield Spread** – The difference in yield between different types of bond of the same maturity. The spread is generally attributed to issues of credit, liquidity, or anticipated interest rate changes.



## **Appendix 1 – Sallie Mae’s Early History**

### **Legislation Creating Sallie Mae**

In 1972, Congress created the Student Loan Marketing Association (SLMA),<sup>1</sup> Sallie Mae as it was nicknamed,<sup>2</sup> to help banks address the shortage of funds available for student loans and by providing liquidity for these loans.<sup>3</sup>

Congress had established the Guaranteed Student Loan Program (GSLP) in 1965 to encourage lenders to make more student loans as the baby boom generation began to go to college. In the early 1960s inflation was rising and budget problems stemming from the War in Vietnam made it difficult for Congress to expand grants, so the idea of guaranteed loans rather than loans or grants directly from the government was appealing.

Under the GSL program, eligible lenders made low-interest, long-term loans to students attending postsecondary educational institutions. Loan repayment was either guaranteed by state or private nonprofit guaranty agencies and insured or reinsured by the Federal government. By 1971, many lenders accumulated relatively large portfolios of student loans. Because of the relatively long repayment periods and high servicing costs of student loans and the lack of a mechanism for easily converting the loans to cash or other assets, lenders often became reluctant to lend additional funds under the program. To alleviate this situation, Congress created SLMA to serve as a secondary market similar to the Federal National Mortgage Association (Fannie Mae), which it created as a secondary market to stimulate increased financing for home mortgages.<sup>4</sup>

By 1969, the banks that had made GSLP loans were holding long term loans with fixed rates that were below market rates. The student loan rate was seven percent and the Fed funds rate was over eight percent. Congress addressed the interest rate gap by passing the

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<sup>1</sup> Amendments to the Higher Education Act of 1965, Pub. L. 92-318, Sec. 133(a) 20 USC §1087-1, signed by President Nixon June 22, 1972. The Education Amendments of 1972, later became Part B of Title IV of the Higher Education Act of 1965 (P.L. 89-329) that had established the Guaranteed Student Loan Program (GSLP).

<sup>2</sup> Even in the earliest hearings on establishing SLMA, witnesses referred to it as “Sallie Mae.” Statement of Charls E. Walker, Under Secretary of the Treasury, June 11, 1970, Hearings before the House Special Subcommittee on Education of the Committee on Education and Labor on H.R. 16098, 1969-1970, p.1540.

<sup>3</sup> H.R. Rep. 92-554, 92<sup>nd</sup> Congress, 2<sup>nd</sup> Sess. 1972, 1972 U.S.C.C.A.N. 2462, 2489.

<sup>4</sup> GAO, *Secondary Market Activities of the Student Loan Marketing Association*, Report to the Senate Committee on Labor and Human Resources, May 18, 1984, p. 1

Emergency Student Loan Act of 1969 to provide for a “special allowance” of up to three percent over the loan interest rate to be paid to lenders.<sup>5</sup>

The Nixon Administration was advocating revenue sharing to send money to the states and to set up off-budget operations. If SLMA could be financed through non-Federal sources and managed with the discipline of the marketplace, it would fit into that policy.<sup>6</sup>

After extensive hearings, the House and the Senate approved legislation to create the Student Loan Marketing Association. Congress intended that this government sponsored enterprise would meet the liquidity concerns of lending institutions in the student loan program by creating a secondary market for student loans to provide opportunities for others to purchase an originating lender’s interest in a loan. SLMA would also offer to buy Federally-guaranteed student loans from the original lenders, allowing them to replenish their supply of lendable funds and inducing them to commit a greater share of their portfolios to student loans.<sup>7</sup>

SLMA was to be a stockholder owned corporation, paying Federal taxes but exempt from State and local taxes. It would have a Board of Directors of 21 members, seven representing lenders under the program, seven from educational institutions, and seven appointed by the President. It was authorized to but did not use \$5 million in appropriated funds for its start up. To raise its initial capital, SLMA was to sell common stock to eligible lenders and educational institutions. It would then issue its own debt obligations which would be guaranteed by the Department of Health Education and Welfare as to principal and interest without limit for ten years.<sup>8</sup>

Congress intended that the two basic secondary market mechanisms of purchasing loan paper and warehousing would achieve the goals of adequate liquidity, low interest charges, and efficient loan servicing. In the purchasing operation, SLMA would offer to

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<sup>5</sup> In 1972 it continued the special allowance and extended the Federal guarantee to interest as well as principal of student loans to allow free transferability needed for the warehousing and marketing functions of the new Student Loan Marketing Association. The special allowance remained a fixture from then on. The House Committee on Education and Labor described its thinking about the special allowance in 1972:

“As interest rates go up and money becomes more scarce, students have found difficulty in obtaining loans. This problem has engaged the attention of Congress for the last several years. In order to make the loans more attractive to lending institutions, interest rates were first increased from 6% to 7%. Subsequently an emergency act was passed authorizing federal payment of a special allowance of up to 3% on outstanding loan volume. The Secretary of the Department of Health, Education and Welfare was authorized to decide at the end of each three month period how much the special allowance should be. It has ranged from 2 1/4% to the current figure of 1 1/4%. The special allowance has worked well and the Committee recommends that it be continued.”

H.R. Rep. 92-554, 92<sup>nd</sup> Congress, 2<sup>nd</sup> Sess. 1972, 1972 U.S.C.C.A.N. 2462, 2488-9.

<sup>6</sup> Nelson, Gordon, *The History of Sallie Mae, 1972-1986* [Nelson], published by Sallie Mae, 1987, quoting Edward Fox, p. 19.

<sup>7</sup> H.R. Rep. 92-554, 92<sup>nd</sup> Congress, 2<sup>nd</sup> Sess. 1972, 1972 U.S.C.C.A.N. 2462, 2489.

<sup>8</sup> In 1973 Congress set up the Federal Financing Bank, PL 93-224, 87 Stat 937. The FFB was to consolidate and reduce the government's cost of financing a variety of Federal agencies and other borrowers whose obligations are guaranteed by the federal government. Once HEW approved guarantees of SLMA’s obligations, the FFB handled them.

buy student loans from schools and banks at a price that would take servicing costs into account and provide a yield consistent with the current money markets. Under the warehousing operation, SLMA would advance funds to lending schools and banks at up to 80 percent of the face value of the insured loans pledged. The school or bank could reinvest these funds only in student loans.

The student's relationship to the lender would remain unchanged. Student loans would be serviced by the original lender under the warehousing arrangement. Under the purchasing alternative, the lending school or bank would usually continue to service its student loans for a fee set by SLMA. Interest rates payable by students would be limited to 7 percent.

A Conference Committee worked out the differences between the House and the Senate versions of this legislation that had to do with how long SLMA would exist, how extensive would be the Federal guarantees to SLMA, who would chose the Chairman of the Board, and how much oversight would be needed.<sup>9</sup>

- Duration and Federal Guarantees. The Senate wanted the authority for SLMA to lapse after five years, but in agreeing to the House provision that SLMA should continue until dissolved by Congress, it persuaded House negotiators to end Federal guarantees in ten years, on July 1, 1982. The Senate agreed to the House provision that the amount guaranteed by the Federal government would not be limited by appropriations and there would be no limit on the number of notes to pay for the guarantees.
- Chairman and Stockholders. The Senate agreed with the House provision that the U.S. President, rather than the Board, select the Chairman. The House prevailed in its preference that both lenders and educational institutions would be eligible to own common stock, rather than only lenders as the Senate preferred.
- Audits and Treasury Recommendations. Audits would not be done by Treasury as the Senate preferred, but instead would be done as the House provided, by independent public accountants using generally accepted audit standards, and Treasury would have access to the accounts and would receive audit reports. The House agreed to the Senate's preference that Treasury rather than HEW make recommendations when the audit was sent to the President and Congress.

### **Continuing Issues**

The issues that the conferees struggled with continued over the life of SLMA as a GSE. Federal guarantees of SLMA's obligations were extended for two years, to 1984, and before that period ran out, SLMA negotiated an agreement of borrow up to \$5 billion for a 15 year term guaranteed by the Federal government.

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<sup>9</sup> S. Conf. Rep. 92-798, S. Conf. Rep. No. 798, 92ND Cong., 2nd Sess. 1972, 1972 U.S.C.C.A.N. 2608, 2626.

SLMA worked for years to have Congress lift the limitations on stockholders. It was able to issue non-voting stock to the public in 1983 and then in 1992 Congress acted to convert all of its common stock into voting stock on a one share one vote basis. Seven Board members were to represent schools and seven represented financial institutions, but all voting shareholders could vote for them. Seven members were still appointed by the President, and it was only through privatization that the Chairman and all Board members were elected by stockholders.

Oversight became more of an issue in the 1990s after the savings and loan crisis. In 1992 Congress gave Treasury authority to audit SLMA and to receive its financial reports. It was not until the 1996 privatization legislation that Congress authorized Treasury to conduct annual examinations and have oversight authority over SLMA's safety and soundness. Reports on SLMA were consistent that it was a well-run financial institution, with an AAA rating from Standard & Poors. Although Treasury had asked repeatedly for the oversight authority of other financial regulators, Congress did not feel the need to provide strong regulatory authority over it.

### **Getting Set Up - 1972-1974**

In the first years SLMA began to issue debt obligations, sell common stock, establish warehouse lending programs and programs for purchasing student loans, and establish servicing standards for third party servicers. It also began its long range plan of setting up a matched book between SLMA's interest rate on its debt and on its assets.<sup>10</sup>

SLMA was modeled on Fannie Mae which at the time dealt in federally insured and guaranteed FHA and VA mortgages. Its loans were standard, long term and backed by real property. The cost of servicing mortgage loans was small compared to the size of the loans, and there was long repayment experience. The secondary market was already large by the time the shareholder-owned version of Fannie Mae was created in 1968. The market understood mortgage loans and their interest rate risk.

SLMA's business looked straight forward: SLMA could borrow at favorable rates, and use the funds to purchase federally guaranteed student loans from banks. It would then collect on those loans, and if a borrower defaulted, the government guarantee would make up for its losses. However, SLMA's management<sup>11</sup> had to deal with many unknowns. Student loans were very different than mortgages and came in many types. State loan guaranty agencies set different requirements and endorsed notes created by commercial banks. There was very little information on repayment histories, and repayment would not begin until borrowers were out of school. Student loan servicing had not become the business activity it was for mortgages and its costs were high.

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<sup>10</sup> SLMA Annual Report 1976, pp 3-4.

<sup>11</sup> The first president and CEO was Edward Fox, who had financial and Federal experience: working at Treasury to set up revenue sharing, CFO and administrator of the Federal Home Loan Bank System, and leading a consortium of Federal agencies and entities such as farm credit, home loan banks, Fannie Mae, the postal service and others that marketed their own debt, to talk about their problems and how they financed their agencies. He had also managed international investments for Mobil and an equity portfolio for a pension fund. The general counsel, Timothy Greene, had worked as a special assistant to the SEC chairman and later at Treasury on a Lockheed loan guarantee. Nelson, p. at 15, 16.



Neither the borrower nor the lender knew until the school year how much the student would be borrowing so the ultimate size of the note could change.

#### Debt obligations

SLMA raised funds in the private capital markets to finance its operations.<sup>12</sup> Congress had authorized SLMA to issue debt obligations to be guaranteed by the Department of HEW for ten years, until 1982, with each debt obligation approved by both the HEW Secretary and the Treasury Secretary. In December 1973 Congress created the Federal Financing Bank (FFB) which began purchasing these SLMA obligations with its rates at 1/8 of a point over 91 day Treasury bills.<sup>13</sup> In 1973 the Federal Reserve Bank of New York became the fiscal agent of SLMA, treating SLMA as an agency of the United States for purposes of transactions in Federal funds.<sup>14</sup> At the end of 1973 SLMA had raised \$200 million by selling short term notes guaranteed by the United States.<sup>15</sup>

#### Warehouse lending

SLMA acted as a lender's bank, offering financial services to eligible lending institutions. It was easier to warehouse - lend money on security of loans - than to buy them since lenders would own and service the loans and SLMA would not need to examine them the way it would if it purchased loans. Advances would be for amounts of \$1 million or more for up to 80 percent of the face value of the GSLP collateral. Lenders had to reinvest proceeds in more student loans. For commercial banks, not required to maintain reserves against loans from SLMA, interest rates were as much as 3 percent lower than other short term loans, and up to .5 percent lower for long term loans with 7 to 10 year terms. Educational institutions benefited by having lower rates and a source of funds other than the commercial banks. They could use endowment funds to make student loans, collateralize them for low interest rates, and arbitrage the proceeds by reinvesting at higher rates.

In 1973 SLMA lent \$75 million to lenders, and in 1974 it advanced \$191.6 million.<sup>16</sup> It offered a variable rate warehousing program in December 1974 to be indexed to Treasury bills, a bond equivalent or the guaranteed student loan rate of 7 percent plus the special allowance ranging from zero to 3 percent, set by HEW every quarter. For these loans the collateral had to be at least 125 percent of the principal amount of the loan and consist of guaranteed student loans with interest rates of at least 7 percent.<sup>17</sup>

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<sup>12</sup> GAO, *Secondary Market Activities of the Student Loan Marketing Association*, Report to the Senate Committee on Labor and Human Resources, May 18, 1984, p. 2.

<sup>13</sup> Federal Financing Bank Act, PL 93-224, Dec. 29, 1973, 87 Stat 937.

<sup>14</sup> SLMA Annual Report 1973, p. 7.

<sup>15</sup> SLMA Annual Report 1973, pp. 1-2.

Congress also appropriated \$5 million for a start-up loan to SLMA, but SLMA did not use those funds. SLMA Annual Report 1974, p. 3.

<sup>16</sup> SLMA Annual Report 1973, pp. 1-2; SLMA Annual Report 1974, p. 3.

<sup>17</sup> SLMA Annual Report 1974, p. 10.

### Purchasing student loans

To purchase student loan portfolios, SLMA had to arrive at a way to price them and to service them. Pricing student loans was difficult. There were more than 200 versions of guaranteed student loans because of Federal and state laws, repayment deferrals and differences in guarantees for principal and interest. Students' grace periods, deferment and repayment status were uncertain as was the size of the loans and their maturity. The special allowance payments and servicing costs were also uncertain.<sup>18</sup> In the early 1970s student loans had default rates as high as 24 percent for non-profit schools and 50 percent at for-profit schools, the government took a long time to pay claims and many students declared bankruptcy after finishing school. Interest rates were doubling in the market place so that lenders with fixed rate loans were losing money.

SLMA used computer modeling, a cutting edge tool at the time, to simulate the life span of student loans using discounted cash flow techniques.<sup>19</sup> It learned that of all the variables, the size of the loan and the servicing costs were the most important pricing factors, since SLMA paid a fixed amount for servicing no matter how big the loan.<sup>20</sup>

To make purchases possible, SLMA made an effort to set servicing standards for third party servicers. This was difficult because the notes were small, maturing at different times with different guarantors, the yields fluctuated with the special allowance, and claims were paid only if there was adequate due diligence in origination and servicing the loans.<sup>21</sup> SLMA first purchased student loan portfolios in 1974 amounting to \$4,391,500.<sup>22</sup>

Accounting for the yield was difficult because of the many unknowns. SLMA treated interest income as income in the period when it was accrued, adjusted by a share of any purchase discount and further adjusted for estimated future costs of servicing. The objective was to determine a constant yield over the life of the loan net of the cost of servicing. In 1974 this was 6.25 percent; with the maximum special allowance in 1974 the yield was 9.25 percent.<sup>23</sup> The average yield on T-bills, discount basis average was 7.89 percent in 1974.

### Initial stock sale

In July 1973 SLMA attempted to raise \$105 million by selling 700,000 shares of its common stock to the 16,000 lenders and 7,500 educational institutions that had participated in the guaranteed student loan program.<sup>24</sup> In March 1974, SLMA's Board required that participants in its programs purchase a minimum of 100 shares, later reducing this to 50 shares. Despite this, by June 1974, the stock sale had only brought in

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<sup>18</sup> SLMA Annual Report 1974, p. 11.

<sup>19</sup> SLMA Annual Report 1974, p. 11.

<sup>20</sup> Nelson, p. 39.

<sup>21</sup> SLMA Annual Report 1974, p. 11.

<sup>22</sup> SLMA Annual Report 1974, p. 18.

<sup>23</sup> Nelson, p. 43.

<sup>24</sup> NY Times, July 17, 1973, 7/17/73 N.Y. Times (Abstracts) 53

\$24 million for 166,667 shares.<sup>25</sup> Of the 571 stockholders, 399 financial institutions owned 66.5 percent of the shares while 172 educational institutions owned 33.5 percent.<sup>26</sup>

The statute allowed the Board to be elected once “sufficient common stock” had been purchased by “educational institutions and banks or other financial institutions.” The imprecision in the statute may have worked to SLMA’s advantage since even the small sale of stock was enough for President Ford to determine that sufficient common stock had been purchased to allow for an election of directors.<sup>27</sup>

The schools that held stock would elect seven directors, and the financial institutions would elect seven, with the remaining seven to continue to be appointed by the President. Because of the statute the representation on the board did not change. Each class of stockholders was able to elect seven members even though by 1982 financial institutions owned 76.8 percent of the shares and educational institutions owned 23.2 percent.

### **Early years 1975 – 1980**

In the early years SLMA dealt with borrowing uncertainties, interest rate risk and political risk. It faced differences between fixed rate and variable rate instruments and set up a matched book of assets and liabilities to handle this problem. It dealt with the uncertainties of the amount and maturity of the debt obligations it sold to the Federal Financing Bank by negotiating a \$5 billion master agreement extending its obligations for 15 years. It resolved to be non-partisan, and then faced attacks from the Federal agency with power to guarantee its loans. Congress passed the Education Amendments of 1980 that addressed several of SLMA’s problems.

#### Matched book of assets and liabilities

SLMA faced two kinds of interest rate risk: in market rates and in the rates set for the special allowance payment (SAP). In 1974 the cost of funds in the money markets was high, so SLMA chose to issue relatively short term obligations, planning to refinance them when longer term instruments when better rates became available.<sup>28</sup> During 1975 the two interest rate spreads widened, helping SLMA’s interest margin. A large block of fixed rate warehousing advances earned interest at higher rates that had been set before money market rates began to drop, and SLMA refinanced its short term funding for these advances at lower rates. The other interest rate spread during that time was for purchases and warehouse advances keyed to the special allowance, historically at 2.51. In 1975, that allowance averaged 3.02 % over the three-month Treasury bill rate.

For many years the conventional wisdom of financial institutions was that since interest rates were cyclical, lenders would have periods with little or no profit when they had to pay high rates to savers and hold old loans with low rates, but when rates changed they

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<sup>25</sup> SLMA Annual Report 1974, pp. 1, 3.

<sup>26</sup> SLMA Annual Report 1974, p. 9.

<sup>27</sup> Letter from President Gerald R. Ford to Edward A. McCabe, SLMA Chairman of the Board, January 29, 1975.

<sup>28</sup> SLMA Annual Report 1975, p. 17.

would catch up.<sup>29</sup> In the 1970s, for example, Fannie Mae's yields on the fixed-rate mortgages it bought were not sufficient to cover its rapidly rising cost of funds when interest rates were high.<sup>30</sup> Sallie Mae had been in the practice of signing fixed-term, fixed-rate notes with the Federal Financing Bank every 13 weeks, a period corresponding roughly to the time span used to determine the special allowance, and with some lag, to the yield on its variable rate advances.<sup>31</sup> It was SLMA's goal to match its assets and liabilities as soon as it could.

Under pressure to make college more affordable for middle-income students and their parents, Congress and the Carter administration agreed in 1978 to open the Federal loan program to any student, regardless of financial need.<sup>32</sup> Because Congress removed income limits from students qualifying for interest subsidies on their GSLP loans there was a 60 percent surge in applications.<sup>33</sup> In 1979, as interest rates rose, Congress also eliminated the 5 percent ceiling on the special allowance payment so that the yield on student loans could float.

With this change Congress eliminated the SAP risk, and SLMA's matched book could function smoothly and unimpeded. As the Washington Post wrote later, Sallie Mae never had to worry about getting what financiers call "a mismatched portfolio" because its variable lending rate and many of its variable borrowing rates run in tandem.<sup>34</sup>

#### Political uncertainties.

In 1976, an election year, the Board adopted a resolution saying that SLMA was not a partisan organization and it would not solicit contributions from its employees, shareholders or directors for partisan purposes or to engage in or allow the use of its name and offices in connection with partisan political activity.<sup>35</sup>

During Jimmy Carter's presidency, the political climate changed for SLMA. HEW Secretary Joseph Califano wanted to re-establish SLMA within the Office of Education, and possibly have the government begin to make student loans as a direct lender. The Secretary said that SLMA had not fulfilled its purpose and supported the idea of consolidating all of the student loan programs. He said that existing student loan programs were overly costly to the government because of "reliance on administrative middlemen and their generous incentive to the private sector."<sup>36</sup> Secretary Califano

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<sup>29</sup> Dr. James J. O'Leary, SLMA board member, Nelson, p. 65.

<sup>30</sup> Washington Post, 2/21/1983, Nancy L. Ross, *Sallie Mae Works A Risk-Free Arena*

<sup>31</sup> Nelson, p. 66

<sup>32</sup> Middle Income Student Assistance Act, Pub. L. 95-566; Nov. 1, 1978. This Act eliminated the adjusted family income ceiling for determining eligibility for interest benefits.

<sup>33</sup> Nelson, p. 66.

<sup>34</sup> Washington Post, 2/21/1983, Nancy L. Ross, *Sallie Mae Works A Risk-Free Arena*

<sup>35</sup> Nelson, p. 51.

<sup>36</sup> Nelson p. 73, quoting Anne C. Roark, Chronicle of Higher Education, April 1979. The article said "Sallie Mae is acting 'more like a Wall Street bank than a government service agency,' says one high-ranking HEW official." The article said complaints against SLMA were that:

- It had produced only a fraction of the student loan money it could have;
- Its "strenuous accounting and reporting procedures" kept out less sophisticated schools and lending institutions;

criticized Sallie Mae for not achieving its goals of encouraging private lenders to stay in the student loan market. Other critics claimed that the matched portfolio arrangement unduly enriched the banks and Sallie Mae at the expense of the taxpayer.<sup>37</sup>

SLMA's proposed master agreement for financing through the FFB had waited for ten months without the necessary approval from HEW. Since SLMA's chairman and seven members of its board were appointed by the president, it was possible to go to the White House and lobby against HEW's proposals.<sup>38</sup> The chairman of the board, E.T. Dunlap complained about the delay on the FFB agreement to Stuart Eizenstat, Carter's assistant for domestic affairs and policy. Within a few days Secretary Califano released SLMA's request for a master agreement on loan guarantees of debt sold to the FFB and HEW began to leave SLMA alone.<sup>39</sup>

On Capitol Hill, there were several proposals to change SLMA, incorporate it into the Office of Education, make it a non-profit, or make SLMA the government's direct lender. Congressman William Ford's proposed H.R. 5192 to expand SLMA, was attractive to the education lobby.<sup>40</sup>

SLMA beat down the proposals and won legislation that resolved problems and expanded its powers. The House committee report, issued in October 1979, disapproved of Secretary Califano's slow responses to SLMA's requests for guarantees:

As a means of facilitating the decision-making process with regard to granting approvals of Sallie Mae's financing arrangements, the bill requires that where approval or denial of Sallie Mae's financing requirements is not forthcoming within 60 days, the Congress be informed of the reasons by the Secretaries of Education and Treasury.<sup>41</sup>

### **Education Amendments of 1980**

In September 1980, Congress passed and on October 3, 1980, President Carter signed the Education Amendments of 1980.<sup>42</sup> These amendments authorized SLMA to issue non-voting common stock that would allow SLMA to obtain equity financing from the public supplementing the financing from its common stock holders, all eligible

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- Sallie Mae declined to disclose the names of its shareholders, which "make substantial profits" from doing business with Sallie Mae.
  - Sallie Mae's profits were ballooning, and not enough were being plowed back into student loans.
  - The corporation's "relatively high salary structure, its plush offices, and its generous perquisites" suggest, in the opinion of unnamed Carter administration officials, that Sallie Mae's officers and directors "appear indifferent to what Congress intended as its mission: helping needy students."

<sup>37</sup> Washington Post, 2/21/1983, Nancy L. Ross, *Sallie Mae Works A Risk-Free Arena*.

<sup>38</sup> Nelson, p. 73.

<sup>39</sup> Quoting SLMA Chairman E.T. Dunlap, Nelson, p. 73-76.

By July 1979, Joseph Califano was fired and replaced by Patricia Roberts Harris.

<sup>40</sup> Nelson, p. 77.

<sup>41</sup> House Report 96-250, to accompany H.R. 15192, the Education Amendments of 1980.

<sup>42</sup> Education Amendments of 1980, Oct. 3, 1980, Pub. L. 96-374, Title IV, §421(a) to (e)(1), (3), 94 Stat. 1427 to 1430, 1503.

guaranteed student loan lenders or schools. The new legislation gave the board the authority to fix the par value of common and preferred stock in line with normal par values, eliminated the requirement that the Secretary of Education approve stock issues, and extended the Department of Education's authority to guarantee SLMA's debt from June 30, 1982 to September 30, 1984. The stated intent of these modifications was to provide SLMA stability and efficiency in debt financing in order to prepare it for the transition to private funding. The legislation provided SLMA with a \$1 billion backup line of credit with the Treasury if needed as a source of funds.

The Amendments also allowed SLMA to adjust warehousing collateral requirements, allowed collateral other than guaranteed student loans for warehousing advances, and changed the requirement that all proceeds from warehousing advances be used for student loans. It also allowed SLMA to consolidate student loans and extend the repayment terms for those loans.

### **FFB Master Agreement**

For its first fourteen years, Congress allowed SLMA to issue debt backed by the full faith and credit of the United States.<sup>43</sup> SLMA did this through short term refinancings at six-week intervals. When Congress created the Federal Financing Bank (FFB),<sup>44</sup> Sallie Mae used it exclusively and the FFB owned its entire debt.

The statute was unclear about what the 1984 deadline meant, and there may have been an argument that SLMA would have to cease its borrowing from FFB in 1984 and find a way to refinance its outstanding debt. To immediately counter that argument, in 1973 SLMA went to the Attorney General of the United States, and obtained a legal opinion<sup>45</sup>

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<sup>43</sup> Higher Education Act of 1965, as amended,

439(h)(1). The Association is authorized with the approval of the Secretary of Health, Education and Welfare and the Secretary of the Treasury to issue and have outstanding obligations having such maturities and bearing such rate or rates of interest as may be determined by the Association. Such obligations may be redeemable at the option of the Association before maturity in such manner as may be stipulated therein.

(2). The Secretary of Health, Education and Welfare is authorized, prior to July 1, 1982, to guarantee payment when due of principal and interest on obligations issued by the Association in an aggregate amount determined by the Secretary in consultation with the Secretary of the Treasury.

<sup>44</sup> Federal Financing Bank Act, Dec. 29, 1973.

In December 1973 the Congress created the Federal Financing Bank (FFB) within the Department of the Treasury in order to provide a focal point for a more coordinated and cost-effective approach to financing for entities that use the full faith and credit of the federal government to support their debt. From 1974 through 1980, the Secretary of the Treasury required SLMA to borrow exclusively from FFB at a rate slightly higher than FFB paid for its funds. GAO, *Secondary Market Activities of the Student Loan Marketing Association, Report to the Senate Committee on Labor and Human Resources*, May 18, 1984, pp. 2-3

<sup>45</sup> On May 30, 1973, shortly after SLMA began operations, Attorney General Elliot Richardson signed a legal opinion for HEW Secretary Caspar Weinberger, saying that (1) guarantees by HEW are fully binding on the United States and are backed by the full faith and credit of the United States and (2) that Federal guarantees shall remain fully binding on the United States, regardless of the maturity date of the obligations guaranteed, provided that the guarantee was made prior to July 1, 1982. United States Attorney General Opinion to Secretary of HEW, May 30, 1973.

that the United States was bound on its guarantees of SLMA's obligations regardless of the maturity date of the obligations, provided that they were guaranteed prior to July 1, 1982. The opinion also said that the deadline for SLMA to stop borrowing from the FFB in the statute applied to the date when the debt was issued, not the date it was due.

SLMA had to obtain regular approvals from HEW even when there were no increases in the amount of its guarantee. Arguing that these approvals took time and presented problems when SLMA needed funds on an immediate basis as it increased its loan purchases and variable rate advances, SLMA asked for a six month blanket approval for up to \$500 million.<sup>46</sup> HEW approved this arrangement in December 1975, later approving increases in the authority up to \$800 million. To obtain the maximum financial advantage in financing its secondary market activities, SLMA sold individual guaranteed debt obligations with 91-day maturities to the FFB on a weekly basis.<sup>47</sup>

At first SLMA borrowed from the FFB with short term notes, refinanced its loans every six weeks after obtaining approvals from the Secretaries of Treasury and HEW. In January 1975 SLMA persuaded Nixon's HEW Secretary, Caspar Weinberger, to authorize and guarantee an amount to cover projected borrowings for six month periods. Its notes began to pile up. In May 1978 Edward Fox began to press for a master note for \$1 billion with variable interest for a 15 year term.<sup>48</sup> The FFB agreed to the terms of the master note, including notice and documentation requirements, but HEW deferred considering it.

In December SLMA asked again, arguing that because long term financing was uncertain it had already had lower bond ratings for its commitments to state agencies, it needed assurances that it would have long-term financing available at a reasonable cost. SLMA owned student loans or made advances at variable rates for periods between ten and twenty-four years. In order to match its variable rate assets to its debt it regularly refinanced its debt with three-month obligations tied to Treasury bills. This created a match that allowed a positive spread between its revenues and costs, regardless of the prevailing level of short-term interest rates. Because the spread was relatively predictable, SLMA was able to price its programs without adding a financing risk premium and adjust its outstanding debt as needed by student loan purchases, advances or repayments and reduce its risk from prepayments. It argued that a variable rate long term arrangement of financing through the FFB would avoid the cost of financing student loans and variable rate advances by issuing fixed rate, fixed term obligations. It would allow SLMA flexibility in its secondary market programs based on the relatively risk-free financing through the FFB. SLMA was also concerned that without a long term

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Mr. Richardson had himself been HEW Secretary, and then Secretary of Defense for four months before being appointed Attorney General on May 24, 1973, after John Mitchell resigned.

<sup>46</sup> Letter from Edward A. Fox, SLMA President, to Caspar Weinberger, Secretary of HEW, January 10, 1975.

<sup>47</sup> The FFB would not make loans that were not specifically for purchase of federally guaranteed loans. Using the FFB prevented SLMA from taking advantage of the cost of funds spread to make a profit. SLMA would rather be scrutinized by bankers concerned with its diversification of risk and its profitability rather than bureaucrats concerned with whether it was financing only mission-related activities.

<sup>48</sup> Letter from Edward A. Fox to Joseph A. Califano, Jr., HEW Secretary, May 10, 1978,

agreement it would face a higher cost of funds after 1982 and since the assets it had on its books in 1978 had maturities extending beyond 1982, it would have trouble offering attractive prices for its warehousing advances and student loan purchases.<sup>49</sup>

In May 1979, SLMA negotiated an agreement with the FFB to provide weekly refundings. This provided SLMA with a better match with the yield on its variable rate warehousing advances, which also fluctuated weekly, and with student loan assets on which the yield was tied to the average weekly Treasury bill auction rates. The disadvantage was that in a period of rapidly rising short-term rates such as 1979, Sallie Mae's debt costs responded more quickly to interest rate changes.<sup>50</sup>

In mid 1980 the Secretary of the newly created Department of Education approved:

- SLMA 15 year note with FFB,
- refinancing \$2.65 billion of outstanding debt at a
- variable-rate indexed to the 91-day Treasury bill rate.

With this agreement the benefits of federally guaranteed debt would continue through 1995. This deal averted SLMA's weekly refundings with the FFB until authority for the Federal guarantee ran out. At that time SLMA would have had to roll over its huge debt all at once, or phase it out by the deadline at an accelerated rate.

In March, 1981, SLMA made another agreement with FFB to allow up to \$5 billion to be refinanced no later than September 30, 1982 – two years before the 1984 deadline. This basically increased the amount SLMA could borrow from its current \$3.2 billion by an additional \$1.8 billion. This agreement removed SLMA's debt management from the control and review of the Department of Education and the Department of the Treasury. Edward Fox said later:

"I can't tell you how important [the FFB agreement] really was to the long - term strength and stability of Sallie Mae," said Mr. Fox. "As a manager, I think it was probably the most important thing I did here. It was during a period when the new [Reagan] administration was trying to cut back on privatized institutions like ours. Joe Barr was chairman of our finance committee. I negotiated with Treasury, OMB, and the White House and kept the key committee members on the Hill informed--both Democratic and Republican. They were very concerned at that time that a proposed budget resolution was going to substantially cut back on education funding."<sup>51</sup>

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<sup>49</sup> Letter from Edward A. Fox to Joseph A. Califano, Jr., HEW Secretary, December 4, 1978, and attached Background Memorandum Concerning the Need for a Master Note.

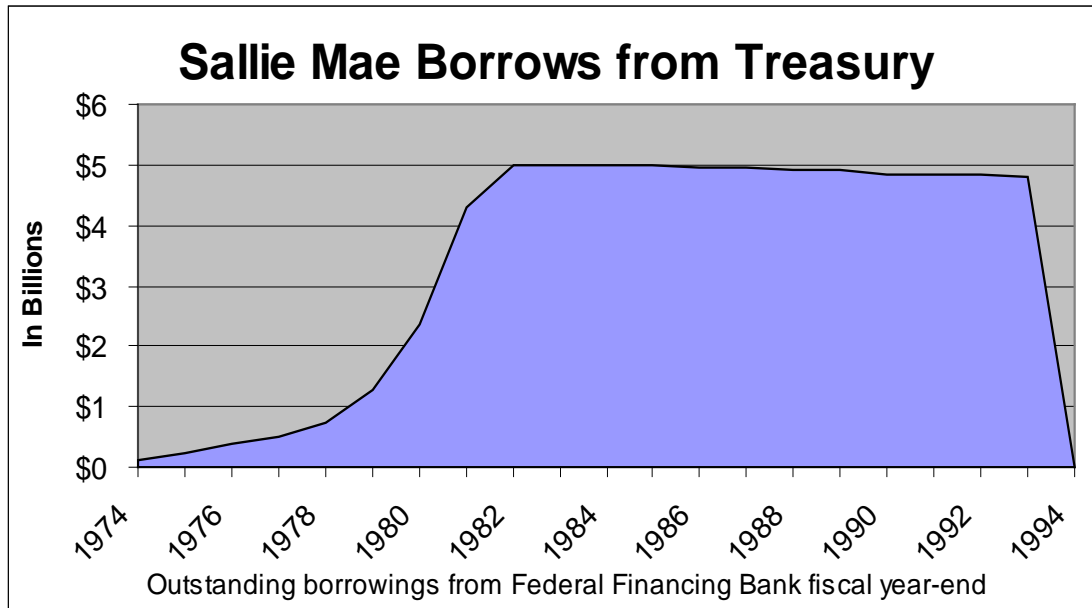
On January 4, 1979, SLMA met with Secretary Califano to discuss the proposal for a \$1 billion long term variable rate master note. SLMA said it was becoming difficult to provide financing because its bond ratings were being hurt by its lack of long term financing capacity beyond 1982. Secretary Califano not only did not approve the request for a long term Master Note, and but he prepared proposed amendments to greatly cut back SLMA. Before he could present these amendments, Mr. Califano resigned on July 17, 1979.

<sup>50</sup> Nelson, p. 76.

<sup>51</sup> Nelson, p. 80-81.



The following depicts the history of Sallie Mae's FFB borrowings. SLMA used the FFB financing to fund a period of rapid growth in the early 1980s and continued to benefit from the FFB financing until 1994.



When the Reagan Administration came into office its cost cutting goals were a threat to student loan funding and potentially to SLMA. As part of the Education Amendments of 1980, Congress had already removed the requirement that SLMA use the FFB for all of its debt obligations. Even though the FFB would increase its holdings of SLMA obligations to \$5 billion from the \$3.3 billion in 1981, SLMA was able to announce that it was phasing out its dependence on government financing. As *Forbes Magazine* reported, Edward Fox had been pushing for almost from the time he took office to go it alone in the public capital markets rather than rely on the Federal Financing Bank. “When we started,” said Fox, “no one thought we could make it. But we’ll be the first to go public.”<sup>52</sup>

Sallie Mae viewed itself as a financial company, not as a charitable institution.

Since day one we have run this corporation as a business. We're not educators and we don't pretend to be. We know there are people out there primarily interested in education who have no notion what the banking business is. Somebody once suggested at a [congressional] hearing that people would be willing to put money into Sallie Mae stocks and bonds at a lower return to themselves . . . even if we were losing money, because they would know in their gut we were doing something good. That is the most naive, simplistic pap I have heard in my life.

<sup>52</sup> *The Quick Ed Fox*, Ben Weberman, *Forbes*, April 13, 1981, p. 178.

I'm competing with some of the largest, most highly successful capitalized companies in the country to obtain capital. I've got to get it where I can. Only if our balance sheet and profits stand that scrutiny will sophisticated portfolio managers invest their money in this program. And only if I can get that money can I turn around and do what has to be done in support of social programs.<sup>53</sup>

### **Refinancing and Alternative Sources of Capital**

At the end of the period when SLMA could borrow from the FFB SLMA had to raise funds through non-federally guaranteed borrowing in the capital markets and the public issuance of stock.

#### **Common stock sale**

Since the 1980 Higher Education Act allowed SLMA to issue non-voting stock, SLMA's board decided to have a stock split six for one, to increase the outstanding shares to 1 million shares. The new shares were worth \$67.71 by the end of 1981.<sup>54</sup>

In February 1983, SLMA announced that it planned its first issue of 4 million shares of preferred stock. The adjustable-rate stock had a stated value of \$50 a share.<sup>55</sup> Adjustable rate stock had become popular with large bank holding companies such as Citicorp, Bank of New York, and Fleet Financial Corp. SLMA's shares were priced at 450 basis points below the highest of the 3-month Treasury bill rate or the 10-year or 20-year constant maturity rates. SLMA guaranteed it would pay a rate that would not fall below 5% or rise over 14%, beginning with a 9% annual dividend for two quarters, and floating after that. SLMA had the option of redeeming the shares for two years starting in 1986.<sup>56</sup>

On March 1, 1983, SLMA sold another five million shares of adjustable rate preferred stock at \$50 each. The dividend rate was 4.5 points below the lowest of three Treasury securities. This additional \$250 million was equity not debt, but it acted like debt and floated like SLMA's debt, tied to the T-bill rate.<sup>57</sup>

In July 1983 SLMA split the common stock at 35 for 1, and gave its shareholders the opportunity of converting shares to non-voting shares, to be available to the public for sale. SLMA put forward 4 million in new shares, and the shareholders offered 6 million, all sold on September 29, 1983, for \$20 each. The New York Times estimated that SLMA's intended sale of 1.5 million shares would double its equity, and SLMA did much better with its sale of 4 million shares for \$20 each.<sup>58</sup> The sale provided Sallie Mae

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<sup>53</sup> Ross, Nancy, *Sallie Mae Works a Risk-Free Arena*, Washington Post, Feb. 21, 1983, p. WB1.

