The Role of the U.S. Federal Government in the Student Loan Industry

by

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Submitted to the MIT Sloan School of Management
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Abstract
Beginning in the early 1980’s, average tuition and fees for higher education institutions in the United States experienced two decades of unprecedented growth. Over the 10-year period ending in 2003-2004, average tuition and fees rose 47 percent at public four-year colleges and universities and 42 percent at private four-year institutions. The growth rate over the preceding decade was even more significant at 54 and 50 percent, respectively. Much of the liquidity required by students and families to fund the cost of higher education has been supplied by the SLM Corporation, also known as Sallie Mae. Founded in 1972 as a Government Sponsored Enterprise (GSE), Sallie Mae is the nation’s largest source of funding for higher education loans. Like other GSE’s, Sallie Mae has been accorded a series of benefits which it has used to great benefit.

Objective: This thesis:
1) Discusses the history of the student loan industry, including origins and significant events in its development
2) Examines the financial relationship between the federal government, Sallie Mae, institutions of higher education, and students
3) Evaluates the role of the federal government in the student loan industry and proposes alternative models

In light of the social, economic, and political benefits affiliated with higher education, potential obstacles such as accessibility and affordability are critical considerations. As a significant funding mechanism, the student loan industry directly impacts these issues and therefore plays a critical role in the current and future welfare of society.

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I. Executive Summary

"Over the past three decades, the Federal Government has poured three-quarters of a trillion dollars into financial aid for college students...so why is college getting less – not more – affordable? One answer seems to be that all those federal dollars have given colleges more room to jack up tuition ...the more cash the government pumps into parents’ pockets, the more the schools siphon from them." ¹

Beginning in the early 1980s, average tuition and fees at colleges and universities in the United States experienced two decades of unprecedented growth. Over the 10-year period ending in 2003-2004, average tuition and fees rose 47 percent at public four-year colleges and universities and 42 percent at private four-year institutions. The growth rate over the preceding decade was even more significant at 54 and 50 percent, respectively. ² Much of the liquidity required by students and families to fund the cost of higher education has been supplied via programs funded by the U.S. federal government and, in turn, the SLM Corporation, also known as Sallie Mae. Sallie Mae is the nation’s largest source of funding for higher education loans. It was founded in 1972 as Government Sponsored Enterprise (GSE). Like other GSE’s including mortgage giants Fannie Mae and Freddie Mac, Sallie Mae has been accorded a series of implicit and explicit benefits by the federal government which it has used to great advantage and which has resulted in significant financial rewards for investors and executives. Yet not everyone has been satisfied with the federal government’s role in facilitating aid for post secondary students. In particular, the student loan industry, the largest and fastest growing segment of student aid, has come under fire.

Since the 1970s federal student loan programs have been a public policy nightmare. While politicians, economists, industry experts and everyone in between have lodged their opinion, comparatively few have actually attempted to disentangle the web. The result has been a snarled mélange of inconsistent, controversial, ill-advised, and occasionally downright confusing attempts to correct and regulate this industry.

In light of this, the objective of this paper is to achieve a detailed understanding through research and reflection of one of the more contentious topics in U.S. public policy: the federal government’s affiliation with the student aid industry. At the outset of my research, I believed the key question was whether or not the federal government should continue to intervene in an industry that appears to be serving its stated role remarkably well. After all, since 1966, approximately 50 million American students and their families have borrowed more than $485 billion in higher education-related loans to finance their education at more than 6,000 schools across the United States. However, after completing preliminary research and attaining a much deeper appreciation of the issues and challenges, I believe that given the fundamental importance of higher education, its changing financial dynamics, and its role in shaping the economic, social, and political aspirations of the nation, the more appropriate question is not whether or not the government should intervene in the industry, but rather in what capacity the federal government should interact with the student aid industry.

Assuming that the government should indeed continue to participate, the appropriate solution then is to propose a role that will ensure the efficacy, efficiency, and longevity of the student aid industry and, in turn, directly serve the needs of past, current, and prospective students. In attempt to answer this question as well as contemplate aspects that such a strategy might include, this paper is segregated into three sections. Section 1 provides historical context regarding the birth of the student aid industry, including origins and significant events in its development, re-examines its objectives, and discusses the fundamental importance of the industry. Section 2 examines the relationship between the four key constituents, including federal government, Sallie Mae, institutions of higher education, and students. Section 3 identifies some of the hallmarks that a successful policy might include and proposes a series of recommendations including:

1. Simplification of rules and regulations
2. Allow the industry to be guided by free market principles
3. Facilitate collective oversight to ensure that the goal of the marketplace – namely that students have access to liquidity - is being satisfied

3 http://www2.sallie Mae.com/news/highereducationstats
4. Encourage participation by colleges and universities

I.a Is This Topic Important?