<sup>54</sup> Nelson, p. 86

<sup>55</sup> American Banker, February 14, 1983.

<sup>56</sup> Forde, John P., American Banker, Feb. 16, 1983.

<sup>57</sup> Nelson, p. 86

<sup>58</sup> NY Times, Section D, "Sallie Mae Arranging Sale of 6 million Shares," Sept 14, 1983, and, Section D, "Sallie Mae is Offering 10 Million Shares at \$20," Sept. 22, 1983.

with an additional \$104.4 million for operations.<sup>59</sup> Original shareholders who had bought for \$150 a share in 1974, had their shares split into 210 shares, each worth \$20, so that the original investment grew to be worth \$4,200.<sup>60</sup> In November 1983 Sallie Mae announced a 2.7 cent dividend for its new common shares, saying the dividend reflected a 35-for-1 stock split in September and was the equivalent of a 32 cent increase over the pre-split dividend of 62 ½ cents.<sup>61</sup> In April 1984 the stock was listed on the NY stock exchange.<sup>62</sup>

The chairman of the board, Edward McCabe believed that issuing nonvoting common stock was an important step in SLMA's progress toward being a private company. "Summing it up," he says, "we wanted more equity, but we also wanted to substantially broaden our shareholder base beyond the banks and schools that held our voting stock. With just plain people in sizeable numbers now holding our shares--in addition to the banks and schools--we're much more the private company and less vulnerable than before--less vulnerable to governmental tinkering."<sup>63</sup>

### **Floating Rate Discount Notes**

As a first step in its transition to the capital market (i.e., GSE or agency debt), SLMA began offering discount notes. It launched a sale on May 19, 1981, of \$35.8 million in notes with a weighted average maturity of 24 days and an average rate of 17.45 percent at a time when T-bills reached a high of 17.24 percent. By the end of the year SLMA had \$419.5 million outstanding in discount notes with an average maturity of 9 days and an average rate of 11.5 percent. By that time a little more than 8 percent of SLMA's debt did not have Federal guarantees.

In January, 1982 SLMA began to sell floating rate notes with weekly adjustments tied to 91 day Treasury bills. The first \$250 million issue of three-year floating notes was sold through an underwritten offering in February 1982. These may have been the first floating rate agency securities as well as the first with a weekly adjustment. In the resale market they sold close to par because of the frequent adjustments in a volatile market. By the end of the year SLMA had issued \$650 million in these floating rate notes.<sup>64</sup>

### **Interest Rate Swaps**

SLMA aggressively pioneered interest rate swaps in the American market in 1982-83, after Fox and SLMA's EVP for finance and administration, John K. Darr learned about the concept of interest rate swaps while they were on a trip to Europe to explore using floating rate debt instruments in the European market.

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<sup>59</sup> GAO, *Secondary Market Activities of the Student Loan Market Association, Report to the Committee on Labor and Human Resources*, US Senate, May 18, 1984, p. ii, & p. 12.

<sup>60</sup> Nelson, p. 87

<sup>61</sup> Philadelphia Inquirer, Business Section, Nov. 19, 1983.

<sup>62</sup> Nelson, p. 87

<sup>63</sup> Nelson, p. 88

<sup>64</sup> Nelson, p. 88

The idea is that parties trade, or swap, away the parts of their debt issues that they don't want. Matching the parties to make good trades is the difficult part. SLMA could issue long term fixed rate loans with good rates, but preferred floating rates to match its other assets. Other issuers could reach the short-term markets, but preferred the stability of fixed rates. The swap would trade streams of interest payments, while each party kept its original obligation. To address the problem that a party might not fulfill its obligation, a third party such as a commercial bank could offer to guarantee the payments, and one of the parties might require collateral. For SLMA this was a solution to the problem that the floating rate market was drying up.

Its first swap was with ITT Financial Corporation to pay a floating rate of 75 basis points above the 91 day T-bill rate on \$100 million for seven years. ITT promised to pay a fixed rate of 13.15 percent interest on \$100 million for the same time. SLMA sold \$100 million of fixed rate debt at 13.15 percent in the "agency" sector of the market on September 9. The fixed rate debt was swapped for an effective floating rate debt, and ITT said it would save more than 100 basis points on the swap.<sup>65</sup> This swap was followed by another \$100 million, seven year swap and by January 1983, Sallie Mae had executed approximately \$500 million swaps with a dozen counterparties and by the end of 1983 had entered into \$1.9 billion in swaps. SLMA was the acknowledged leader as swaps became increasingly popular in the American markets.<sup>66</sup>

### **Financing Debt without Federal Guarantees**

In 1984 SLMA used floating rate notes with weekly resets, zero coupon bonds and 25-year convertible subordinated debentures. By the end of the year less than half of its debt was federally guaranteed.<sup>67</sup> In 1985 it made offerings in the Eurobond market and the Japanese market, both dollar denominated and indexed to the yen. In the same year it offered in the U.S. \$250 million in notes indexed to the yen. These offerings all came to approximately \$900 million in 1985.<sup>68</sup>

### **State Tax Exempt Bonds and Bank Purchase**

The Guaranteed Student Loan Amendments of 1976 pushed administration of the GSLP to the states, and the states found that they could finance these loans with tax exempt bonds. They could make a profit on these bonds by issuing them below Treasuries and then investing the proceeds in student loans that gave a high rate of return because of the Federal government's SAP payment. Treasury was losing business to the state bonds, and enriching the states with the SAP payment. The spread was about 16 percent. When the loans went into repayment, the states could sell them to SLMA and avoid the expense of servicing. Congress became concerned.<sup>69</sup>

However, instead of reducing the SAP where states had financed the student loans through tax-exempt bonds, Congress allowed states to sell their tax-exempt bonds to

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<sup>65</sup> Nelson, p. 89

<sup>66</sup> Nelson, pp. 89-91.

<sup>67</sup> Nelson, pp. 91-92

<sup>68</sup> Nelson, p. 92

<sup>69</sup> Nelson, p. 93

SLMA. SLMA got tax-exempt income, the state agencies benefited since rating agencies had been lowering ratings, and the Treasury continued to lose money from the arbitrage. SLMA limited its purchases of tax-exempt bonds to 2 percent of its assets because of IRS limits. By purchasing \$52.7 million in 1983, the taxes that SLMA paid went from 45.1 percent in 1982 to 44.9 percent, and in 1984, the rate went down to 40.4 percent, saving \$8 million. The only problem with these bonds was that they could only amount to 2 percent unless SLMA was a financial institution.

### **Bank Purchase**

In 1981, Congress expanded Sallie Mae's mission<sup>70</sup> and authorized the company to deal in non-insured loans and to undertake other activities deemed necessary by the board to support the needs of students generally.<sup>71</sup> In 1982 SLMA decided to buy a savings institution as a way to increase its holdings of tax exempt bonds and develop products for financing education such as home equity loans.<sup>72</sup>

It abandoned its attempt to purchase a Federal savings bank in 1984 when the Federal application process was too slow and could fail.<sup>73</sup> Instead it acquired a state chartered bank that it called First Capital Corporation. This subsidiary would be able to buy tax exempt bonds without the two percent limit. As it became clear that Congress was opposed to SLMA's owning a bank, and as the tax law changed to cut back on tax-exempt bonds, SLMA sold its bank in 1986.<sup>74</sup>

Sallie Mae appeared to be contemplating total privatization in 1983. The Washington Post reported that Sallie Mae's CEO, Edward A. Fox, "conceded the acquisition of a bank might be one option in its move towards total privatization." Subsequently, Sallie Mae help financed a start-up bank – congress reacted negatively to this business activity. In 1986 Congress restricted Sallie Mae's broad authority to undertake "any activity" by stating that Sallie Mae is not authorized to "acquire, own, operate, or control any bank, savings and loan association, savings bank or credit union."<sup>75</sup>

### **Loans to States.**

In 1983 SLMA started making direct loans to states after the Federal tax benefits from tax exempt bonds were reduced and Congress required state agencies to obtain non-tax-exempt funding if possible from such sources as SLMA. By the end of 1984, SLMA had \$2.3 billion in commitments to states.<sup>76</sup>

It began, in 1983, to issue irrevocable letters of credit backing state bond issues for student loans. SLMA guaranteed to the bondholders that it would pay the interest and principal if the issuer could not.<sup>77</sup>

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<sup>70</sup> Pub. L. No. 97-35

<sup>71</sup> 20 U.S.C. 1087-2(d)(1)(E)

<sup>72</sup> Nelson, p. 94

<sup>73</sup> Nelson, pp. 95-96

<sup>74</sup> Nelson, p. 97

<sup>75</sup> Pub.L. No 99-498; 20 U.S.C 1087-2(d)(1)(E)(ii)

<sup>76</sup> Nelson, p. 100

<sup>77</sup> Nelson, p. 100

### **Sallie Mae Stock Value**

In 1983, the Board of Directors had approved the issuance of a non-voting class of common stock equal in all other respects to the voting common stock and transferable without restriction. In connection with a September 1983 public offering, holders of voting common shares were granted the right to periodically convert a portion of their holdings to non-voting common stock.

In May 1984 SLMA's stock had a "buy" recommendation from John Keefe of Drexel Burnham Lambert. "Sallie Mae is the major intermediary for educational credit in the form of the guaranteed-student-loan program. The federally chartered company makes loans to banks, thrifts and state agencies to facilitate \$8 billion per year of GSL's and also purchases the institutions' outstanding loans. The company's balance sheet is of very high quality; substantially all of Sallie Mae's assets are fully collateralized or federally insured against default risk. We recommend purchase with an eye toward the firm's profit growth potential (we estimate earnings per share growth at 30-35 percent for the next five years) and insensitivity to interest-rate conditions (Sallie Mae's cost of funds in 1983 exceeded the T-bill rate by just 32 basis points). The company has been publicly traded since September 1983."<sup>78</sup>

By December 1984, its political risk hit the stock hard. Reagan recession fears and the budget cutting debate brought down stock prices by nearly 10 points since the budget-cutting debate went public. Analysts saw the decline as being caused solely by concern that student loans would be targeted for budget reductions."<sup>79</sup>

In September 1986, Sallie Mae's Board of Directors authorized management to repurchase common stock at market prices. As of December 31, 1989, Sallie Mae held \$537 million of treasury stock. The Board authorized Sallie Mae to repurchase up to an additional 3.5 million shares (including up to 2 million shares of voting common stock) on or after February 1, 1990.<sup>80</sup> On December 31, 1989, there were 12.9 million voting and 85.7 million non-voting common shares outstanding, net of treasury stock.<sup>81</sup>

In 1991 there were 11.9 million shares of voting common stock, held by educational and financial institutions eligible to participate in GSL programs, 82.1 million non-voting shares of common stock and 4.3 million shares preferred stock. SLMA's market value as of December 31, 1990, was \$3.8 billion.<sup>82</sup>

In 1990, Edward Fox, the first CEO, resigned and the Board replaced him with Lawrence Hough as President and CEO. Timothy Greene was the new General Counsel and Albert Lord, who had been CFO was named EVP and COO.

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<sup>78</sup> Davis, Dick, *Student Loan Outfit Called A Safe Bet*, Miami Herald, May 30, 1984.

<sup>79</sup> Henriques, Diana, Inquirer Staff Writer, *As the Dow Falls 1.11, Stock Analysts See Signs of Anxiety Market's Malaise is Said to Reflect Worries About Recession*, Philadelphia Inquirer, Dec. 7, 1984.

<sup>80</sup> Treasury GSE Report, May 1990, Appendix F, Student Loan Marketing Association, pp F-36 to F-37

<sup>81</sup> Treasury GSE Report, May 1990, Student Loan Marketing Association, pp F-36 to F-37

<sup>82</sup> CBO Report, "Controlling the Risks of Government-Sponsored Enterprises," April 1991, p. 245.

**GSE Risk**

As a result of the savings and loan crisis in the late 1980s, Congress asked Treasury to study GSE risk, including that of SLMA.<sup>83</sup> Treasury noted that S&P had given SLMA an AAA credit rating, compared to A+ for Freddie Mac and A- for Fannie Mae. It also noted that SLMA was virtually unregulated, since Congress had specifically said in the Higher Education Act of 1965 that the Secretary of Education and the Treasury Secretary could not limit, control or constrain programs of SLMA. The Department of Education could review SLMA's compliance with its servicing requirements and participation in the guaranteed student loan program. SLMA submitted its annual audit reports as Congress required to Treasury. The report set out elements necessary for effective safety and soundness regulation:

- 1) Authority to determine capital standards
- 2) Authority to require periodic disclosure of relevant financial information
- 3) Authority to prescribe, if necessary, adequate standards for books and records and other internal controls
- 4) Authority to conduct examinations and
- 5) Enforcement authority, including cease and desist powers, and the authority to take prompt corrective action for a financially troubled GSE.

Treasury and Education did not have the necessary authorities to provide it with effective financial safety and soundness regulation.<sup>84</sup>

**SLMA's Business**

In 1990 SLMA's business was purchasing and holding government guaranteed student loans and providing warehouse financing secured by student loans. SLMA maintained a sizable portfolio of short term investments for liquidity purposes, made limited construction loans to educational institutions and invested in bonds for student loans and facilities.

Outstanding guaranteed student loans had gone from \$23 billion in 1982 to \$53 billion in September 1990, when SLMA held 31 percent, the largest market share. The outlook for student lending was positive because of the increased demand, but governmental concern about costs was growing. In 1990 the guaranteed student loan program cost the government \$4.4 billion, with \$2.5 billion for defaults and claims, and the rest for subsidies. If there were to be restrictions, they would fall mainly on trade school loans since that was were most of the bad credit experience lay.

SLMA expanded its market share as private financial institutions saw holding and servicing loans as unattractive because of default rates and other problems. SLMA increased its servicing capacity so that in 1990 it was servicing over half of the loans it held in seven servicing centers, which S&P characterized as technologically advanced, and had a well organized growth strategy for training, capacity and workflow.<sup>85</sup>

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<sup>83</sup> Treasury GSE Report (April 1991).

<sup>84</sup> Pp. 10, 38-40

<sup>85</sup> 1991 Treasury Report p. A-47.

**Interest Rate Risk**

Treasury found that Sallie Mae carefully managed its interest rate risk position and its reported gap position shows minimal exposure to interest rate risk. Student loans, while fixed to the borrower, were floating rate assets to Sallie Mae since the government paid a spread over T-bills to the holder of the loan. Its warehouse advances were either floating rate or matched funded to term, and its investment portfolio was also predominantly short term. Long term liabilities carried floating rates or fixed rates that were either matched to fixed rate assets or swapped into floating rates. Sallie Mae carefully monitored its swap exposure and counterparty risk.<sup>86</sup>

**Servicing Risk**

By 1991 SLMA was managing the servicing risks of guaranteed student loans and its advances secured by these loans. Even though student loans had a poor credit history, they were insured by the Federal government, so the risk was low. In 1991 Treasury felt that SLMA's capital was high enough to protect against risks such as the failure of a guarantor, even though its leverage had increased recently from an active stock buyback program. SLMA's profitability was strong, reflecting its low operating expense and attractive cost of funds.<sup>87</sup>

**Asset dispersion/Quality**

At the end of 1990 SLMA had assets of \$41.1 billion, up 16 percent from the year before and 44 percent from 1988. In 1990 it had 46.8 percent of its assets in insured loans, 23.2 percent in warehouse advances and 27.3 percent in cash and investments. The investment portfolio had grown from 22.9 percent in 1988, and warehouse advances had dropped from 27.9 percent that year.<sup>88</sup>

The investment portfolio was maintained for liquidity reasons, and generated income. Since Sallie Mae funded on a low cost basis as a GSE, it was able to make a spread between its cost of funds and the yield on this investment portfolio. This was a high grade, short term portfolio, comprised heavily of fed funds (69% of the portfolio at 1990 year-end) and supplemented primarily with Treasury securities, money market preferred stock (high grade issues), student loan revenue and facilities bonds.<sup>89</sup>

Sallie Mae's portfolio of insured student loans represented the largest part of its business. These loans were purchased from primary originators (banks, thrifts, state agencies, non-profit originators) and virtually all were ultimately insured by the U.S. government. Insurance coverage aside, student loans do not have a very good credit history. The national default rate in 1990 was 6.8% (claims paid during the year to loans in repayment), and the cumulative national rate (total defaults since inception of the program to loans that have entered repayment) was 14% on a gross basis and 9.6% on a

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<sup>86</sup> 1991 Treasury Report p. A-50.

<sup>87</sup> Report of the Secretary of the Treasury on Government-Sponsored Enterprises, April 1991, Student Loan Marketing Association (1991 Treasury Report), p. A-46.

<sup>88</sup> 1991 Treasury Report p. A-48.

<sup>89</sup> 1991 Treasury Report p. A-48.



net basis (net takes into consideration recoveries). The insured nature of these loans provided considerable comfort to the holder or to a warehouse lender that has taken these loans as collateral, but there could be problems related to claims payments. Claims may be rejected if the holder has not followed proper procedures; for example, if it has not made adequate effort at collection. This underscores the importance of good servicing, which we believe Sallie Mae has; it has never had a significant problem with its claims.<sup>90</sup>

### **Profitability**

Sallie Mae was a strong earner. ROA trended downwards from 0.94% in 1985 to 0.78% in 1990, in part reflecting the growth in the investment portfolio and the narrower returns on this line of business and in part tighter pricing on student loans. Reflecting increased leverage, ROE actually increased to 28% in 1990 from 20% in 1985. Sallie Mae benefited from its funding as a GSE, as well as from its market position as a titan within the guaranteed student loan business. While Sallie Mae's margins were narrow, and declining, it benefited from an extraordinary low expense ratio. Overhead to operating income at 16% compared favorably to that of other financial institutions. The stability of Sallie Mae's ratio reflected the wholesale nature of its operations and also suggested good cost controls. Net income also benefited from the historical absence of any provision for loan losses, reflecting the minuscule credit losses sustained by Sallie Mae over the years.<sup>91</sup>

### **Funding and Asset Liability Management**

Sallie Mae's funds were raised in the public debt markets. As a government sponsored enterprise with significant links to the Treasury, Sallie Mae was perceived by the markets as an "agency" and benefited accordingly. Sallie Mae issued both long and short term debt, with a breakdown between the two of 62% long term (maturities greater than one year) and 38% short term. The relative proportion of short term rose, reflecting the growth in the investment portfolio, which tended to be short term in nature, mitigating any concern about the shift. The high proportion of long term debt mitigated liquidity risk.<sup>92</sup>

### **Capital**

Measured in terms of asset leverage or loan leverage, leverage rose substantially. Average equity to loans went from 5.69% in 1985 to 4.11% in 1990 and average equity to assets went from 4.77% in 1985 to 2.83% in 1990. Although strong earnings combined with a modest (20%) payout ratio, led to good earnings retention, capital was pressured by an aggressive policy of stock repurchasing. Given the rating category, in S&P's view, Sallie Mae was not overcapitalized and continued leverage could have had negative implications. Nonetheless, capital was appropriate to the asset and business risks of Sallie Mae at the AAA level.<sup>93</sup>

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<sup>90</sup> 1991 Treasury Report p. A-48-49.

<sup>91</sup> 1991 Treasury Report p. A-49-50.

<sup>92</sup> 1991 Treasury Report p. A-50.

<sup>93</sup> 1991 Treasury Report p. A-50

## 1992 Legislation

### Minimum Capital Requirements

In February 1992, the House Committee on Education and Labor based the safety and soundness provisions for SLMA in the Higher Education Amendments of 1992<sup>94</sup> upon the studies by CBO and Treasury. Finding that SLMA presented no current risk to the Federal government and that it was among the most safe and sound of the GSEs, it proposed legislation that it described as not remedial, but instead intended to provide Congress with early and adequate warning should SLMA's condition deteriorate and to enable appropriate and timely action to be taken.

The legislation, enacted as part of the Higher Education Amendments of 1992, enhanced Treasury's oversight of SLMA by requiring SLMA to provide copies of its financial reports to Treasury and authorized the Treasury Secretary to audit SLMA. SLMA was required to maintain a two percent capital ratio (shareholder equity to its total on-balance sheet assets and 50 percent of certain off-balance sheet items). At the time, said Congress, savings and loans and national banks holding the same assets as SLMA would have had to maintain a 1.7 percent capital ratio. As of March 31, 1991, SLMA had \$1.129 billion in capital and a capital ratio of 2.54 percent. If its capital ratio fell below two percent, SLMA would have to submit a business plan for increasing its capital to Treasury. If Treasury disagreed with the plan and SLMA refused to make changes proposed by Treasury, Treasury would inform Congress and if Congress took no action within 60 legislative days, SLMA could implement its plan.

Because a sizable reduction in SLMA's capital would likely be as a result of structural problems in the student loan program, and actions by SLMA to improve its condition could compound such problems Congress provided that the Secretary of Education would also report on what administrative and legislative steps should be taken to increase SLMA's capital while maintaining the viability of the student loan programs.

Congress allowed a safe harbor for SLMA even if its capital ratio fell as low as one percent if at least two nationally recognized credit rating agencies rated SLMA at AA- or better. These ratings, like the Standard & Poor's rating in the 1991 Treasury report, must be without consideration of SLMA's status as a GSE. If only one credit rating agency was willing to provide that kind of rating, Congress said that only one rating would be required.<sup>95</sup>

Congress established safety and soundness capital requirements for SLMA. It gave the Treasury Department supervisory authority to monitor SLMA financial condition and establish a minimum equity-to-assets ratio of 2 percent.<sup>96</sup>

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<sup>94</sup> H.R. Rep. 102-447, to accompany the Higher Education Amendments of 1992, P.L. 102-325. H.R. 3553, included the text of H.R. 3083, voted out of Committee on July 30, 1991.

<sup>95</sup> Higher Education Amendments of 1992, Sec. 431(e); H.R. Rep. 102-447 accompanying Higher Education Amendments of 1992, P.L. 102-325 (Feb. 27, 1992), at 387-8.

<sup>96</sup> SLMA Annual Report 1992, p. 4.

**Voting Common Stock – 1992 changes**

While Congress imposed minimal capital requirements on SLMA, it also allowed SLMA to convert all of its voting and non-voting common stock into a single new class of voting common stock with unrestricted ownership.<sup>97</sup> Up until then only participating lenders and schools could own voting common stock. The previous class of non-voting common stock would be converted to voting common stock, on a “one-share, one-vote” basis, on the effective date of the Act, July 23, 1992.<sup>98</sup> Of the 21 board members, shareholders could elect 14 board members, seven representing financial institutions, and seven representing educational institutions.<sup>99</sup> The remaining seven would continue to be appointed by the President who would designate one of the directors to serve as chairman.

The Department of Education had argued that there was no good reason for the change and that it would mean a windfall gain to some stockholders without any benefit to the government or student borrowers.<sup>100</sup> Congress explained that making this change would “promote good corporate governance by ensuring that the Board of Directors is accountable to all Sallie Mae shareholders.”<sup>101</sup> It said the changes in the stock and the composition of the board would simplify SLMA’s capital structure and expand public stockholder participation in the affairs of SLMA. The stock traded on the New York Stock Exchange as SLM, the symbol previously used for the non-voting common stock.<sup>102</sup>

On July 23, 1992, all of the outstanding voting and nonvoting common shares converted to a single new class of unrestricted voting common shares. The conversion was automatic with the enactment of the Higher Education Amendments of 1992. With the exception of voting rights, Sallie Mae’s nonvoting common stock was equal in all other respects to the voting common stock and transferable without restriction.<sup>103</sup>

In July, 1988, Sallie Mae offered to exchange for unrestricted common stock 2,149,960 restricted book value shares issueable upon exercise of stock options held by current and former management under the stock option and incentive performance plans. The exchange was offered in four annual installments. The fourth and final exchange of 227,040 restricted book value shares occurred in January 1992. As of September 31, 1992, all the restricted book value shares had been exchanged for 1,135,210 shares of unrestricted common stock.

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<sup>97</sup> Higher Education Amendments of 1992, Sec. 431, Pub L. 102-325, June 29, 1992.

<sup>98</sup> Higher Education Amendments of 1992, Sec. 431(f); S. Rep. 102-204, 102<sup>nd</sup> Cong. 1<sup>st</sup> Sess. 1991, p. 55

<sup>99</sup> Higher Education Amendments of 1992, Sec. 431(a).

<sup>100</sup> Treasury notes from “Sallie Mae GSE Legislation Briefing Book, January, 1992”

<sup>101</sup> House Committee on Education and Labor Report 102-447 (Feb. 27, 1992).

<sup>102</sup> SLMA Annual Report 1992, p. 4

<sup>103</sup> SLMA Annual Report 1992, p. 41



## Appendix 2– Vexing Accounting

Capital is the primary tool for regulators to monitor the health of financial institutions. Not only is the appropriate *level* of capital a matter of some debate, but increasingly there is debate on how to *measure* capital as accounting standards for financial institutions have become more complicated.

Sallie Mae provides a case study of the increasing complexity of the financial services business and the simultaneous rise of problematic accounting standards for securitization, derivatives, hedging transactions, and unconventional loan products that impact the quality and quantity of reported capital. Earnings volatility that in some cases does not reflect economic results is caused by certain accounting practices.

While the accounting pronouncements issued by the Financial Accounting Standard Board (FASB) for securitization, derivative, and hedging transactions are largely seen as having improved financial reporting overall, they have also created challenges for legislators, regulators, boards, management, investors and other stakeholders. In the early 1980s, in response to threatened insolvencies of savings and loan associations, regulators implemented what is now seen as a misguided policy by providing for “augmentation” of capital through regulatory accounting principles (RAP) that were considerably less stringent than generally accepted accounting principals (GAAP). Unfortunately, in the current environment GAAP accounting now needs to be monitored for results that overstate capital from a safety and soundness perspective, as the Sallie Mae case illustrates.

### Financial Reporting Issues - GAAP and Alternative Performance Measures

The graph on the next page plots GAAP comprehensive net income<sup>1</sup> of SLM Corporation and a non-GAAP performance measure that SLM management calls “core cash” income. SLM management claims that core cash earnings are more reflective of the economics of the company’s business, and most equity analysts following the company seem to rely on this measure to gauge the company’s performance.

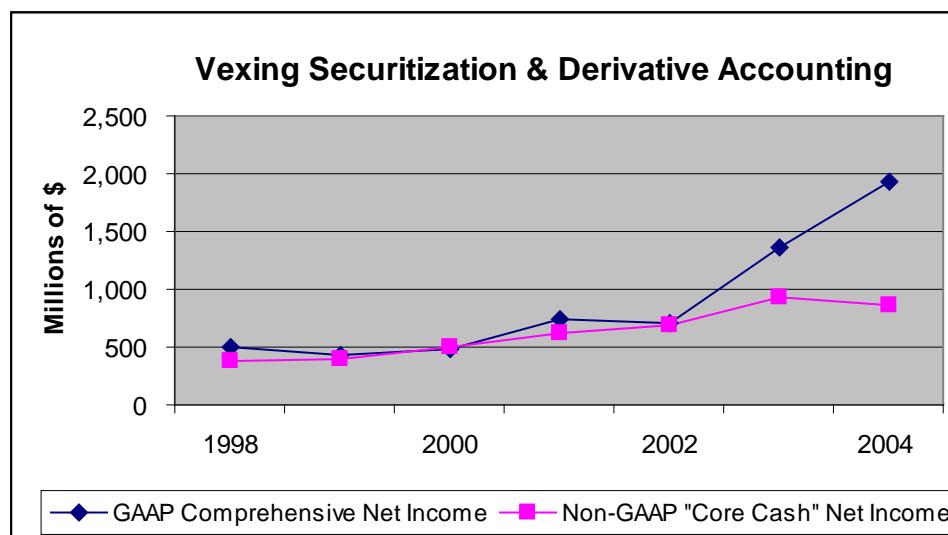
In 2004 GAAP net income for SLM Corporation was \$1.9 billion, yet core cash income was only \$0.7 billion. This significant disparity of \$1.2 billion, which was nearly 40 percent of total GAAP equity, indicates that in certain periods the quality of GAAP

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<sup>1</sup> In yet another example of the creeping complexity of financial reporting, there are two net income numbers reported in a set of financial statements prepared in accordance with GAAP, “net income” and “comprehensive net income.” Comprehensive net income is more meaningful for purposes of understanding change in GAAP capital. Certain mark-to-market adjustments are excluded from the statement of income, but are reflected in the balance sheets and included in the “comprehensive net income” disclosure, which is presented in the statement of capital. For SLM Corporation the difference between comprehensive net income and net income ranged from a positive \$359 million (1991) to a negative \$166 million (2003).

earnings may be in question. If as management contends core cash income is more reflective of the company's true earnings, it indicates that GAAP earnings may overstate results, which in turn means GAAP capital may be overstated. GAAP capital, therefore, may not be the most appropriate basis for regulatory capital.

Most of the difference between the two measures of net income plotted in this graph results from applying different accounting for securitization and derivative related transactions,<sup>2</sup> as discussed in Parts 1 and 2 below.



### Part 1 - Securitization Accounting Issues

Highly Leveraged Assets and Off-Balance Sheet Accounting. As of December 31, 2004, Sallie Mae had a \$2.3 billion asset on its balance sheet known as the “retained interest in securitized receivables” (retained interest). While this was not a huge asset on an \$84 billion balance sheet, its size belied its risk. Effectively concentrated in the retained interest was the financial risk (and reward) of \$41.5 billion of off-balance sheet loans. This retained interest results from securitization accounting standards. While the retained interest is a much smaller asset under GAAP than the pool it is derived from, due to the subordinated structure of the underlying securitization, much if not all of the interest rate and credit risk from the pool remain embedded in the retained interest.

About half of the \$2.3 billion of the value in the retained interest in securitization receivables reflects the premiums Sallie Mae incurred to acquire the \$41 billion of student loans; the other half is additional mark-to-market adjustments recognized when Sallie Mae applied “gain-on-sale” securitization accounting to the sale of the \$41 billion of loans. This accounting limits the usefulness of traditional asset-to-capital rules and

<sup>2</sup> In general, the accounting for securitization and derivative transactions are under Statement of Financial Accounting Standard, “SFAS,” No. 140, “Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities—a Replacement of SFAS No. 125,” and SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities,” respectively. In addition, new SFASs, FASB interpretations, technical bulletins, and other authoritative accounting literature may also apply.

weakens the balance sheet as a means to understand the loan servicing portfolio and its associated operating risk.

Traditional Tools Are Less Effective. Retained interest in securitization loans (retained interest assets) and other types of non-traditional assets illustrate the problem with traditional capital ratio requirements and analyses that are based on assets as shown on the balance sheet. Consider the case of Sallie Mae, which at one point had a simple statutory leverage capital ratio requirement of 2 percent.

At December 31, 2004, Sallie Mae's balance sheet reflected a \$2.3 billion retained interest assets. This asset represented Sallie Mae's equity-like interest in a pool of \$41.5 billion off-balance sheet loans. At issue is how much capital should be held. Much if not all of the risk from the pool of loans securitized by Sallie Mae remained embedded in the retained interest assets.

- If one applies the simple leverage capital rule after securitization accounting, the amount of capital required would be **\$46 million** (2% capital for only the \$2.3 billion retained interest that are on balance sheet- the balance sheet approach).
- Yet, if Sallie Mae should hold capital commensurate with risk of the loans, the amount of capital it should hold is **\$830 million** (2% capital for all of the underlying \$41.5 billion of loans that are off-balance sheet – the so-called “look-through” approach).

In this case, the traditional simple leverage rule no longer sets an appropriate level of capital commensurate with the GSE's risk and is no longer an effective regulatory tool.

Alternative Disclosures that Work Around GAAP. Sallie Mae and others that securitize loans and hold the retained interest in securitization receivables related to those loans present portfolio and income based on non-GAAP measurement concepts like “managed loans” and “core cash income,” respectively. That is, they explicitly recognize securitized assets that are not recognized on a GAAP balance sheet. Management's logic for these types of disclosure is that it views securitization as a financing transaction rather than a sale of assets, as the transaction is accounted for under GAAP.

A widely used ratio skewed by gain-on-sale accounting is return on assets. The return on assets calculation, a common ratio that is valuable in assessing risk to creditors, is problematic due to both distorted numerators and denominators, by income and off-balance sheet assets that are recognized under “gain-on-sale accounting.”

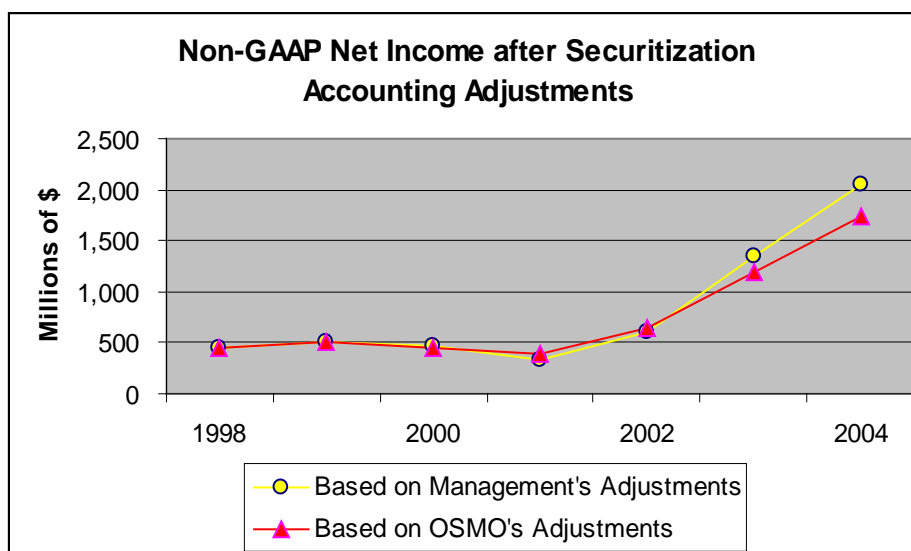
Are they Valid? - Alternative Non-GAAP Measures. OSMO concurs with Sallie Mae's management that an alternative performance measure that adjusts for gain-on sale securitization accounting is a valid alternative measure. However, the concern with broad acceptance of non-GAAP measures is that they are established by management and

are not subject to rigorous outside standards or audits.<sup>3</sup> Further, as each company can choose its version of non-GAAP performance measures, such measures are generally not useful for comparing companies across an industry. Further, as management might refine its own non-GAAP metrics from period to period, comparability over time may also suffer.

During the wind down period from 1996 through 2004, SLM Corporation reported GAAP net income of approximately \$7 billion, including \$2.1 billion (approximately \$1.4 billion after tax) due to “gain-on-sale” securitization accounting. During this period \$89 billion of student loans were securitized and de-recognized from the balance sheet in conjunction with the gain on sale accounting. As of December 31, 2004, \$41 billion of these loans were still held in the ABS trusts. The economic substance of Sallie Mae’s ABS activity is to finance loans that Sallie Mae expects to manage for the life of the loans (long-term non-recourse financings). Income based on gain-on-sale accounting is not deemed to be as useful in providing information regarding the operational and performance indicators that are most closely assessed by management.

### Are they Reliable? Alternative Non-GAAP Measures.

This graph illustrates there are also alternatives to the alternatives. It plots two non-GAAP performance measures, one prepared by SLM Corporation (see page 61 of its 2004 10-K), and the other prepared by OSMO.



Both SLM Corporation and OSMO adjust SLM Corporation’s GAAP net income by eliminating only the effect of gain-on-sale securitization accounting. For the period 1996 to 2004 the accumulated difference was approximately \$400 million. However, most of the difference was in 2004. In 2004, the difference between the two methods was approximately \$300 million. OSMO’s methodology is described in the following two pages.

<sup>3</sup> The independent accountant has the responsibility to make sure that other information that accompanies the audited financial statements is not inconsistent with the audited financial statements. However, this is not the same as having the non-GAAP measures subjected to independent audits.



The lesson learned is that although there is value in alternative performance measures, they should be viewed with an appropriate degree of professional skepticism. Such measures may not be comparable to similarly titled measures reported by other companies. They generally are not subject to a rigorous, transparent development process that seeks experts' advice and comments from the public.

OSMO's Methodology for Adjusting for Securitization Accounting. OSMO believes its non-GAAP measure of adjusting GAAP income to eliminate the effects of securitization accounting is valid and reliable. OSMO's methodology to adjust Sallie Mae's GAAP income for the period from 1996 through 2004 for securitization accounting is presented below.

Effectively, OSMO defers GAAP securitization gains at the time of the GAAP income recognition. These gains are then recognized (amortized) when/as the underlying securitized loans repay.

The supporting amortization table for this chart is on the following page.

| Years 1996 through 2004  | (In Millions) |
|--|---------------|
| GAAP net income  | \$7,007       |
| <u>Adjustments:</u>  |               |
| Beginning of period - December 31, 1996  | n/a           |
| End of period - December 31, 2004  |               |
| Less gains on student loan securitization recognized under GAAP that have not been earned (realized) based on the amortization of deferred gain analysis - see supporting amortization schedule within this appendix | (1,391)       |
| Estimated income tax effect (35%)  | 487           |
| Adjustment to GAAP Net Income  | (904)         |
| Non-GAAP Income after adjustment for alternative securitization accounting   | \$6,103       |

A description of Sallie Mae's securitization history is discussed in Section II, Business Summary. In general, traditional securitization transactions are subject to gain on sale accounting. The more complicated securitization structure (e.g., "reset rate" ABS, that allow Sallie Mae to remarket the ABS bonds) are accounted for as on-balance sheet because they do not meet the sale criteria of SFAS No. 140. Since these securitization transactions do not impact the non-GAAP measures they are not included in the supporting amortization table on the following page.

## Non-GAAP Amortization Schedule

(Dollars in thousands)

| <b>Non-GAAP measure of unearned (deferred) gains associated with all Sallie Mae "gain on sale" securitization transactions as of December 31, 2004</b> |  |                                 |   |   |      |                    |                    |
|--|--|---------------------------------|---|---|------|--------------------|--------------------|
|  | Percentage of ABS Remaining at Year End 2004 | Initial Gain Recognized By GAAP | Non-GAAP Deferred Gain at Year End 2004 |   |      |                    |                    |
| ABS  | A  | B                               | A*B                                     | ABS   | A    | B                  | A*B                |
| 1995-1   | 0%   | n/a                             | n/a                                     | continued   |      |                    |                    |
| 1996-1   | 0%   | \$9,929                         | \$0                                     | 2003-1 (a)  |      | n/a                | n/a                |
| 1996-2   | 0%   | 9,474                           | 0                                       | 2003-2  | 89%  | 217,831            | 194,296            |
| 1996-3   | 13%  | 12,028                          | 1,605                                   | 2003-3  | 61%  | 18,805             | 11,421             |
| 1996-4   | 13%  | 17,550                          | 2,285                                   | 2003-5  | 90%  | 215,922            | 194,152            |
| 1997-1   | 17%  | 33,992                          | 5,655                                   | 2003-6  | 66%  | 12,229             | 8,024              |
| 1997-2   | 14%  | 30,638                          | 4,259                                   | 2003-8  | 70%  | 20,900             | 14,577             |
| Adjustmt   | 9%   | 97,000                          | 9,199                                   | 2003-9  | 71%  | 15,200             | 10,854             |
| 1997-3   | 17%  | 62,959                          | 10,988                                  | 2004-4  | 81%  | 32,448             | 26,178             |
| 1997-4   | 17%  | 55,632                          | 9,652                                   | SLM Private 2002-A  | 91%  | 42,663             | 38,747             |
| 1998-1   | 22%  | 60,174                          | 13,305                                  | SLM Private 2003-A  | 92%  | 69,166             | 63,884             |
| 1998-2   | 24%  | 56,894                          | 13,509                                  | SLM Private 2003-B  | 97%  | 86,069             | 83,198             |
| 1999-1   | 25%  | 7,913                           | 1,981                                   | SLM Private 2003-C  | 98%  | 84,812             | 83,310             |
| 1999-2   | 24%  | 3,627                           | 878                                     | SLM Private 2004-A  | 99%  | 113,954            | 112,725            |
| 1999-3   | 28%  | 23,740                          | 6,631                                   | SLM Private 2004-B  | 101% | 127,000            | 128,533            |
| 2000-1   | 29%  | 21,079                          | 6,052                                   | 2004-6  | 84%  | 38,552             | 32,482             |
| 2000-2   | 43%  | 21,251                          | 9,078                                   | 2004-7  | 92%  | 21,197             | 19,436             |
| 2000-3   | 32%  | 26,024                          | 8,438                                   | 2004-9  | 95%  | 42,393             | 40,470             |
| 2000-4   | 28%  | 22,656                          | 6,306                                   | Total   |      | <b>\$2,102,161</b> | <b>\$1,390,759</b> |
| 2001-1   | 30%  | 9,478                           | 2,807                                   |   |      |                    |                    |
| 2001-2   | 31%  | 18,300                          | 5,600                                   | (a) Beginning with ABS 2003-1, "gain-on-sale" accounting was not applied for certain ABS transactions in 2003 and 2004. |      |                    |                    |
| 2001-3   | 34%  | 27,143                          | 9,157                                   |   |      |                    |                    |
| 2001-4   | 42%  | 20,278                          | 8,442                                   | n/a = not applicable  |      |                    |                    |
| 2002-1   | 42%  | 18,978                          | 8,039                                   |   |      |                    |                    |
| 2002-2   | 43%  | 25,282                          | 10,850                                  |   |      |                    |                    |
| 2002-3   | 43%  | 13,759                          | 5,966                                   |   |      |                    |                    |
| 2002-4   | 50%  | 9,467                           | 4,753                                   |   |      |                    |                    |
| 2002-5   | 55%  | 8,352                           | 4,598                                   |   |      |                    |                    |
| 2002-6   | 58%  | 59,858                          | 34,755                                  |   |      |                    |                    |
| 2002-7   | 86%  | 121,492                         | 104,059                                 |   |      |                    |                    |
| 2002-8   | 52%  | 38,073                          | 19,624                                  |   |      |                    |                    |
| continued in columns at right  |  |                                 |   |   |      |                    |                    |

\* This list shows that all of Sallie Mae's securitization activity that has off-balance sheet treatment is a subset of all of its ABS transactions during the wind down. This schedule supports the analysis discussed on the previous page.

## Part 2 - Derivative and Hedging Activity Accounting Issues (SFAS No. 133)

Lengthy and Complex Standard. The first accounting pronouncement issued by FASB for all derivative and hedging transactions is SFAS No.133 (other subsequent SFAS are also applicable). Prior to SFAS No. 133, income recognition practices for derivatives varied, generally at the discretion of management. SFAS No.133 is vexing, however, because of its length, detailed interpretations, and complex text. As of December 2001 FASB's codification of SFAS No. 133, including amendments and implementation guidance was 795 pages, and additional guidance has since followed. By way of comparison, the first 83 SFASs combined, issued between 1973 and 1985, are only 800 pages.

Economic Hedges but Asymmetric Accounting - The "Mixed Attribute" Problem. Recently, the biggest difference between Sallie Mae's GAAP income and its non-GAAP core cash income results from accounting for derivatives and hedging activities. In 2004, GAAP net income for SLM Corporation was \$1.9 billion, yet core cash was only \$0.7 billion. In calculating its core cash income, Sallie Mae reduced its 2004 GAAP income \$1.6 billion for its derivative accounting adjustments. These adjustments represented fifty percent of SLM Corporation's stockholders equity at December 31, 2004, a staggering amount.

SFAS No. 133 is based on a relatively straight-forward concept called "fair value hedge" accounting. Under that accounting, gains and losses on derivative financial instruments are reflected in income in the same periods as offsetting losses and gains on qualifying hedged positions. However, the rules that allow or disallow a given position to be accounted for as a hedge are an issue for many financial companies. Positions that are entered into for the purpose of hedging an economic exposure may not qualify as a hedge under SFAS 133. The result is that the derivative gains and losses flow through income, but the offsetting gains and losses on the hedged item do not. This asymmetrical treatment can cause a great deal of income volatility. Sallie Mae complains in financial statement filings with the SEC that it is frustrated that many of its hedged positions do not qualify for fair value hedge accounting, and that it needs alternative performance measures:<sup>4</sup>

- *We believe that our derivatives are effective economic hedges, and as such, are a critical element of our interest rate risk management strategy.*
- *However, some of our derivatives,..., do not qualify for "hedge treatment" as defined by SFAS No. 133, and the stand-alone derivative must be marked-to-market in the income statement with no consideration for the corresponding change in fair value of the hedge item.*

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<sup>4</sup> For example, see pages 61 and 62 of Form 10-K for the year ended December 31, 2004.

- “Core cash” measures exclude the periodic unrealized gains and losses primarily caused by the one-sided derivative valuations, and recognize the economic effect of these hedges...

Sallie Mae’s case illustrates what is called the “mixed attribute” problem in accounting where certain financial instruments are measured using historical cost accounting (e.g., student loans purchased) and other financial instruments are measured using mark-to-market accounting (e.g., derivatives). Sometimes there is no ready market for financial instruments and the fair value is determined by a model. To deter or “fence out” abuses, FASB required that hedge positions qualify as effective in order to apply fair value hedge accounting. In Sallie Mae’s case the result of these fences exacerbate the mixed attribute problem.

Full Mark-to-Market Accounting May be Better. Measuring an entity’s net income is a straightforward economic concept; it requires the measurement of two balance sheets and knowing the amount of equity contributions and withdrawals during the period.<sup>5</sup> Per SFAS No.133, all derivatives are marked-to-market. However, also per SFAS No. 133, non-derivative financial instruments may be carried at historical cost, partial mark-to-market, or full mark-to market. Thus there are several variants of the mixed attribute problem that arise from applications of SFAS No. 133.

SFAS 133 is an Issue Not Only for Sallie Mae. In 2004 and 2005, the giant housing GSE’s, Fannie Mae and Freddie Mac, hired thousands of consultants to restate financial statements, in large part, due to improper implementation of the SFAS No. 133.<sup>6</sup> The implementation of SFAS No. 133 requires the application of a complex algorithm that determines which method of measurement should be applied for the non-derivative financial instruments based on whether they can be linked to a derivative and other criteria. With mark-to-market accounting, there would be no need for the “forensic accounting” processes that can result under SFAS No. 133 accounting. For Sallie Mae, the housing GSEs, and other financial institutions the mixed attribute problem might be resolved if all financial instruments were carried on the balance sheet at market value.<sup>7</sup> Mark-to-market accounting versus current GAAP may be a more meaningful tool to monitor the financial health of regulated financial institutions.

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<sup>5</sup> See FASB’s Statements of Accounting Concepts for formal documentation of this accounting theory.

<sup>6</sup> The American Banker on August 15, 2005, reported that Fannie Mae hired 1,500 consultants and that Freddie Mac had 2,900 at the peak of its effort in 2004 to restate and rebuild accounting systems and financial reporting controls that arose from the implementation of SFAS No. 133. Many of the FHLBanks have had similar need for consultants in 2005 for the same reasons, but on a smaller scale.

<sup>7</sup> If FASB adopts as an SFAS the proposed “The Fair Value Option for Financial Assets and Financial Liabilities—Including an Amendment of FASB Statement No. 115” issued January 25, 2006, it may effectively result in reducing the mixed attribute problem and contribute to a mark-to-market accounting for all financial instruments for large financial institutions.

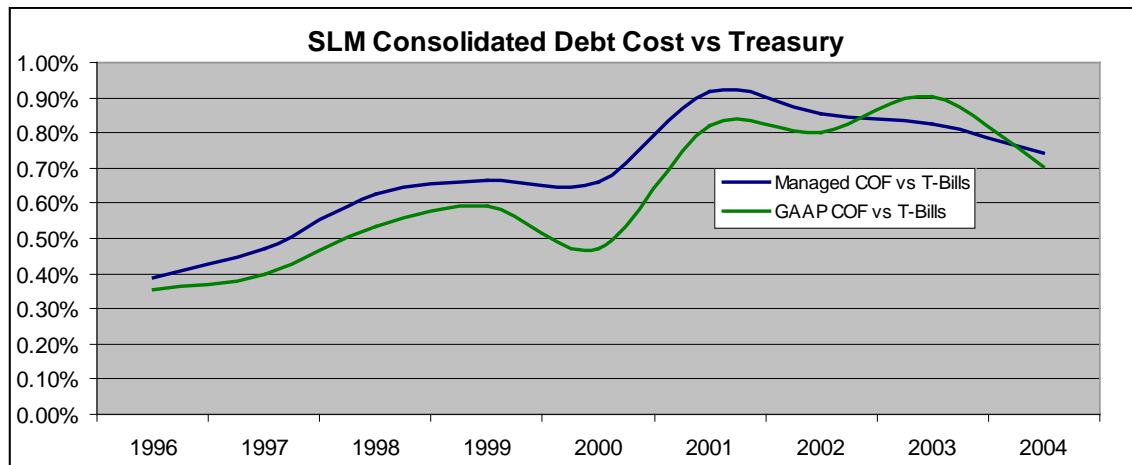
A previous CEO of a GSE publicly detailed his criticism of SFAS 133 and opined that the proposed fair value option accounting implicitly admits that SFAS 133 is a failure. See Pollock, Alex J., *FASB Fesses Up to Derivatives Disaster*, American Banker, March 10, 2006, page 11.

Impact on Interest Spread Analysis. A time-worn adage about bankers is that they follow the 3-6-3 rule - borrow at 3 percent, lend at 6 percent, and be on the golf course by 3 o'clock. This anecdote reveals the fundamental importance of net interest spread to those engaged in borrowing and lending. Reliable net interest spread information is also important to those analyzing financial institutions' health. Net interest margin is affected under SFAS 133 depending on whether gains or losses from a derivative are considered a hedge.

By SFAS 133 accounting logic, however, if a derivative does not qualify for "hedge treatment," its effect on income, including all realized cash flows, also cannot be linked to the financial instruments that drive net interest income. Thus the cash flows and mark-to-market adjustments for the "unlinked" derivative are classified as "other income." The resulting financial reporting of net interest income often does not reflect the economics of the borrowing/lending business. Interest spread analysis is opaque.

Based on alternative measures presented by Sallie Mae, due in large part to the effect of classifying certain cash payments on derivatives as other income rather than part of net interest income, the result has been an overstatement of GAAP net interest income as measured. Sallie Mae's GAAP net interest income was overstated by **approximately 28 percent** in each of the last three years (2002-2004) due to this accounting convention. Comparing net interest spread between periods and among peers has become more problematic with the Byzantine application of SFAS No. 133.

Alternative non-GAAP measures such as managed cost of funds (COF) plotted against GAAP COF (see below) provide another illustration that supports Sallie Mae management's claim that GAAP is not reflective of the economics of the company's business.



The lesson learned is that assessing the performance of a financial institution has become more complicated under SFAS 133. The financial services business itself has become much more complex and accounting standards may add to the challenge of understanding the business.

### Part 3 - Accounting for Unconventional Loan Products.

Reserve Accounting Standards May Lead to Unintended Consequences. While the bad debt reserve methodology that SLM Corporation applies for its on-balance sheet private credit is apparently acceptable under current Securities and Exchange Commission (SEC) accounting literature, it may have unintended consequences on the appropriate measurement of capital.

In general under Sallie Mae's methodology, a reserve for loan losses is accrued when the loans begin *repayment*, and not at *origination*.<sup>8</sup> Due to in-school deferment and forbearance policies, many student loan borrowers do not begin *repayment* until five years from the date of the initial loan. At the same time no losses are recognized during this period, interest due on the loan is capitalized during this period due to the company's reserve accrual policy. In effect, even though there is no cash flow on the loan, income is recognized but loss accruals are deferred. This may have the effect of "frontloading" earnings on private loans and "back ending" bad debt expenses. The net result may be an overstatement of the earnings or yield on the loan portfolio for a period of time, particularly when the portfolio is growing rapidly as is the case for Sallie Mae.

The underpinning for this accounting methodology is an accounting industry position on whether the act of making a loan drives losses. Certain accounting literature rejects the view that the making of a loan is a loss event, because it is believed that when a lender originates a loan it is expecting to be paid back. Thus bad debt reserves are not recognized at loan origination, but rather during the period in which the loan is repaid. For most types of loans this position is benign because most loans go into repayment status soon after origination. However in some cases, particularly for private student loans where repayment does not begin for years, the result may distort timing of bad debt recognition. The unintended consequence is that the recognition of bad debt expense may not occur for years after origination, while recognition of income from interest and upfront borrower fees begins at origination. In periods of rapid growth, when a high percentage of borrowers are not required to make any payments, or are only required to make partial interest payments, this accounting approach may understate the bad debt reserve and overstate capital of the company that holds the loans. The lesson learned is that this condition might also develop in other credit markets as the use of other nontraditional loan products grows.

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<sup>8</sup> A nominal reserve for borrower deaths and dropouts is made for all loans. Certain private credit begins repayment immediately.

## **Interview with Edward Fox**

CEO of Sallie Mae – 1972 to 1990

Boston, MA, October 13, 2005

Interviewed by Suzanne McQueen  
Treasury's Office of Sallie Mae Oversight

### **Sallie Mae's Mission**

Congress very simply wanted to create liquidity in the student loan market and to encourage participation on the part of primary lenders. That was our charter. That was what we believed at the time. Did it change? I think that both Congress' views and Sallie Mae's views changed. Sometimes one was responding to the other. Other times we might have gone in different directions. But yes, the mission of the program changed. Originally the program was a middle income loan of convenience. At the end it turned out to be an alternative primarily for lower middle and poor people to give them access to education. That was not subtle, that was a substantive change over time. So I think the mission changed as the government's budgetary constraints or lobbying interests encouraged them to change.

Sallie Mae had no role in the change from middle class loans to lower middle income roles. I think it primarily was that Congress didn't continue to fund the NDSL, what used to be called the National Defense Student Loan. They stopped funding that at one point in time and as increases, in what came to be known as Pell Grants, were not growing with either inflation or with the accelerated cost of college (which was growing far more rapidly than the cost measured by the CPI, though the colleges will tell you their own costs were going up rapidly). We were simply providing access consistent with Congress' mission. Later on the mission was enhanced with things like consolidation and loans of much higher magnitude to medical health professionals. There was an awful lot of politics in all of that.

### **Private loans**

Private loans didn't come into being in any great amount until the last five years. The first 20 years or so of Sallie Mae, while we tried to find alternatives or different guarantors or whatever, was essentially government insured programs of one type or another.

The original charter of Sallie Mae was only four or five pages. About three of those pages described the start up and who the board was going to be. About one page described its mission and the next page described how it had to go out and raise capital in the private capital markets at which time its board would change. So from the get go the desire was to use private capital. What could have been an incongruity was that you have a social mission and if you raise private equity the market expects a return. You cannot go out and sell bonds if you don't have some net worth behind it. So the most important thing for us was to go out and raise some equity. It was the toughest thing I've ever had

to do personally. It took us over a year to do. We thought we could raise \$100 million, and we wound up raising about \$24 million. A significant portion of that was actually held in treasury by the Bank of America because I think we only sold about \$16 or 18 million early on. But from that we built a company. The expression we used was that “we would do good by doing good.” I think we always had the two missions. There were things that we were doing early on that actually would appear to the casual observer to be against our short term interests as to our shareholders, but in the long term made a lot of sense to us. We wrestled with that, but we always knew that we would have to be dependant on private capital, except for that point, a short number of years when it was the Federal Financing Bank. We actually went out to the private markets. Actually I think we were the only entity that ever gave up the full faith and credit of the United States voluntarily, which we did as part of that process of becoming a private entity.

The government guaranteed our debt. Early on that enabled us to go into the capital markets in ways that we otherwise couldn't have gone. The FFB financing was in the late 70s, just before Ronald Reagan came in as president, because we were working with the Carter Treasury. What we did was just extended our loans. We got an extension on them, which was also in the interest of the Treasury, it wanted to keep us out of the market place. The whole purpose of the Federal Financing Bank was that – There had been such an explosion of numbers of entities that were going to the marketplace, that Paul Volker, who was the Undersecretary for debt management, created the idea of the Federal Financing Bank as a vehicle for the government to do the funding at one point in time, and then lend those monies at its cost plus an eighth of a percent to the various entities to keep them out of the market place. The fear was that this increasingly large number of accessors to the market were getting in the way of the Treasury. Remember there were big deficits in the post-Johnson years and later on in the early Reagan years and they had to manage that.

### **FFB negotiation to extend the loans**

The FFB arrangement was a refinancing our existing debt plus our outstanding commitments to buy student loans. Most of those assets were going to be on our books for a long time. We had borrowed money, essentially on relatively short term, for assets that were going to be long term. We had been purchasing those assets from banks and others on the assumption that we were going to have the Federal Financing Bank available to us. To the extent that the plug would have been pulled on us we would have been a big S&L with short term assets and long term liabilities. I don't think the government wanted that either. This was not a one-sided negotiation. This was a practical way of financing through the life expectancy of that portfolio, that particular set of assets. But also it wasn't a 15 year deal because we started paying it down at some point. We had to make payments on an amortization schedule. The whole point was that it funded either the existing portfolio which was long term or the outstanding assets we'd acquire under our outstanding commitments.

In actuality what happened was that our growth was incredible over the next three years. As a matter of fact that could have put us at extreme risk. As a corporation we grew modestly from 1973 to about 1978. Then starting from '78 to about '83 we started to



double almost every year. We went from \$500 million to \$9 billion in five years. Those were days when everything was done on paper, not on computers. Our thought that we were going to be about a \$5 billion corporation in the early 80s, within the foreseeable future, grossly underestimated what happened. That is when the Fed under Volker took rates up to 17 and 18 percent. That caused terrible dislocations in the banking system, so that bankers were unloading assets on us at an incredible level. We were actually flooded with paper. For us access to the capital markets was absolutely essential, both for debt and eventually for equity.

### **After FFB**

At the beginning of the decade we were a \$1 or \$2 billion corporation. At the end of the decade we were at \$40 billion. The \$5 billion FFB loan basically just funded the existing, or in the pipeline assets. Looking at what was in the pipeline and what was on the balance sheet I think everybody recognized that we would want to essentially make certain that the balance sheet was not going to erupt with several mismatches. Certainly my own perspective was that I had to have some assurance that the Federal Financing Bank wasn't going to stop. They had made certain promises to us in terms of the financing, that was the intent of that legislation. Predicated on those assurances of funding we had made certain commitments at prices that were assuring the flows in the primary market at a time of terrible dislocations in the market place. We just weren't funding. I don't consider that particular transaction of super significance other than protecting the parties. It was certainly no windfall or anything like that.

### **Early Privatization Hopes**

On our own we went out into the market place and decided to do something without the government's guarantee on our debt. We were hoping to fully privatize ourselves then. It just wasn't meant to be because of political issues between the Democrats who controlled the legislature and Republicans who controlled the executive branch. But we wanted to totally privatize.

Because of that we decided to bite the bullet almost immediately after coming out of the Federal Financing Bank. We started selling our debt which was given I think an A plus rating. We weren't even triple A, but rather we got an A plus rating. We had some pretty broad spreads. Now I know that there is an issue here about spreads, but we decided that was essential for us.

### **Innovative financing.**

The one thing that wasn't available to us at first was long term financing at very low rates. We had to try to figure out how to do that because our assets were going to be very long term and costs were becoming higher. That's when we became very innovative in the capital markets. We sold a long term bond which we swapped to variable rate financing. That created that market for us. Innovative financing techniques eventually created our ability to issue intermediate term securities with the characteristics of our short term asset. We became quite innovative. My financial people were quite good at that. I came up through finance. My background is finance, so we could act very, very quickly. I gave them broad authority in the market place. They knew that if there was

something that was unusual or unique, they could come up to me and with five minutes conversation I would get enough of the thrust of it to say “Go for it.” The board had given me absolute authority to fund the corporation without having to go to the board for individual transactions. That was very helpful because a number of our competitors needed board approval for their transactions and the like. So the board’s comfort with us as managers, and my comfort with my financial people enabled us to be very dexterous.

We started doing some of the most unusual things. I think Wall Street recognized that and so if there was something unusual they would come to us. I remember one day I got a call from Goldman Sachs asking would we be willing to do a 40 year zero coupon bond. The only way to do that would be to hedge it with some kind of 40 year securities. But the buyer was so determined (this was somebody in Japan) to have 40 year paper that we could actually finance it at two full percent below US Treasuries at the longest end of the curve. So we did a \$5 billion zero coupon, which meant we received a \$125 million because of the way the coupons accrete over time. We hedged it with 25 year Treasuries in which we were making a 2 percent positive spread. Every year it got bigger and bigger and bigger. When we came back in, as a private corporation, that was a big chunk of the capital for us.

The point was that we were innovative and the Street would come to us to try things. We would do them, if they made sense. I think I ran a very strict and carefully managed shop.

I don’t know why Fannie and Freddie couldn’t do these innovative things. They certainly would have had a more difficult time given their size. We were certainly much more nimble, I think, than just about anybody out there. We loved being thought of as pigeons. There was always somebody out there who would say “Oh, those poor government folk.”

The swaps at the very beginning were a solution to the matched book problem. Other things presented themselves. The creative people created, oh, I can’t even describe them: “bulldogs,” “zippers,” currency swaps, interest rate swaps. Sometimes it got a little scary when you do a transaction in another currency, swap it into dollars, swap it into T-bill variable rate securities. We’d have three counterparties. By the time I left the company I think we had \$40 billion assets, \$40 billion in liabilities and \$40 billion in counterparty transactions, all of which were things which you could trade. I am very much aware that it was a far more risky balance sheet than just a plain vanilla kind of thing. But they managed it very well. They did a great job of it.

Selling our debt and using these instruments enabled us to raise money with the characteristics we needed. Costs were more expensive, and over time as we became more accepted in the market place those costs became thinner. Wherever there was an opportunity to try to figure out how to raise money at a more advantageous price we would look into it and try to sort it out. Sometimes it worked, sometimes it didn’t.

One of the more recent examples of things we got into was the student loan asset backed securities a number of years ago. It looked very promising. What we hadn’t realized

early on was that the first three or four billion that were sold were going to hedge funds. When Long Term Capital went under, the hedge funds were under pressure. We were trying to sell our asset-backs into the market place while some of these hedge funds were unbundling their holdings and we were selling against our own bonds coming back into the market place. I was really ticked at the investment bankers because we were trying to get distribution, not sell it to the easiest place so they all went to one place. That happens. It gave us a tough patch about 5 or 6 years ago because it raised our spreads, as it did for many others. Our own bonds were coming back into the market place and the market wasn't fully formed yet. I suspect we are doing quite well because I think that some of the mortgage-backed securities don't look quite as attractive today as they might have looked. That changes all the time.

### **Libor**

We financed in Libor, but I don't think the yield of the student loans was ever indexed to Libor. The student loan was indexed to 90 day Treasury. I think the 90 day commercial paper is being used today. They went to a rate that was more amenable to the banking system in that it aligned the rate with the bank sources of moneys, which made their spread more predictable. The spread between the banks' sources of money and the Treasuries could expand and contract. I suspect we supported that, but I think it was probably coming more from the banks.

### **Going private.**

Going private was the goal of our chairman and myself from day one. McCabe and myself always felt that we should have private capital here.

The question comes up, why did the government do it? There was a very simple reason: nobody else could. The student loan program in the late sixties and early seventies had 17,000 institutions participating, not because they wanted to but because they were being pushed by the Treasury and the regulatory agencies to do it and by the political process. Johnson was first and then Nixon. Nobody got paid on time from the government for their interest on loans, because the committee that would figure out the allowance didn't meet for sometimes two or three months after the quarter. The best guess is that some intermediary Treasury was used as a proxy for what should have been the yield. It had nothing whatsoever to do with the short term instrument. So you didn't know what you were going to get paid, there was no formulaic way of getting paid or knowing. You didn't get paid on time. If you lose interest on interest that haircuts your return significantly.

Quite frankly one our major missions was to go out and not only educate the marketplace and encourage them to participate, and point out that we can be there either to lend them money or to buy their loans, but also to help work with Congress to make the program a more bankable type program. This was a very complex, long term consumer borrowing, with reams of paper attached to it, run by a non-financial agency of government. Many, many times Treasury wanted to take this thing over and manage it, because they knew that as well-meaning as the people at Education were, they didn't have the financial skills to run this type of program. So that was an ongoing set of issues. So early on our

mission was missionary: to go out and work with bankers, insurance companies and savings institutions and encourage them to stay with the program; to work with Congress to come up with a series of changes.

Over time those changes included coming up with a formula for a special interest allowance. A couple of years later making the Department of Education pay within 30 days of the end of a quarter, so at least you knew that. There were a series of other bank-like applications that were put into the program. I had an associate who came with me from the Treasury Department, who put on the screen of about 30 pages of a schematic of a loan from beginning to end. Really. Early on a loan file could be two inches thick. Until we had microfiche, and after that computers, it was ungodly. So a lot of the first five years it was the Congress, the Feds, and ourselves working together to try to make the program more amenable to the banking industry. We worked with the Consumer Bankers Association and their counterparts in other areas. We worked with Education to try to come up with something that made some sense, to try to make it look more like a real consumer loan is the fairest way of saying it.

There were so many checks and balances and bells and whistles and different statuses and stages, and constantly changing rates. You couldn't say, "What would you pay for this student loan?" You had to know what year it was made, what state it came from, what the interest rate was, whether it was in school, in grace, in default or in repayment. Then if you had to model a portfolio, it was incredibly complex, because there had been so many changes over time. This inhibited competition because people were afraid to enter the program. It created a complexity that was really unnecessary. Eventually they sorted most of it out I think.

### **High defaults.**

There was an underlying difference between the Senate and the House. Ultimately they created one program which included students going for PhDs and kids going for 90 day certificates to become metal workers. One program was designed to help with upward mobility, another program created a whole different class of highly educated individuals with, a much lower propensity to default. The significant majority of defaults was in the trade school programs. There were also an awful lot of scams in the trade school programs. It took years before they sorted out that mess. A lot of it was equity. They wanted to make sure that everyone had access to the program. They didn't want just affluent students or middle income college students have access to these low cost loans. So a lot of labor Democrats particularly wanted to see access expanded. My recollection was that the trade school access issue was a labor Democrat, House issue. My closest associate in the legislature was a labor Democrat, House person, Bill Ford, with whom I worked for many years as the Democrats controlled the Congress most of the years I was there. He would just explain, he just couldn't sell the notion of student loans in his blue collar district in Michigan if the blue collar kids didn't get those loans. They probably should have had separate programs with separate funding and separate rules. Eventually they squeezed most of the malfasants out. I think even one congressman went to jail under this program, Congressman Flood, from Wilkes-Barre, PA.

Because we owned such a large percentage of the loans we always knew that the default problem was greater than people were hearing. We owned 15, 20, 25 percent of the loans. Statistically we had a good sample. But we could follow a cohort from loan to its end. Because of the way they looked at loans we could look at all the loans in repayment relative to loans that go into default. Each year a larger and larger group was going into repayment, which increased the denominator. So the numerator never caught up. At the time they were talking 13 to 14 percent, we knew those rates were somewhat higher in actuality. They did a terrific job at the government level and at the originator level in cleaning that up over the last 20 years.

Mortgage loans started out as more unique and became more standard. That was part of what the Home Loan Bank did while I was there to create a uniform note because each state had a different one. It was only when they got uniform notes and uniform documentation that you had a national marketplace in the secondary market in mortgages. They were fungible. The federal student loan program is pretty straightforward. They do have parent loans, they have student loans. Within programs there is lots of "stuff." I think these are big enough programs that people know how to write their own.

### **Ownership of Sallie Mae**

We were shocked to find out who owned our stuff. At one point I found out that our stock was owned by the government of Singapore. One time I was doing an Asian tour and one of the guys said "We own some of your stock." Singapore, Singapore, they are pretty smart.

We didn't know who our shareholders were because so much of the shares were in nominee name. In more recent years, the large mutual funds have to report their holdings.

When we first started the company we hired four of the best investment companies in New York, and went around the country for three weeks trying to raise \$100 million, and absolutely failed. We sold \$500,000 to one of our board members and that was it. That was the biggest shock of my financial life. Over the course of the year we reduced the size to about \$35 million and went out and sold roughly \$35 million. Then there was the Federal Reserve rate increase about a day before we were going to close and we lost half of our circlers. We wound up selling \$16 million and one of the underwriters kept a bit more, so we had a \$24 million deal, of which maybe 2/3 was really placed. I would say that 2/3 of that went to financial institutions and 1/3 went to educational institutions. Almost everybody had their arm twisted one way or the other.

I have to give great credit to Harvard and George Putnam of Harvard, who was one of the five overseers of Harvard Corporation, who basically went out and said, "You've got to support education. This is absolutely essential. Just put it away. It is your responsibility." A very significant amount of stock, maybe \$7 or 8 million of the \$24 was bought by the 80 or 90 colleges. The rest was bought by banks, savings and loans and whatever. Most of the people didn't think of it as an investment as much as a contribution. When we paid our first dividend, one banker who had expensed it didn't

quite know how to deal with the fact that he didn't have it on his books. The accountants were trying to figure out how to deal with it.

For the better part of ten years, from 1974 to 1983, we didn't pay a dividend. Stock ownership was a requirement of doing business with us. You had to own 100 shares, which was \$15,000. That was the way we got a lot of small owners. Without it we couldn't have sold the deal just on the dozen big guys and a dozen big colleges. We couldn't put it together if we didn't have that purchase requirement. Over the years anybody who wanted to do business had to go to the Bank of America and buy \$15,000 worth of stock. I bet that \$15,000 is worth \$15 million today if they kept it because I think our original basis is probably less than ten cents on a \$50 stock, 20 years later. As a matter of fact, in the early '80s Brown University and Citicorp bought \$1 million apiece of the remaining part of the stock at Bank of America.

Nobody ever really cared about the stock in the first 6 or 10 years. But as we got into the early 80s, and particularly when we went public with the stock in 1983, the early shareholders, who still didn't have a market, and that was the only voting stock by the way, asked if we could figure out some way to monetize that stock. So we got a law passed that permitted us to convert some portion of the voting stock – A shares I guess they were called – to public shares and to give voting rights to everybody. Over the next 5 or 6 years we sold tranches, because we couldn't sell it all at one time. We sold tranches of that to the general public and eventually did away with the original shares. At that point people were not interested in things like voting rights, they were interested in return. They became regular stockholders. We had a public offering in 1983. In 1983 we ended up with about \$100 million of capital and about \$9 billion of assets. We were actually matched book so we had no real financial risk, even at 90 to 1 leverage. But we had the banking standard. We couldn't survive as a public corporation. So we decided to do a public underwriting which wound up being very successful for us. Later that year, we sold about \$250 million of common. We followed that up with a sizeable preferred issue at a very attractive rate. We had started the year with roughly \$100 million of equity and \$9 billion of assets. We ended the year with almost \$500 million of equity or equity equivalents and about \$11 billion of assets. So we went from 90 to one to about 20 to one in one year. That is when we started getting public attention.

The next five years we had public attention. We were written up in magazines, we were a hot stock. We had actually had 20 percent increases, year over year over year for about 10 years. We were considered a hot stock, which creates expectations.

It did not really affect decision making. We had to pay attention to short term kinds of things, but at the same time we were long term goal oriented. Very conservative in our accounting, very conservative in how we managed the company. To give an example in the accounting, currently if we sell student loans into a student loan trust, current accounting insists that we recognize a very significant portion of that sale as an immediate gain. An awful lot of companies would love to do that. From our perspective this is just another means of creating financing on a matched book basis where we are looking for spread income ratably over its term, so we'd rather not recognize that as

income right now. The market has us doing that for GAAP purposes, but we actually report on a spread basis, what we call our constant yield accounting, core constant yield accounting. The costs of the derivatives go up and down too, where the derivatives only account for the changes on one side of the balance sheet instead of both sides. That has a big impact, not only for us but for mortgage people. I don't see the purpose of that.

Generally we would report lower earnings than GAAP would require. Usually we came up with something very similar. Student loans yield is a lot more when a kid is in school and you don't have any servicing. But we knew that at some point in its life you would not collect enough income to pay for its costs. So we came up with something called constant yield accounting, where we would only recognize for income purposes, the average yield expected over its life. We might be 5 percent over the first quarter and minus 3 then years later. But we would earn 1 percent over its life. We would recognize the 1 percent in our reported earnings, but we would pay taxes on the full 5 up front. We were actually paying incredible taxes early on. Eventually we got away from that accounting. I think we were obliged not to do that anymore, not because it was wrong from a conservative perspective, but because it was a non-traditional accounting.

We paid taxes. But at the same time we were reporting lesser income, telling people what we were doing. It was right up front. I think we stopped that ten years ago or more. The point wasn't to try to mislead anybody. It was because we understood that that the dynamic of the loan changed over a 10 or 15 year life.

From my perspective, GAAP is meaningless. It is a joke. It doesn't provide correct information to the people who are reading the reports. The trick is to stay consistent and to be up front about your consistency and not change the rules quarter by quarter by quarter. That way you don't get into trouble. You just spell out what your criteria are. We have always reported on a GAAP basis, but then we have this reference number, which what the street accepts as our earnings, which is frequently lower than GAAP.

When our stock went public, people expected us to be nimble. That is what we were selling. They looked at us a relatively cutting edge financial institution. Nobody really cared about student loans. I would say that 95 percent of our people were on the operational side, that is where the risk was. It was operational risk. Yeah, the spread might go up or down, depending on the market, and it could hurt you, but operational risk, where you are managing millions of loans, and the cost of change – every time the government changed something, large systems had to be changed and they had to reflect the past as well as the current and future, and the systems became massive. One of the things that scares me today is that there are very few entities that are putting the capital into these systems who are in the student loan business. We know just how much it costs to fully comply. When I look at the earnings of some of these companies I don't see the R&D and I don't see the investment in software. I have to wonder who is minding the store, but that is another matter on the regulatory side. The amount of money we put into operations, of course this gives us an edge over time. If we get economies of scale that results in operating efficiencies, but I can't speak to the others in the business.

**State tax exempt bonds.**

Because the spreads are rather thin, you have to be highly leveraged and relatively nimble. I think you are going to see a small number of large entities. That is what has happened. Maybe 8 or 10 plus a bunch of states have the ultimate good deal with tax exempt bonds, which is the most expensive arbitrage, the most expensive cost to the government right now, if they would look at it. Its cost is on the income side to the government. The appropriating committees don't pay attention to it. If you can sell 2.5 percent munis as opposed to 4 percent Treasuries, and you are a tax exempt entity collecting a taxable income on your student loan, you've got a spread you could drive a truck through. The states love it. All sorts of politicians go to work for those state agencies. They make profits that go into other parts of the state coffers. It is a transfer mechanism that benefits the states at the expense of the Federal government. Only the Treasury understands it. We managed to get a law passed at one point that said that states shouldn't be able to do that if there was fully taxable capital available. But that got overturned in a hurry. Most of the states saw that. That is an abuse of states' tax exempt authority. Treasury is always trying to curb that. There are billions there. It makes every other cost of this program peanuts.

We have actually bought a few of the issuers, and that eliminates the tax exempt aspect. We get servicing capacity when we do that. We have access to some lenders because of that. In one case we got a guarantor. Although we can't own a guarantor, certainly we have a relationship with a guarantor.

**Privatization.**

The culture of the people who started the business was free enterprise – the notion that you didn't need government to do anything. It is not a Democrat or Republican kind of thing, we just thought that this should be in the private market place and survive or fail. The notion that this was a public good encouraged the government to create it the way it did because otherwise it couldn't have gotten started. I think in talking with some members of the Congress, they were hoping, with the thought that we could sell stock to the public, that one day we would be a private corporation. Whether they envisioned it with oversight like Fannie Mae or whether they envisioned it to be fully private, I am not sure. I heard both sides early on. I think mostly when they started us it was with a prayer that we would do some good, with no real sense that we could.

We had just gone through a couple of really cruel credit crunches in the late 60s and early 70s. Banks had withdrawn from an awful lot of consumer programs when money got tight. We haven't seen tight money in a lot of years. Notwithstanding people's feelings about Sallie or Fannie or Freddie, you'd be surprised how quickly some institutions can walk away from certain programs when they just haven't got the liquidity or the spread is working against them. There is a reason for having the various Fannies and Freddies and Sallies, and I am sure there is for Farmer Mac and some others. I think you can abuse that. If there is a lot of liquidity in the system, you start competing against it. That's another matter.



We always were going to go private and I don't think we ever said otherwise. We thought that we could create a reasonable balance sheet, and on the strength of that balance raise capital in our own name rather than the government and move ahead. We did that on our own in the early 80s after the Federal Financing Bank, without the privatization. I had thought the Reagan White House would be big supporters of privatization but we could never get their attention. Likewise it was very clear that the Democrats in the House were not particularly interested in giving up whatever control they had over us.