Given well-documented trends in the price of higher education, it is not difficult to understand why “public anxiety about college prices has risen along with increases in tuition. It is now on the order of anxiety about how to pay for heath care or housing, or cover the expenses of taking care of an elderly relative. Financing a college education is a serious and troublesome matter to the American people." If we assume that college prices are unlikely to be altered downward, the question becomes one of affordability verses the cost/benefit relationship between a college verses a high school education. Further, if we assume that for many students, pricing and the related concept of liquidity rather than grades, desire, supply, or other significant hurdle, is the gatekeeper to a college education, is the benefit of the advanced education enough to outweigh the cost of the education financed by student loans?

The American public has responded overwhelmingly “yes.” In the last 40 years, approximately 50 million American students have borrowed close to $500 billion in higher education-related loans. Even still, according to the Advisory Committee of Student Financial Assistance, “cost factors prevent 48 percent of college-qualified high school graduates from attending a four-year institution, and 22 percent from attending any college at all.” This, despite the fact that “today, the average value of bachelor’s degree is about $1.5 million higher than a high school diploma, a differential that is growing as rapidly as today’s tuition costs.” Students and their families recognize the economic benefit of higher education. Sadly, one in five young Americans who desire a post-secondary education cannot afford it.

The issue at hand then is the machination of an industry that fundamentally impacts the affordability and accessibility of higher education. One critical challenge – and thus a significant opportunity - is that the federal student loan program, the principal vehicle by

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4 The College Cost Crisis: A Congressional Analysis of College Costs and Implications for America’s Higher Education System. September, 2003. pg. 4
5 http://www2.salliemae.com/news/highereducationstats
6 Sallie Mae 2004 Annual Report, pg. 3
7 Sallie Mae 2004 Annual Report, pg. 3
which the primary source of student aid is disseminated, "is not and never has been a coherent public policy. Rather, 'it is a pastiche of goals, programs, strategies, incentives and disincentives' that has no overall philosophy or purpose...it has become a thicket of statutes, regulations, guidelines, and confusing and contradictory policy objectives.'" 8

True to its turbulent roots, the last decade has offered significant upheaval in the industry. In the late 1990s, the central debate focused on the interest rate: a significant cost and profit driver of the industry. The federal government frequently toyed with the rates at which lenders could lend and the rates at which borrowers could borrow by instituting a complex series of implicit and explicit charges and subsidies. As we will see, given the volume, even small changes in these rates have the potential to create both huge incentives and disincentives for participation. As 6 million eager college students looked on, lenders grew increasingly disenchanted with the government’s intervention. Republicans and banking executives warned that any miscalculations in the rates would be dangerous because lower rates of return could significantly hinder the liquidity of the student loan marketplace, something that has been largely taken for granted for over four decades.

For decades, Sallie Mae was able to borrow money at below market rates due to its favored status as a GSE. However, in the 1990s Congress decided again to intervene, this time by instituting a 30 basis point fee against its borrowing. In an effort to distance itself from the interventionist tinkering by the government as well as the inherent limitations of its status (both topics discussed later in the paper) as a GSE, Sallie Mae initiated a privatization movement in 1997. Privatization was viewed as a vehicle that would permit Sallie Mae to diversify its fundamental operations, moving into areas contiguous to its operations such as debt collection and guarantor servicing, yet which it was previously unable to invest in due to its GSE status. On December 29th 2004, Sallie Mae finalized its separation from the federal government four years ahead of schedule; clearly, a highly motivated effort.

8 Condemning Students to Debt: College Loans and Public Policy, Richard Fossey and Mark Bateman, pg. 179
Sallie Mae has recently been referred to as “Frankenstein’s monster,” created through a series of misguided policies and then let loose by the federal government to prey upon an unsuspecting populace. Even still, Sallie Mae is aggressively pursuing its own fate. However, a $100+ billion question remains: what of the federal government’s role in the industry? In light of the social, economic, and political benefits affiliated with higher education, potential obstacles such as accessibility and affordability are critical considerations. As a significant funding mechanism, the student loan industry directly impacts these issues and therefore plays an important role in the current and future welfare of society. Is this topic important? I believe it to be crucial to the nation’s vitality!

II. Section I

This next section introduces and frames the issue by contextualizing college costs and highlighting important shifts in the way the public views higher education. Additionally, it provides an overview of the development of the student loan industry and role of the federal government in its evolution.

II.a Framing the Issue: Contextualizing College Costs

Although the system of higher education in the United States is widely considered to be the preeminent one in the world, spinning on a dual axis of quality and access, colleges and universities are facing significant criticism from both external and internal sources. At the core of recent volleys has been the ever-increasing rise in tuition rates. Despite the fact that tuition has been rising by 2-3 percent per year in real dollars since first tabulated early in the century, only since the late 1990s have critics become so voluminous and outspoken.

Despite the fact that tuition grew at a constant rate throughout much of the century, it was not until the 1980s that it began to outstrip family income, vis a vis the Consumer Price Index (CPI). Since that time, tuition has eroded ever-increasing shares of family income. “In the 1970s, there was little, if any, real growth in college prices. In the early 1980s, however, tuition and fees began to grow much more rapidly than consumer prices. In constant 2004 dollars, over the 10-year period ending in 2004-05, average tuition and fees rose 51 percent
($1,725) at public four-year colleges and universities, 36 percent ($5,321) at private four-year colleges, and 26 percent ($426) at two-year public colleges.” Further, from the two-year period spanning 2002-03 to 2004-05 there has been a 20% increase.  