As a matter of fact, I think it was pretty clear during the Carter administration that they wanted to get control of us to access to our off the balance sheet sources of funding. They tried to put us out of business so that they could get control of that. And also Fannie, as a matter of fact. But because we were much smaller and less political the fight was over us. The two point persons were Patricia Harris who was Secretary of HEW and Joe Califano, who was also a secretary around that time. There were big, big budget deficits. They thought that if they could get control of us who had off the budget sources of funding, that they could use those to offset things that the government would like to do but couldn't do. Actually they tried to put us out of business at one time. So we wanted to be as far away from them as we could be.

### **The FFB negotiation.**

Interestingly the chairman of my board during the Carter years was a gentleman by the name of E.T. Dunlap, who was commissioner of education in Oklahoma. E.T. was close to President Carter, and if there had been a second term, he may well have been Secretary of Education. He was invaluable to us in our negotiation. I think to try to constrain us they just stopped financing us period for some time. Since we had a mission by Congress, this was a political purpose that had nothing to do with us, this certainly encouraged us to want to be free of that kind of hard ball.

We needed approvals at HEW and Treasury for the FFB funds, and they refused. They stopped. It started out just as an attempt on the part of the administration to get some budgetary room. What they wanted to accomplish was to take control of Fannie and Sallie and I don't know about anybody else, for the purposes of being able to fund whatever they wanted to fund, not necessarily the primary mission of either of these entities. In order to do that they had to get control of them. They could do that with a board membership or through some kind of suasion. We had a mission. We had some debt outstanding to the Financing Bank. Actually we had some private debt outstanding.

Every time we wanted to finance we had to get approvals of these two entities and the Undersecretary Hale Champion just put the screws into us and said, "No." He wasn't going to finance us. The Treasury had to go to the president (I believe that's the way it went) and say "Look, these are bonds in the marketplace and the U.S. government cannot default." Eventually Califano lost, but not because of us. Unfortunately it became very personal, and he started attacking us personally. I was a political nonpartisan. I have been accused by both parties of being a strong partisan for the other side. Nobody has a clue how I vote. I knew I had to deal with both parties. The Democrats think I am a

Reaganite, and the Republicans think I'm a who? You name it. Certainly not Jimmy Carter. I think a civil servant has to be straight down the middle. You can't profess any kind of beliefs. Eventually it got sorted out. At the end of the day I thought our boss was going to become Secretary of Education, but he didn't.

We knew why they wanted to take us over. We knew it wasn't a personal thing, at least at first, but when we started to object they became very upset. I said look, we have a congressional mandate. The Congress was very much on our side, by the way. It was the same party, the Democrats on the Hill were very much on our side. I think legislation got passed that basically took it out of HEW's hands and gave Treasury the financing rights.

Commerce requires timeliness and probity and being able to do what you are supposed to do without the Congress hanging you up. If the government hangs you up you lose credibility immediately and you can't, so what are you supposed to do. You certainly don't want to be in a position where you don't honor your debts. It was crazy. It started out as just wanting to have access to our sources of funding. It was a while before I knew that. Eventually a fellow came on our board who went to work for a university and who was formally an undersecretary explained it to me. I remember, this is embarrassing, that we were called up on the Hill he as undersecretary and I, and I from Sallie Mae, and the whole purpose was just to crucify HEW. The fix was in between the members of the Hill and myself. We just chewed this guy up and it wasn't his fault. He was just trying to represent whatever he could. It was funny. Then he came on my board and we became good friends.

Our inclination from the beginning was eventually to wean ourselves from the federal government and become a fully private company. Over the years our experiences with the political process, frequently having nothing to do with us, but creating havoc in the market place or uncertainty, certainly encouraged us to do that even quicker. So we decided in the early 80s, that when we no longer had access to the Federal Financing Bank that we would go into the public markets without the full faith and credit of the government, take the hit immediately and eventually working with the Congress we'd pass some legislation that enabled us to raise initial capital. I am just surprised that during that period that we didn't get totally privatized. I would have thought there could have been a negotiation between the Executive branch and the Congress. But it never happened. There just didn't seem to be the willingness on the part of either party. We were working with the Council of Economic Advisors and others, but it just didn't happen.

It happened about a dozen years later for a different set of reasons. I wasn't a party to it. We came in with our group just at the time that it was working its way through. But it always was the intent, and I think it was the appropriate intent, so that the government didn't have to keep putting up all those bucks.

### **Government Strings**

I learned about government strings while I was at the Home Loan Banks. The Home Loan Banks got set up the same way. My mentor was Preston Martin, to whom I owe a

great deal. Whether it was in setting up Freddie Mac or setting up Sallie Mae, his philosophies of things like matched book and other kinds of things which he taught me. He was a big proponent of matched books in the early 70s at the savings and loans. He tried to force that discipline but he couldn't get it through. The savings and loans just wouldn't respond to it. I learned a great deal from him. He was a PhD economist and I owe him a great debt.

He told me one time that when the Home Loan Banks were set up they had a \$75 million initial contribution from the Feds. When they paid it back the Feds didn't undo all of the regulatory and other kinds of controls that had been embedded as the requirement for the contribution. So I figured if I don't take the contribution I won't have all that put in place that I may have to try to undo someday. That is a lesson I learned from him. Preston wound up as vice chairman of the Fed and he is still living. He is a great person.

### **Oversight for Sallie Mae**

Sallie Mae had Congressional oversight as a creature of statute. Our regulators were not the SEC, the Comptroller of the Currency or FDIC. Treasury had some oversight over a portion of us, HEW had oversight over a portion of us, and both houses of Congress. In Congress there must have been 4 or 5 different committees that oversaw us. There were budget committees, appropriation committees, authorizing committees – authorizing committees in health, authorizing committees in education, authorizing committees for Treasury. There must have been 8 or 10. I testified so damned many times over the years, the House and Senate. Also the sunset provisions of all the education legislation. We were up there constantly. There were probably revisions of this legislation almost every year for 30 years, one way or another.

A lot, lot of oversight. I once figured out that there were over 20 different agencies or entities in government that had an interest in us.

The thing about a regulator like OFHEO [Office of Federal Housing Enterprise Oversight] is it is dedicated sole source directive. I don't know who the people are or how they work or anything like that, but presumably if appropriately staffed and given a mission that's supported by the hierarchy, that should be a reasonable kind of a deal.

When I came back to SLM Corp I was not on the board of Sallie Mae. It was Sallie Mae that Phil Quinn dealt with, not SLM Corp, the parent. I got all the reports from him but I didn't attend the meetings. I was not on the board. He was focused on that entity. He had staff I guess at the time. So he was focused on Sallie Mae matters and just tangentially with the parent. But it is focused, very focused at that point.

### **Lobbying every year**

The stake of the regulator in keeping the entity is no different than any bureaucrat in any other country in the world. That is why Sallie Mae had difficulty in becoming a non-government entity, because committees of the Congress had oversight. One fascinating thing is that if there is legislation every year, there are lobbyist contributions every year.

I am not clever. I have just seen this in every industry in America. That is why there is a tax bill every couple of years.

I go back to the days where you had a lot of careerist in the upper levels of the grades who were very well educated, very caring, for years and years. They all got pushed out years ago. We used to have some incredible conversations. I used to bring together a lot of people in education, incredible conversations. When Mr. Carter decided not to raise anybody's salary for five years they couldn't afford to send their kids to college, they didn't get a pay raise for five years during a highly inflationary period. So we lost a lot of good people.

### **Direct Loans**

I left Sallie Mae in 1990. Let me make a point about the direct loans. I had been told in 1989 or 1990, just before I left, by Congressman William Ford, that he intended to put in place some kind of direct loan program. He hoped it would represent perhaps, eventually up to 5 or 10 percent of the program. The reason for that was to create an alternative that would hold the private sector's feet to the fire and give them an opportunity to judge the efficacy of the private programs. I understood that when I left. I think it is pretty clear that my successors decided to make a fight about it. But I got a good report on the bill and I understood that there were quid pro quos and we could work something out and I understood that this was going to happen. My successors apparently felt that this was a battle worthy of fighting. But this was not the first time I had had this kind of discussion with Bill and we had worked something out. My successor had a rocky relationship with the Clinton administration. I don't know the genesis of that.

I remember when we came back we had to do our mea culpas all over the Hill and the Executive branches as well. The Clintons were still there.

My successor was Larry Hough. It may well have been the Board. I have a suspicion that an awful lot of Sallie Mae's policies after I left were much more directed by the Board than bottoms up from the management. That is just a guess.

I can't say that Larry Hough didn't know what he was doing, just that he had a vision that was different. Larry was a very decent individual. I liked him very much. He might not have been my first choice to be CEO when I left, but the company didn't ask. They were a little ticked off at me because I didn't give them a lot of notice when I went off to Dartmouth.

I have to admit to my own failure here. During the 1980s I was the point person on the Hill. I did a lot of the external stuff. The two or three people who reported to me who were my potential successors were not well trained or as knowledgeable as they should have been on Hill relationships and external relationships. And I left maybe two or three years earlier than I expected to, I had the opportunity to go to Dartmouth as a Dean. I had always speculated to the Board that I would do something like that if it came up. In 1990 seven in the top ten deanships came up, and I knew if I didn't do it in that year or get a job doing something like that that year, that I wouldn't have the chance. So I did it.

So it is my fault that the key staff people were really not that ready to take on some of the external responsibilities. It is my failure, quite frankly. I insulated them. I let them do their work. They ran a great operation. My job was strategic and external by that time. Nobody knew the business as well as I did because I had started it. At that point in time I had not expected on such short notice to both have the opportunity and have to go as I did in early 1990. It just prejudiced the company for some period of time and I have to take some of the responsibility.

We had good lobbyists and I just don't know what happened at that point and whether they stayed with those lobbyists or went with others. I had personal relationships with a couple of lobbying firms that worked with us. I don't really know what happened but I have to take a lot of the blame for that.

The offset fee happened sometime after I left and I really can't speak to that at all.

### **Buying a bank.**

There were two times, once just a couple of years ago when we talked about it, Golden State. But I actually bought one in back in the 1980s. We didn't want a bank to compete with bankers. But probably for the same reasons that Al Lord looked at one several years ago, was that deposits appeared to be an inexpensive source of funding if you could generate deposits. That's not always the case. I looked at it for two reasons back in the mid-80s. One, banks could invest up to 25 percent of their assets in tax exempt securities, and at that time tax exempt student loans were becoming a bigger and bigger part of the business. We wanted to be able to participate as an owner of those loans. We were providing a lot of service to a lot of those issuers in those days, but we couldn't own very many of the bonds. So part of the reason was not to collect deposits in the traditional way, but to finance with commercial paper or financing from us or cds. In the middle of one night we acquired for a very small amount of money a de novo bank charter in North Carolina. On our board we had Sen. Jesse Helms' representative, the Democratic governor's representative. We had the whole community on it. A little \$2 million bank, never been opened, in Southern Pines, North Carolina. Well you would have thought it was an eruption on Mount Vesuvius. Everybody went to hell in a hand basket going after us. Eventually we agreed for some quid pro quos. But the bank was not to compete on a deposit basis with traditional banks at that time or to become originators at that time. It was to hold tax exempt student loan bonds and to hold assets off of our balance sheet.

Now more recently it was for deposits (we were originating already), to build a balance sheet. I don't think the branch network would have generated that many student loans, but I think it was a funding mechanism. We would have a very successful small bank. Citicorp came in and paid more for it and that was that. At the end of the day the outcome was good for Sallie Mae, I believe, because we were able to discover alternative sources of financing through Jack Remondi, who is very good, and we unbundled Sallie Mae very quickly, because the market was amenable whenever things cleared. In retrospect we would have a lot of political hurdles and banking opposition, and God knows what else.

In the 1980s we had all of that and we got rid of it in a hurry. Without going into the details, there were quid pro quos at the time. I don't want to talk about them. We could have afforded that if we had wanted to make a big fight about it. Probably in the House we could have won because it was the Senate that was coming after us. But there was no percentage in doing it. So I sat down with the appropriate people in the house and I said "Look, you don't want a big fight. This is not an issue you really need and we don't need it. How can we reach an accommodation?" They had some ideas and I had some ideas and we graciously gave up the bank. That was that. That is the way Washington works. You don't go up there with a big stick and whamp everybody and hope that they're not going to do it back. Intimidation doesn't work. Unless you are Fannie Mae and it only works so long.

### **Capital requirements**

Today the capital requirements are a function of rating agencies, lets face it.

Why not do this as a purely private venture.

Well you couldn't. From the get go you couldn't. There was no capital in the program. There was no capital for this kind of thing. Nobody had ever done any of this before. So when government does what it does best, it provides the seed capital, the initiative, tries to solve the social problem and hopes that what they set up will work. I think that in this case it did. I don't anybody envisioned a market this large, a quarter of a trillion of student loans outstanding or whatever the number is, or even more. I don't think they could have done it any differently. In many cases I think it is a win win.

There is one aspect of the social policy. You don't like to see such a heavily indebted population out there. I have seen people with six figures, high six figures. You don't like to see that. But the resources aren't otherwise there. If you believe the model that says these people will do a lot better in life with an education, and that the taxpayer roll will be enhanced, if you believe in that, then you can understand why they do it. Former Treasury Secretary Joe Barr used to say that this program gave more bang for the buck, using the Defense Department analogy. There was a multiplier in the old days of about ten to one in terms of access by using loans instead of grant money which would have been much more narrowly focused. I've seen studies of every conceivable type on this thing, but I think that more people got an education because these programs were out there. Whether this has encouraged schools to raise tuition is another matter, I just don't know that part. As a dean with a faculty that spent 96 hours a year in the classroom for a six figure income, I'm not quite sure what all this means. The joke is that they understand just what a great deal they have and they feel guilty and they start acting out.

### **Business model**

In my first 17 years there I divided it up into three phases. The first 5 to 7 years I characterize as an entrepreneurial stage where we had to try to create a market, create a product, create an infrastructure and systems and operations. Then when it hit the fan in the late 70s, high inflation, limited amount of liquidity in the system, Sallie Mae doubling every year just about, that was the growth phase, the incredible growth phase. So

entrepreneurial and then to growth. People ask me how do survive doubling? And that is basically it, surviving. The culture of the corporation changed and the people who were entrepreneurial didn't like the larger more segmented type of business. When we were entrepreneurial, we were 60 people and everybody is hands on. It was much more familial, more friendly. So a number of people couldn't make that transition. I am surprised that I could, because I had come from large corporations originally where I had had entrepreneurial opportunity. So I guess that is why I survived it. Then in 1983 when we sort of got through that, we were still growing very rapidly but by that time we were now a very well structured, well positioned American growth company. A more traditional kind of a growth company. So the first stage was entrepreneurial, the second was making that great transition and the third was becoming a somewhat iconic American growth company that was in the portfolios of the smart mutual funds and the like. We were a public corporation. People asked what was our secret and that sort of thing.

I left at the end of that. Competition was starting to become more prevalent. The role of primary and secondary lenders was becoming a little less obvious. The distinction between primary and secondary lending was becoming less obvious.

I think that during my successor's seven years was a period when they were questioning their mission: Whether they could continue as a spread business. That was my understanding. I wasn't there. They were making, I don't know what their concept or perception was of the student loan market, but my understanding was that they started moving towards becoming a technology company.

### **Proxy battles**

A small group of outside investors saw the company's stock price decline dramatically. It started in 1992. The company did well the first couple of years after I left in terms of its earnings. It never saw the momentum we had. I don't know what happened after that. They had a small marketing staff, competition was stronger and there was a question inside I believe as to whether there really was much of a future in an asset that earns on a spread basis. My successor was an MIT graduate. They were users of technology and they thought that there was a technology opportunity here, which was big in the marketplace at the time. But they outlined a strategy where they would be reducing their reliance on spread income from student loans and the income would be relatively flat for a few of years. That didn't exactly impress shareholders.

There was some question about how and when the earnings were going to turn around. Then towards the mid 90s when the holders of the stock became aware that the mission seemed to have changed, two or three large holders were motivated enough to try to get more representation, not control, but more representation. That eventually wound up two years later with the outsiders gaining total control of the board. But that was not the original intent. The original intent was to place two people on the board. The board basically said no, even though they owned the seats. The two corporations that were interested, Capital Research and I think one big other, owned about, 15 or 20 percent of the company. They owned two seats, worked out proportionately. The board in its

wisdom decided not to give them those seats. So they chose to put up their own slate of two. Then they got some people who came along with them, so that would be four, and a couple more people joined them. That was before me, so in 1995 they wound up with a majority of the elected seats, eight seats to six.

But the seven appointees sided with the minority so it was 13 to 8 against the newly elected people. Then two years later those 13 threw those eight off, which engendered the next proxy contest at which point in time I joined and in the course of the year we won all 15 seats. I believe in the final vote they may not have gotten much more than 20 or 25 percent of the total shareholders. It was remarkable. I had never seen a company do this.

I got a call in 1995 from a portfolio manager at a major holder asking me if I would call up the chairman of the board and try to arrange a meeting, because this portfolio manager had a big stake. He was concerned enough about it that he didn't think he could get out without serious loss. He wanted to get representation on the board. So he asked me if I could arrange for a meeting between this individual and the chairman of the board, just before the board meeting when they were going to nominate the slate. That would have been early 1995. I made that call and arranged that meeting. At that board meeting the board, knowing who this person was, and knowing how many voting shares he had, which meant he owned two seats, denied access to the two seats.

The two people he wanted to put on the board at that time representing shareholder interests were myself and Al Lord. We were outsiders at this point in time, who were known to the board, who could work with the board, but would have been there to represent the outside shareholders. So the board said no. I do not know why. I think the board had a sense of itself. The board at that time still included seven educators and seven bankers.

Early on when we became a public corporation, in the mid 70s, when we sold our stock. The Ivy League owners made certain that it was the Consortium of Financing Higher Education (COFE) [Ivy League plus MIT and Stanford] type schools who got the seven seats on the board. Not all of them, but most of them. They had one public and one trade school, but the majority were the COFE school members. You had Harvard, Stanford, Northwestern, Brown, University of Michigan and a trade school. I am probably missing somebody. On the finance side, a young banker from Chicago who was a very senior banker at First Chicago, on the nominating committee, started bringing on his buddies who were second and third level bankers at major regional banks in the United States. So we got the executive vice president at J.P. Morgan, the executive vice president of this bank, the chief operating officer of that bank. These were all the group of bankers who knew each other and were relatively young and were all from the same level. Many of those, over the next few years became heads of their banks. This was a very strong group. This was the dominant group on the board. The fellow at First Chicago by this time was vice chairman at First Chicago. I think that was the group that dominated not only the board, but most of the corporation for most of the seven years I wasn't there.



That domination wasn't there in most business matters when I was there. It was that group that denied the seats.

A couple of years later, I guess when they lost the eight seats, they threw all the educators off and kept the bankers on. Even though the educators didn't own that many seats by then, I don't think the bankers owned that many any more either. I think they made the point that only us bankers could run this corporation. A fascinating story. I wasn't in the room to know how it really happened.

I wasn't involved in that first proxy contest but two years later I did get involved and was part of the process. Al asked me if I was willing to stand as chair and I said I would, so I did. So I was chair until this year. I guess a couple of us had a cache with the market. Al and group did a fine job. The last seven or eight years they did a terrific job with the company. I am very impressed with them.

The biggest shareholder of all was Capital Research and Capital Guardian out on the west coast. They are the ones who inquired as to whether the company would entertain some outside board members. That is when I approached the board on their behalf, with Al, to try to see if we could encourage that kind of thing and the board declined. I didn't stand for the board at that time. Actually instead of getting two seats we wound up with eight.

It was very contentious for the next two years. They did some of the things that the new group wanted them to do. But the markets were roiled and the stock didn't do very much I don't think. Then in January of 1997, the thirteen members of the board who were not the outsiders decided not to nominate the outsiders on their board slate for that year. One can talk about corporate governance and ethics and the like, because I think this was a shock to the members of the nominating committee that were part of that outside group. Notwithstanding that they basically said, "Go fly a kite." At which point in time a group of us were invited to New York, on behalf of these large shareholders if we would participate in a much more serious proxy contest. Which we did.

Al and I and others criss-crossed the country. I don't think we could have accomplished much if we had too many shareholders, but because about a dozen institutions controlled about 50 percent of the stock, we had to win the hearts and minds of a majority of them.

I think as the year progressed the other side began to fracture. People dropped off their slate. They fired their president and the chairman who agreed to resign. Eventually we had more current board members and more current executives on our slate than they had inside. We won all 15 seats. It was a remarkable thing. I don't think a company of that size had ever gone through anything like that before. A Fortune 100 company, a Forbes 100 company, whatever you want to call it in terms of assets. Unique.

They had increased the size of the company dramatically because to this technology stuff, so we were obligated to cut back. Over the last decade there have been strategy changes, acquisitions and ultimately success.

### Student Loan Asset.

It is a two edged sword. What has been happening is that the technological innovations of the last 20 years and the consolidation of the business into a smaller number of larger holders have worked to actually cut the costs very dramatically. Telephone calls don't cost very much any more. Postage has gone up but we don't rely on it that much anymore. We can do things on the Internet that we couldn't do 20 years ago. Computers and software – computers cost less, software costs more – but there's a confluence of events that actually worked to make the asset less costly in many ways. That's a plus. That has enabled the government to bring down the costs. If the government brought it down quicker than those cost savings we wouldn't have a program, I mean, people are not going to invest and lose money. All these technological and other kind of developments and consolidations to an almost oligopoly kind of nature with maybe five big holders, have enabled it to come down. The government is comfortable with the creation of what appears to be an oligopoly with maybe a half a dozen big participants. The government appears to like that because the consolidation reduces cost. I have had people on the Hill tell me they like that in years past.

We have made no more money with the 3.5 percent T-bills spread than we are making now with the 2 point something. We were pushing reams and reams of paper years ago. The government's requirements would have made it more costly. Operational risk has always been the real Achilles heel here.

The two-edged sword is that these things come down pretty much concomitantly. I think there is pressure on one side or the other from time to time. There is the fact that they can always change it. One time the government came back to us when we were in the HEAL program and said we know you bought all of these loans under these terms and conditions, but now when somebody doesn't pay on time, we want you to go into bankruptcy court, force a bankruptcy, and get a claim in bankruptcy before you file the claim to the Department of Health on the HEAL loans. We figured that was adding about \$300 to \$500 to cost to every HEAL loan we bought. See if we were making X amount, this after-the-fact kind of a thing was going to wipe out not only the profitability, but a portion of the underlying capital of all the business we'd done. What was happening was that the Department of Health was trying to push a portion of their costs and their budget on us. That was basically what they were doing. Obviously if you are trying to force this, I am going to drop out of the program. Forced us, I dropped out. We were 70 percent of the HEAL program, and just stopped. Not a medical school, health loan, anything was being made for about two weeks. We were brought on the Hill, read the riot act by Senator Kennedy, whose fault this all was. Eventually we cut a deal. The deal was, if you want on a prospective basis to have us undertake a certain set of costs, we'll price the loans accordingly and we'll make loans on that basis. But you can't go back like that, because that kind of thing puts you out of the market place. The fact that they change the terms of these things every year, or the fact that people find loopholes in programs which Congress wants to cut. The fact that what looks like a safety net one year looks like a boondoggle the next. What looks like a safety net may not be there.

There were times when there were limits on the upside of student loans when we went up to 18 percent on the cost of money. We were getting clobbered. We were losing 6 or 7 percent on every loan we owned. We needed help in the Congress immediately. What appears to be a benefit isn't always a benefit. It goes up and down. Historically I think yields of these things looking at Sallie Mae, look pretty consistent over time. A little bit up, a little bit down, per unit. It is less than one percent. Banks make 1.2 to 1.5, I think traditionally, percent on their assets after taxes. We make more like  $\frac{3}{4}$  of a percent. But we are heavily leveraged so our return on capital is relatively high.

### **Origination**

There were two or three times when we originated loans. We had to find some way to work within the existing legislation. For example in the District of Columbia, almost no loans were being made for a significant period of time. We suspected red lining. Something like \$7- 800,000 in loans were being made in the jurisdiction, while in any other part of the United States it would be \$10 or 12 million a year. So we suspected red lining. With the concurrence of the Department of Education, and we had no support from the Black banks in the District (they were more conservative than other banks). Eventually we put one of the banks in business with one of our employees and I think that made up 90 percent of their income over time. We cut a deal with a bank, I don't know if it exists anymore. They would make – We would do all the work. We would originate the loans and make them available. They would go on their books for about 30 seconds and they would get X dollars just for putting their imprimatur on it. Then it would move to us.

End of the story is we made \$30 million dollars in loans the first year. Immediately every entity from out of DC saw this and moved in and we were thrown out. But we had gotten done what we wanted to get done.

Congress knew what we were doing. I never kept secrets from Congress. HEW was very supportive. We all suspected that the four or five antediluvian banks just didn't want to deal with the populations that they served. That was probably in the late 70s.

We were selling turnkey operations to institutions who couldn't do this but wanted to provide a service and create a fee in their local community. If you had a local bank that wasn't able to provide student loans to the college in town, that was not good town gown relationships. We had programs where essentially we would create a package where the bank would make the loan, but the back office but all the origination, the documentation, and ultimately the sale of the loan to us at some point in the future was part of the deal. They would get either an origination fee, or they would hold the loan for 6 months or a year, maybe even the whole time the kid was in school and would make a nice spread during that period and at the end we'd wind up with the loan. So we were originating loans for a long time. There were a lot of reasons why that was appropriate.

Our mission was to create liquidity and create access. We were invited in by members of Congress in their district. There are a bunch of stories I can't tell. I had Congressmen

who knew more about what was going on in a local bank than the bankers did. Sometimes it was scary.

There was a volatility to the financial markets. We started out at a time when interest rates were relatively benign. Interest rates were in the 3, 4, 5 percent range. Ten years later we were in the 17, 18, 19, even 22 percent range. (I got an adjustable rate mortgage at 9 and it floated to 18 about six months later.) We then went through a period where governments at 10 percent were the norm for a number of years and during the last five years you've had the interest as low as 1 percent for three or four years and have now risen to about 5 percent. The matched book dealt with those fluctuations.

It was not just Congress that presented risk, it was the Executive branch had different missions too. You would get somebody on somebody's staff who just was against the free market, just on general principles. He didn't know squat about us or anything else. Then you get some people, who... this notion that Sallie Mae is less efficient than the direct loan program because it costs them 3 percent less than it would cost us. If you don't include the cost of funds it's a wonderful calculation. If you don't include the cost of collections that come up the road, it's a wonderful calculation. When they go up on the Hill they use formulations that are 10 years old of "expected" costs. But there's real numbers out there from the Congressional Budget Office or whatever. People have their political axes to grind, everybody, probably including us I'm sure at times, have used the numbers that are most attractive. The notion that the government is more efficient at running a very complex financial program doesn't make much sense to me.

With all due respect to the Department of Education, they are not a financial institution. They are a social, programmatic institution. There was a time we lobbied for the Treasury to have oversight of the program for just that reason. It didn't endear us to HEW.

### **Leaving the FFB vs leaving GSE status**

Leaving the Federal Financing Bank, we were a relatively small entity. We had to deal with higher costs. We were a much better known entity 20 years later. It was a different world. I guess the commonality is increasing costs, but the market environments were so different. There was a high cost, high yield environment.

### **SLM Corp's credit rating.**

My recollection was that we had a single A rating when we were trying to go to the credit markets with the government behind us. We had a triple A rating when we went by ourselves. I may have the exact digits wrong, but there is some anomaly like that because the thought was that the government might not honor their guarantees. That was early on, that the market thought they might not honor their guarantees. That is the market, early on. I am sure you can find some commonalities between 1983 and 2003. The job is so much larger, the interest rate environments were so different, the corporations were so different. I think the fact that we were dealing with a higher cost environment and how to manage it was the common denominator. I had no part in the negotiations on the FFB in 1983.

**Verticle integration**

Vertical integration was just trying to control costs and make the process as simple as possible. I think SLM recognized that the name of the game was service. If you could provide better service, the product on its face was relatively similar, but what kind of service you can provide for your customers? They put in place a much larger market extent, trying to find out what the individual issues were on any campus, began to offer incremental non-guaranteed loans because many of these programs wouldn't come close to funding the real cost of education. It tried to become a full service provider. They also needed to come up with other businesses. They went into loan collection, went actually into loan collection for direct lending and other programs, which also gets them into lending for credit cards. I understand they are on the short list right now for possibly being one of the IRS's collection agents next year. I don't know when or if that decision is going to be made. As a matter of fact I think we may have had the more attractive deal for HEW to service their loans. I don't think we got the contract. They had a sole source bid. We complained. So when they got two new bids, the bid from the others was about 30 percent lower than the original bid. We would have made money on our bid, which was about the same price, maybe even better. I don't think we ever got a thank you but I think it was worth hundreds of millions of dollars.

We do credit collections for credit cards. We have different kinds of loans. It was a trying to control all aspects of it from the inceptional contact to the hard core collection at the back end.

**In school period**

During the in-school period there is no material servicing cost. There is some modest, very minimal amount. Origination has a cost. The loan has three different stages. It has got the in-school, and when you make the first loan for \$2,500 it is not that much of an income producer. Then you have to originate another one and another one and another one. By the time you three or four loans on your books then you have a loan that is generating a pretty sizeable income in that third or fourth or fifth year. Then you have to find the student and put him into repayment, and that's expensive. So if you were to chart the costs, and say the income was here ..., then you would have cost, income, another cost, and income. So if you plot it, which we do, you would see that it's not a straight line. That income is declining over its life in repayment pretty considerably. You can look at the probable life of the loan at any point in its 10 or 15 or 20 years or whatever its going to be, and you can come up with a price for that asset. If you buy the loan earlier in its lifespan, or even originate it, you have certain benefits and certain costs. You price it accordingly.

Clearly there is more gain during the in-school period. That's why we had current yield accounting that we had years ago, because over the last 3 or 4 years we lose money. That is just the way it goes. You get a \$300 loan, the last 3 or 4 months, and you are collecting 40 cents of income and have \$5 of costs, you are getting slaughtered. That's why I look at some of these residuals in some of these tranches. I don't know how they're going to work out over time, but that's another matter.

As a business person you want to maximize your income. So does everybody you're competing against. There're no free lunches anywhere. I just wonder how some people are doing it when I don't see the capital investment in the infrastructure. That is another matter.

Most of those who hold the loans don't actually do the servicing themselves. They'll go to a third party servicer, including the federal government. You have got to audit that servicing to make sure they are in compliance or else you are in real trouble. There have been some problems with that.

### **Privatization**

We are just a business. We have to do what other businesses do. "We." I am no longer "we." They. SLMA disappeared last December and I left the board in May.

Jack Remondi did a fantastic job on the financing side. Clearly the markets were amenable, but the appetite was there. The market environment was good. I think he moved \$40 billion of assets off of SLMA's balance sheet onto SLM's. Now for SLM for the last 3 years, we were watching our cost of funds go up. Let's say our cost of funds went up by 50 basis points, or some number, over three years. Each years it was going up by 15 or 20 basis points. Our earnings were going up during that period. Part of it was volume, part of it was efficiency, part of it was stock buybacks. That was an incredible performance during that period.

Loan consolidation came from back in the mid 1980s, when I used to have meetings from time to time with the chairman of my committee, Bill Ford of Michigan. He was the third or fourth ranking Democrat in the House in that period. He would bring in 2 or 3 other people, we'd have bull sessions, maybe a couple times a year. One of the persons he used to bring in was Harold Shapiro, who was the president of the University of Michigan, who went on to Princeton. Harold was a very bright guy. Ann Arbor was in Ford's district. He'd bring in one or two others. He had a very astute staff person who became assistant secretary of Education. We'd have bull sessions. He was bemoaning the fact that kids were getting loans from multiple institutions: a loan from their local bank, a loan from the district where they went to school, maybe when they went to graduate school they got another loan. Each of these loans had a minimum repayment and so instead of having a \$50 repayment, they had a \$2 or 300 payment from all the different banks, and they were getting killed. They didn't know what to do about it. I said it is simple, just consolidate them in one loan, modify and extend. That is what you do in banking, modify and extend. He said that was a great idea. He made it into legislation that gave Sallie Mae sole authority to do it.

It was complex. You had to calculate interest on each loan to a date specific, make sure the cash was transferred, create a new loan, a new note. It was an awesome amount to do. They couldn't put the NDSL in because it was a different program. It was just the GSL program at the time. We did 80 or 90 percent of them for the longest while. And all of a sudden what was happening was that the consolidation was taking a loan from this

originator, and that originator. They got ticked off. They didn't have a clue how to do this either. We were putting the hardware and software in place. So they went to Congress and Congress said yes, anyone can do it. So that's how it happened.

It was sort of like a Judy Garland, Mickey Rooney movie where we were sitting there and someone said "Let's have a show!" Two or three things came out like that: "Let's have a bank! Lets put a program together for med students, called HEAL!" Ford was quite innovative, and also John Ehrlenborn on the Republican side, was very helpful as well. Those were the two mainly responsible for putting the programs together. Then there was a woman named Edith Green, Congresswoman, who was very important in all this.

I can't conceive of us buying a bank at this time unless that was the only viable alternative for fundraising. You go to an industrial bank charter only because the regulatory oversight is different. I hadn't realized they did that. There used to be a couple of states that did it. We went to North Carolina back in the 1980s because they had the equivalent of the FDIC, Federal Reserve and the Comptroller under state authority there. There was state oversight, which just made it easier. I looked at industrial banks in years past too. But you know they are in a whole bunch of other kinds of things now. They are doing home mortgages. They are looking at a handful of other kinds of things. There may be a variety of reasons why they want to do that. It is not surprising. A de novo charter is a lot different than taking over a large, multi branch institution.

But as to buying a bank or being bought? I've thought about this recently. You know the company has about a \$22 billion market cap right now. That's a lot. It has capital accounts of maybe 15 percent of that, so there is an awful lot of goodwill if anyone were to buy this company for anything near that. The fact that it is no longer a GSE, and that it has cleaned up its balance sheet the way it has over the last couple of years, and doesn't have the regulatory oversight that it used to have, makes it a more possible candidate to be taken over by somebody. If you look around, you'll see that there are probably a couple of dozen institutions with market capitalizations between \$50 and 200 billion who could easily digest this thing. Maybe half a dozen big American banks, maybe half a dozen large now public insurance companies, GE Capital itself, maybe some foreign institutions that want to get into these markets, maybe a GMAC credit or something like that. The point is there probably are a dozen institutions for whom it would not cause great indigestion. If Bank of America is taking over MBNA, a \$40 billion company, it could easily take over us. MetLife which is maybe \$35 to 40 billion market cap, could easily take over us if they wanted to.

What do we have? We have two things. We've got a very successful business with a future. Also we have credit information on about 12 million people. We have data for marketing or whatever, that could be very attractive to others who if they owned it could use it. It is fresh, not stale data. Its useful now. Someone once told me that was worth more than our company. I don't know if I believe that.

On the negative side. We are selling at about 18 or 20 times earnings. So somebody who would buy us would more than likely suffer some dilution, because there is not a lot of overhead you can cut out. There is not a lot of overlap. When one bank buys another its frequently the overlapping that is knocked out. That's why we couldn't buy a bank in California, and somebody like Citicorp could. They could cut costs by 30 or 40 percent. There is no way we could have competed to buy a bank like that. The other side is that if somebody took us over, there would be a considerable amount of good will on their books. Hell, if you are a \$150 or 200 billion operation, who cares? Would it surprise me? No.

I think we will probably become, in some ways, more like GE Capital, as a large, non-regulated (when I say "non-regulated," I mean by the banking system, because there are checks and balances), a large financial intermediary in a growing number of consumer financial service businesses. That's what I am guessing they would become. They are throwing off a lot of capital. They are buying back some stock. They have a new CEO. He is a consumer banking person before he came to Sallie Mae. I wouldn't want to speculate what he'll do over the next few years.

Our prospect was never that this was going to be a totally private entity with anywhere near this level of size and sophistication. But we did feel that we were doing missionary work early on. This was not meant to be my last career when I started this thing. I signed up for three years. It was uncertain just how much support we really had in the Congress. Not that they didn't wish us to do well, but I don't think anybody expected us to do well. I think there was a partnership for a lot of years, and it was a very positive partnership between the Congress, Executive branch and ourselves. It began to unravel as a bit once we got bigger and there were real resources there, particularly during the Carter administration. There were some very partisan people there. People are surprised when I say this but the most bipartisan president that we worked with was President Nixon. He put together a board that was Democrat and Republican, young and old. It was about as broadly prescribed as anything. What was interesting was that the Secretary of Treasury during the Johnson administration who was pushing this came on our board after the Nixon election, and the bankers association head who was pushing this from the bankers side, became a deputy secretary of the Treasury in the Nixon administration. So there was continuity. For the two or three years of the Johnson administration and the first two or three years of the Nixon administration they had the same point of view. They got there for different reasons. Johnson because, he had gotten loans when he was a kid. The Republicans because they felt that private sector loan programs could work. If they were nurtured they could move on and work. That was our goal early on.

This thing just exploded in the late 1970s and early 80s and got so big. One of my favorite stories was when I was interviewed by the Washington Star. We had \$1 billion in assets. I described what I thought was going to happen to the company. This is probably in the late 70s. They said where do you expect to be in ten years. I said I expect to be a \$20 billion corporation. They wrote a sarcastic article about how I was really off the mark. And they were right. It wasn't 20, it was \$40 billion. They only survived another year as the Washington Star.



It was a long run. It was good. Am I glad I left in 1990? Yes. I went over to something else that was fun.



## **Interview with Marianne Keler**

EVP and General Counsel of Sallie Mae – 1984 to 2005

Reston, VA, September 1, 2004

Interviewed by Suzanne McQueen  
Treasury's Office of Sallie Mae Oversight

### **Capital Risk Levels**

MK: Capital risk levels are a critical issue for any privatization. Not that I want to make that a big topic. It has been sort of a quiet issue between Treasury and Sallie Mae. It is a critical issue for any privatization: the extent to which the bargain you're striking with the shareholders of the company, the owners of the company, is understood at the outset. If there was any issue with that, it was that we cut a deal with Congress to have a 2.25 percent capital requirement, and that was the basis on which we went ahead. Congress gave us this ultimatum: "Either you privatize or we liquidate you." None of the privatization legislation would have gone ahead actively unless we put the proposals forward and at the same time we sold privatization actively to our shareholders. The premise of it all was that the capital, the leverage, was going to be maintained for them. I think Congress was looking for more capital, but the deal got struck the way it got struck and yes, we did have to up our capital slightly.

But then, 2 or 3 years into the privatization process, Treasury said to us, "We really think we need to look at you like a bank, we need to have risk capital. We need to create all this." That is one issue that is a sensitive one for us.