Average Tuition and Fees Growth since 1993 in Constant 2003 Dollars

Source: The College Board

II.a.1 Why Has Cost Risen So Dramatically?

There are many possible explanations for the meteoric rise in the cost of post-secondary education, each of which merits some consideration. The purpose of this short section is not to comment on the accuracy or plausibility of the explanations. It is simply to present information. In reality, each of the factors presented below likely has some causal relationship with the sharp increase in tuition.

First, colleges and universities, specifically public ones, are dependent upon state and federal government appropriations for revenue. Appropriations are cyclical. From 1986-87, appropriations declined for six consecutive years and appropriations per full time equivalent (FTE) student “declined by 9 percent in constant dollars between 2001-02 and 2002-03.” Not surprisingly, tuition and fees also exhibit cyclical behavior, tied directly to appropriation. The portion of institutional revenues coming from government appropriations has declined from 50 percent in 1980 to 43 percent in 1990 and 36 percent in 2000. Tuition, meanwhile, at

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10 Ibid
11 Ibid, pg. 4
public four-year colleges and universities has increased more than 51% in the past decade alone. Thus not only has the students’ portion of the burden increased dramatically, so too has the overall burden.  

Second, colleges and universities, historically slow to adapt to changes in the economic environment, were unable to raise tuition rapidly enough to keep up with the inflationary economy of the 1970s. As a result, faculty salaries lagged behind cost of living increases and colleges and universities deferred maintenance on capital property. Despite the fact that inflation slowed dramatically in the 1980s, institutions, again, slow to react, continued raising prices, ostensibly to restore faculty salaries and address deferred maintenance issues. These increases persisted to outstrip the CPI, resulting in even further erosion of family income. While potentially acceptable in the 1980s and perhaps even early 1990s, unfortunately, this explanation holds less merit when examined over a longer period of time. It has now been more than 20-years of dramatic growth in “sticker price”. University administrators would not be considered slow to react, simply asleep at the wheel. “Institutions of higher education, even to most people in the academy, are financially opaque. Academic institutions have made little effort, either on campus or off, to make themselves more transparent, to explain their finances.”

Third, as a means to garner external funding and respect, many colleges and universities became embroiled in a competition for public and private gifts and grants. In the fight to become “upwardly mobile,” colleges and universities initiated new departments and research programs. New programs such as these required funding. Student tuition represents a primary source of unrestricted revenues.

Fourth, competition for quality students became increasingly intense. A broad swath of institutions continue to invest in “high appeal” equipment such as state-of-the-art dormitories, computing centers, athletic facilities, and other physical plant in an attempt to attract such students. A Boston Globe story published December 18, 2004, begins as follows:

12 Ibid, pg. 4
“The climbing wall is 35 feet high. The hot tub fits 25 people, maybe more. Then there’s the lazy river, a 100-foot-long pool with water flowing around its curves. Membership in this deluxe health club will be free, at least for students already paying $40,000 a year to live and study at Boston University.” BU’s chief spokesman, Stephen Burgay, stated that “(t)he university needed to make an investment that really differentiates us. It gets us competing for the best student and faculty.” In fact, BU is not alone in their $90 million “investment.” The article goes on to identify MIT’s $54 million Zesinger Center and Northeastern’s $15 million Marino Center as other significant student-focused capital outlays. In order to balance the books, such significant outflows require concomitant inflows. In the same article, Robert Atwell, president emeritus of the American Council on Education, notes that the “high appeal” equipment is “driving up the sticker price, no question.”

Fifth, as costs escalated it became apparent that students and their families were willing to pay more for a “name-brand” institution. Described as the “Chivas Regal effect,” some believe that during the 1980s price became equated with quality. Under the rubric of competition, colleges and universities felt compelled to keep their prices abreast of the “market.” When questioned about the reality of cutting tuition John Fry, the University of Pennsylvania’s Executive Vice President for Finance, replied: “… I know the sort of instinctive response is: Hey, we won’t look as good as Harvard. It is a tricky thing. You don’t want to get into a situation where this thing (reducing price) hurts you.”

Lastly, there is one remaining factor to be considered, student loan aid programs. A final explanation for rising costs that certainly could have a profound impact on the student loan industry is the following: It is precisely because of the vast and growing availability of federal funding through the liquidity provided by the student loan industry that colleges and universities have been able to raise tuition and fund the necessary expenses to remain competitive. This claim was specifically refuted by the members of The National Commission on the Cost of Higher Education, a federally mandated group of industry experts.

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14 The Boston Globe, December 18, 2004
16 Ibid
whose charge it was to analyze the casual factors and effects of rising costs of higher education. In their report, *Straight Talk About College Costs and Prices*, they stated that: “The Commission finds no evidence to suggest any relationship between the availability of Federal grants and the costs or prices of these institutions.” However, the paper then goes on to state that “this question (specifically with respect to loans) should be studied in greater detail and with much greater attention to empirical facts.”

Given the complexity of the relationships and the number of constituents in the industry, it would be difficult to prove or refute a relationship between the availability of funding and the rising cost of higher education. It is a classic chicken-or-egg conundrum: Does liquidity/availability drive costs or do costs drive liquidity. It would be ironic to find that one of the cornerstones of the federal government’s quest for social mobility and equity had actually de-stabilized the industry. At a minimum, the ramifications of this allegation are relevant to this analysis. Simply put, it illuminates the growing necessity of the presence of the student loan industry, specific concerns about its workings, and the role that it has played and will likely continue to play within the higher education industry.

II.a.2 A Shift in Public Perception: The Student/ Family as Investors

In many ways it may be irresponsible to simply consider the student/family as the sole purchaser of the educational “product” that is being sold. In a larger and perhaps more relevant sense, it is society at large which is purchasing the education. To understand the motives of the student as investor then, it is important to consider this role within the context of the rising cost of tuition. “Higher education is now much more widely appreciated as an investment in human capital than it once was. While many economists have always regarded education as an investment, the more widespread acceptance of this view may make the public more willing to tolerate - at least for the time being - sizable price increases. And like many investors, the public is willing to pay a premium for blue-chip quality.” Interestingly, the author exhibits remarkable foresight in his thinking (this quote was culled from a text

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18 Ibid
19 Beneath the Surface: College Is Not as Costly as It Seems, Educational Record, Spring/ Summer 1986, pg. 17
written in the mid-1980s). Indeed, higher education has increasingly grown to be considered an investment.

At first pass, this usage of standard business jargon such as “investment” seems dissonant with higher education. However, the fact is that it has come to resonate with industry experiences in the past few decades. Why? Simply put, the rising cost of tuition has forced most students to “invest” in a future return of risky nature. Indeed, according to a study produced by the United States General Accounting Office, “from school year 1980-81 through 1994-95, tuition at 4-year public colleges and universities has risen nearly three times as much as median household income.” Further, since the 1980s tuition and fees have far outstripped both median family income and consumer prices. In fact, from school year 1980-81 through school year 1994-95, the average tuition increased from $804 to $2,689 per year, or 234 percent, for full-time, in-state residents. Conversely, median household income rose from $17,710 to $32,264, or approximately 82 percent, and the CPI rose 74 percent during the same time period. On an annualized basis, tuition has increased approximately 9 percent and median household income has increased approximately 4.4 percent while the CPI has increased approximately 4 percent. When evaluated over the broader horizon of 1976 to 2003, according to Dr. Mike Walden of North Carolina State University, “annual tuition and fees at public four-year colleges jumped 143 percent, in inflation-adjusted terms...over six times faster (emphasis added) than the increase in median household income.” Finally, according to the U.S. Department of Education’s National Center for Education Statistics, over the 1980s and 1990s, “adjusted for inflation, tuition more than doubled at public and private not-for-profit 4-year colleges and universities. During the same period, median household income grew 27 percent.”

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21 Ibid
22 You Decide: How Can We Afford College, Dr. Mike Walden, North Carolina State University http://www.cals.ncsu.edu/agecomm/writing/newsrels/5-26-04a.htm
23 Congressionally Mandated Studies on College Costs, pg. 6
II.a.3 Access and Future Return on Investment

Implicit in this data are several important considerations. First, as discussed earlier, one of the bedrock foundations upon which our system of higher education is premised is accessibility, particularly in public institutions. In contrast, the relationship between CPI, family income and comparative tuition increases in colleges and universities, especially public ones, illustrates that colleges and universities are becoming less accessible, when analyzed as a function of these same metrics. Although there are mitigating factors, including the omnipresent cost versus price debate, the fact remains that tuition dollars consume approximately twice the proportion of household income as they did in 1980. One might easily speculate that these increases in tuition could have the effect of placing a collegiate education out of reach of those students marginalized by economic factors.

Interestingly, despite these rapid increases in the cost of attending both public and private institutions of higher learning, young men and women are attending post-secondary institutions in ever-increasing droves. Why? Society “rewards” these individuals by paying them greater salaries than their less educated peers. “Within each demographic group, median annual earnings for year-round, full-time workers with bachelor’s degrees are about 60 percent higher than earnings for those with only a high school diploma. The typical earner with a graduate degree earns over twice as much as a high school graduate. Over a lifetime, the gap in earnings between those with a high school diploma and those with a B.A. or higher exceeds $1,000,000 by some statistics.
As a result, students and their families are not only willing to invest in higher education but engage in fierce competition with one another for acceptance into the “best” schools. In fact, despite the aforementioned increases in the tuition, many of the preeminent colleges and universities in the United States are experiencing record application rates. This is not surprising given the fact that it is the graduates of these same institutions who, on average, earn the “highest rate of return” on an otherwise risky investment.

Ultimately, as economic actors in the business of higher education, the fundamental shift by students towards viewing education as a long-term investment is not without merit. Like most other investments, a future return in the form of monetary gain is not necessarily guaranteed. However, unlike most other investments, the primary benefit, that of the transferal of knowledge necessary to achieve monetary gain, is guaranteed as long as there is a receptive pupil and a reasonably adept teacher. In this respect the true investment lies in one’s own education, which represents a portable version of human capital - the benefit of which may or may not yield monetary gain. “Education, then, must (emphasis added) be thought of in terms of the benefits it will yield over a lifetime. In this sense it is an investment.”