I would certainly say that the reason that Sallie Mae's privatization was successful is that it was a negotiated arrangement as opposed to a mandated or dictated arrangement that said, "This is what you are going to do." Plus, there was the benefit of insider knowledge to strike a feasible deal, and the cooperation of management to make it work. Otherwise it would be doomed to failure. No regulator is going to be able to impose a perfect privatization process on a recalcitrant, reluctant GSE. Well, I guess they could, but it would be difficult. I think that would jeopardize the government's ability to create new GSEs. There has to be some sense of accommodation.

### **Why did Sallie Mae want to privatize?**

MK: In the mid-80s when I joined the company, privatization was already on the lips of management. In the Reagan era there were already a number of proposals to privatize. Al Lord would tell you that when he was interviewed for his job and joined the company in the late 80s, as a matter of fact I think he showed me a letter he gave to his boss at the time about how the company would ultimately privatize. Privatization was something that this management group was already culturally pointed toward, not necessarily just as an escape from direct lending or the offset fee, but as something that made sense to us. Nor was it necessarily just so that we could diversify the business. It was because we felt

that at some point our mission would be accomplished and to the extent that it is accomplished, the screws would be tightened.

We had actually purchased a savings and loan company, First American Bank of North Carolina. We got our wrists slapped and Congress made us divest that acquisition. I don't remember all the events surrounding that. But that was a very stark reminder that we can't just go anywhere in the business, even though the bank was supposed to be there to acquire student loans. I think there was a tax angle to it as well.

I just think the capital issue is important. The importance of the Board oversight was big issue for you guys. How independent the Board members were of management.

SM: And whether there was a firewall between the GSE and the non-GSE. That was another big issue.

MK: That was I think somewhat covered in the legislation. The governance issue wasn't as directly addressed, but certainly I think we tried to recognize these issues. We tried to deal with them and address them. I'm not sure that having them brought up in the legislative process would have necessarily made for a better or different result. But I do think that the capital issue could be, has to be addressed more clearly in the legislative process.

SM: What would have been a way to deal with that?

### **Risk Capital Issue**

MK: I think that to the extent to which the regulator wants flexibility to develop capital requirements as they go along, or adapt to whatever circumstances arise, I think that authority needs to be stated more clearly. If there's going to be an impact on the investors or the shareholders in the company, if there's built in discretion they need to know that. Otherwise, the deal that we sold to the shareholders was that we need 2 ¼ percent capital, while it turns out what Treasury really wants is 4 percent capital. Well, in our case we could manage that because of the growth on the other side of the business and we could accommodate 4 percent capital within the GSE because on a consolidated basis we maintained the 2 or 2 1/4 percent. But, there is a huge goodwill issue here with our investors.

I would say that if there had been an impact on our shareholders, I think we would have had to contest it politically somehow.

SM: It seems like there already was an impact.

MK: Well yes and no. But I think what really, as a practical matter, we did was move capital into the GSE and deplete it from the other subsidiaries. So it was more earmarked towards the GSE. We were comfortable with that because ultimately our shareholders get that capital. It wasn't terribly at risk. I suppose it would have been at risk if we had messed up the enterprise. But it was available.

If I were in your shoes, I would mention that as an issue.

We laid out very clearly for Treasury what our position was. Certainly we felt all along that the 2 ¼ percent was adequate capital. It was maybe a simplistic formula. We have a risk-based model that we also use for our rating agencies and it still gets us all, even today, into a 2 to 2 ¼ percent level. So when I say it's an important issue, I am just saying that Sallie Mae's position is that what we did in the '96 legislation was by definition safe and sound. It was adequate.

I think the issue was raised in '99 or something like that, in one of the first audits. I think part of it was that as the staff got deeper into the balance sheet and into the risk profile of the company, they saw things that they felt were inconsistent with their general understanding of Sallie Mae. The private credit portfolio was growing. We had the lease portfolios that I guess they opposed.

I would say that a threshold issue when you're privatizing a GSE is the degree to which you really are specific in whether you give the regulator rule making authority to design things as it goes along when you only have a regulated class of one. Or do you try to codify every potential direction that the company could pursue, and answer all these questions, which of course would be a completely imperfect and frustrating exercise because you don't know the future. You don't know how the business is going to evolve.

Certainly with hindsight I would say it was great that there was as much fluidity and generality in our legislation. It required some level of (a) - business success on our part so that we were somewhat indifferent to some of these issues and (b) - I think - reasonableness is probably not the right word, but the relations between the regulator and the GSE had to be manageable and there had to be mutual respect. And I think there was that. There was a back and forth.

#### **The Department of Education.**

Since the legislation passed, I think they were really out of the picture. And I think that is appropriate because really, our role in the student loan program was not critical the way it was at the inception of that program. The last thing they did that could have affected the privatization course was whether we could avoid the offset fee as we securitized loans. Their position initially was that we still had to pay the offset fee even as we securitized. Of course we litigated that issue and won. All of that I think got resolved, either in '94 or '95. And we could not have privatized without securitization of student loans.

That is not an issue for the housing GSEs but student loan securitization didn't happen until the SEC effected a rule change under the 1940 Act in 1992 allowing certain kinds of asset backed securities. Otherwise we would have had to classify these things as mutuals, as funds, as investment companies under the Investment Company Act. That was just a pure coincidence. I remember when that legislation first passed, we were saying, "Why would we ever want to take those things off the books?" I forget which of the smaller student loan companies had pursued that, it might have been Nelnet. But we were the ones to really first put a deal together of any scale in a non-tax-exempt mode.

**Drafting of the Holding Company memo.**

There was a memo, and I used to have it around for the longest time, I'm not sure what I did with it. I no longer remember if this was in '92 or '93. Al, who was still at the company had asked me to think about how we would affect the privatization. We had gone to our large outside law firm in the past, I think it was Milbank Tweed, in the ,80s. It was kind of an awkward thing because what they had in mind is that the Federal guarantee would have to stay behind our debt. It wasn't really workable, because the guarantee was maintained for some time. Basically an explicit guarantee was introduced and then I suppose that was going to somehow go away.

**Cut over vs Phase In**

Anyway I came up with this idea of the holding company in a gradual metamorphosis of the franchise from a GSE to a non-GSE. Certainly I had in mind something that would allow us to grow the private side at the same time we were shrinking the GSE. Not the hard and fast cut over which is what we ended up having to live with mostly for budget reasons. It was more expensive for us to privatize that way, and then it was of course baked in in the course of the legislative process.

The offset fee pushed us to privatize and illustrated to investors that we weren't going to be losing that much because our funding advantage had been pretty much taken away. At the same time, the structure of the final legislation had to keep that offset fee revenue in place for some significant time frame, which is why we came up with this cut over event. There were still sufficient classes of assets that we could put on the private side of the company including consolidation loans which aren't subject to the fee, and private credit, of course. We could actually grow the non-GSE balance sheet and the revenue streams - the fee income - were pretty much all coming through the non-GSE side of the company.

We knew that the cut over was far enough out into the future and at the time the legislation passed we weren't quite sure how we were going to deal with it, but we hoped that we could get waivers if we needed them. As a practical matter, you see that we achieved the cut over, just now, fairly late into the privatization process. But I don't think that we would have been able to do it if it hadn't been for these other businesses that we were able to put into the private side of the company to build it up. It is really important that there be something there. You can't just flip the switch overnight, move all your contracts and move all your funding to the other side.

How unique this problem is to Sallie Mae I don't know. If you were to try to encourage the other GSEs to leave the fold by taxing them, then by definition your ten year budget forecast is going to assume 10 years worth of forward taxes from those GSEs and it then becomes expensive to privatize them because you lose that income. That is sort of silly. Unless you adopt legislation that at the outset taxes them but anticipates a privatization event where you lose the tax so it's not baked into the forecast. I don't know how you would do that. I don't need to solve their problems. Maybe there is a way to get around their issue.

There was definitely a carrot and stick approach to this privatization. Clearly direct lending was very much the stick, or a reinforcement of the notion that our mission was more than accomplished and that we were paying shareholder capital and had to reinvest it. I think management always wanted to go to privatization rapidly. Certainly in order to sell this to investors it was necessary to illustrate that this was an imperative, due to the offset fee and the direct lending.

After the '96 legislation was passed there were two booklets. There was one in '95 and then another after the legislation passed.

### **Proxy Fight**

Between fighting with the direct loan program and then the proxy fight, the internal governance struggle was very, very dramatic. We were embarking on all kinds of new directions. Securitization was not a developed program and we had no confidence that that was really a viable financing method. The fundamentals of the industry were so powerful with the growth in education financing. The Higher Ed Act increased loan limits and the increased volumes in the program almost compensated for the loss of volume to direct lending. So, I would say that if we had lost 30 percent of market share to direct lending, as we did, without an increase in loan limits, that would have been incredibly difficult. Both the demand for loans and the loan limit increases certainly mitigated that.

There were several very happy coincidences. As difficult as that time was, as tense as it was, as bleak as things looked at times, there were still some very powerful, positive forces. And clearly management and leadership were critical elements. I would tell you that. I am not sure that we would have really pushed as aggressively for privatization if there hadn't been this ongoing proxy fight with the divergent views of a long term business plan. It was almost a beauty contest: which one had the better vision or the future? I think it made each side sharpen their thinking. It got a little bit beyond the traditional constituencies of the company, which were basically the banks. We were created to help banks and be a secondary market and be behind the scenes. Now we were increasingly taking on the banks. Certainly Al Lord's business plan was very much to take on the banks. Why do we need the banks to act as middlemen? They don't have the investment in the business that we have. We are a monoline. We've made this is our bread and butter, we put the servicing centers in. There is a tension here that is not unlike the Fannie/Freddie tension with their banking/lending limits. Loan origination didn't happen until after the Privatization Act.

I don't know how many people would find this fascinating, but it is. And it is even with hindsight, and the story has never really been laid out. There were newspaper reports at the time of the proxy fight.

Our industry is really dramatically changed. I went to a financial aid conference with a hundred vendors. There were little start-up companies, like "My Rich Uncle" and who knows what else, who were just jumping into the student loan business as if it was the high tech or software business of the '90s. That is the future.

**Refinancing the Balance Sheet**

I truly do not profess to have any understanding of the Fannie and Freddie situations. But one thing, if I were intuitively trying to design something for them, I would look at the average life of their balance sheet as a way to guess how long it would take for them to privatize, or for any privatization process to be successful. I think privatization of a financial GSE really requires them to refinance their entire balance sheet. So they would be trying to effect a complete refinancing at the same time they are trying to finance in new, much smaller, much more difficult markets, the new business that's coming on, that's being developed. So you want to minimize the refinancing burden to the maximum extent. The best way to do that is to let those assets run off, so that they don't have to actually refinance them, they are just refinancing the incremental volume. What they are really refinancing is debt, not parity(?). So you really would have to look at the structure of the liability to see how far they run, to see how much is weighted to the out years. If we had had to defease \$6 billion six years ago, that would have been a much bigger deal. Obviously defeasing the dollar amount we are doing now is less burdensome to us.

**Time and Growth**

Time is an important factor and growth is a critical factor. For Fannie and Freddie you almost have to start with the premise that do you want the debt out there 50 years from now. If it's not 50, then is it 40 years, 30 years? Where is the appropriate cut off time and how do you go from here to there? How much is there going to be anyway? For new GSEs the better approach is to have some clear cut sunsets, so that when you are inviting private investors to put capital into a franchise, there is some notion that there is an end date. It forces the government and the investors, the shareholders, to either renew, re-up, their relationship or to keep extending that deadline. A sunset provision makes it clear that it is not a perpetual relationship.

Clearly the difference in the asset that Sallie Mae deals with, and that Fannie and Freddie deal with is significant.

**Gradual Cut Over**

I may try to find the memo that I wrote on this notion of the holding company structure and the gradual approach to it, along with the fact that we had a huge communication challenge for us. I think it was huge advantage in that the plan came from inside the company, that management would own this idea. That we would propose it and that we would need to sell it at the same time to our oversight committees, to Treasury, to Education, to the White House, to employees, to investors. Everybody was going to be completely thrown by it and be uncomfortable with it. There was the uncertainty of it all. Launching a legislative process that we couldn't quite control was somewhat problematic. But we were in somewhat dire straits. Sometimes I think you can't do things like this unless you're desperate. Even though it would have been a good idea even in the best of times, you could have never have sold it then, because, "Gee, everything is looking good."

There was a silver lining.



**Stock Options**

The way we kept management incented here, certainly in the way everybody did in the '90s was with stock options. We struck options at low prices because the stock was in the toilet and there was a lot of upside on the table for those who took a long term view on where this might go. It was more of a gamble. Still the people who stayed with the company did very well. It was a big win-win for everybody.

**Exit Fee**

You know the exit fee was one of the big things that during the legislative process was a big focal point. What should we pay for the privilege of leaving? Even the notion that we would have to pay – I don't know which way the payments should go. In any event it was conceded that we should pay something. The deal that was cut was \$5 million cash and stock options or warrants equivalent to 1 percent of our outstanding capital float. The DC school system was going to be a beneficiary because the legislation came through the Education Committees. Of course the DC schools got these warrants and didn't know what to do with them. They consulted with Wall Street who immediately told them "Oh that's too risky, you've got to get out of these things." So they immediately sold them, realizing what seemed to them like great money at the time, I suppose, \$38 million, but leaving a huge amount of upside on the table. They could at least have cashed them out over the course of some number of years. One of the big international banks ended up with the warrants, and just exercised them.

Congress had all of the best intentions. Of course, it seemed too risky, and DC wanted to cash out immediately. They could have gotten some portion of it immediately and there would have been any number of alternatives. Anyone advising them in a fiduciary capacity would probably have done the same thing.

I was just asking honestly, which way the exit fee should go. There is an open ended, implicit contract when Congress charters a new company and says "We want to invite private investors to put money into this arrangement." And of course they don't say "We are implicitly going to back them," but that is what the world thinks. I guess at some point in time they say, "Oh we don't need these guys any more," or "we don't plan on operating the same way." Each time presumably shareholders want to keep the bargain they have. It is the government that wants to change the nature of the bargain. In the private sector when one party wants to change the deal, that party generally has to pay its way.

**Sallie Mae Name**

We also got the Sallie Mae name. What we were paying for to continue was the name. Well the name wasn't anything that Congress gave us. It wasn't in the formative legislation. It was a nickname that we adopted, but we used it while we were a GSE, so the idea was to be able to continue to use the name. And there is definitely good will associated with it. It made some sense. The exit fee wasn't explicitly tied to the name but I think that is what we would have said was the case. It seemed like a good deal. We weren't allowed to use it for the privatization process, for debt issue.

**Privatization Legislative Process**

The government affairs function was really with the general counsel at the time. I was more of a technician. I worked pretty closely with the Treasury staff. The legislative group worked very closely with Larry Huff, the then CEO, on the lobbying. That was kept very close.

**Loan Servicing Subsidiary**

Prior to privatizing we set up a separate subsidiary for loan servicing operations. That was important, even while it was under the GSE before privatization. The GSE had the implicit Federal guarantee. The idea was that when we did the first ABS transaction, we told our investors and rating agencies that after privatization, if we were to privatize, we would be moving that loan servicing facility off to the private side of the company, so there would be no implicit GSE support behind the servicing component. In the student loan world, really all the risk is in the servicing: Are you properly complying with the Higher Ed Act requirements? We wanted to be sure that there was not even the slightest notion or taint of the implicit GSE backing to our securitization deals. We wanted to make sure that the listing element would really be independent. Otherwise, people would say, "Oh the reason you're getting such good pricing on your securitization deals is because the market thinks that the Federal government is implicitly going to backstop any servicing errors that a GSE sub is committing." So, step one is to drop the subsidiary down, clearly isolate it legally with what we hoped was no recourse, and explain clearly that this thing was moving over. Even though this ABS deal was issued in '95 it had a 5 or 10 year life, and two years into that life the subsidiary was going to move over. We didn't want a credit event to occur when the subsidiary was transferred, knowing that was the direction we ultimately were heading in and that we wanted to head in.

We didn't know if it was worth a couple of basis points. We didn't want people to accuse us by saying "Well that's not really privatization. You still have a GSE benefit."

It was important also for the offset fee issue. At the time securitization was a novel idea. There was not much of a template on which to proceed.

The minute we dropped that entity down, we also created a state chartered entity that was subject to state taxes. There was a price to pay for each one of these new legal structures. So we really started absorbing the costs of privatizing even before we privatized by taking some of these steps.

**Securitization and SEC Registration**

One thing that we got from the first securitization that was valuable experience for management was that we did the first SEC registration. Before that we were doing financial deals with disclosures that that never went through any review. While you would go to expert lawyers that can help you through the process, it is still a very critical step for management to take to go through SEC scrutiny. Our business so closely mirrored the securitization product itself that it wasn't that big of a leap from getting SEC

sign off on the securitization deal to getting SEC scrutiny of our 10-K. It was a comfort factor for our investors, our board, to know that we could do this.

### **Proxy Fight**

Our perspective is very human. A lot of it is mixed in with proxy fight. It was a very difficult time. It was like a civil war here. We really had factions. Some people want to hold on to what they've got, what they know, what they're comfortable with. Other folks knew that it wasn't tenable and that we needed to take some leaps. It helped, at least for the lawyers, to know that when you are working for a public company, you have to act in the best interests of the shareholders. You have to at least keep that perspective in mind. The fiduciary responsibility. It helped in sorting through what to do.

When we did our first securitization deal, we had no idea how much capital would be required by the rating agencies, even though we have very sophisticated finance guys here. We ended up needing maybe a quarter of the capital that we initially thought we would have to put up. Still, not only did we not know, the investment bankers didn't know, nobody really knew at the outset of this process. It turned out to be a much more efficient funding vehicle than we thought possible. Part of the benefit was going through the exercise and preparing the case ourselves to the rating agencies. I am sure that by the time we put all that together we had a much better feel for why the capital should be as low as it was. When you think about it now, with 20/20 hindsight you say, of course, what better asset could there be than a student loan that is 98 or 100 percent backed by the federal government? But when the case has never been made you don't know. Compare it to a credit card.

The student loan program is an amazing program. I really think the praises of the program have not been sung appropriately. I think it really has lifted a whole generation of Americans. We have all had, especially in this country, an aversion to indebtedness. But it is so positive. Jack Remondi says this all the time, this is the only borrowing that you do that actually improves your repayment prospects. Every other borrowing depletes your assets, but this makes you a better credit risk over time.



## **Interview with Jack Remondi**

CFO of Sallie Mae – 1999 to 2005

Reston, VA, July 26, 2005

Interviewed by Suzanne McQueen  
Treasury's Office of Sallie Mae Oversight

### **Nellie Mae Experience**

Nellie Mae was a 501(c)(3) a non-profit organization, created under section 150(d) of the tax code that allowed us to issue tax exempt bonds. As a result of that charter, in exchange for the right to issue bonds, similar to some of the restrictions that Sallie Mae had, that company could only be involved exclusively in the federal student loan program and couldn't do other things. As a result anything we wanted to do outside of student loans was done under a sister non-profit entity. When direct lending passed we had some of the same issues and concerns that other student loan companies had. What are we going to do? Our corporation's business line was restricted to federal student loans only. If federal student loans went away this entity had no business which it could conduct.

So we began a process to request legislation in the U.S. Congress that would allow these entities to convert. That was passed in 1997. We then began a process working with the attorney general's office in Massachusetts, as non-profits are regulated by the AG's office, to begin a conversion of the company into a for-profit entity. The result of this was almost like a two-fer, because the way we structured the privatization is the non-profit remained and owned 100 percent of this newly created for-profit. So when the for-profit entity was sold the non-profit continued to exist but exists as a foundation rather than as a public charity. So the state benefited. The attorney general's process said ok we've got this student loan company that's going to continue to do business and provide services to Massachusetts residents in a similar fashion, and, we now have this private foundation that is going support educationally related activities in the state. So it was a good deal.

There was a little bit of opposition from Consumer's Union principally because they had been developing the practice of opposing hospital conversions from non-profit to profit for different reasons, so they thought the issues would be the same here. They raised a bunch of concerns and the attorney general's office for Massachusetts which is a very liberal state and highly consumer focused with an individual who happened to be running for governor at the time said to these guys "You are so off base on this topic, you haven't even done enough research to look at what's going on here. We have. Go away." The conversion ultimately happened. Scott Harshberger was the attorney general, and he did not win on the election. It just puts this in light of – no one's going to step out on a limb here against Consumer's Union while running for governor if they didn't really believe there were no issues in the process.

So we converted in July of 1998 and then about a year later in July of 1999 is when Sallie Mae acquired Nellie Mae. We had looked at a number of different types of activities from a leveraged buyout to partnering with some other participants in the federal student loan program, and we just felt that this transaction offered the greatest certainty and we thought we had an ability to play a role in Sallie Mae's conversion which is really a two step issue, as a business conversion to a direct originator and a financing conversion as well.

Before we even began the corporate structure conversion at Nellie Mae we had previously converted the business model from a secondary market to a direct originator. We didn't need any charter changes for that side of the equation. Still limited to federal student loans, but we were a direct originator. Now unlike Sallie Mae there were no refinancing requirements under the 150(d) legislation. The existing tax exempt bonds which were the only thing that would be equivalent to a GSE financing were allowed to convert over to the new for-profit, but there was no ability to refinance or do anything beyond what was already there. So if you had a bond that would mature at 2002, it would mature then, you couldn't refund it.

I am sure you are aware of this 9.5 percent stuff that has been happening. The abuse that's happened there didn't exist here because you couldn't extend the bonds indefinitely.

#### **Nellie Mae's conversion compared with Sallie Mae's privatization**

Sallie Mae's was far more complicated. In that there were two pieces. One was that it was trying to convert its business model into a direct originator – and that had its own set of challenges. Sallie Mae was a much larger organization, much more public, whereas Nellie Mae was much smaller and could quietly kind of do this without involving a lot of people. And then the more difficult and unproven piece was can you actually refinance this balance sheet outside of the GSE sector. You could clearly do it in the asset backed world, but could you finance the whole thing in the asset backed world was a big question.

#### **Nellie Mae**

The bonds came over to the for-profit. You couldn't refinance them going forward, but you retained the rights to the bonds until the stated maturity date was on the conversion. It wasn't huge money for Nellie Mae. It was \$500 or \$600 million so it easily could have been refinance if that had been the requirement.

#### **Impression of Sallie Mae before merger**

The biggest issues going on at Sallie Mae at that time was the huge turmoil from the proxy battle that was happening. At the same time we were promoting this legislation, Sallie Mae was going through this pretty bloody proxy fight. From an outsider's perspective it was obviously very interesting to watch because something like that had never happened before. From a competitor's perspective it was great because it was very distracting to Sallie Mae and I think it probably hurt them in the market place. People were lining up on different sides and really not sure who was going to win and what

direction the company would take. That part was very interesting to watch, just to see how that transpired.

Beginning in '97 after AI took over I think there was still a fair amount of confusion as AI and team had to basically find the believers and the non-believers and fix the house. There was a fair amount of confusion. You probably would see not a whole lot of dissimilar kind of views and concerns at the other GSEs right now. Probably more so with Fannie as they are going through much more of a regime change and the chaos and crisis hasn't been resolved yet. That creates an awful lot of uncertainty, people go from an organization that basically had kind of a lifetime employment philosophy. Very safe, very profitable not a whole lot of external risk, to one where all of a sudden the new CEO is saying we have to radically change the way we do business. We are going to pursue this path that is completely unclear because it has never been done before. In order to succeed we are going have to become dramatically more efficient. Lots of jobs were lost. That culture change takes an awful lot to implement.

Sallie Mae didn't play much of a role in the conversion legislation. It was a tax code change, not a Higher Education Act amendment. I am sure that they were aware of it and following it but they didn't really do much. Nellie Mae was involved in lobbying.

### **Sallie Mae purchase**

Well the benefit of course was that we had previously converted to a direct origination model. If you look at the 150(d)s that are still out there today, the premium that someone would have paid for a Nellie Mae franchise versus some of these other companies that are just now converting, that are really nothing more than secondary market business models, they get value as a portfolio purchase. They've got a portfolio of loans and they get assessed and valued. But in Nellie Mae's case it was more of a franchise because it was originating loans. We did in the year before the acquisition by Sallie Mae, about \$250 million in student loan originations. They're going to pass \$2 billion this year. But it was \$250 million more than Sallie Mae was doing at the time. So those were the positives. I think clearly there was also some belief or interest in the management team in Nellie Mae. Nellie Mae had probably been the most successful competitor to Sallie Mae at the time. It had a very good reputation in Washington in terms of some of the initiatives that we had been able to get passed and through. I am sure that had a role in the process as well.

### **Securitizing student loans.**

Nellie Mae was the first to securitize student loans. We did our first securitization in 1991. Sallie Mae did their first in 1995. It was a private loan transaction as well. We had done three private loan transactions before the acquisition. The first ones were tough, and very expensive compared to what we are doing today. There was no credit enhancements on the bonds, so they were senior subordinated structured, similar in fashion to what we use here today. They didn't have to go – the first two deals, the company was a non-profit, so the company was already bankruptcy remote, and so we were able to avoid some of the significant issues that were associated with securitization at that time which restricted securitization activities to goods and services – transactions

that were generated as a result of goods and services. It wasn't clear if student loans fit that bill. Whereas credit cards got a specific exemption and were able to do things, the student loans needed something more. We were able to do that because we were already in a bankruptcy remote structure. We didn't need any legislative issues to fix that. Our last deal in 1996.

### **LLC structure**

Moody's had decided that 150(d)s and 501(c)(3)s were no longer bankruptcy remote. They made this decision for about a three month period of time. So that deal used an LLC structure. It was the first time that an LLC had ever been employed in an asset backed financing. We did some interesting and creative stuff to resolve problems. LLCs at that time I think were only about six months old. So it was a creative piece in its fashion.

The LLC issue was something that I came up with as an idea, not the legal team actually. I mentioned it at a meeting. The investment bankers and lawyers were there and they were trying to figure this out and how we could do this and that. Of course we needed something that didn't create a taxable structure. We were a non-profit so we didn't want to start paying taxes. And the LLC was the perfect solution to that. When I mentioned it they all just kind of stopped. "Hmm I don't see why that shouldn't work." So we went forward. It was complicated but it got done. It proved to be something that got replicated pretty widely.

### **Senior subordinated structures**

Another financing has become a mainstay for non profits. We did the same thing for FFELP loans in 1992 where we used senior subordinated structures to create the internal credit enhancement for the bonds. That also was basically copied by everybody in the industry soon thereafter. In 1993 we became the first student loan company, including Sallie Mae, to have a corporate rating. Even though we were a nonprofit, and the rating agencies, when we first went to them and said we want to be rated, and they said you can't because you are a nonprofit and we don't rate nonprofits. It took us about a year but we finally convinced them that they could and we got a single A rating. At one point we got as highly rated as A plus. Then we stopped doing structured financings and started issuing on a general obligation basis. So by the time Sallie Mae had come along and acquired us we were already doing holding company debt issuance, secured financing trades, learning the CP program. We had done everything that Sallie Mae needed to create, just on a much, much smaller scale.

### **Coming to Sallie Mae as part of the Nellie Mae acquisition:**

It worked out well for everybody. This has been a great job for me. You look at my background. I got the CFO job at Nellie Mae in 1988. I was 26 at the time, so I didn't have a lot of experience at the time in finance. I helped Nellie Mae raise money but I didn't have an accounting background or anything. But it was always a relatively small company, it was a nonprofit, so you don't get a whole lot of ... those two things kind of diminish some of the accomplishments I guess. Then coming here and being given the opportunity for this role was huge. Most people would have said no way. Al gave me



the chance. Similar to what Larry did. Larry offered me the CFO job at Nellie Mae and I met with the board. I was 26 but I didn't look 26, I probably looked 19. There were a lot of raised eyebrows at the time. Larry was very young as well. I remember one banking group that came through and one of them said "My biggest concern is that there is no one here with any grey hair." I told Al he gave me this grey hair. But he saw something and he gave me the opportunity to run this process and I am very grateful for that and it has been a tremendous amount of fun. There is no way that I would be making this change if the wind down hadn't been complete right now.

The acquisition of Nellie Mae was a traditional M&A activity. I led the Nellie Mae team on negotiating the sale, the covenants, reps and warranties, purchase price and that kind of thing. It was interesting, certainly interesting. We felt that we were negotiating from a point of strength rather than weakness. We didn't need to do this. It wasn't something that we had actually pursued. Sallie Mae had approached us on this. I don't think it was something where we said let's do this. We couldn't say no either. We had a fiduciary responsibility to the nonprofit to get the best price.

### **USA Group**

Some other negotiations that we were working on, with USA Group actually, to do a merger, just weren't working out. They weren't ready in their time frame to do it. Ironically when we got here, we said well what do we do now? I said, go buy these guys. Their big issue was that they needed a massive culture change. They really were a nonprofit. They operated as if there were no bottom line urgency to things. But when I came on the board at Nellie Mae in '88, and that's kind of how Nellie Mae was run too, and I had no nonprofit background or experience. I had a for-profit background. I said yes, we are a nonprofit, we have a public good. But that means we should be making as much money as we can. Once you have profits then you can give them away. If you have no profits you can't do anything special. That culture was readily adopted by Larry and the board and that's what really made Nellie Mae successful as a very profitable company. Jim when we were talking about merging the two companies, wanted to get there, but the big obstacles were who was going to control and run the organizations and whatnot. Although I was going to be the CFO of the combined companies, I was going to be the only one moving to Indianapolis. I said to Larry, based on the negotiations, there is just no way that one person is going to change the culture of 3,000 people. I decided it just wouldn't work. Sallie Mae came along and we began that negotiation.

### **Conversion to direct origination**

Certainly on the business side of the equation, when we made the conversion from a secondary market to being a direct originator, my view at the time was that we were competing against an organization that has a cheaper cost of funds, lower servicing costs, buying a commodity asset, we can't compete against this. We needed to become a direct originator of loans. Sallie Mae made similar decisions for a little bit different reasons. They were a bigger entity and their issues were: we can't rely on banks to deliver high quality product to us so that schools don't venture into direct lending and we have no control over the pricing and profitability of this company. Al was making those arguments at the same time that we were already converting the business. So we

certainly shared a similar philosophy in terms of the direction in this industry, the desire to be as separate as possible from the Federal government and whatnot. Keys to benefiting differently than say banks do in the industry.

One of the criticisms that nonprofits and Sallie Mae always got was that they had an unfair advantage over banks. Which is crazy. But the banks made these arguments. In fact when Sallie Mae bought Nellie Mae or USA Group, Citibank complained about an unfair competitive advantage to the Justice Department. The Justice Department said, You guys have \$35 billion in assets here are several hundred million dollars in assets and you're telling me they have an unfair advantage against you. I don't get it.

### **Capital requirements for insurance requirements.**

Most banks run their business not on straight regulatory leverage ratios, they allocate capital according to the risk of the business. They could have allocated it differently. I don't think that was so important. Their argument was more of the GSE funding advantage, not the low capital levels.

But Sallie Mae already had ... today... our last securitization deal dealt with FFELP Federal loans went out at a cheaper all over rate than what we paid as a GSE with the offset fee. The offset fee took away all of the GSE advantage. Now this changed a little bit. When we were a T-Bill financier the GSE with the offset was still a positive because you could issue T-bill denominated securities in the agency markets whereas it is very hard to do that in the private markets. Once we converted to CP and now your indices are matched with what, we issue everything on a Libor basis, but Libor and CP are much more closely related. It became easier for us to finance because we didn't have to deal with that differential basis. Ironically if they had left it at T-Bill we would have made more money over the last 5 years because the spread that they set it at off of CP has been lower than what the T-bill equivalent would have been. It just eliminated a huge barrier to the financing process.

### **Refinancing the GSE debt**

There was a lot to learn. It was a learning issue as we went for sure. Because the ABS issuance program had started in '95. It was all T-bill indexed at the time and came to a screeching halt in '98 when the Asian currency crisis hit and T-bill spreads widened dramatically. Basically the first deal that we did after I had gotten here was a Libor-indexed deal. In my view you could just see what was happening. People would anticipate when a securitization transaction from Sallie Mae was coming and the swap markets for T-bill – Libor would start to widen because a large number of our investors were buying student loan asset backed in order to keep a basis for swapping them back to Libor. So it was driving our funding costs, in effect manipulating, people trading ahead of us, manipulating is a bad word, but they were driving the spreads out so that when we would come to market it would cost us 5 to 10 basis points more in the market place.

By shifting to Libor, our goal was still to hedge that basis risk, but we could now hedge it on our terms. So when we announced the deal on the marketplace, the T-bill basis swap

market would widen out. We would just wait it out and hedge it three months later. Or we would hedge it in advance of the transaction. It just changed the game tremendously. Put it back in our fold, instead of leaving it with investors.

When we were issuing asset backed securities, we denominated the price of the securities on a T-bill index. Our investors were converting those deals, a good chunk, over 60 percent of the deals typically got swapped by investors who were converting that T-bill asset into a Libor indexed asset through a basis swap. As a result, when we announced a securitization deal, the swap markets knew, say we launched a billion dollar deal, they knew that somewhere between \$500 and \$700 million of that is going to be swapped at the same time as the deal. So swap spreads would widen and then investors would say, ok, instead of T-bill plus 70 I now need T-bill plus 80 to do this deal. The swap dealers were holding the cards. There is a very thin market for T-bill Libor swaps. There is no natural offset to that. So the huge demand for swaps created a timing play that people took advantage of.

What we decided to do was to put that back in our control, issue securities on a Libor index and then we would swap it at our timing. We could either do it gradually so that instead of \$500 million hitting the market on one day or one week we would spread it out over 4 or 5 weeks. We might do something at the beginning, we might do something at the end, but it basically put the control back in our hands versus the hands of the investors. The investors all they said is I have a bogey of Libor plus 20 as a yield. I don't really care what the T-bill index is as long as I can swap that back to Libor floating. Well the swap market widened by 10, their T-bill demand could widen by 10. It just changed the dynamics completely. Had we continued to issue, and needed to do all this refinancing on a T-bill basis, we could never have accomplished it 4 years ahead of schedule. It was just too big.

There was no regulatory requirement to use T-bills or Libor. It was just how we chose to hedge basis risk. My view was that we hedge it differently. That is what changed the process. The other thing is that the company always hedged their basis risk, but they always tended to do it in very short durations, so that is not really very much of a hedge if you are only hedged for 90 days. The other thing we did was we started lengthening our swaps so it gave us more flexibility through more constantly rolling over basis swaps and flooding the market with activity.

### **Swaps before Joining Nellie Mae**

Before I joined Nellie Mae I worked for a bank in the corporate finance group. In addition to helping companies like Nellie Mae raise money I also ran the swap book. The bank was relatively small. We had a special key niche in student lending. Sallie Mae did the first swap in '78. I remember doing these transactions while I was at the bank. They didn't think logically about these transactions. An investor would come in and want a fixed rate debt instrument issued by the bank. The funding desk would say no we have no interest in issuing fixed rate money, so I said, well I'll do it. And all of a sudden we realized, oh, we can do this. So we did a fair amount of activity. I remember some of the treasurers of the various county banks, had no idea what we were doing.

They didn't like it. So I had to walk them through it and explain it. It helped that they never met me in person.

### **CFO at Sallie Mae**

I joined in July, I was treasurer, and I think it was February when they reorganized and I took over the finance group, February or March. I didn't move here until January. In the six months prior I think Al was waiting to see whether I would move or not and how committed I was. When you physically pick up your family and move it is a pretty good sign. I didn't have any kids at the time so it was easier and harder. Kids are a great introduction to an area. You tend to meet a lot of people very quickly when you have young kids. It was hard. Neither of us had ever relocated for a job before. It was harder than we expected. Just because we had no idea where doctors, stores were. It worked out great. It has been six years.

### **The Reorganization**

We announced the shortening of the reorganization in 2002 or 2003. We did not get serious about the privatization process until 2002. Maybe even 2003. In 2002 we did our first holding company financing activity, but it was relatively small. There were a lot of question marks. The finance group was certainly confident about our ability to do this, although unclear what was going to be the cost. We knew we could get the financing done, but there was a lot of doubt.

Up until 2002 the GSE balance sheet was continuing to grow rather than shrink. It raised a fair amount of questions. That was really about the point that OSMO started to get a little bit more difficult in terms of challenging us in how we were going to get there, starting to express some doubt about our abilities. It was then we said we can do this, and the only way to prove it is to do it. In 2003 my goal was to issue more debt outside of the GSE than we acquired in loans, so that we could actually demonstrate some shrinkage of the GSE balance sheet. We did about two and a half times issuance. We thought we would do about \$30 billion and we got to \$45 billion of issuance.

There was no road that had been paved by somebody else in this process. So you have no idea how investors are going to react if they've never been given the opportunity to react before, so you're guessing at a lot of this. You're doing analysis to say look, this is why we think we can do this in the asset backed market. These are the attractive features here, here is the investor base that's been buying it to date. Why do we think we can expand it any more.

On the holding company data there was a little bit more question, but we made similar points to rating agencies and investors why this was a solid credit, what differentiated us from other entities in the market place. The fact that there were starting to be some concerns about consumer credit with investors at that point in time helped us. We were a safe credit and diversified and a new name to investors. On an unsecured basis there is no collateral, but they can look through the company to see the assets. We knew we had to pursue both debt and asset backed securities because you couldn't finance all of it in one vehicle.

It was a process of meeting with investors. We did. Now all of a sudden we had to do fixed income investor development, something we had never had to do as a GSE. So I spent a fair amount of time meeting with investors – pension funds, insurance companies. We met with investors, explained the process to get them to understand it and, hopefully by the time you are issuing securities you have more investors than you have securities to sell. We were constantly working that process. We targeted specific investors. These are people who own these type securities, they should be a natural buyer. How do we get in front of them to convince them that this is something that they should own. That kind of process. It is constantly evolving. We went to the traditional investor base and a year and a half ago we said central banks are entities that should be big buyers of these FFELP asset backed securities. How do we get there? How do we convince them that this is a better transaction for them than other alternatives. We have grown that marketplace as well. It was a worldwide thing. Half of our asset backed securities are generally placed overseas.

Certainly just in terms of the size of activities and the creativity that had been brought to bear, people started to recognize it. The trophies for the year 2003: we were issuer of the year. We received a number of awards based on our asset backed financing structures to unsecured debt for the last several years. We were one of the top issuers of securities in the world. If you pull the mortgage entities out of the equation we were in the one or two kind of numbers, total. We were big.

In 2003 the GSE balance sheet actually began to shrink. The interesting piece, the piece that I don't think anyone would have been able to predict was that our strengths, despite tripling our volume, we did about \$15 billion in 2002, \$45 billion in 2003, our spreads actually tightened. The reason is that people were becoming more familiar with the story. We were really pushing to develop the investor base.