From this perspective, it would appear the increase in tuition has some merit. In a classic quid pro quo relationship, the students/investors are paying for the right to earn a greater potential return.

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24 Ever the Teacher, Thinking About Tuition, William Bowen, pg. 529
How then, in the facing of rising prices, are students paying for this investment? Increasingly, post secondary education is being funded through both public and private loans, generally guaranteed by the federal government. While the volume of student loan borrowing is staggering ($485 billion), even more relevant is the slope, or rate of growth, in loans as a source of funding. In fact, during the 1990s “American college students have borrowed as much as the amount borrowed in the 1960s, 1970s, and 1980s combined.” Furthermore, “borrowing is increasing at a rate nearly three times as fast as college costs and four times as fast as personal incomes.” In 1965, there was $600 million available for financial aid. For the academic year 2004-05, there is $122 billion!

II.b The Federal Government and Higher Education: A Brief History

This next section outlines major developments in the tumultuous role of the federal government in higher education, and traces its roots from the Morrell Act of 1862 through today.

II.b.1 Pre 1960s: Early Forays into Funding Higher Education

“For most of American history, the federal government had little to do with higher education. It neither regulated the activities of the nation’s colleges nor provided them with much money.” Colleges and universities were “ivory towers”, free to pursue the academic interests of their students and professors.

Four notable exceptions to the generally “hands-off” policy included the Morrell Act of 1862, which instituted land grant agricultural colleges, the National Defense Act of 1916, which…… the Service Man’s Readjustment Act of 1944 and the National Defense Act of 1962. Targeted at assisting the millions of veterans returning from World War II to return to

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25 The Educational Resources Institute (TERI), College Debt and the American Family, pg. 6
26 Ibid
27 http://www2.salliemae.com/news Quick stats
28 Removing the College Price Barrier $$ $$: What government has done and why it hasn’t worked. Michael Mumper, pg. 75
the domestic labor force, Service Man’s Readjustment Act of 1944 authorized benefits ranging from family allowances to educational vouchers. These vouchers provided veterans with portability, access and choice when pursuing their educational goals. The most important concept of the so-called “GI Bill of Rights,” however, was that it invested in young people at the outset of their professional careers. “To its many supporters, it was a benefit program for military service that was merely disguised as college aid.”

With the backdrop of the late 1950’s Cold War, the federal government moved to create a closer, more formalized relationship between itself and U.S. institutions of higher learning. President Eisenhower, in response to the launch of the Sputnik, asked Congress to appropriate $1.6 billion to improve education in the sciences and foreign languages. Ultimately, in 1958 Congress passed the National Defense Education Act (NDEA). A primary provision of the NDEA was the creation of the first federal student aid program, the National Defense Student Loan (NDSL), now called the Perkins loan. The NDSL provided colleges and universities with capital that in turned could be used to lend to students and low interest rates. Initially, the federal government was to contribute approximately 90 percent with the remaining 10 percent provided by the colleges and universities themselves. The strategy was to create, through an initial seed investment, a self funding mechanism whereby loans would be made to students directly from the institutions. The students would graduate, and the loans plus a small interest charge would be collected. The capital and proceeds would be used then to fund additional students.

The importance of the NDSL and NDEA was two fold: It was the first notable attempt at providing liquidity for the general populace to attend a college or university; second, there was a clear recognition of the need to provide access for talented yet financially needy students.

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Ibid
II.b.2 The 1960s and 1970s: Promoting Equal Opportunity

If the NDSL and NDEA represented a cautious attempt to “dip the toe in the water”, the watershed event then in the establishment of the federal government’s role in higher education was the passage of the Higher Education Act of 1965. “The Higher Education Act (HEA) of 1965 was sweeping legislation intended, among other things, to provide disadvantaged students with the financial resources to attend college.” 30 The underpinning of this legislation was providing opportunity to underprivileged students. As far back then as 1965 it was recognized that federal intervention was required to remedy “the appalling frequency with which a student is presently forced to forego the opportunity of post-secondary education because of inability to meet the costs.”

The HEA of 1965 included five major provisions, or “titles”. “In combination, these titles drew the federal government into the funding of higher education to an unprecedented degree and, for the first time, explicitly articulated the clear national goal of making college affordable to all Americans through student aid.” 31 Title I focused on community service and continuing education programs. Title II focused on upgrading college and university libraries. Title III ensured aid to historically black colleges. Title IV provided provisions for student financial aid. Title V created the National Teachers Corps.

Ultimately, Title IV provided the most far reaching effects. Title IV created two new types of student assistance, Educational Opportunity Grants (EOG) and the Guaranteed Student Loan (GSL) Program, and essentially formalized the structure of a third, pre-existing format, campus-based aid including College Work-Study aid and the Perkins loan, previously known as the NDSL.