Almost any way you would have forecast, you would have forecast a widening credit spreads. Just simply supply and demand issues would have led you to conclude that. So it was big. Then again when we issued \$45 billion in 2004 the spreads continued to hold steady. At that stage of the game we were able to tell investors, the peak is behind us. That was the biggest question mark that people had. Ok you're doing \$45 billion this year, how much, are you going to do? Are you going to do \$60 billion next year or \$50 billion? At that point we could see the end of the tunnel in terms of what we needed to accomplish the wind down of the GSE barring any acquisitions. We said ok, it is \$45 billion today but it is not going to be \$45 billion in 2005, it will be less than that. Once people realized that bubble was through the sink, spreads really started to tighten.

There is still a huge amount. We'll do \$30 billion in 2005, maybe a little more than that with the consolidation surge. In 2003 a typical Stafford deal might have cost us a Libor plus 17 and now it is costing us Libor plus 11. That kind of movement in basis points is a big movement in a triple A security.

Low interest rates can actually make it a little more difficult because the types of securities that people look for might be different. It is just a function of credit quality and familiarity with the asset class. Central bank buyers have become bigger in the process. They weren't doing that before the marketing push. In fact when we were doing T-bill asset backed securities our largest buyers were hedge funds, which proved to be problematic, especially since they were anticipating Sallie Mae's actions. They were taking advantage of our issues, so that option changed to more of a buy and hold.

There was a huge team behind that process. The people coming up with the structuring ideas, Lance Frank and his team came up with some very innovative structures like our reset note programs that really expanded the investor base, allowed us to do foreign currency transaction and interest rate tranches.

### **Reset notes**

Student loan asset backed securities are sold in amortizing tranches. If you have a floating rate asset it is tough to deal in a transaction that has an interest rate or currency swap tied to it. You have uncertain cash flows as long you can either extend or shorten the duration. By doing the reset notes we basically took transactions, or structured cash flows, let's say. Here is a tranche that shouldn't start paying and there shouldn't be any principal collections coming in on this tranche until 2010 at the earliest. We can sell a security that has say a three year term associated with it with almost complete certainty that there will be no cash flows against so it will look like a bullet tranche to an investor. That can then be sold in a defined time [????] sealed with a fixed rate coupon. At the end of that three year period we would resell the note to new investors. Because of the collateral type, being a federally guaranteed student loan, there was really no question about loan performance issues or concerns that investors took that risk that the note would have to be resold. And they took that risk, it didn't come back to the company. We couldn't take it given our needs to wind down the GSE. That really helped expand the investor base.

Last year I think we had over 600 investors, for example, participating in our financing program. It is a fairly wide range... all of these investors have different appetites. Some want dollars, some want pounds, some want Swiss francs, some want fixed, some want floating, long term, short term.

It wasn't really the asset class, being federally guaranteed. You could do it with any asset class. That didn't really change it. The bigger question has to do with credit quality. If you did it with credit cards those borrowers' credit profile could be very different three years from today. In student loans, guaranteed student loans, there is no question that the credit quality would be the same three years from today. That is really what allowed that to happen.

The SEC didn't bless the deal from a registration perspective until this year. So the transactions had to be done as 144 ADLs that had reset note features. That made it a little bit more difficult, but they finally did bless the structure and agreed to allow it to be registered.

**Loan consolidations**

Loan consolidations dramatically increased the refinancing needs of the company. The reason for this is we were securitizing all these Stafford loans and when they consolidated they came out of the trust and back on balance sheet. So in effect we had to refinance them a second time. These were big numbers. In '03 and '04 it added about \$5 to 6 billion a year in financing activities for the company. It was not a small task considering what we needed to do in the first place. It did change what we did a little bit. We were far more focused on securitizing consolidation loans versus Stafford loans so we didn't have to do it twice, or identifying Stafford loans that were less likely to consolidate in the process, and financing those loans that were likely to consolidate more on balance sheet than elsewhere.

It definitely caught us by surprise. It was an interesting classic example of bad legislation that was almost like the 9.5 percent legislation. They pass this legislation and the problems don't arise until 3, 4, 5 years later. In this case it was almost 10 years later for consolidation activity. In 1993 they converted the interest rate on Stafford loans from a fixed rate to a variable rate. This was deemed to be a good thing since it made interest rates on loans more variable in the current rate environment and took Congress out of the rate picking decision. Unfortunately when they changed that legislation they never changed the legislation for consolidation loans.

The interest rate on consolidation loans was set at the underlying rate of the Stafford loans. So Stafford loans were fixed rate. So the legislature said depending upon when you got your loan you could have a 7, 8 or 9 percent loan. So when you moved it from one program to the next you kept whatever rate you had. When Staffords became variable they never changed the legislation or the rules for setting the interest rate on consolidation loans. This didn't show up as a problem since for the next several years Stafford loan interest rates were basically at their cap. There was no rate play to be had here. It wasn't until after 2001 when interest rates plummeted and kept falling that this loophole became noticeable and people started taking advantage of it. The irony of it is despite what certain Senators will get up and say that Congress intended this, that is not true. They changed one rule and forgot to change the other.

**9.5 percent loans**

The 9.5 percent issue is exactly the same thing. The biggest irony on that is that regulation was issued in part after an audit that was done at Nellie Mae. The way the tax exempt formula worked, back when rates were high and the 9.5 rate was lower than what you were actually earning, the formula was T-bill plus 350, minus the loan coupon divided by 2. So you want that number you're dividing by 2 to be as small as possible. In higher rate environments, if you had 7, 8 and 9 percent loans you wanted your 9 percent loans funded with the tax exempt bonds. In a low rate environment you wanted your 7 percent loans funded with tax exempt bonds. As rates were moving I was moving loans in and out of my tax exempt facilities. To manage that interest rate and to maximize the interest rate benefits there. The Department of Education audited this and said you can't do that. I said, "Show me where." They said, "You're right, you can. We

don't want you to do that anymore." So they issued this regulation. By the time they got around to issuing the regulation, rates had plummeted and 9.5 percent was now a huge benefit. We wrote the Department and said don't do this, it is going to cost you billions of dollars. They responded and said "You're right, we don't want to do it." Then about four months later they said, "No, we are doing it anyway." That is just a bigger debt. If they had never issued the regulation there would be no 9.5 percent interest abuse right now.

Then you've got some law opinions that have been issued, and this is the piece that I don't understand. Why the Department hasn't ruled differently on this. There have been legal opinions that said you can take your old tax exempt bond that had a maximum life of 17 years, get a new cap application from your state, refinance that old bond (for IRS purposes it would be a new bond, but for the Department of Education purposes it is considered an old bond), and extend what Congress had thought would end in 2002 or 2010 all the way out forever. Some of these guys have issued bonds going out to 2040s. The Department never issued any guidance on this. That is not right. We never agreed to this, that is your law firm that has agreed to this and they are wrong. It would shut down over half of the 9.5 percent abuse and reduce over 99 percent of the benefit overnight. They had that opportunity with New Mexico's audit and they didn't take it. I don't understand. It is complicated stuff.

On the flip side you have all these non-profits running around telling the Department if they do this they'll put them out of business, they'll go bankrupt, they're just giving the money back to students anyway, which isn't true, none of those statements are true, but they all make them. Some of them end up believing them.

### **Low interest environment**

We were issuing on a variable rate. Rate environments have very little impact on us. What impacts us is the credit spread environment. When credit spreads were at historically tight levels, that would benefit the company. There is a lower cost. It doesn't make issuing any easier, it just means your cost of funds is better.

Now when you get into these kinds of rate, credit spread environments it actually can be a slight negative. Negative is not quite the right word - competitive leveling. Investors tend to differentiate credit risk less. So if we are a single A issuer and they want 15 over Libor for a four year instrument, a triple B might only be 17 or 18 over. There is not a whole lot of premium to approve credit. It makes our bonds more difficult. It makes the competitive landscape for us a little bit more challenging. In the asset back world, some of these smaller, less frequent issuers are issuing asset backed securities only 2, 3, 4 basis points wider than what we issue. For something that has a 30 plus year life I find it hard to understand why an investor would take that additional risk for so little premium. It happens. It's a diversification issue, I think, for most of these players on the asset backed side, but I just don't think they are getting paid for the incremental risk they are taking. This is a self-serving comment.



### **The Wind-down**

This was a challenge to us. We were really not used to running a multi sided business with a regulated GSE entity and a non-GSE subsidiaries. We weren't used to dealing with a regulatory authority that was asking us questions about how we run our business and giving opinions as to how we should run our business. It was a lot of challenge in that process. We always felt that we were trying to do the right things. We made mistakes along the way. We accounted for our finance transactions differently than they should have been done. All honest errors, and when we found out about them we fixed them immediately. As a regulator, those things tend to raise lots of questions. They raise questions about controls and what not. For years and years it had operated as a monoline, single corporate structure entity and these requirements of running different businesses or even the same business through multiple entities was not something they had ever built a control structure around. So when I got here the accounting group was a big mess when I inherited it. It took a number of years to fix. Part of it was that we were buying companies and people and integrating them as a first priority over some of the control structures that needed to be placed.

In my experience in dealing with a regulatory authority I always felt that logic and an explanation would work. I had different priorities than OSMO had and those didn't always match. It became a challenge at times but it was a great learning experience. I understand it a whole lot better today and will do things a lot differently going forward. It was a hard thing. When you couple onto that the corporate scandals that erupted in 2001 it became even more challenging because you could no longer as a regulator trust somebody. Those days were over. Now you didn't need just proof you needed complete proof, double suspended, you had to be absolutely positive that what you thought was happening was actually what was happening. If there were questions about it, the party was guilty until proven innocent. The rules of the game changed. It was a hard process for us. It was probably our biggest challenge. The other sides of conducting this wind down went far more smoothly than the control side of the equation. There were some unfortunate moments. This company, and myself included, when we first started this process of winding down and [Warren and staff heard] ? and working more closely with Phil and team it was like, "we are doing the right things and our way is the right way, and we're going to get there and we're not going to disappoint you and you are not going to have any problems." It was much more of "this is acceptable." That doesn't work in all environments and clearly didn't work here. We made some changes.

### **Risk-based capital**

For example we ran the GSE capital requirement at its bare minimum. We had a 2.25 percent capital level and that's where we ran it. Every quarter we disbursed any additional. We did it and I carried on that practice until we finally started saying when Phil started asking questions about it, "Well, why are we doing this? We don't need the capital over on the other side of the business. It's irrelevant where it is. Why not leave the capital in the GSE?" It would make Phil happier because the excess capital was there, and go forward. It didn't matter to the company. We didn't care at all. It took us forever to figure that out. There were long, fairly significant battles over this whole problem. Because what is the appropriate level of capital for this subset versus that. We

read that statutory minimum as the requirement and it took a long time for us to conclude that statutory minimums do not necessarily mean appropriate. It is a minimum. You only have to look at the banking industry to realize that minimums are not what banks run at they run at levels well above minimums to eliminate concerns. These are the types of things that it took us a long time to learn, but we did learn eventually. It was a big issue for Treasury and there were reports written on it.

### **Separation between the GSE and non-GSE**

OSMO was just getting going in 1999 when I got here. People didn't have a whole lot of experience to date with them. We saw them infrequently. It was like, "Here's our reports." It was easy. It started to become more challenging as people started to say now we need to understand this and we need to understand that. We are trying to run a business and hadn't really staffed to address some of the constructive questions that were being answered and we hadn't, as I said, developed the control structure to really isolate and insulate that GSE from other activities that were not permitted inside the GSE. OSMO certainly raised issues that we would not have done on our own. Now, there were internal controls that had differences between consolidated entities, so on an external basis, from an SEC perspective for example, there would have been no issues. It was not corporate accounting rules being debated, it was more "this activity is not permitted to be in the GSE," or, "can the company fund this." It was those sorts of things, the real separateness of the organizational structures. "Can you book operating expenses."

### **Accounting controls**

We would buy something, and the tradition was that since the GSE was the only entity, the GSE paid. Well those practices just continued to happen and continued to direct bill the GSE and if a bill came through that way the payment clerks paid it. It took a lot to change that. It was 30 years of history they had to change. To their credit they identified those issues, we did not bring those issues out on our own, and fixed them. As I said, our philosophy at the time, accounting controls and things of that nature just weren't that important to the outside world. Our goal was to convert the business, integrate companies we were acquiring and wind down the GSE. This stuff was back office, behind the scenes and wasn't priority for us. Making us take that medicine was sometimes painful.

Our view was that we thought we were doing the right things. Occasionally we made mistakes. We just didn't see it as significant or appreciate the significance of the mistakes. We fixed it and went forward.

These were not "Did you book FAS 133 right and overstate profits." Those weren't the issues. The issues were for example, when we were doing the swaps inside the GSE, but the asset may not have been in the GSE, the asset might have been over here, but all our swap and counterparty documents between banks were with the GSE. We didn't have swap counterparty documents with the holding company and these financial institutions. The balance sheet started to shrink and these assets grew then we're doing swaps in the wrong place. We were hedging and running the business in the aggregate. The siloed approach was what was required.

**GSE benefit**

There was some benefit to running these transactions through the GSE, it was certainly easier, but the economic benefit that got generated was minor. We never viewed it as material. Certainly things like owning the building by the GSE was definitely cheaper, but it was \$40 million on a \$35 or \$45 billion balance sheet. It doesn't make a big difference in the grand scheme of things. But yes, on that individual transaction it was cheaper to finance the ownership of our real estate in the GSE.

It was definitely true that raising money through the GSE was easier. We didn't have to talk to investors when we raised money at the GSE. We just said we are doing this and the investors bought the securities. Sure. Swaps became an issue. I don't think the pricing differential we received between the holding company and the GSE was non-existent. We would get the same levels. We would have to post collateral on one side versus the other. We had more than enough excess collateral. We didn't have to go out and buy collateral, it was just sitting on our books, so it didn't really cost them anything from that perspective. I would describe this as more of a control issue.

You have to think about this stuff as you are going through this process and you're conducting this business as a GSE, every transaction you do you should be asking yourself is this where this should be booked. Instead, we were doing it as we had always done it. The back office questions were not getting asked at the speed in which everything else was moving. That created some tension in the process. But nothing blew up and we got this done faster at the end of the game. There were bumps in the road but I think everyone is very happy with the way the process went. Once we realized what we had to do, I think that control environment changed and the last two years of the process were very different.

**CE Andrews**

CE came on board, not so much from the regulatory side of the equation, but the post-Enron side of the equation. By that point, most of the internal controls had been built and were in place. It was now Sarbanes-Oxley and the accounting side of the equation that was getting tremendous scrutiny. The view was that we needed it. The skill sets required to do the financing side were of course very different from the skill sets on the accounting control side of the equation. Those things should be separate. I didn't like the move at the time, but it was a very right decision. I still signed everything, but not having to actually implement Sarbanes Oxley, I don't regret not having that opportunity.

I mention these other issues because I think this wind down process was not without challenges and difficult periods. It was not all smooth sailing or just understanding the different perspectives that come to bear and then realizing that there's a point of view different than the firm's historical point of view.

**Buying a Bank**

That is one of the reasons why I thought we shouldn't buy a bank. We just weren't... I was talking to Al and said, "You guys think that OSMO gives us fits and challenges, it's

going to be far worse.” I really think so. There was a big debate inside the company on that topic. There were a number of people who were convinced it was necessary, and ultimately including Al. We did pursue some of this with the Golden State discussions which never went as far as got extrapolated out in the world. We didn’t believe it in corporate finance, none of us thought it was a good idea. Again, that was in 2003 with Golden State. In 2003 we said if we can demonstrate that we can do this outside of the banking environment, we can then avoid this whole process. I would much rather that.

### **Massive refinancing effort**

So if we prove it we eliminate the doubt. People are questioning, can we actually issue this much debt. So the only way you can solve that question is to do it. It was one of those things where I could say, “Trust us. This is a government guaranteed asset, we can do it. We know we can.” They would say, “Yeah but you haven’t yet, therefore I’m concerned.” So by actually doing it you eliminate the concern. People then say, “Ok they actually did it. They can do this and we don’t have to be worried about it.”

In addition to OSMO asking if we were really going to wind down there was more external pressure. The external pressure was more real because the investors started to question it, saying, ok it’s getting closer. And that is part of the reason for accelerating the wind down because everyone was wondering what was going to happen to our financial results post-GSE. They started looking out four or five years and not knowing what it was going to be like. We would say, “Look, this is what we are doing today. You can just extrapolate.” Again, you haven’t really done anything. Financial markets hate uncertainty. So if you were to eliminate the uncertainty, it cost more to do it. In fact the big question I used to get in 2002 from investors and in the middle of ‘03 was “why are you doing this faster. Why not just milk the GSE for as long as you can?” Of course after Fannie and Freddie’s experience no one asks that question anymore.

### **Wind down Legislation**

Legislation is a difficult thing, because if you get too specific and then you’re always bound to have missed something in the process. You get too narrow and you’re struggling for interpretations. We always understood that the requirement was that the GSE had to be wound down. We didn’t necessarily know how we were going to get there in the late 90s early 2000s, but we knew what we had to do. Just some of the interpretations of how you get there had to be debated and negotiated.

### **Defeasance Trust**

Even look at the defeasance trust. How many defeasance trusts. It didn’t say you could only have three trusts, it didn’t say that you could have a hundred. It was unclear. Obviously the more that we had, the cheaper it was going to be to defease the bonds. The less we had the easier it was for the Federal Reserve and OSMO to understand and regulate it. That kind of debate has a real economic cost to us. We had to manage through that. The legislation wasn’t really clear. Yet there is no meaningful difference between the two. It is operational, it isn’t credit risk or safety and soundness related issues. What types of collateral count in that process are also things that aren’t particularly clear and had to be interpreted. It costs us more to do it. You won’t see

anyone sitting back here and saying this was bad. The team on the defeasance side of the equation just said “I want this document to say this is a requirement of OSMO,” because someone’s going to come back and look at this thing five years from now and say “Why the hell did these guys do it this way, because there would have been a cheaper way.” They just wanted to make sure that the historical memory didn’t get lost in that transition and get criticized for something. It’s minor now, it might have cost us a million dollars more, or something like that. Small in the grand scheme of things, but a million dollars is a million dollars. If the Department of Ed felt that way we would have a cheaper student loan program.

**The firewall, the separation between the GSE and non-GSE.**

Those were legitimate issues. I don’t think there was an appreciation for them pre-Enron. Just simply I would describe it as, we didn’t have people here who had experience in the regulatory world and understood that those barriers are appropriate to exist. It is just that there was just a tremendous amount of activity going on and the people booking transactions didn’t necessarily understand or appreciate the importance of the GSE boundaries. We had a number of meetings with people to get them to understand that this is important. You can’t just book something because this is the way you’ve always booked it, you really have to understand and ask yourself every time you’re billing something inside the GSE, “Is this appropriate?” If you’re not sure raise it up. Don’t just say, ok it happened before so it must be ok. In an organization this size there are a lot of moving parts, and you don’t see those moving parts if the questions don’t get asked and they didn’t.



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STATEMENT OF DARCY BRADBURY  
DEPUTY ASSISTANT SECRETARY OF THE TREASURY  
FOR FEDERAL FINANCE  
BEFORE THE SUBCOMMITTEE ON EDUCATION, ARTS, AND HUMANITIES  
OF THE COMMITTEE ON LABOR AND HUMAN RESOURCES  
UNITED STATES SENATE

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JUNE 20, 1995

Chairman Jeffords and members of the Subcommittee, on behalf of Secretary Rubin, I welcome the opportunity to appear before you today to discuss the Administration's proposals to cut the ties to the Federal Government of two Government-sponsored Enterprises (GSEs) -- the Student Loan Marketing Association (Sallie Mae) and the College Construction Loan Insurance Association (Connie Lee). The Treasury has for a number of years, in Democratic and Republican Administrations, believed that it is appropriate to wean a GSE from Federal 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.

The GSEs expose the Government to the market perception of implicit risk that legislation would be enacted to prevent a GSE from defaulting on its obligations. As the Treasury said in its 1990 Report on GSEs<sup>1</sup>:

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<sup>1</sup> Report of the Secretary of the Treasury on Government-sponsored Enterprises, May 1990, page 1. This 1990 Report was required under section 1404 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) (P.L. 101-73).



The market perception of Federal backing for GSEs weakens the normal relationship between the availability and cost of funds to the GSEs and the risks that these enterprises assume . . . The prospect that Congress would use taxpayer funds to prevent the failure of a GSE is perceived in the securities markets as protecting investors in GSE debt securities or GSE-guaranteed securities from loss . . .

In April 1991, as required by FIRREA and the Omnibus Budget Reconciliation Act of 1990<sup>2</sup>, the Treasury followed up with a further report on the GSEs.<sup>3</sup> The 1991 Report reiterated statements of concern about the Government's risk exposure to the GSEs. At the Treasury's request, as part of the 1991 Report, Standard and Poors (S&P) assessed the likelihood that a GSE would be able to meet its future obligations from its own resources and expressed that likelihood as a traditional credit rating. S&P gave a triple-A credit rating to Sallie Mae. Connie Lee had obtained a triple-A credit rating from S&P previously, and in March 1990, S&P indicated to the Treasury that Connie Lee's status as a GSE was not a factor in granting the triple-A rating to Connie Lee as a bond reinsurer.

In 1992, legislation was enacted to provide for Federal financial safety and soundness oversight of the housing-related GSEs -- the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation -- and Sallie Mae to mitigate the perception of implicit risks to the Government. Federal

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<sup>2</sup> Public Law 101-508, section 13501.

<sup>3</sup> Report of the Secretary of the Treasury on Government-sponsored Enterprises, April 1991, or the 1991 Report.

oversight of the Farm Credit System had been tightened earlier as a result of problems that arose and required Federal assistance in the mid-1980s.

As a general principle, we believe that the Government and the GSEs would benefit from removal of the Government ties because privatizing the GSEs would:

- Reduce the amount of GSE debt, over time, that carries some perception of U.S. Government support;
- Demonstrate our commitment to moving from creating effective public-private partnerships to then enabling complete privatization when Government support for an activity is no longer needed;
- Show the financial markets that the Government respects the interests of private bond- and shareholders; and
- Support Federal efforts to create new GSEs in the future, when appropriate, by demonstrating that the Federal relationship can be severed when the time is right. A business operation that starts as a GSE with a limited charter can be freed to operate in other markets once it has fulfilled the purpose for which it was created.

Sallie Mae

Under a statute enacted in 1992,<sup>4</sup> the Treasury has a special relationship with Sallie Mae as its financial safety and soundness regulator. We have reviewed Sallie Mae's financial condition and can see their successes to date and challenges for the future. Sallie Mae increased its use of leverage and its balance sheet grew rapidly in the 1980s, when it expanded market share in response to opportunities arising from amendments to its charter. Sallie Mae benefitted from relatively low-cost GSE funding through the early 1990s. The company's earnings record was especially strong in 1992, 1993, and early 1994, when market interest rates were low and Sallie Mae was able to capture windfall profits as a result of a floor on the interest rate on most of its student loan assets. Since then, however, return on assets and net interest margin have been negatively impacted by a rise in market rates of interest and shifts towards lower yielding assets.

The financial environment for Sallie Mae has changed since enactment of the Student Loan Reform Act of 1993<sup>5</sup>, which amended the Higher Education Act to reduce the returns on guaranteed student loans and to impose a 30 basis point fee on all

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<sup>4</sup> P.L. 102-325, enacted on July 23, 1992, added subsection 439(r) to the Sallie Mae charter in the Higher Education Act of 1965 (20 U.S.C. 1087-2(r)), providing a capital standard for Sallie Mae and for Treasury financial safety and soundness oversight.

<sup>5</sup> P.L. 103-66. Subtitle A of the Omnibus Budget Reconciliation Act of 1993.

guaranteed student loans purchased by Sallie Mae after August 10, 1993. Even more significantly, the Act also established the Federal Direct Student Loan Program (now the William D. Ford Federal Direct Loan Program), under which loan capital is provided directly to student and parent borrowers by the Federal Government rather than through private lenders.

The Student Loan Reform Act authorizes the Department of Education to fund as direct loans up to 60 percent of the total of new guaranteed and direct loan volume combined in the 1998 academic year. The Act further provides that the proportion of direct loans may rise above 60 percent, if the Secretary of Education "determines that a higher percentage is warranted by the number of institutions of higher education that desire to participate in the program . . . and that meet the eligibility requirements for such participation."<sup>6</sup>

The Direct Student Loan Program is one of the President's top priorities. The Administration, in the Budget for FY 1996, proposed implementation of 100-percent direct lending (new loan volume) in 1997. Consistent with the implementation of direct lending under current law, the Administration has been studying options for the future of Sallie Mae, including in particular, restructuring the company into a fully private company. As noted above, privatizing Sallie Mae would significantly benefit the U.S. Government. In addition, removing Federal ties would mean

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<sup>6</sup> Subsection 453(a) of the HEA of 1965, as amended (20 U.S.C. 1087c(a)).

that the restrictions on Sallie Mae's business operations under its current charter would cease to exist and that Sallie Mae could engage in profit-making activities that it cannot enter into as a GSE.

In any restructuring, currently outstanding Sallie Mae debt would retain the characteristics of GSE debt, and customers with pre-existing commitments with the GSE would not be affected. Any new debt issued by a private company successor to Sallie Mae would not possess the characteristics of GSE debt.

The Administration believes that the benefits to be gained by the Government and Sallie Mae from privatization, in the context of continued expansion of the Direct Student Loan Program, are such that Congress should favorably consider legislation to authorize Sallie Mae's management to form a fully private company and to wind down the GSE during a transition period.

In this connection, we have been working with the Department of Education, the Office of Management and Budget, the Domestic Policy Council, the National Economic Council, Sallie Mae, and Congressional staff to develop legislation to privatize Sallie Mae. Moreover, on May 3, I testified in general support of privatization before two subcommittees of the House.<sup>7</sup>

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<sup>7</sup> 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.

I am encouraged that the House Committee on Economic and Educational Opportunities voted on June 8 to report a bill that provides for privatizing Sallie Mae. The Administration supports many of the provisions of the reported bill, which we understand may be amended before the bill is sent to the floor.

Nonetheless, I also believe there are some differences which should be worked out to the satisfaction of the Administration, Congress, and Sallie Mae.

As I indicated at that time, we are working on an Administration draft bill, which we look forward to sharing with Congress in the near future. The key elements of our privatization proposal are:

- The Sallie Mae Board of Directors would be authorized to carry out a reorganization -- which would be voted upon by the holders of Sallie Mae common shares -- under which Sallie Mae the GSE would become a wholly-owned subsidiary of an ordinary state-chartered holding company whose other subsidiaries could engage in other businesses;
- If the shareholders choose not to proceed with a reorganization, Sallie Mae would prepare a plan for an orderly termination of the Association that would ensure that the GSE will meet its ongoing capital requirements and have adequate assets to transfer to a trust to ensure payment of outstanding GSE debt obligations.
- After the decision by the shareholders, Sallie Mae would enter a wind down period during which new business

activities of the GSE would be restricted and new debt issued by the GSE would be restricted as to purpose and maturity;

- During the wind down, excess capital of the GSE could be transferred to the new private holding company or paid out to shareholders subject to continued compliance with the GSE's statutory capital requirements;
- The GSE would be protected from the financial failure of the holding company or its other subsidiaries in the event of reorganization;
- The GSE would cease to exist at a certain point in time and its remaining assets and liabilities would be liquidated;
- The bill would be deficit-neutral; and
- As a form of "exit fee", to recognize the benefits Sallie Mae has received because of its GSE status, the legislation would enable the United States to participate in the success of the company, for example through the issuance of stock warrants.

The Administration will also propose that certain provisions be included in the privatization bill to facilitate Government oversight of the relationship between the GSE and, if applicable, the new private company during the wind down period. The Administration bill will provide that:

- The reorganization plan and other actions of the GSE during the wind down period be subject to certain reviews by the Departments of Education and Treasury;

- The Government's financial safety and soundness oversight and enforcement authorities over the GSE be enhanced and the minimum capital ratio of the GSE be increased gradually during the wind down period;
- The Secretary of the Treasury be authorized to collect an annual assessment to pay the Treasury's reasonable costs and expenses for carrying out its oversight responsibilities over the GSE during the wind down; and
- The new company and any of its nonGSE subsidiaries be prohibited from using the name Student Loan Marketing Association, Sallie Mae, or any variation on that name in securities offerings in order to prevent confusion in the financial markets.

Connie Lee

The Administration transmitted legislation in May to convert Connie Lee to a fully private enterprise. Congress structured Connie Lee as a private, for-profit corporation, but provided for a limited infusion of Federal capital in the form of stock purchases by the Secretary of Education in order to get the corporation started. Congress clearly intended the Federal Government's direct interest in Connie Lee to diminish and eventually terminate,<sup>8</sup> as evidenced by the statutory limitations

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<sup>8</sup> U.S. Congress, House, Committee on Education and Labor, Higher Education Amendments of 1985, 99th Congress, 1st sess., 1985, H. Rept. 99-383 to accompany H.R. 3700, page 74.



on purchases of stock by the Secretary of Education and the authorization of the sale of such stock.

The Administration's legislation severs all Federal ties with Connie Lee, largely by requiring that the Connie Lee stock that is held by the Department of Education be sold by a date to be specified in the bill<sup>9</sup>. The legislation would eliminate Federal appointment of directors as well as all business restrictions. In marketing securities, Connie Lee would have to notify potential investors of these changes to reduce the risk of confusion regarding its status. The Treasury is prepared to act on behalf of the Department of Education to sell the Government's stake in Connie Lee. Thus, Connie Lee would be permitted to pursue business opportunities and the Federal Government would be free of any perception of implied risk that it would be called upon to provide assistance in the unlikely event that Connie Lee gets into financial difficulty.

#### Conclusion

We appreciate the opportunity to testify on these two proposals. Privatization, if implemented in a careful and deliberate manner, can benefit the U.S. Government and taxpayers, as well as Sallie Mae's and Connie Lee's stockholders, and the students and schools we are all trying to serve.

I will be glad to answer any questions that you may have.

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<sup>9</sup>In the 1990 Report, the Treasury proposed that the Federal Government sell its Connie Lee stock when it had authority to do so (February 1992).



## MASTER DEFEASANCE TRUST AGREEMENT

This MASTER DEFEASANCE TRUST AGREEMENT (this "Agreement"), dated as of December 29, 2004 by and among the Student Loan Marketing Association, a corporation established by an act of Congress and organized and existing under the laws of the United States of America (the "Grantor" or "SLMA"), SLM Corporation, a corporation organized and existing under the laws of the State of Delaware ("SLM Corporation"), and the Federal Reserve Bank of New York, a federal reserve bank established by an act of Congress and existing under the laws of the United States of America (the "Trustee").

### WITNESSETH:

WHEREAS, pursuant to the Student Loan Marketing Association Reorganization Act of 1996, 20 U.S.C. § 1087-3 (as amended, the "Privatization Act"), SLMA must dissolve, and its separate corporate existence must terminate, on or before September 30, 2008;

WHEREAS, on November 1, 2004, SLMA notified the Secretary of Education and the Secretary of the Treasury pursuant to Section 1087-3(d) of the Privatization Act of its intention to dissolve on December 31, 2004;

WHEREAS, on December 20, 2004, Education advised SLMA in writing that Education had determined that it is not necessary to require SLMA to serve as a lender of last resort pursuant to Section 439(q) of the Higher Education Act of 1965, as amended, or to purchase loans under an agreement with Education under Subsection (c)(6) of the Privatization Act, and that Education did not object to the accelerated dissolution of SLMA in accordance with the provisions of the Privatization Act;

WHEREAS, the Privatization Act requires SLMA to establish a special and irrevocable trust and to irrevocably transfer all SLMA debt obligations outstanding as of the Dissolution Date, as such outstanding obligations are more specifically described on Schedule A (the "Remaining Obligations"), to the trust;

WHEREAS, subject to the terms and conditions of this Agreement, the Master Defeasance Trust (as hereinafter defined) and each of the individual Defeasance Subtrusts (as hereinafter defined) are established for the sole benefit of the holders of the Remaining Obligations;

WHEREAS, concurrently with the execution and delivery of this Agreement, subject to the terms and conditions of this Agreement, SLMA will irrevocably deposit with the Trustee to be held in trust for the sole benefit of the holders of the Remaining Obligations, cash or direct noncallable obligations of the United States or any agency thereof for which payment the full faith and credit of the United States is pledged, in accordance with the Privatization Act and as more fully described on Schedule C, maturing as to principal and interest in such amounts and at such times as are

determined by Treasury to be sufficient, without consideration of any significant reinvestment of such interest, to pay the principal of, and interest on, the Remaining Obligations in accordance with their terms;

WHEREAS, to the extent SLMA cannot provide money or qualifying obligations in the amount required, SLM Corporation is required to transfer to the Master Defeasance Trust, including the Defeasance Subtrusts, money or qualifying securities in an amount necessary to prevent any deficiency;

WHEREAS, subject to the terms and conditions of this Agreement, the Trustee is willing to serve as trustee with respect to the Master Defeasance Trust and including each of the individual Defeasance Subtrusts; and

NOW, THEREFORE, in consideration of the premises and the mutual covenants and agreements contained herein and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, SLMA, SLM Corporation, and the Trustee agree as follows:

## ARTICLE I DEFINITIONS

Section 1.01. Capitalized Terms. For all purposes of this Agreement, the following terms shall have the meanings set forth below:

“Business Day” means a day other than Saturday, Sunday or a day on which the Federal Reserve Bank of New York is authorized or obligated by law or executive order to be closed for business.

“Collection Account” means an account established pursuant to Section 2.06. Each Collection Account shall be established under a specific Defeasance Subtrust and shall be separate and distinct from every other Collection Account established under this Agreement.

“Defeasance Subtrust” shall have the meaning set forth in Section 2.01.

“Dissolution Date” shall mean December 29, 2004, the date on which SLMA dissolves pursuant to Section 1087-3(d) of the Privatization Act.

“Education” means the Secretary of Education of the United States of America.

“Effective Date” means December 29, 2004.

“Excess Trust Assets” means, subject to the limitations and calculation methodology in Schedule E, the amount of initially deposited Trust Assets specified in Schedule E that are no longer needed to pay the principal of and interest on the Remaining Obligation due on October 3, 2022 and identified in Schedule E because such Remaining Obligation has been purchased or otherwise acquired in part or in whole, in

the open market, in negotiated transactions or otherwise, by SLM Corporation, which has voluntarily surrendered such Remaining Obligation, or part thereof, to the Trustee which in turn has canceled or retired such Remaining Obligation, or part thereof, in accordance with this Agreement.

“Excess Trust Assets Distribution Request” shall have the meaning set forth in Section 3.03(c).

“Final Payment Date” means (i) with respect to each Defeasance Subtrust, the date on which the final distribution is to be made from such Defeasance Subtrust by the Trustee to SLM Corporation pursuant to Section 3.05 and Section 6.01, and (ii) with respect to the Master Defeasance Trust, the date on which the final distribution is to be made from the Master Defeasance Trust pursuant to Section 6.02.

“Full Payment Amount” means, as of any date of determination, the amount required for the payment at their respective maturities of 100% of the principal amount of the Remaining Obligations and the payment when due of the interest due and payable to the Holders on such Remaining Obligations through and including their respective maturities.

“Grantor” shall have the meaning set forth in the preamble to this Agreement.

“Holders” means the holders, from time to time, of the Remaining Obligations as identified on the Fedwire Book-Entry system if the Remaining Obligations are in book-entry form or as identified in the records of the Trustee if the Remaining Obligations are in definitive form and, with respect to any specific Defeasance Subtrust, means the holders from time to time of the Remaining Obligations assumed and defeased by such Defeasance Subtrust.

“Interest Payment Amount” means, for any given Interest Payment Date, the amount of interest due and payable to the Holders on the related Remaining Obligations on such date.

“Interest Payment Date” means, with respect to each Remaining Obligation, any day on which interest is due and payable to the Holders thereon; provided, however, that if the day on which interest is due and payable in respect of any Remaining Obligations is not a business day (as defined in the agreements governing such Remaining Obligations), then the “Interest Payment Date” in respect of such Remaining Obligations shall be the day on which the agreements governing such Remaining Obligations require payment of such interest.

“Master Defeasance Trust” shall have the meaning set forth in Section 2.01.

“Payment Account” means an account established by the Trustee pursuant to Section 2.06(b).

**“Permitted Investments”** means money or direct noncallable obligations of the United States or any agency thereof for which payment the full faith and credit of the United States is pledged, including cash and United States Treasury securities.

**“Person”** means an individual, partnership, corporation (including a business trust), joint stock company, estate, trust, limited liability company, unincorporated association, joint venture, governmental authority or other legal person.

**“Principal Payment Amount”** means, for any given Principal Payment Date, the principal amount of the related Remaining Obligations due and payable to Holders on such date.

**“Principal Payment Date”** means, with respect to each Remaining Obligation, any day on which any principal amount is due and payable thereon to the Holders; **provided, however,** that if the day on which principal is due and payable in respect of any Remaining Obligations is not a business day (as defined in the agreements governing such Remaining Obligations), then the “Principal Payment Date” in respect of such Remaining Obligations shall be the day on which the agreements governing such Remaining Obligations require payment of such principal.

**“Privatization Act”** shall have the meaning set forth in the recitals to this Agreement.

**“Remaining Assets”** means any Trust Assets remaining in each Defeasance Subtrust at its termination under **Section 6.01**, as well as any Trust Assets that remain at the termination of the Master Defeasance Trust under **Section 6.02**.

**“Remaining Obligations”** shall have the meaning set forth in the recitals to this Agreement.

**“Securities Account”** means an account established by the Trustee pursuant to **Section 2.06(a)**.

**“SLMA”** shall have the meaning set forth in the preamble to this Agreement.

**“SLM Corporation”** shall have the meaning set forth in the preamble to this Agreement.

**“Treasury”** means the Secretary of the Treasury of the United States of America.

**“Trust Assets”** means cash and Permitted Investments held by the Trustee for the account of the Master Defeasance Trust and/or either of the Defeasance Subtrusts.

**“Trustee”** shall have the meaning set forth in the preamble to this Agreement.

Section 1.02. Rules of Construction.

(a) As used in this Agreement, the words “hereof,” “herein,” “hereunder” and words of similar import shall refer to this Agreement as a whole and not to any particular provision of this Agreement; references to Articles, Sections or Schedules are references to Articles, Sections and Schedules in or to this Agreement unless otherwise specified; the word “or” shall be interpreted inclusively; and the term “including” shall mean “including without limitation.”

(b) With respect to each and every term and condition of this Agreement, the parties understand and agree that the same have or has been mutually negotiated, prepared and drafted, and that if at any time the parties desire or are required to interpret or construe any such term or condition or any agreement or instrument subject thereto, no consideration shall be given to the issue of which party actually prepared, drafted or requested any term or condition of this Agreement.