The next major development in the federal government’s role in student aid did not arise until the Higher Education Reauthorization Act of 1972. In lieu of the EOG, Senator Claiborne Pell proposed and Congress subsequently approved the Basic Education Opportunity Grant (BEOG). The BEOG provided a greatly expanded and stable base of

30 Ibid, pg. 78
31 Ibid, pg. 78
funding and support, administered from a central location in Washington. This ensured that requests for funding were both examined and approved in a consistent fashion, rather than the ad hoc, campus based approach that was used under the EOG. The BEOG, renamed the Pell grant, grew quickly in popularity. In 1974, just the first year it was offered, more than 1.2 million students, approximately 16% of all undergraduates, received support through the program. 

Throughout the remainder of the 1970’s, other new programs such as the Supplemental Education Opportunity Grant (SEOG), providing federal matching funds for state scholarship monies, the Middle-Income Student Assistance Act (MISAA), providing assistance for the increasingly marginalized middle class, and enhancements to the core HEA through additional provisions, most notably Title IX, were developed and embraced. By the end of the 1970’s, it was generally recognized that the federal government’s expanding role of providing liquidity to needy students was successful. “As the 1970s came to an end, the situation of the lower-income student hoping to go to college was better than it had been at any time in more than twenty years.”

II.b.3 The 1980s: A Not-So-Subtle Shift in the Burden

The year 1980 found the United States in tumultuous social, political, and economic times. High unemployment, high inflation, high interest rates, and international strife proved a noxious cocktail for voters. Student aid programs grew 66% in a four year span. In 1978, the government appropriate $10.6 billion. By 1982, this figure had ballooned to $16.8 billion. Much of the cost of the program was due to two factors. First, the MISAA program had been wildly successful, accounting for much of the 200 percent participation increase from 1978 to 1982. Second, the GSLP capped interest rates at 7 percent, and as noted above, was required to provide a subsidy to the lender equal to the net of the market rate and rate at which the borrower paid. In 1978, the market rate was approximately 14 percent. The result was: 1) an incredibly cheap sourcing of funding for students, 2) marketing returns for the lenders who

32 Ibid, pg. 83
33 Ibid, pg. 88
were “made whole” by the government, and 3) a highly expensive program squarely supported on the shoulders of the federal government. 34

Even as President Carter was re-authorizing a slightly more restrictive Higher Education Act of 1980, the American public’s choice for leadership focused on Ronald Reagan and his platform of cutting non-defense spending. Elected President in 1981, Reagan moved quickly to decentralize government, reducing and in some cases eliminating, federal funding. Given its rapid rise, the federal student loan programs fell under the knife. There were substantial adjustments made to the programs including the re-instatement of a needs analysis test as well as additional fees assumed by the students. In short, Reagan was re-adjusting the relative financial burden borne by the three legged chair represented by the student, the institution, and the government.

Despite Reagan’s early cutbacks and substantial influence, the higher education lobby successfully confronted additional attempts. Congress and President Reagan reached a stalemate that would not be undone and although a compromise was ultimately reached in via the HEA of 1986, neither side was happy with the results.

Further, as a direct result of the stalemate a subtle but important shift had taken place in the underpinnings of the federal aid programs. “The rapid tuition inflation of the 1980s meant that even as federal support was holding steady, the purchasing power of that support was eroding. Also, each year a larger percent of the total federal aid was going to support the rising costs of the GSLP, leaving fewer dollars for grants. As a consequence, the federal student-aid programs were changing, but not as a result of explicit policy choices. They were being transformed as a result of legislative deadlock and programmatic drift.” 35 Furthermore, this “drift” occurred during a time when average college costs had more than doubled.

34 Ibid, pg. 90
35 Ibid, pg. 96
II.b.4. The 1990’s to Present: More Attempts at Disentangling the Web

Since the HEA of 1962, the federal government has played a significant, if highly inconsistent, role with respect to the student loan industry. In a not-so-subtle example of this inconsistency, according to an Investor’s Business Daily article from June 29th, 1993, President Bill Clinton criticized Sallie Mae, “noting that between 1986 and 1991, the company’s costs ‘went down by 21% and its profits went up by 172%.’…Sallie Mae responded basically by noting that the federal government set it up as a profit-making corporation.” Never-the-less, Sallie Mae’s stock plunged in February of 1994, losing over 40% of its value, thanks in large part to Bill Clinton’s crusade against for education funding reform.36

As the federal government analyzed the cost of doing business using middlemen like Sallie Mae, the Department of Education (ED) and President Clinton believed that it may be cheaper to “cut out” the middlemen and provide federally funded money directly to the students. Concerned with Sallie Mae’s flourishing financial picture and the rewards being reaped by executives and a limited number of investors, Clinton first levied a 30 basis points “offset” fee on Sallie Mae’s borrowing, which initially curtailed its borrowing advantage. Next, by an act of Congress, Clinton pushed through the establishment of the Student Loan Reform Act (SLRA), which was targeted at simplifying and reducing the costs associated with the increasingly complex and difficult to regulate student loan industry. Despite its current and potential shortcomings, the FDSLP has provided a necessary form of market competition in the student loan industry, forcing existing lenders to innovate, which is exactly what Sallie Mae has done.

On August 7th of 1997, Sallie Mae consummated a reorganization that was originally scheduled to dissolve its status as a Government Sponsored Entity (GSE) as of September 30, 2008, a goal which was achieved almost four years early, on December 29th, 2004. Just as the scope of the operations of any other GSE is limited by its charter, so too was Sallie Mae’s. Most notably in Sallie Mae’s case, the act of privatization will free it from the following

36 End Bank Loans to Students? If government takes over, it could cost billions
burdens. First, it will no longer be liable for the 30 basis point offset fee which Clinton established. Second, it is no longer required to be the "lender of last resort." In other words, as an entirely private company, it reserves the right to make or withhold loans at its own discretion. Finally, and perhaps most significantly, Sallie Mae is no longer restricted as to the scope of its operations. Whereas it previously was only chartered to act as a secondary market purchaser, Sallie Mae’s operations are no longer constrained, either within the student loan industry or outside. In short, the fledgling Sallie Mae that received significant operating advantages via support and protection from the government throughout its formative years, will now go out on its own and reap the benefits of its substantial competitive advantage.

With this most recent shift in events, the student loan industry, the federal government, institutions of higher education, and of course, the 7,000,000 students across the nation find themselves at a significant crossroads. Later in this paper, we will consider the implications of the FDSL and the privatization of Sallie Mae. But first, the next section examines the mechanics of the student loan industry - including a summary of federal financial aid programs, identifies the benefits and, more recently, the charges that have accrued to Sallie Mae, and discusses the emergence of the FDSL as a significant source of competition.

III. Section II

III.a Summary of Federal Financial Aid Programs

Before we investigate the complexities of the lender marketplace, it is worthwhile to summarize the various federal financial aid programs available to students. There are, in essence, six ways of funding a college education. The vast majority of students take advantage of a number of these vehicles. These six vehicles are scholarships, loans, grants, tax credits, family savings, and work-study programs. This discussion will focus on loans and grants which are dramatically larger in size and scope than the other federal programs, including tax credits and work-study. "The federal government provided over $70 billion in student aid during 2002-03, a real increase of 11 percent over the previous year. Loans constitute 69 percent of federal aid, down from 78 percent in 1997-98, but still higher than the
64 percent a decade ago. Grants constitute 22 percent of federal aid and the Hope and Lifetime Learning federal tax credits now account for almost 8 percent.37

III.a.1 Grants

Grants represent aid that does not have to be repaid. Grants offered through the federal government are generally for undergraduate students and are based upon three criteria: need, cost of attendance, and enrollment status.38 The two predominant federal grants include the Pell Grant and the Supplemental Education Opportunity Grant (SEOG).

- Pell Grants: “Pell Grants are entitlements. This means that if a student qualifies, he automatically receives the money. The determination of how much a student receives is based on a separate formula…Since Pell Grants are based on need, the student will receive more money if he attends a more expensive school. In other words, how high the tuition is, not how low family income is, determines the size of the grant.”39

- SEOGs: SEOG’s are designed specifically to augment the Pell Grant. Unlike the Pell Grant, the money that funds the program is distributed to colleges and universities. The institutions themselves then analyze each student’s financial burden. “SEOG is not an entitlement program. Rather, it is discretionary on the part of the colleges.”40

III.a.2 Loans

“The size of the federally insured student loan market has more than doubled over the last ten years with student loan originations growing from $24 billion in FFY 1994 to $52 billion in FFY 2003.”41 Unlike grants, loans represent money students borrow and which must be repaid with interest. Loans offered through federal government programs fund both

40 Ibid, pg. 36
41 United States Securities and Exchange Commission, Form 10-K Filing, SLM Corporation, page 7
undergraduate and graduate students. In addition, parents may also borrow to fund their child’s education.

There are two primary vehicles for lending/borrowing federal money: The William D. Ford Federal Direct Loan (Direct Loan) Program and the Federal Family Education Loan (FFEL) Program. Under the Direct Loan program “eligible students and parents borrow directly from the federal government at participating schools. Direct Loans consist of Direct Stafford Loans, Direct PLUS Loans, and Direct Consolidation Loans.” 42 Under the FFEL program “private lenders provide federally guaranteed funds. FFELs consist of FFEL Stafford Loans, FFEL PLUS Loans, and FFEL Consolidation Loans.” 43 Perkins loans represent yet another source of government funds, yet are disbursed through the institution rather than directly from the federal government. The next section discusses the types of loans in more detail.

III.a.3 A Summary of Options 44

- Stafford Loans: Both Direct and FFEL Stafford Loans are either subsidized or unsubsidized. A student can receive both a subsidized or an unsubsidized loan for the same enrollment period. A subsidized loan is one in which the government pays the interest on the loan through the grace period. An unsubsidized loan is one in which the student is responsible for paying the interest throughout the life of the loan. Stafford Loans are variable rate loans, which means that the interest rate upon which interest owed is calculated is tied to an underlying rate, in this case the 91-day T-Bill rate. In order to protect the borrower (student), the maximum interest rate is capped at 8.25%.