(c) With respect to all terms in this Agreement, the singular includes the plural and vice versa and words importing any gender include the other gender.

ARTICLE II  
ESTABLISHMENT OF THE MASTER DEFEASANCE  
TRUST AND DEFEASANCE SUBTRUSTS

Section 2.01. Creation. Pursuant to the Privatization Act and subject to the terms and conditions of this Agreement, the Grantor, SLM Corporation and the Trustee hereby establish a special and irrevocable trust designated as the “Student Loan Marketing Association Master Defeasance Trust” (the “Master Defeasance Trust”), for the sole benefit of the Holders, to be held, administered and maintained by the Trustee separate and apart from all other assets and properties of the Grantor, SLM Corporation and the Trustee. In furtherance of the requirements of the Privatization Act and subject to the terms and conditions of this Agreement, the Grantor, SLM Corporation and the Trustee hereby establish within the Master Defeasance Trust, two subtrusts identified on Schedule B, each such subtrust being a separate and distinct special and irrevocable trust designated as indicated on Schedule B (each, a “Defeasance Subtrust”), for the sole benefit of the Holders of the Remaining Obligations defeased by such Defeasance Subtrust and identified as such on Schedule B. The Grantor, SLM Corporation and the Trustee acknowledge and agree that, within the Master Defeasance Trust, each of the Defeasance Subtrusts constitutes a separate and distinct trust that is being created for the convenience of the parties under this Agreement rather than under the terms and conditions of a separate agreement in respect of each such trust.

Section 2.02. Purpose. Pursuant to Section 1087-3(d)(1) of the Privatization Act, the Master Defeasance Trust and the Defeasance Subtrusts are being established for the sole purpose of assuming Grantor’s obligations under the Remaining Obligations and defeasing the Remaining Obligations for the benefit of the Holders in accordance with this Agreement with no objective to continue or engage in the conduct of a trade or business. Accordingly, the Trustee shall, in an expeditious but orderly manner,

take or omit to take such actions as are consistent with the purposes of the Master Defeasance Trust, the Defeasance Subtrusts, this Agreement and the Privatization Act, and shall not unduly prolong the duration of the Master Defeasance Trust or any of the Defeasance Subtrusts.

**Section 2.03. Initial Deposits.**

(a) On the Effective Date, subject to the terms and conditions of this Agreement, the Grantor and SLM Corporation hereby transfer, assign, set over, deliver and convey to the Trustee, without recourse, for the sole benefit of the Holders, in accordance with the terms and conditions of this Agreement, all of their right, title and interest in and to the Trust Assets specified in Schedule C, and the Trustee, acting solely on behalf of the Master Defeasance Trust and each of the Defeasance Subtrusts, as trustee and not in its individual capacity, assumes all of the Grantor's obligations (including payment obligations and obligations in respect of the conversion of definitive securities to book-entry securities) under the Remaining Obligations. With respect to the transfer, assignment, set over, delivery and conveyance of the Trust Assets, the Trust Assets are transferred, assigned, set over, delivered and conveyed only to the individual Defeasance Subtrusts identified on Schedule C and not to the Master Defeasance Trust or the other individual Defeasance Subtrusts. With respect to the assumption of the Grantor's obligations under the Remaining Obligations, such obligations are assumed only by the individual Defeasance Subtrusts identified on Schedule B and not by the Master Defeasance Trust or the other individual Defeasance Subtrusts. The Grantor also will make an initial deposit of \$500.00 into each of the Collection Accounts.

(b) At any time and from time to time on and after the Effective Date, Grantor (until its Dissolution Date) and SLM Corporation agree (i) at the reasonable request of the Trustee, to execute and deliver any instruments, documents, books, and records (including those maintained in electronic format and original documents as may be needed) and (ii) to take, or cause to be taken, all such further action as the Trustee may reasonably request, in each case in order to evidence or effectuate the transfer of the liabilities associated with the Remaining Obligations and the Permitted Investments to the Defeasance Subtrusts and the consummation of the other transactions contemplated hereby and under the Privatization Act, and to otherwise carry out the intent of the parties hereunder and under the Privatization Act.

**Section 2.04. Appointment of Trustee.** The Grantor hereby appoints the Trustee as trustee of the Master Defeasance Trust and as trustee of each of the Defeasance Subtrusts to have all the rights, powers and duties set forth herein and in the Privatization Act. The Trustee hereby accepts such appointment and covenants that it will hold the Trust Assets in trust upon and subject exclusively to the terms and conditions set forth herein and in the Privatization Act solely for the benefit of the Holders and SLM Corporation insofar as it is entitled to Excess Trust Assets and Remaining Assets in accordance with and subject to the terms and conditions of this Agreement.



Section 2.05. Title to Trust Assets. The transfer of rights under or interests in the Remaining Obligations to the applicable Defeasance Subtrust shall be made by the Grantor to the Trustee for the sole benefit of the respective Holders. The transfer of the other Trust Assets to the Master Defeasance Trust and the applicable Defeasance Subtrusts shall be made by the Grantor and SLM Corporation to the Trustee for the sole benefit of the respective Holders and for SLM Corporation insofar as it is entitled to Excess Trust Assets and Remaining Assets in accordance with and subject to the terms and conditions of this Agreement. Upon the transfer of the Trust Assets to the Master Defeasance Trust and the applicable Defeasance Subtrusts, the Trustee shall succeed to all of the Grantor's and SLM Corporation's right, title and interest in the Trust Assets, and the Grantor and SLM Corporation, except to the extent set forth herein, will have no further interest in or with respect to the Trust Assets.

Section 2.06. Establishment of Accounts.

(a) Securities Accounts. On or prior to the Effective Date, the Trustee shall establish (and during the term of the Agreement shall maintain) segregated securities custody accounts at the office of the Trustee in the name of each of the Defeasance Subtrusts (a "Securities Account"), bearing a designation clearly indicating that the securities held therein are held for the benefit of the Holders. The Trustee shall possess all right, title and interest in all securities held from time to time in the Securities Accounts for the benefit of the Holders. Each Securities Account shall be under the sole dominion and control of the Trustee for the benefit of the Holders.

(b) Collection Accounts. On or prior to the Effective Date, the Trustee shall establish (and during the term of the Agreement shall maintain) segregated trust accounts at the office of the Trustee in the name of the Trustee, as trustee of each Defeasance Subtrust (a "Collection Account"), bearing a designation clearly indicating that the funds deposited therein are held for the benefit of the Holders. The Trustee shall possess all right, title and interest in all moneys on deposit from time to time in the Collection Accounts for the benefit of the Holders. Each Collection Account shall be under the sole dominion and control of the Trustee for the benefit of the Holders.

(c) Payment Account. On or prior to the Effective Date, the Federal Reserve Bank of New York shall establish (and during the term of this Agreement shall maintain) a segregated, noninterest bearing account, at its office in the name of the Federal Reserve Bank of New York, as fiscal agent in respect of the Remaining Obligations (the "Payment Account"). The Payment Account shall not be part of the Defeasance Trust.

Section 2.07. Governance of the Master Defeasance Trust and the Defeasance Subtrusts. The Master Defeasance Trust and each of the Defeasance Subtrusts shall be governed by the Trustee pursuant to this Agreement. In the event the Trustee delegates any of its responsibilities hereunder, the Trustee shall be responsible for any actions taken by any Person to whom the Trustee has so delegated its authority hereunder as if such actions were taken directly by the Trustee.

Section 2.08. Recourse. From and after the Effective Date, the sole recourse of the Holders for payment of amounts owed under the Remaining Obligations shall be against the Trust Assets of the respective Defeasance Subtrust that assumed the Grantor's obligations in respect of the particular Remaining Obligations. No recourse under or with respect to any Remaining Obligation shall be had against SLM Corporation or its successors or assigns.

ARTICLE III  
PAYMENTS, DISTRIBUTIONS AND REINVESTMENTS

Section 3.01. Interest and Principal Payments on Remaining Obligations.

(a) On each Interest Payment Date, the Trustee shall cause an amount equal to the Interest Payment Amount to be transferred from the applicable Collection Account to the Payment Account and therefrom distributed to the Holders of Remaining Obligations entitled to receive payment of interest on such date, all in accordance with the respective terms and conditions of the related Remaining Obligations.

(b) On each Principal Payment Date, the Trustee shall cause an amount equal to the Principal Payment Amount to be transferred from the applicable Collection Account to the Payment Account and therefrom distributed to the Holders of Remaining Obligations entitled to receive payment of principal on such date, all in accordance with the respective terms and conditions of the related Remaining Obligations.

(c) If for any reason an amount in excess of that which is needed to pay the entire Principal Payment Amount and Interest Payment Amount is transferred to the Payment Account, the excess funds will be returned to the appropriate Collection Account. Amounts needed to support principal and interest payments made by check shall be held in the Payment Account by the Federal Reserve Bank of New York as fiscal agent in respect of the Remaining Obligations separate and apart from the Master Defeasance Trust and Defeasance Subtrusts.

Section 3.02. Collection Accounts.

(a) At all times, the Trustee shall maintain a minimum balance of \$250 in each of the Collection Accounts. The Trustee shall deposit all amounts received in the payment of principal of and interest on Permitted Investments held in any Defeasance Subtrust in the Collection Account in respect of such Defeasance Subtrust for distribution pursuant to Section 3.01 or reinvestment pursuant to Section 3.02(b).

(b) The Trustee shall perform limited investment transactions for certain Trust Assets, as identified in Schedule D. Thirty calendar days prior to a transaction date identified on Schedule D, SLM Corporation will notify the Trustee of the upcoming transaction. On each transaction date identified in Schedule D, unless the Trustee determines that it is impossible, the Trustee shall reinvest funds from the Collection Account in the amounts specified by Schedule D in any Permitted Investments to mature on or before the maturity date identified in Schedule D and without regard to

interest rate on the Permitted Investments available as of the transaction date. For purposes of this Section 3.02(b), the term “impossible” shall include but is not limited to a market closure, a market squeeze, a fail, a disruption of communication or computer facilities, war, emergency conditions, failure of equipment or other circumstances beyond the reasonable control of the Trustee, provided that the Trustee exercises such diligence as the circumstances require. In the event the Trustee determines that it is impossible to reinvest funds on a reinvestment date specified in Schedule D, but prior to the maturity date identified in Schedule D it becomes possible to reinvest such funds, the Trustee shall reinvest such funds in accordance with this Section 3.02(b).

Section 3.03. Cancellation or Retirement of Remaining Obligations.

(a) The parties to this Agreement acknowledge that from time to time after the Effective Date SLM Corporation may acquire Remaining Obligations in open market transactions, in negotiated transactions or otherwise. In the event SLM Corporation acquires Remaining Obligations and wishes to surrender such Remaining Obligations to the Trustee, SLM Corporation must provide the Trustee with 48 hours advance notice. If the Remaining Obligations are in book entry form, the Trustee will provide SLM Corporation with transfer instructions that SLM Corporation can use to transfer the Remaining Obligations to the applicable Securities Account free of payment. If the Remaining Obligations are in certificated form, SLM Corporation will be required to surrender the certificates.

(b) If SLM Corporation transfers or surrenders Remaining Obligations in accordance with Section 3.03(a), the Trustee shall cancel or retire such Remaining Obligations on behalf of and in the name of the Trust.

(c) With respect only to the Remaining Obligation specified in Schedule E, SLM Corporation shall be entitled to submit a request (an “Excess Trust Assets Distribution Request”) to the Trustee, pursuant to Schedule E, to transfer the Trust Assets specified in the Excess Trust Assets Distribution Request to SLM Corporation as soon as practicable, but only after the Trustee receives Treasury approval. At the time SLM Corporation submits an Excess Trust Assets Distribution Request to the Trustee under this Section 3.03, SLM Corporation shall provide a copy of the Excess Trust Assets Distribution Request to Treasury.

(d) If Treasury approves an Excess Trust Assets Distribution Request, Treasury shall direct the Trustee in writing to transfer from the applicable Securities Account to SLM Corporation free from trust the Trust Assets specified in the Excess Trust Assets Distribution Request as soon as practicable. If the Treasury approves an Excess Trust Assets Distribution Request, the Trustee shall have the right to object to the approved transfer only if distribution of the Trust Assets is impossible.

Section 3.04. No Substitution Rights. The Trustee may not sell, transfer or otherwise dispose of or request the redemption of all or a portion of the Trust Assets for the purposes of altering the composition of the Trust Assets or optimizing the return on the Trust Assets, except as contemplated by Section 3.03.

Section 3.05. Final Distribution.

(a) Upon the termination of a Defeasance Subtrust pursuant to Article VI, subject to applicable escheat or abandoned property laws, (i) the Trustee shall transfer all Remaining Assets in the Defeasance Subtrust, free from trust, to SLM Corporation, and (ii) all amounts remaining on deposit in the Collection Account and the Payment Account shall be transferred, free from trust, to SLM Corporation.

(b) Upon the termination of the Master Defeasance Trust pursuant to Article VI, after payment of all remaining fees and expenses payable to the Trustee in respect of its services as trustee under this Agreement, the Trustee shall transfer any assets remaining in the Master Defeasance Trust, free from trust, to SLM Corporation. Notwithstanding any other provisions of this Agreement, the Master Defeasance Trust shall not terminate and no distribution may be made from the Master Defeasance Trust to SLM Corporation as long as any Defeasance Subtrust shall remain in existence.

ARTICLE IV  
CONCERNING THE TRUSTEE

Section 4.01. Duties of Trustee.

(a) Generally. The Trustee shall have no duties or responsibilities whatsoever except such duties and responsibilities as are specifically set forth in this Agreement, and no covenant or obligation shall be implied in this Agreement on the part of the Trustee.

(b) Payments on Remaining Obligations. The Trustee shall make payments and distributions as required by Article III.

(c) Records. The Trustee shall maintain appropriate books of account and records relating to services performed hereunder, including books and records relating to the Trust Assets and Remaining Obligations held by the Master Defeasance Trust and the Defeasance Subtrusts, and such books of account and records shall be accessible for inspection by a representative of SLM Corporation or Treasury from time to time during normal business hours upon reasonable notice. The Trustee's books and records relating to services performed hereunder shall be maintained on a basis sufficient to enable the Trustee to comply with its obligations hereunder and shall include books and records relating to (i) payments made on the Remaining Obligations, (ii) the composition and timing of payments with respect to the Trust Assets, (iii) debits and credits to each of the Collection Accounts and the Payment Account and (iv) any distributions to SLM Corporation pursuant to the provisions of Article III, in such detail and for such period of time as may be necessary to enable it to make full and proper accounting in respect thereof. Prior to the destruction of any books or records maintained by the Trustee pursuant to this Section 4.01(c), a copy of such book or record shall be provided to SLM Corporation.

(d) Reports.

(i) The Trustee shall provide SLM Corporation with the following reports at the times indicated:

- Accounting Statement (delivered when activity occurs in any of the trust accounts)
- Funds Subsidiary Statement (monthly)
- Funds Detail Activity Statement (monthly)
- Book Entry Detailed Activity Statement (monthly)
- Notification of P & I Credits (delivered when principal and interest payments are made on securities held in the accounts created under this Agreement)
- Book Entry Subsidiary Statement (monthly)
- Definitive Destruction Letter (delivered monthly when Remaining Obligations are received to be canceled, retired or surrendered)

(ii) Tax Reporting. SLM Corporation will be solely responsible for any tax returns or any other statements, returns or disclosures required to be filed by the Master Defeasance Trust or any Defeasance Subtrust with any federal, state or local taxing authority. The Trustee will not provide any tax reporting services with respect to SLMA book entry securities. If SLM Corporation provides the Trustee with the OID factors for the two SLMA definitive securities that are Remaining Obligations, the Trustee will perform OID tax reporting for those obligations, including printing and mailing of OID 1099 Forms to Holders. SLM Corporation must provide the OID factors to the Trustee by December 15<sup>th</sup> of each year in order for the Trustee to timely fulfill its obligation under this Section 4.01(d)(ii). In no event will the Trustee be liable for any delay in the OID tax reporting caused by SLM Corporation's failure to provide the OID factors to the Trustee in a timely manner.

Section 4.02. Representations and Warranties. The Trustee hereby represents and warrants, as of the Effective Date, as follows:

(a) Due Organization. It is a federal reserve bank duly organized and validly existing in good standing under the laws of the United States. It has all requisite power and authority to execute, deliver and perform its obligations under this Agreement.

(b) Authorization. It has taken all action necessary to authorize the execution and delivery by it of this Agreement, and this Agreement has been executed and delivered by one of its officers who is duly authorized to execute and deliver this Agreement on its behalf.

(c) Binding Obligation. This Agreement constitutes the legal, valid and binding obligation of the Trustee, enforceable in accordance with its terms, except as enforceability may be limited by bankruptcy, insolvency, reorganization, or other similar laws affecting the enforcement of creditors' rights generally and by general principles of equity, regardless of whether such enforceability is considered in a proceeding in equity or at law.

(d) Compliance with Laws and Contracts. The execution, delivery and performance by the Trustee of its duties under this Agreement will not violate any provision of any law, rule, regulation, order, writ, judgment, injunction, decree, determination or award to which the Trustee is subject, or of the organizational or other organic documents of the Trustee.

#### Section 4.03. Liability of Trustee.

(a) The Trustee shall have no lien, security interest or right of set-off whatsoever upon any of the Trust Assets for the payment of fees or expenses for services rendered by the Trustee under this Agreement or otherwise.

(b) The Trustee shall not be liable for any action taken or omitted in good faith in reliance on any notice, direction, consent, certificate, affidavit, statement, designation or other paper or document reasonably believed by it to be genuine and to have been duly and properly signed or presented to it by SLMA, SLM Corporation or Treasury.

#### Section 4.04. Fees and Expenses.

(a) To compensate the Trustee for its services hereunder and to reimburse the Trustee for all reasonable costs, disbursements, charges and expenses (including reasonable fees and expenses of its counsel) incurred by the Trustee in acting hereunder or in connection herewith, and to compensate the Federal Reserve Bank of New York for its fees for servicing the Remaining Obligations as fiscal agent for SLMA, SLM Corporation shall obtain the agreement of a depository institution's account for the amount of such fees and expenses. If for any reason the depository institution revokes its authorization, SLM Corporation shall have 10 days to obtain a substitute depository institution or make such other arrangements acceptable to the Federal Reserve Bank of New York.

(b) The Trustee shall advise SLM Corporation from time to time of the amount of the fees and expenses payable by SLM Corporation in accordance with Section 4.04(a), which fees and expenses shall be based on a methodology consistent with past practices and with the fees and expenses the Federal Reserve Bank of New York charges government sponsored enterprises for services as fiscal agent in respect of debt obligations issued by such government sponsored enterprises.

Section 4.05. Permitted Acts. The Trustee may become an owner of or may deal in the Remaining Obligations as fully and with the same rights as if it were not the Trustee. Notwithstanding Section 3.04, the Trustee may take whatever actions it deems necessary to protect the Trust Assets.

Section 4.06. Limitation of Trustee's Authority. Notwithstanding anything herein to the contrary, the Trustee, in its capacity as trustee of the Master Defeasance Trust and each of the Defeasance Subtrusts, shall not be authorized to engage in any trade or business, and shall not take any actions inconsistent with the orderly defeasance of the Remaining Obligations as required or contemplated by the Privatization Act and this Agreement.

Section 4.07. Standard of Care. The Trustee assumes no liability hereunder except for its own malfeasance, misconduct, fraud or gross negligence or that of its officers, agents (including any Person to whom the Trustee has delegated any of its responsibilities hereunder in accordance with Section 2.07), representatives or employees in carrying out the provisions of this Agreement.

## ARTICLE V INDEMNIFICATION

Section 5.01. Indemnification of Trustee. SLM Corporation shall indemnify and hold harmless the Trustee and its successors, agents and servants from and against any loss, liability or reasonable expense (including reasonable attorneys' fees) arising out of or in connection with its entering into this Agreement and performing its duties hereunder; provided, however, that no such indemnification will be made for such actions or omissions as a result of malfeasance, misconduct, fraud, or gross negligence on the part of the Trustee.

## ARTICLE VI TERMINATION OF DEFEASANCE SUBTRUSTS AND DEFEASANCE TRUST

Section 6.01. Termination of Defeasance Subtrusts. Each Defeasance Subtrust shall terminate on the date that is the earlier of (i) the date the Trustee determines that payment in full has been made to all Holders of the Remaining Obligations assumed and defeased by such Defeasance Subtrust, or (ii) 30 days after the final maturity date of the last of the Remaining Obligations assumed by such Defeasance Subtrust, provided in the case of this clause (ii) that (a) all principal and interest payments in respect of all Remaining Obligations in book-entry form assumed by such Defeasance Subtrust have been made and (b) an amount sufficient to make all remaining principal and interest payments in respect of all Remaining Obligations in definitive form assumed by such Defeasance Subtrust shall have been transferred to the Payment Account.

Section 6.02. Termination of Master Defeasance Trust. The Master Defeasance Trust shall terminate as soon as practicable after the Trustee has terminated the last of the Defeasance Subtrusts in accordance with the terms and conditions of this

Agreement. Upon such termination, any Remaining Assets (other than Remaining Assets held in the Payment Account to the extent necessary to make all remaining principal and interest payments in respect of all Remaining Obligations in definitive form) shall be distributed, free of trust, to SLM Corporation pursuant to Section 3.05.

## ARTICLE VII AMENDMENTS

Section 7.01. Irrevocable Trust. It is the intention of the Grantor that the Master Defeasance Trust and each of the Defeasance Subtrusts created hereby be irrevocable, notwithstanding any statute or rule of law to the contrary. Except as otherwise expressly contemplated by Section 7.02, neither the Grantor nor the Trustee shall have any power to alter, amend, modify or revoke any of the terms and conditions of the Master Defeasance Trust or any Defeasance Subtrust.

### Section 7.02. Technical Amendments.

(a) SLM Corporation and the Trustee may, without the consent of or notice to the Holders, amend, supplement, modify or restate this Agreement in order to:

(i) cure any ambiguity, omission, formal defect or inconsistency in this Agreement;

(ii) grant to or confer upon the Trustee for the benefit of the Holders any additional rights, remedies or powers that may lawfully be granted to or conferred upon the Trustee; or

(iii) evidence and provide for the acceptance of appointment hereunder by a successor Trustee in the event the Trustee merges with and into another Person;

provided, however, that any such amendment, supplement, modification or restatement (x) shall not adversely affect the rights of the Holders and (y) shall not be inconsistent with the terms and conditions of this Agreement or the Privatization Act.

(b) The Trustee shall be entitled to rely upon an unqualified opinion of counsel with respect to compliance with this Section 7.02.

(c) The Trustee shall deliver a copy of any amendment, supplement, modification or restatement pursuant to this Section 7.02 to SLM Corporation and to Treasury.

## ARTICLE VIII MISCELLANEOUS PROVISIONS

Section 8.01. GOVERNING LAW. THIS AGREEMENT AND ALL MATTERS ARISING OUT OF OR RELATING TO THIS AGREEMENT SHALL BE GOVERNED BY AND CONSTRUED IN ACCORDANCE WITH THE LAWS OF



THE UNITED STATES OR, WHERE APPLICABLE, THE LAWS OF THE STATE OF NEW YORK APPLICABLE TO TRUST AGREEMENTS MADE, EXECUTED, DELIVERED, AND TO BE PERFORMED ENTIRELY WITHIN SAID STATE BUT, IN ANY CASE, WITHOUT REGARD TO THE CONFLICT OF LAWS PRINCIPLES OF SAID STATE.

Section 8.02. Severability. If any provision of this Agreement or the application thereof to any Person or circumstance shall be finally determined by a court of competent jurisdiction to be invalid or unenforceable to any extent, the remainder of this Agreement, or the application of such provision to Persons or circumstances other than those as to which it is held invalid or unenforceable, shall not be affected thereby, and such provision of this Agreement shall be valid and enforced to the fullest extent permitted by law.

Section 8.03. Notices. Any notice or other communication to a beneficiary hereunder shall be in writing and shall be deemed to have been sufficiently given, for all purposes, three Business Days after deposit in the mail, designated as certified mail, return receipt requested, postage-prepaid, one Business Day after being entrusted to a reputable commercial overnight delivery or courier service to the designated office or person indicated herein and addressed as follows; provided, however, that only one notice or other communication hereunder need be sent to Holders sharing the same address:

*To SLMA:*

Student Loan Marketing Association  
c/o SLM Corporation  
12061 Bluemont Way  
Reston, Virginia 20190  
Attention: Vice President  
Telephone: 703-984-5680

*To SLM Corporation:*

SLM Corporation  
12061 Bluemont Way  
Reston, Virginia 20190  
Attention: Controller  
Telephone: 703-984-6815

with a copy, which shall not constitute notice, to:

Attention: Vice President and Associate General Counsel,  
Corporate Law Division  
Telephone: 703-984-5680

*To the Trustee:*

Federal Reserve Bank of New York  
Electronic Payments  
East Rutherford Operations Center  
100 Orchard Street  
East Rutherford, New Jersey 07073  
Attention: Theodore Lubke  
Telephone: 201-531-3979

*To Treasury:*

United States Department of the Treasury  
1500 Pennsylvania Ave., N.W.  
Washington, DC 20220  
Attention: Under Secretary for Domestic Finance  
Telephone: 202-622-1703

The Trustee is not required to provide Treasury with copies of reports sent to SLM Corporation.

Section 8.04. Headings. The article and section headings contained in this Agreement are solely for convenience of reference and shall not affect the meaning or interpretation of this Agreement or of any term or provision hereof.

Section 8.05. Counterparts. This Agreement may be executed in any number of counterparts, each of which shall be deemed to be an original instrument, but all together shall constitute one agreement.

IN WITNESS WHEREOF, the parties hereto have either executed this Agreement as of the date first above written.

STUDENT LOAN MARKETING ASSOCIATION,

as Grantor

By: 

Name: Marianne M. Keler

Title: President

SLM CORPORATION

By: 

Name: Albert L. Lord

Title: Vice Chairman and CEO

FEDERAL RESERVE BANK OF NEW YORK,

as Trustee

By: 

Name: Theo Lubke

Title: Vice President

FEDERAL RESERVE BANK OF NEW YORK,

as Fiscal Agent in respect of the  
Remaining Obligations

By: 

Name: Theo Lubke

Title: Vice President

**Schedule A**  
**Remaining Obligations**

| <u>Debt Security</u>        | <u>CUSIP</u> | <u>Original Principal Amount*</u> | <u>Principal Amount Outstanding</u> |
|-----------------------------|--------------|-----------------------------------|-------------------------------------|
| 6.05% MTN due<br>01/03/05   | 86387RJU7    | \$1,700,000                       | \$1,700,000                         |
| 1.20% MTN due<br>01/27/05   | 86387SJJ0    | \$100,000,000                     | \$100,000,000                       |
| 2.00% Notes due<br>03/15/05 | 86387UBJ3    | \$1,000,000,000                   | \$386,423,000                       |
| 1.45% MTN due<br>06/15/05   | 86387SJK7    | \$150,000,000                     | \$143,200,000                       |
| 1.5% MTN due<br>06/15/05    | 86387SJG6    | \$100,000,000                     | \$87,900,000                        |
| 5.75% MTN due<br>08/01/05   | 86387RKM3    | \$5,300,000                       | \$5,300,000                         |
| 7.00% MTN due<br>08/01/05   | 86387RGP1    | \$5,160,000                       | \$5,160,000                         |
| 6.125% MTN due<br>12/01/05  | 86387RLS9    | \$7,750,000                       | \$4,190,000                         |
| 8.55% MTN due<br>12/01/05   | 86387RDM1    | \$1,000,000                       | \$500,000                           |
| 9.15% MTN due<br>12/01/05   | 86387REF5    | \$1,400,000                       | \$1,300,000                         |
| 5.75% MTN due<br>12/05/05   | 86387RKN1    | \$2,600,000                       | \$1,600,000                         |
| 5.25% Notes due<br>03/15/06 | 86387UAV7    | \$1,000,000,000                   | \$260,200,000                       |
| 7.6% MTN due<br>04/19/06    | 86387RNM0    | \$1,000,000                       | \$1,000,000                         |
| 5.80% MTN due<br>07/31/06   | 86387RKP6    | \$5,800,000                       | \$2,900,000                         |
| 7.10% MTN due<br>08/01/06   | 86387RGQ9    | \$5,660,000                       | \$3,910,000                         |
| 8.41% MTN due<br>12/01/06   | 86387RCT7    | \$1,000,000                       | \$200,000                           |
| 9.15% MTN due<br>12/01/06   | 86387REG3    | \$1,600,000                       | \$100,000                           |
| 5.80% MTN due<br>12/04/06   | 86387RKQ4    | \$2,800,000                       | \$2,650,000                         |
| 8.20% MTN due<br>05/30/07   | 86387RPQ9    | \$1,600,000                       | \$1,000,000                         |
| 5.85% MTN due<br>06/01/07   | 86387RKR2    | \$3,900,000                       | \$3,325,000                         |

| <u>Debt Security</u>                                      | <u>CUSIP</u> | <u>Original Principal Amount</u> * | <u>Principal Amount Outstanding</u> |
|---|--------------|------------------------------------|-------------------------------------|
| 9.35% MTN due<br>06/01/07                                 | 86387RAV4    | \$3,900,000                        | \$1,400,000                         |
| 5.85% MTN due<br>08/01/07                                 | 86387RKS0    | \$6,100,000                        | \$4,190,000                         |
| 7.125% MTN due<br>08/01/07                                | 86387RGR7    | \$6,070,000                        | \$4,539,000                         |
| 5.85% MTN due<br>12/03/07                                 | 86387RKT8    | \$2,900,000                        | \$2,095,000                         |
| 8.44% MTN due<br>12/03/07                                 | 86387RCU4    | \$2,900,000                        | \$2,750,000                         |
| 7.15% MTN due<br>08/01/08                                 | 86387RGS5    | \$5,370,000                        | \$3,250,000                         |
| 7.75% MTN due<br>09/02/08                                 | 86387RNS7    | \$2,000,000                        | \$2,000,000                         |
| 6.25% MTN due<br>12/01/08                                 | 86387RLT7    | \$9,250,000                        | \$6,115,000                         |
| 8.47% MTN due<br>12/01/08                                 | 86387RCY6    | \$3,100,000                        | \$835,000                           |
| Zero Coupon Notes<br>due 05/15/14 (called<br>to 05/15/09) | 863871AL3    | \$967,190,000                      | \$262,975,000                       |
| 7.30% MTN due<br>08/01/09                                 | 86387RGT3    | \$4,440,000                        | \$1,340,000                         |
| 7.35% MTN due<br>08/01/10                                 | 86387RGU0    | \$5,530,000                        | \$3,120,000                         |
| 6.83% MTN due<br>04/04/11                                 | 86387RUT7    | \$3,000,000                        | \$2,575,000                         |
| 9.40% MTN due<br>06/01/11                                 | 86387RAW2    | \$1,400,000                        | \$300,000                           |
| 7.375% MTN due<br>08/01/11                                | 86387RGV8    | \$7,000,000                        | \$3,615,000                         |
| 8.72% MTN due<br>12/01/11                                 | 86387RDU3    | \$4,000,000                        | \$2,000,000                         |
| 7.30% Notes due<br>08/01/12                               | 863871NB1    | \$109,932,000                      | \$72,018,000                        |
| 8.44% MTN due<br>12/03/12                                 | 86387RDJ8    | \$4,400,000                        | \$1,420,000                         |
| 6.55% MTN due<br>12/02/13                                 | 86387RLU4    | \$14,750,000                       | \$10,192,000                        |
| 8.44% MTN due<br>12/01/16                                 | 86387RDK5    | \$3,100,000                        | \$2,450,000                         |
| 8.47% MTN due<br>12/01/16                                 | 86387RCS9    | \$3,000,000                        | \$3,000,000                         |

| <u>Debt Security</u>              | <u>CUSIP</u> | <u>Original Principal Amount</u> * | <u>Principal Amount Outstanding</u> |
|-----------------------------------|--------------|------------------------------------|-------------------------------------|
| 9.25% MTN due<br>11/30/18         | 86387RAX0    | \$2,100,000                        | \$2,000,000                         |
| 8.41% MTN due<br>12/14/18         | 86387RCJ9    | \$500,000                          | \$500,000                           |
| Zero Coupon Notes<br>due 10/03/22 | 863871AM1    | \$616,910,000                      | \$445,812,000                       |

\* Amount outstanding as of July 28, 2004.

**Schedule B**  
**Defeasance Subtrusts Created Under Master Defeasance Trust Agreement**

| <u>Name of Defeasance Subtrust</u> | <u>Remaining Obligations Assumed and Defeased</u>    | <u>CUSIP</u> |
|------------------------------------|--|--------------|
| SLMA Defeasance Subtrust I         | 6.05% MTN due 01/03/05                               | 86387RJU7    |
|                                    | 1.20% MTN due 01/27/05                               | 86387SJJ0    |
|                                    | 2.00% Notes due 03/15/05                             | 86387UBJ3    |
|                                    | 1.45% MTN due 06/15/05                               | 86387SJK7    |
|                                    | 1.5% MTN due 06/15/05                                | 86387SJG6    |
|                                    | 5.75% MTN due 08/01/05                               | 86387RKM3    |
|                                    | 7.00% MTN due 08/01/05                               | 86387RGP1    |
|                                    | 6.125% MTN due 12/01/05                              | 86387RLS9    |
|                                    | 8.55% MTN due 12/01/05                               | 86387RDM1    |
|                                    | 9.15% MTN due 12/01/05                               | 86387REF5    |
|                                    | 5.75% MTN due 12/05/05                               | 86387RKN1    |
|                                    | 5.25% Notes due 03/15/06                             | 86387UAV7    |
|                                    | 7.6% MTN due 04/19/06                                | 86387RNM0    |
|                                    | 5.80% MTN due 07/31/06                               | 86387RKP6    |
|                                    | 7.10% MTN due 08/01/06                               | 86387RGQ9    |
|                                    | 8.41% MTN due 12/01/06                               | 86387RCT7    |
|                                    | 9.15% MTN due 12/01/06                               | 86387REG3    |
|                                    | 5.80% MTN due 12/04/06                               | 86387RKQ4    |
|                                    | 8.20% MTN due 05/30/07                               | 86387RPQ9    |
|                                    | 5.85% MTN due 06/01/07                               | 86387RKR2    |
|                                    | 9.35% MTN due 06/01/07                               | 86387RAV4    |
|                                    | 5.85% MTN due 08/01/07                               | 86387RKS0    |
|                                    | 7.125% MTN due 08/01/07                              | 86387RGR7    |
|                                    | 5.85% MTN due 12/03/07                               | 86387RKT8    |
|                                    | 8.44% MTN due 12/03/07                               | 86387RCU4    |
|                                    | 7.15% MTN due 08/01/08                               | 86387RGS5    |
|                                    | 7.75% MTN due 09/02/08                               | 86387RNS7    |
|                                    | 6.25% MTN due 12/01/08                               | 86387RLT7    |
|                                    | 8.47% MTN due 12/01/08                               | 86387RCY6    |
|                                    | Zero Coupon Notes due 05/15/14 (called to 05/15/09)* | 863871AL3    |
|                                    | 7.30% MTN due 08/01/09                               | 86387RGT3    |
|                                    | 7.35% MTN due 08/01/10                               | 86387RGU0    |
| 6.83% MTN due 04/04/11             | 86387RUT7  |              |
| 9.40% MTN due 06/01/11             | 86387RAW2  |              |
| 7.375% MTN due 08/01/11            | 86387RGV8  |              |
| 8.72% MTN due 12/01/11             | 86387RDU3  |              |
| 7.30% Notes due 08/01/12           | 863871NB1  |              |

| <u>Name of Defeasance<br/>Subtrust</u> | <u>Remaining Obligations<br/>Assumed and Defeased</u> | <u>CUSIP</u> |
|--|---|--------------|
| SLMA Defeasance<br>Subtrust II         | 8.44% MTN due 12/03/12                                | 86387RDJ8    |
|  | 6.55% MTN due 12/02/13                                | 86387RLU4    |
|  | 8.44% MTN due 12/01/16                                | 86387RDK5    |
|  | 8.47% MTN due 12/01/16                                | 86387RCS9    |
|  | 9.25% MTN due 11/30/18                                | 86387RAX0    |
|  | 8.41% MTN due 12/14/18                                | 86387RCJ9    |
|  | Zero Coupon Notes due<br>10/03/22                     | 863871AM1    |

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\* On December 15, 2004, SLMA notified the Federal Reserve Bank of New York, in its capacity as fiscal agent, that SLMA was exercising its call option on these zero coupon notes, effective 05/15/09. These zero coupon notes are to be paid in full on the effective date of the call option (05/15/09).



**Schedule C**  
**Initial Investment Securities**

| <u>Name of Defeasance Subtrust</u> | <u>Investment Securities</u> |
|------------------------------------|------------------------------|
| SLMA Defeasance Subtrust I         | See attached list.           |
| SLMA Defeasance Subtrust II        | See attached list.           |

**Schedule C (MDTA)**  
**Initial Investment Securities**

**Investment Securities**

| Name of Defeasance Subtrust              | CUSIP     | Coupon | Maturity  | Description     | Face Amount       |
|--|-----------|--------|-----------|-----------------|-------------------|
| <b>Master SLMA Defeasance Subtrust I</b> |           |        |           |                 |                   |
|  | 912828AR1 | 1.750% | 31-Dec-04 | 1 3/4 NOTE V 04 | \$ 1,737,000.00   |
|  | 912795RX1 | 0.000% | 27-Jan-05 | BILL 01/27/05   | \$ 100,178,000.00 |
|  | 912828AS9 | 1.625% | 31-Jan-05 | 1 5/8 NOTE G 05 | \$ 3,613,000.00   |
|  | 912795SD4 | 0.000% | 10-Mar-05 | BILL 03/10/05   | \$ 395,046,000.00 |
|  | 912795SG7 | 0.000% | 31-Mar-05 | BILL 03/31/05   | \$ 78,000.00      |
|  | 912795SJ1 | 0.000% | 14-Apr-05 | BILL 04/14/05   | \$ 38,000.00      |
|  | 912795SK8 | 0.000% | 21-Apr-05 | BILL 04/21/05   | \$ 1,038,000.00   |
|  | 912795SS1 | 0.000% | 9-Jun-05  | BILL 06/09/05   | \$ 229,649,000.00 |
|  | 912828BE9 | 1.500% | 31-Jul-05 | 1 1/2 NOTE N 05 | \$ 13,981,000.00  |
|  | 912828BJ8 | 2.000% | 31-Aug-05 | 2 NOTE P 05     | \$ 4,759,000.00   |
|  | 912828BL3 | 1.625% | 30-Sep-05 | 1 5/8 NOTE Q 05 | \$ 115,000.00     |
|  | 912828BS8 | 1.875% | 30-Nov-05 | 1 7/8 NOTE S 05 | \$ 5,208,000.00   |
|  | 912828BX7 | 1.875% | 31-Jan-06 | 1 7/8 NOTE K 06 | \$ 3,292,000.00   |
|  | 912828CB4 | 1.625% | 28-Feb-06 | 1 5/8 NOTE L 06 | \$ 264,986,000.00 |
|  | 912828CD0 | 1.500% | 31-Mar-06 | 1 1/2 NOTE M 06 | \$ 1,116,000.00   |
|  | 912828CQ1 | 2.750% | 31-Jul-06 | 2 3/4 NOTE R 06 | \$ 7,562,000.00   |
|  | 912828CU2 | 2.375% | 31-Aug-06 | 2 3/8 NOTE S 06 | \$ 108,000.00     |
|  | 912828CW8 | 2.500% | 30-Sep-06 | 2 1/2 NOTE T 06 | \$ 87,000.00      |
|  | 912828DD9 | 2.875% | 30-Nov-06 | 2 7/8 NOTE V 06 | \$ 3,581,000.00   |
|  | 9128272J0 | 6.250% | 15-Feb-07 | 6 1/4 NOTE B 07 | \$ 198,000.00     |
|  | 912828CG3 | 3.125% | 15-May-07 | 3 1/8 NOTE J 07 | \$ 15,076,000.00  |
|  | 912833CS7 | 0.000% | 15-Aug-07 | TINT 08/15/07   | \$ 138,000.00     |
|  | 912828AN0 | 3.000% | 15-Nov-07 | 3 NOTE G 07     | \$ 5,245,000.00   |
|  | 9128273X8 | 5.500% | 15-Feb-08 | 5 1/2 NOTE B 08 | \$ 139,000.00     |
|  | 912833GC8 | 0.000% | 15-May-08 | TINT 05/15/08   | \$ 3,558,000.00   |
|  | 912828BG4 | 3.250% | 15-Aug-08 | 3 1/4 NOTE G 08 | \$ 2,045,000.00   |
|  | 912828BK5 | 3.125% | 15-Sep-08 | 3 1/8 NOTE H 08 | \$ 98,000.00      |
|  | 912833GD6 | 0.000% | 15-Nov-08 | TINT 11/15/08   | \$ 4,251,000.00   |
|  | 912828BT6 | 3.375% | 15-Dec-08 | 3 3/8 NOTE L 08 | \$ 85,000.00      |
|  | 912828BV1 | 3.250% | 15-Jan-09 | 3 1/4 NOTE D 09 | \$ 2,805,000.00   |
|  | 912828CC2 | 2.625% | 15-Mar-09 | 2 5/8 NOTE F 09 | \$ 100,000.00     |
|  | 912828CH1 | 3.875% | 15-May-09 | 3 7/8 NOTE H 09 | \$ 148,183,000.00 |
|  | 912828CL2 | 4.000% | 15-Jun-09 | 4 NOTE J 09     | \$ 86,000.00      |
|  | 912828CN8 | 3.625% | 15-Jul-09 | 3 5/8 NOTE K 09 | \$ 4,190,000.00   |
|  | 912828CV0 | 3.375% | 15-Sep-09 | 3 3/8 NOTE M 09 | \$ 101,000.00     |

|           |        |           |                 |    |               |
|-----------|--------|-----------|-----------------|----|---------------|
| 912828DB3 | 3.500% | 15-Nov-09 | 3 1/2 NOTE P 09 | \$ | 2,913,000.00  |
| 912833CX6 | 0.000% | 15-Feb-10 | TINT 02/15/10   | \$ | 6,185,000.00  |
| 912833CY4 | 0.000% | 15-Aug-10 | TINT 08/15/10   | \$ | 102,000.00    |
| 912833JV3 | 0.000% | 15-Nov-10 | TINT 11/15/10   | \$ | 2,849,000.00  |
| 912833CZ1 | 0.000% | 15-Feb-11 | TINT 02/15/11   | \$ | 2,677,000.00  |
| 912833JW1 | 0.000% | 15-May-11 | TINT 05/15/11   | \$ | 6,770,000.00  |
| 912833JX9 | 0.000% | 15-Nov-11 | TINT 11/15/11   | \$ | 4,709,000.00  |
| 912833JY7 | 0.000% | 15-May-12 | TINT 05/15/12   | \$ | 74,640,000.00 |

**Master SLMA Defeasance Subtrust II**

|           |        |           |                 |    |            |
|-----------|--------|-----------|-----------------|----|------------|
| 912795SD4 | 0.000% | 10-Mar-05 | BILL 03/10/05   | \$ | 81,000.00  |
| 912795SR3 | 0.000% | 2-Jun-05  | BILL 06/02/05   | \$ | 277,000.00 |
| 912795SS1 | 0.000% | 9-Jun-05  | BILL 06/09/05   | \$ | 300,000.00 |
| 912828BJ8 | 2.000% | 31-Aug-05 | 2 NOTE P 05     | \$ | 81,000.00  |
| 912828BS8 | 1.875% | 30-Nov-05 | 1 7/8 NOTE S 05 | \$ | 577,000.00 |
| 912828CB4 | 1.625% | 28-Feb-06 | 1 5/8 NOTE L 06 | \$ | 82,000.00  |
| 912828CK4 | 2.500% | 31-May-06 | 2 1/2 NOTE P 06 | \$ | 583,000.00 |
| 912828CU2 | 2.375% | 31-Aug-06 | 2 3/8 NOTE S 06 | \$ | 82,000.00  |
| 912828DD9 | 2.875% | 30-Nov-06 | 2 7/8 NOTE V 06 | \$ | 590,000.00 |
| 9128272J0 | 6.250% | 15-Feb-07 | 6 1/4 NOTE B 07 | \$ | 84,000.00  |
| 912828CG3 | 3.125% | 15-May-07 | 3 1/8 NOTE J 07 | \$ | 599,000.00 |
| 912833CS7 | 0.000% | 15-Aug-07 | TINT 08/15/07   | \$ | 86,000.00  |
| 912828AN0 | 3.000% | 15-Nov-07 | 3 NOTE G 07     | \$ | 608,000.00 |
| 9128273X8 | 5.500% | 15-Feb-08 | 5 1/2 NOTE B 08 | \$ | 87,000.00  |
| 912833GC8 | 0.000% | 15-May-08 | TINT 05/15/08   | \$ | 616,000.00 |
| 912828BK5 | 3.125% | 15-Sep-08 | 3 1/8 NOTE H 08 | \$ | 89,000.00  |
| 912833GD6 | 0.000% | 15-Nov-08 | TINT 11/15/08   | \$ | 316,000.00 |
| 912828BT6 | 3.375% | 15-Dec-08 | 3 3/8 NOTE L 08 | \$ | 301,000.00 |
| 912828CC2 | 2.625% | 15-Mar-09 | 2 5/8 NOTE F 09 | \$ | 90,000.00  |
| 912828CH1 | 3.875% | 15-May-09 | 3 7/8 NOTE H 09 | \$ | 317,000.00 |
| 912828CL2 | 4.000% | 15-Jun-09 | 4 NOTE J 09     | \$ | 306,000.00 |
| 912828CV0 | 3.375% | 15-Sep-09 | 3 3/8 NOTE M 09 | \$ | 91,000.00  |
| 912828DB3 | 3.500% | 15-Nov-09 | 3 1/2 NOTE P 09 | \$ | 635,000.00 |
| 912833CX6 | 0.000% | 15-Feb-10 | TINT 02/15/10   | \$ | 737,000.00 |
| 912833CY4 | 0.000% | 15-Aug-10 | TINT 08/15/10   | \$ | 92,000.00  |
| 912833JV3 | 0.000% | 15-Nov-10 | TINT 11/15/10   | \$ | 645,000.00 |
| 912833CZ1 | 0.000% | 15-Feb-11 | TINT 02/15/11   | \$ | 92,000.00  |
| 912833JW1 | 0.000% | 15-May-11 | TINT 05/15/11   | \$ | 645,000.00 |
| 912833DA5 | 0.000% | 15-Aug-11 | TINT 08/15/11   | \$ | 92,000.00  |
| 912833JX9 | 0.000% | 15-Nov-11 | TINT 11/15/11   | \$ | 645,000.00 |
| 912833DB3 | 0.000% | 15-Feb-12 | TINT 02/15/12   | \$ | 92,000.00  |
| 912833JY7 | 0.000% | 15-May-12 | TINT 05/15/12   | \$ | 645,000.00 |
| 912833DC1 | 0.000% | 15-Aug-12 | TINT 08/15/12   | \$ | 92,000.00  |

|           |        |           |               |    |                |
|-----------|--------|-----------|---------------|----|----------------|
| 912833JZ4 | 0.000% | 15-Nov-12 | TINT 11/15/12 | \$ | 2,061,000.00   |
| 912833DD9 | 0.000% | 15-Feb-13 | TINT 02/15/13 | \$ | 92,000.00      |
| 912833KA7 | 0.000% | 15-May-13 | TINT 05/15/13 | \$ | 585,000.00     |
| 912833DE7 | 0.000% | 15-Aug-13 | TINT 08/15/13 | \$ | 92,000.00      |
| 912833KB5 | 0.000% | 15-Nov-13 | TINT 11/15/13 | \$ | 10,777,000.00  |
| 912833DF4 | 0.000% | 15-Feb-14 | TINT 02/15/14 | \$ | 93,000.00      |
| 912833KC3 | 0.000% | 15-May-14 | TINT 05/15/14 | \$ | 251,000.00     |
| 912833DG2 | 0.000% | 15-Aug-14 | TINT 08/15/14 | \$ | 93,000.00      |
| 912833KD1 | 0.000% | 15-Nov-14 | TINT 11/15/14 | \$ | 251,000.00     |
| 912833DH0 | 0.000% | 15-Feb-15 | TINT 02/15/15 | \$ | 93,000.00      |
| 912833KE9 | 0.000% | 15-May-15 | TINT 05/15/15 | \$ | 251,000.00     |
| 912833JT8 | 0.000% | 15-Aug-15 | TINT 08/15/15 | \$ | 92,000.00      |
| 912833KF6 | 0.000% | 15-Nov-15 | TINT 11/15/15 | \$ | 252,000.00     |
| 912833KG4 | 0.000% | 15-Feb-16 | TINT 02/15/16 | \$ | 92,000.00      |
| 912833KH2 | 0.000% | 15-May-16 | TINT 05/15/16 | \$ | 252,000.00     |
| 912833KJ8 | 0.000% | 15-Aug-16 | TINT 08/15/16 | \$ | 92,000.00      |
| 912833KK5 | 0.000% | 15-Nov-16 | TINT 11/15/16 | \$ | 5,684,000.00   |
| 912833KL3 | 0.000% | 15-Feb-17 | TINT 02/15/17 | \$ | 92,000.00      |
| 912833KM1 | 0.000% | 15-May-17 | TINT 05/15/17 | \$ | 21,000.00      |
| 912833KN9 | 0.000% | 15-Aug-17 | TINT 08/15/17 | \$ | 93,000.00      |
| 912833KP4 | 0.000% | 15-Nov-17 | TINT 11/15/17 | \$ | 21,000.00      |
| 912833KQ2 | 0.000% | 15-Feb-18 | TINT 02/15/18 | \$ | 93,000.00      |
| 912833KR0 | 0.000% | 15-May-18 | TINT 05/15/18 | \$ | 21,000.00      |
| 912833KS8 | 0.000% | 15-Aug-18 | TINT 08/15/18 | \$ | 92,000.00      |
| 912833KT6 | 0.000% | 15-Nov-18 | TINT 11/15/18 | \$ | 2,559,000.00   |
| 912803AZ6 | 0.000% | 15-Aug-22 | 7 1/4 TPRN 22 | \$ | 445,812,000.00 |

**Schedule D**  
**Schedule of Reinvestments**

| Date Available for Reinvestment | Amount Available for Reinvestment | Date Reinvestment Amount Needed | Defeasance Subtrust Subject to Reinvestment |
|---------------------------------|-----------------------------------|---------------------------------|---|
| Thu 03/10/05                    | \$ 397,214,119.00                 | Tue 03/15/05                    | Defeasance Subtrust I                       |
| Thu 06/09/05                    | \$ 232,344,283.00                 | Wed 06/15/05                    | Defeasance Subtrust I                       |
| Tue 02/28/06                    | \$ 267,106,047.00                 | Wed 03/15/06                    | Defeasance Subtrust I                       |
| Tue 05/15/07                    | \$ 11,934,642.00                  | Wed 08/01/07                    | Defeasance Subtrust I                       |
| Thu 05/15/08                    | \$ 6,172,255.00                   | Fri 08/01/08                    | Defeasance Subtrust I                       |
| Tue 02/16/10                    | \$ 6,003,799.00                   | Mon 08/02/10                    | Defeasance Subtrust I                       |
| Mon 05/16/11                    | \$ 6,383,793.00                   | Mon 08/01/11                    | Defeasance Subtrust I                       |
| Tue 05/15/12                    | \$ 74,646,758.00                  | Wed 08/01/12                    | Defeasance Subtrust I                       |
| Mon 08/15/22                    | \$ 445,812,003.00*                | Mon 10/03/22                    | Defeasance Subtrust II                      |

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\* Amount available presumes that there has been no transfer of Trust Assets from the trust to SLM Corporation pursuant to an Excess Trust Assets Distribution Request by SLM Corporation, as limited by and in accordance with Section 3.03(c) and (d) and Schedule E. If such a transfer has been made, the revised amount available for reinvestment is calculated in Schedule E.

**Schedule E**  
**Excess Trust Asset Distribution Requests**

E1 - Limitations on Excess Trust Asset Distribution Requests

SLM Corporation may submit Excess Trust Asset Distribution Requests related to the retirement of the Remaining Obligation listed below. The number of such requests is limited to two, a minimum amount of \$50 million face amount, and must be timely submitted for a settlement (transfers of Excess Trust Assets) before Friday, November 12, 2021.

Eligible Remaining Obligation

CUSIP 863871AM1  
Matures October 03, 2022

Schedules E2 and E3 are tested by an independent accountant as follows:

Each Excess Trust Assets Distribution Request shall include Schedules E-1, E-2, and E-3, and an Agreed Upon Procedures Letter from an independent accounting firm, registered with the United States Public Company Accounting Oversight Board, that tests and confirms that the "Trust Assets", and "Post Trust Settlement Data" per Schedules E-2 and E-3 have been vouched/confirmed to supporting documents, and that the pro rata calculations in Schedule E-3, Lines 1 through 10 are accurate.

E-2 Trust Assets & Reinvestments Linked to Eligible Remaining Obligation

**Linked Trust Assets (from Schedule C)\***

|  |               |
|--|---------------|
| Description  | 7 1/4 TPRN 22 |
| CUSIP  | 912803AZ6     |
| Amount of Face Linked to SLMA Remaining Obligation | \$445,812,000 |

**Linked Reinvestments (from Schedule D)\***

|   |               |
|---|---------------|
| Reinvestment Transaction Date                   | 08/15/22      |
| Original Face Amount Available for Reinvestment | \$445,812,000 |

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\* Linked to SLMA Remaining Obligation due October 3, 2022 (CUSIP 863871AM1)

E-3 Calculation of Excess Trust Assets Distribution

|   | 1st Distribution<br>Request | 2nd Distribution<br>Request |
|---|-----------------------------|-----------------------------|
| <b>Post Trust Settlement Data</b>   |                             |                             |
| Date of Request   |                             |                             |
| Par Amount of SLMA Remaining Obligation Retired                               |                             |                             |
| Date SLMA Obligation Retired  |                             |                             |
| Prior Distribution/Transferred of Permitted Investment                        | n/a                         |                             |
| <b><u>Calculation of Pro Rata SLMA Remaining Obligation Retired</u></b>       |                             |                             |
| Line 1 Face SLMA Obligation Outstanding at Trust Settlement (from Schedule A) | \$445,812,000               | \$445,812,000               |
| 2 Face Amount of SLMA Remaining Obligations Retired (from above)              |                             |                             |
| 3 Pro Rata Amount Retired (line 2/line 1)                                     |                             |                             |
| <b><u>Calculation of Permitted Investment to be Transferred</u></b>           |                             |                             |
| 4 Asset (face) Linked to SLMA Obligation (from Schedule E-2)                  | 445,812,000                 | 445,812,000                 |
| 5 Line 3 X Line 4   |                             |                             |
| 6 Transfer Amount - Round Line 5 down to nearest \$1,000                      | <hr/>                       | <hr/>                       |
| <b><u>Calculation of Adjustment to Schedule D</u></b>                         |                             |                             |
| 7 Original Amount to Reinvest (from Schedule E-2)                             | 445,812,003                 | 445,812,003                 |
| 8 Prior Distribution/Transferred of Permitted Investments (from above)        | n/a                         |                             |
| 9 Amount to be Transferred this Request (line 6)                              | <hr/>                       | <hr/>                       |
| 10 Revised Amount to Reinvest in Schedule D (line 7- line 8 -line 9)          | <hr/>                       | <hr/>                       |

**Schedule would be determined at Request Date and tested by an independent accountant (see E-1).**





DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C.

ASSISTANT SECRETARY

December 29, 2004

Mr. Duane W. Acklie  
Chairman, Student Loan Marketing Association  
400 NW 56<sup>th</sup> Street  
Lincoln, NE 68528

Mr. Edward A. Fox  
Chairman, SLM Corporation  
11600 Sallie Mae Drive  
Reston, VA 20193

Mr. Timothy F. Geithner  
President  
Federal Reserve Bank of New York  
33 Liberty Street  
New York, NY 10045

Dear Sirs:

Pursuant to 20 U.S.C. § 1087-3(d)(1), this letter confirms that Treasury finds the form and substance of the irrevocable Master Defeasance Trust Agreement dated December 29, 2004, among the Student Loan Marketing Association (SLMA), its holding company SLM Corporation and the Federal Reserve Bank of New York as trustee, to be satisfactory.

We note that the Department of Education informed SLMA in a letter dated December 20, 2004 that it does not object to the proposed accelerated dissolution of SLMA.

Sincerely,

Wayne A. Abernathy  
Assistant Secretary for Financial Institutions

cc: Albert L. Lord, Vice Chairman and CEO, SLM Corporation  
Marianne M. Keler, President and General Counsel, SLMA  
Thomas C. Baxter, Jr., General Counsel, Federal Reserve Bank of NY





DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C.

ASSISTANT SECRETARY

December 29, 2004

Mr. Duane W. Acklie  
Chairman, Student Loan Marketing Association  
400 NW 56<sup>th</sup> Street  
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Chairman, SLM Corporation  
11600 Sallie Mae Drive  
Reston, VA 20193

Timothy F. Geithner  
President  
Federal Reserve Bank of New York  
33 Liberty Street  
New York, NY 10045

Dear Sirs:

Pursuant to 20 U.S.C. § 1087-3(d)(1), Treasury has determined that the money and direct noncallable obligations of the United States, described in Schedule C of the Master Defeasance Trust Agreement dated December 29, 2004, among the Student Loan Marketing Association (SLMA), its holding company SLM Corporation, and the Federal Reserve Bank of New York, as trustee, and deposited in the irrevocable trust established by the Master Defeasance Trust Agreement, currently are sufficient, without consideration of any significant reinvestment of interest, to pay the principal of and interest on the remaining obligations of SLMA, described in Schedule A of the Master Defeasance Trust Agreement, in accordance with the terms of such remaining obligations.

We note that the Department of Education informed SLMA in a letter dated December 20, 2004 that it does not object to the proposed accelerated dissolution of SLMA.

Sincerely,

Wayne A. Abernathy  
Assistant Secretary, Financial Institutions

cc: Albert L. Lord, Vice Chairman and CEO, SLM Corporation  
Marianne M. Keler, President and General Counsel, SLMA  
Thomas C. Baxter, Jr., General Counsel, Federal Reserve Bank of NY





DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

December 29, 2004

MEMORANDUM FOR ASSISTANT SECRETARY ABERNATHY

**THROUGH:** Greg Zerzan *GZ*  
Deputy Assistant Secretary, Financial Institutions

**FROM:** Philip Quinn *PQ*  
Director, Office of Sallie Mae Oversight

**SUBJECT:** Assessment of SLMA Privatization Trust

**EXECUTIVE SUMMARY**

Pursuant to 20 U.S.C. § 1087-3(d), Treasury must make two determinations related to the trust (Privatization Trust) to be established by the Student Loan Marketing Association, a government sponsored enterprise (SLMA or the GSE) for the purpose of defeasing the remaining SLMA debt obligations (Remaining Obligations) following the dissolution of the GSE. SLMA is prepared to defease the approximately \$1.8 billion face amount of Remaining Obligations and to dissolve on December 29, 2004.

The Office of Sallie Mae Oversight (OSMO) and staff of the Office of General Counsel have negotiated with SLMA, its private holding company, SLM Corporation, and the proposed trustee, the Federal Reserve Bank of New York (FRB-NY), in the development of the Master Defeasance Trust Agreement (or Agreement) dated December 29, 2004 and related documents (attached at TABS 2 and 3).

For the reasons stated below OSMO finds the Master Defeasance Trust Agreement to be satisfactory in form and substance, and the funding for the Privatization Trust to be sufficient, and recommends that Treasury sign the letters that are set forth in the action memorandum dated December 29, 2004, entitled "Treasury Oversight – SLMA Privatization Defeasance Trust."

**SLMA BACKGROUND**

Congress created SLMA as a GSE in 1972 through amendments to the Higher Education Act of 1965 to provide a secondary market for federally guaranteed student loans. Congress later enacted the SLMA Reorganization Act of 1996 (the Privatization Act) that provided for the dissolution and privatization of the GSE by no later than September 30, 2008, if SLMA's shareholders approved a reorganization plan. Alternatively, the Privatization Act required a plan for an orderly liquidation of the GSE by July 1, 2013, if no reorganization of SLMA occurred.

Pursuant to the Privatization Act, SLMA's shareholders approved a reorganization in 1997 that created a Delaware-chartered holding company (SLM Corporation), and became a wholly-owned subsidiary of, the private holding company. This began the

process designed to facilitate a smooth transition for the student loan market, to culminate in the GSE's dissolution and privatization and to provide for the defeasance of SLMA's Remaining Obligations in accordance with their terms.

Throughout most of the transition period, the GSE continued to purchase and securitize student loans and SLM Corporation established non-GSE subsidiaries to enter new lines of business. OSMO conducted annual examinations of SLMA to ensure that the GSE was operated in a safe and sound manner in compliance with the Privatization Act, and that it was making progress toward privatization in a prudent manner. The wind down plan developed included a risk-based capital requirement for SLMA. On June 30, 2004, SLMA took a significant step toward final dissolution – the cutover - when it ceased acquiring federally guaranteed student loans and its non-GSE affiliates began to purchase them.

The Privatization Act allows the early dissolution of SLMA (prior to September 30, 2008) if SLMA provides notice to Treasury and to the Secretary of Education (Education) of its intent to do so and if Education does not object within 60 days of such notice, on either of two statutory grounds. By letter dated November 1, 2004, SLMA informed Treasury and Education of its intent to dissolve on December 31, 2004, or shortly thereafter (TAB 7). In a letter to SLMA dated December 20, 2004 (TAB 8), Education advised SLMA in writing that it does not object to the proposed accelerated dissolution of SLMA.

## **TREASURY DETERMINATIONS.**

Form and Substance of Agreement. On the dissolution date, the Privatization Act requires that SLMA establish and fund an irrevocable trust to defease its Remaining Obligations in accordance with their terms. The “form and substance” of the Agreement must be “satisfactory” to the Treasury as well as to the trustee and to the GSE.

Sufficient Funding of Privatization Trust. The Privatization Act also requires that the Privatization Trust be funded with money or direct noncallable obligations of the United States or any agency thereof for which the full faith and credit of the United States is pledged. The amount to be deposited by SLMA (or if the GSE is unable, by SLM Corporation) must mature as to principal and interest in amounts and at times that Treasury determines to be “sufficient” to pay the remaining obligations, without considering any significant reinvestment of the interest.

## **SATISFACTORY FORM AND SUBSTANCE OF AGREEMENT**

The statute requires that the trust must be for the sole benefit of the bondholders. In the 2004 report of examination of SLMA, OSMO provided SLMA with guidance on principles for the trust and specifically informed SLMA that the Agreement should be as specific and mechanical as possible to minimize future risks to the bondholders. OSMO's findings are:

- Sole Benefit of the Bond Holders. The Agreement states that the trust agreement between the FRB-NY, SLMA, and SLM Corporation (the Holding Company) is designed to be for the sole benefit of the holders of SLMA's remaining obligations, recognizing that SLM Corporation is entitled to any remaining trust assets after all payments to the bondholders are provided for pursuant to the Privatization Act and Section 6 of the Master Defeasance Trust Agreement (Agreement).
- Trustee. The Privatization Act does not name a specific trustee. FRB-NY has agreed to be trustee and is appointed as such under the Agreement. This appointment is not only acceptable to OSMO, we consider it to be preferable to possible commercial bank alternatives because the FRB-NY is the current fiscal agent for the SLMA obligations, does not have a conflict of interest via a business relationship with SLM Corporation, and presumably will continue in existence beyond the termination of the trust. The Agreement appoints the FRB-NY as trustee and specifies its duties including payment of principal and interest payments to holders of the Remaining Obligations and certain reporting and recordkeeping requirements. The Agreement also provides for the payment of fees and expenses of the Trustee by SLM Corporation.
- Full Funding at Inception. The Privatization Act requires that the deposits pledged to the trust must be sufficient, without consideration of any significant reinvestment of such interest, to pay the principal and interest on the remaining obligations in accordance with their terms. To avoid relying upon reinvestment of interest, the Privatization Trust assumes a reinvestment rate of zero on asset cash flows, so-called "gross funding." That is, the liability cash flow requirements are to be met without relying on additional investment earnings from the reinvestment of deposited assets in any period.
- Limited Reinvestment and Subtrusts. The full or gross funding approach results in an additional cost to (or additional "equity investment" by) SLM Corporation when no Treasury security exists currently that exactly matches the maturity date of certain SLMA bond payments. OSMO believes that this result can be partially mitigated while still protecting the interests of the bondholders. The solution is a two-pronged approach that allows limited reinvestments of certain idle cash when trust assets mature before payments are needed, and establishes two subtrusts one of which matures in 2012.

The Privatization Trust agreement provides for the trustee to make certain, limited reinvestments of idle cash from maturing assets. These limited reinvestments are allowed on nine certain dates that are specified in Schedule D of the Agreement. OSMO concluded that the limited reinvestment activity poses minimal operational risk, while reducing SLM Corporation's additional cost of gross funding as noted above. The Privatization Trust is composed of a Master Trust that includes two subtrusts: the first for all SLMA remaining obligations that mature on or before August 1, 2012, and the second for all SLMA remaining

obligations that mature after August 1, 2012. This allows for an early return of trust reinvestment earnings, if any, from the first subtrust to SLM Corporation in 2012, prior to the final return of remaining assets in 2022. This allow SLM Corporation to recapture a portion of its “equity investment” without disadvantaging the remaining bond holders who interest are protected by the second subtrust. The reinvestment provision, in tandem with the subtrust provision, is designed to limit operational risk yet allow limited reinvestments of idle cash.

- SLMA Debt Retirement Provision/ Limited Future Treasury Approval. The Agreement also provides that SLM Corporation may buy back and retire a certain SLMA Remaining Obligation that matures on October 3, 2022. In this event, pursuant to Section 3.03 (d) of the Agreement, SLM Corporation could submit up to two requests to transfer (release) trust assets (collateral) linked to this Remaining Obligation (“excess trust assets”) from the FRB-NY to SLM Corporation. Subject to Treasury approval, the amounts of excess trust assets to be released would be determined by a simple mechanical calculation specified in Schedule E. SLM Corporation would be restricted to only two requests to Treasury for release of excess trust assets and only for more than \$50 million par amount of SLMA’s October 3, 2022, obligation. OSMO believes that this provision fairly provides some relief from the costs associated with gross funding for the October 3, 2022 bond while still protecting the interests of the bondholders. Any risks to the SLMA bondholders and future administrative burden to Treasury are limited because the number of times SLMA may request such release is limited to two, and the requests only apply to one bond.

Treasury’s future role in approving such excess trust assets release is based on Treasury’s statutory responsibility to determine that the trust is sufficiently funded. OSMO has concurred with SLM Corporation’s request that Treasury provide a letter that sets out the basis on which Treasury will approve the two possible releases of collateral, which is included in the action memorandum dated December 29, 2004 entitled “Treasury Oversight – SLMA Privatization Defeasance Trust”.

- No Substitution. The Trust Agreement provides that the initially deposited securities must remain in the Privatization Trust, other than those contemplated by the SLMA Debt Retirement provision. Both Treasury staff and the FRB-NY’s position was that the Agreement could not provide for ongoing portfolio “re-optimization.” Moreover, the Agreement does not allow substitute securities to be placed into the Privatization Trust or otherwise increase the value to the entity entitled to the residual cash, SLM Corporation.
- 1993 Trust. Documents related to the Master Trust Defeasance Agreement resolve the issue of Remaining Obligations currently linked to a defeasance trust created by SLMA in 1993 for accounting purposes (the 1993 Trust). The collateral (funding) backing such Remaining Obligations did not meet the



statutory requirements for funding in the Privatization Trust in part because the 1993 Trust agreement allowed for investment collateral other than US Treasury obligations and allowed for substitution of investment collateral. OSMO considered the SLMA debt linked to the 1993 Trust to be SLMA Remaining Obligations, like all other GSE debt, and therefore subject to the same requirements for defeasance provided by the Privatization Trust. This issue was resolved by providing for the substitution of collateral in the 1993 Trust with conforming collateral and then the merger of the 1993 Trust into the Privatization Trust (TAB 5). In connection with this transaction, the 1993 Trustee provided representations, SLM Corporation provided a letter of broad indemnity (TAB 6) and an investment bank provided an opinion (TAB 6) that the transaction was fair to the bondholders as beneficiaries of the 1993 Trust - all required by the FRB-NY as trustee.

- Termination. The Agreement provides for the termination of each subtrust and of the Master Agreement after provision for all payments to the Holders.

## **SUFFICIENT FUNDING**

Premise. Sufficient funding for the Privatization Trust is achieved if, on and after the settlement date, the net cash position of each subtrust of the Privatization Trust at each cash flow date is greater than or equal to zero, without relying on additional investment earnings from the reinvestment of deposited assets in any period. Sufficient funding requires that all principal and interest calculations be determined at inception and any investment earnings from reinvesting assets be assumed to be zero.

- Reliability and Review Testing. Schedules by subtrust of the Remaining Obligations, trust assets, and reinvestments amounts and dates are attached to the Agreement (Schedules B-1 and B-2, Schedules C-1 and C-2, and Schedule D-1 and D-2, respectively). Prior to the December 29, 2004 closing date, SLMA used these Schedules to prepare the net cash position for each of the two subtrusts at each cash flow date (Cash Flows Exhibits). To ensure that the net Cash Flows Exhibits are reliable, independent testing of all Schedules and Cash Flow Exhibits was performed by the independent accountant, PriceWaterhouseCoopers, LLP (PWC). OSMO reviewed the results of and relied on the agreed-upon-procedures report provided to OSMO by PWC dated December 22, 2004. OSMO has reviewed the agreed upon procedures performed and determined that the procedures were sufficient for our purpose.

OSMO also reviewed prior to closing the Schedules and Cash Flow Exhibits, and other work papers prepared by SLMA used to estimate the cost of defeasing or retiring SLMA Remaining Obligations. This review confirms OSMO's understanding of: (a) how the Trust would be funded, (b) GSE management's plans to call certain GSE bonds prior to maturity, (c) the volume and cost of the defeasance activity, and (d) the magnitude of the cash balances that arise due to cash flow mismatches. OSMO findings are:

- The Schedules and Cash Flows Exhibits detailing the Privatization Trust's assets and obligations, the dates and amounts of all cash flows, and the net positive cash position for every cash flow date are accurate.
- Subject to the Confirmation Test (see below) the Privatization Trust has sufficient assets backed by the full faith and credit of the United States, without consideration of any reinvestment of interest, to pay the principal and interest on the SLMA Remaining Obligations in accordance with their terms.
- Confirmation Test. On December 29, 2004, OSMO received confirmation from the FRB-NY of the securities that were deposited into the Privatization Trust. OSMO agreed Schedule B of the Agreement to the securities listed in the deposit confirmation from the FRB-NY. OSMO finds that the securities deposited to the Privatization Trust are those included in the Schedules and Cash Flow Exhibits that were tested and reviewed prior to closing, and that the funding for the Privatization Trust to be sufficient.

# SallieMae

## NEWS RELEASE

FOR IMMEDIATE RELEASE

*Media Contact:* Martha Holler  
703/984-5178

*Investor Contact:* Joe Fisher  
703/984-5755

### SLM CORPORATION COMPLETES PRIVATIZATION OF STUDENT LOAN MARKETING ASSOCIATION

#### *Federal Charter Terminated Nearly Four Years Ahead of Schedule*

RESTON, Va., Dec. 29, 2004 – SLM Corporation (NYSE: SLM), commonly known as Sallie Mae, announced today that it has concluded a seven year privatization process by defeasing the remaining debt obligations of its government-sponsored enterprise (GSE) subsidiary, the Student Loan Marketing Association (SLMA), and by dissolving SLMA's federal charter.

SLMA was established by Congress in 1972 to create a national secondary market for student loans. In 1996, Congress authorized SLMA to privatize through a corporate reorganization and a transition of the company's business to state-chartered affiliates; shareholders approved the reorganization on July 31, 1997. SLM Corporation is completing this process almost four years ahead of the statutory timeline.

"I am pleased that we have completed this transformation almost four years ahead of schedule," said Wayne Abernathy, Assistant Secretary Financial Institutions of the U.S. Department of Treasury. "We applaud the transformation of Sallie Mae into a wholly private company, dynamically increasing its options to provide financing services to students. This is a mission well accomplished."

Since 1997, Sallie Mae has refinanced its \$100 billion of assets with securitizations and unsecured holding company debt. It has remained dedicated to its original mission of expanding access to higher education while working more directly with schools and consumers. Privatization has also enabled the company to diversify its business beyond student loans into related areas, including guarantor servicing, debt collection and consumer finance. Net interest income from the company's government-guaranteed student loan portfolio — once Sallie Mae's sole business — today represents just more than half of revenues, while private consumer lending and fee-for service businesses comprise the balance.

"Today Sallie Mae completes its journey from somewhere near the intersection of the public/private sectors to the private sector. We shall forever take pride in the student loan marketplace we created to meet the specific need Congress foresaw at our creation in 1972. We now retire the GSE charter, satisfied government's helping hand is no longer necessary to fulfill

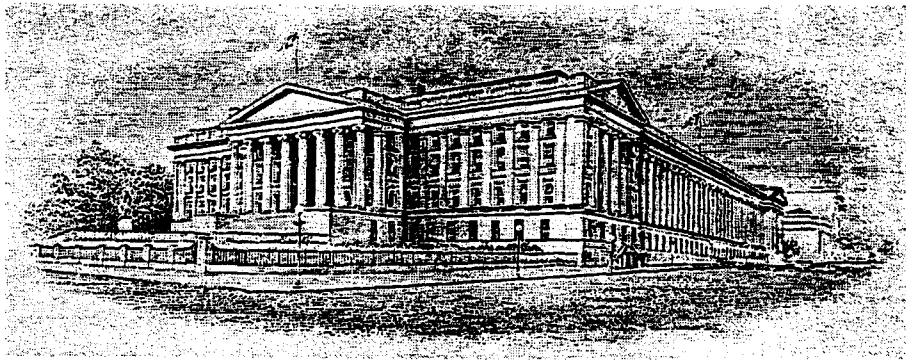
Sallie Mae's higher education mission," said Albert L. Lord, vice chairman and chief executive officer of Sallie Mae.

Lord added, "We are grateful to both the U.S. Department of Treasury and the U.S. Department of Education as we together managed this process in a manner satisfactory to the many interested parties."

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**SLM Corporation (NYSE: SLM)**, commonly known as Sallie Mae, is the nation's No. 1 paying-for-college company, managing more than \$98 billion in student loans for more than 7 million borrowers. Sallie Mae was originally created in 1972 as a government-sponsored entity (GSE) and terminated all ties to the federal government in 2004. The company remains the country's largest originator of federally insured student loans. Through its specialized subsidiaries and divisions, Sallie Mae also provides debt management services as well as business and technical products to a range of business clients, including colleges, universities and loan guarantors. More information is available at [www.salliemae.com](http://www.salliemae.com).

###



## DEPARTMENT OF THE TREASURY OFFICE OF PUBLIC AFFAIRS

**Embargoed Until 12:45 pm EDT  
December 29, 2004**

**Contact: Rob Nichols  
202-622-2920**

### **Treasury Announces Successful Privatization of Sallie Mae**

Treasury officials today completed the formal cutting of all ties of the Student Loan Marketing Association, commonly known as Sallie Mae or SLMA, with the federal government. Documents signed at the Treasury Department this afternoon effectively dissolved Sallie Mae, a government-sponsored enterprise subsidiary of SLM Corporation, completing a process that began in 1996. Today's action completed the transformation of Sallie Mae to a fully private corporation.

"The privatization of Sallie Mae was considered something of an experiment when proposed in 1996," said Treasury Assistant Secretary for Financial Institutions Wayne A. Abernathy, who signed the documents that made the transition final. "I am pleased that we have completed this transformation almost four years ahead of schedule. We applaud the transformation of Sallie Mae into a wholly private company, dynamically increasing its options to provide financing services to students. This is a mission well accomplished."

Congress originally established Sallie Mae in 1972 as a government-sponsored enterprise (GSE) to help students by facilitating a secondary market in federally guaranteed student loans. As a GSE, it had benefits such as exemptions from state and local taxes, but it was limited in the kinds of business it could enter.

In 1996, Congress enacted the SLMA Reorganization Act, which began the process of converting Sallie Mae into a private business while still meeting the needs of the borrowing student public. Sallie Mae's shareholders approved a reorganization that created SLM Corporation, a Delaware-chartered holding company, and the Sallie Mae GSE became its wholly-owned subsidiary. This process facilitated a smooth transition for the student loan market, culminating in the GSE's dissolution today. The Sallie Mae privatization included the establishment of a trust, satisfactory to Treasury, defeasing the remaining liabilities of the GSE. The dissolution of SLMA is well ahead of the September 30, 2008 deadline set by Congress.

The Treasury Department has exercised oversight responsibilities over Sallie Mae, including monitoring its privatization process. The document signed by Assistant Secretary Abernathy today is a formal recognition, required by the law, that the outstanding obligations of the now-dissolved GSE are sufficiently collateralized.