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43 Ibid
• PLUS Loans: PLUS Loans are loans taken out by parent to pay for their dependent undergraduate students. Unlike Stafford Loans, parents cannot apply for both Direct PLUS Loans and FFEL PLUS Loans, except where they may have multiple dependent undergraduates, then they can apply for the Direct PLUS Loan for one student and FFEL Plus Loans for another. All PLUS Loans are unsubsidized, which means that the parents are liable for interest from the point of issuance. There is no deferment period. Loans are variable rate loans, which means that the interest rate upon which interest owed is calculated is tied to an underlying rate, in this case the 91-day T-Bill rate. In order to protect the borrower, the maximum interest rate is capped at 9%.

• Perkins Loans: A Perkins Loan is a low interest loan which must be repaid. It is available to both undergraduate and graduate student who show financial need. Like other federally funded loan programs including the Stafford and PLUS, the loan is made with federal money. However, unlike other federal programs, the school is the lender. Therefore, all borrowing, plus interest, must be repaid to the school. Loans granted under the Perkins program are unsubsidized and are variable rate loans, which means that the interest rate upon which interest owed is calculated is tied to an underlying rate, in this case the 91-day T-Bill rate.

• Consolidation Loans: Direct and FFEL Consolidation Loans are available to help students and parents simplify loan repayment. Essentially, Consolidation Loans offer the ability to combine several types of federal student loans with varying repayment schedules into one loan. Unlike the previous three types of loans, Consolidation Loans offer a fixed rate for the life of the loan calculated as the weighted average of interest rates of consolidated loans, rounded up to the nearest 1/8%. Consolidation Loans are capped at 8.25%.
III.b The Federal Family Education Loan (FFEL) Program

There are multiple constituents interacting the student loan marketplace, including borrowers, schools, originators (original lenders), secondary market purchasers, and guaranty agencies acting on behalf of the federal government. The following represents a distilled explanation of the machinations of this industry. A borrower, either a student or a parent, borrows a sum of money from an originating lender, typically a bank. The lender funds this loan initially with private capital. A guaranty agency acts as the direct insurer of loans made by the lender in each State under agreements with the federal government. These guaranty agencies also provide the banks with assistance in collecting repayment on defaulted and delinquent loans generally after banks holding the initial loans receive default insurance payments from the federal government.

At any time, but typically once a student enters the repayment period, a secondary market purchaser (e.g. Sallie Mae) may purchase the loans from the original lender. All terms and conditions of the original loan, including insurance against defaults provided by the federal government through the guaranty agencies, accrue to the secondary market purchasers. This process provides the necessary liquidity to the banks in order to begin the cycle again and originate new loans to borrowers, this time with money provided by Sallie Mae. The secondary market purchasers are then considered the “holders” of the original loan. Without this process, a restricted amount of new funds be infused into the industry, thereby limiting its liquidity.

At first pass, this relationship appears rather sound: A series of independent entities working in concert to enhance educational opportunities available to the nation’s youth. In reality the relationship is based not upon free market principles rather on the heavy handed intervention of Uncle Sam. 45 The following sections consider the impact of the federal government on the student loan industry, focusing on the benefits/charges that accrue to and the role of Sallie Mae as the self-described “business partner to the higher education industry.”

III.b.1 Encouraging Participation: Early Subsidies

Beyond its significant political hurdles, one of the initial problems with the student loan industry lay with the capitalization process. Banks/lenders who were largely unfamiliar with the concept of student loans believed that they would be too costly to administer. Furthermore, the federal government initially offered no subsidy to provide incentives to ensure broad participation. At the outset of the GSL program, the government subsidized the interest that accrued on student loans while the students were still in school as well as reimbursements for student defaults. In an effort to bolster participation and, ultimately, access to post-secondary education for minority and low-income students, lawmakers enacted a series of subsidies to make the programs more financially appealing. First, for the students, they set a maximum percentage rate at which the loans could earn interest. To address the resultant market fluctuation risk that accrued to the lenders from this first subsidy, the lawmakers created a second subsidy: a “special allowance payment” (SAP) from the federal government. This SAP, which will be discussed in detail later, ensured that lenders would earn a “market” rate of return even if the interest rate rose above the maximum rate that students were liable for. 46

In addition to the two explicit subsidies identified above, two implicit subsidies also accrue to holders of student loans. First, because GSL loans are indexed (reset) annually, the interest rate applied at the outset of the year would prevail throughout the year, regardless of market fluctuations. As a result, lenders actually earned money when market rates decreased because the loans continued to accrue interest at the higher, indexed market rate as opposed to the prevailing market rate. Second, because loans made under the GSL program are explicitly guaranteed by the federal government, the risk inherent in these transactions is negligible. As a result, lenders could borrow money at near government rates.

Lawmakers created both guarantee agencies that would compensate lenders for defaults as well as a secondary market for GSL loans by establishing the Student Loan

46 Ibid

28
Marketing Association (Sallie Mae) in 1972. The purpose of Sallie Mae was to ensure the flow of capital into the industry by purchasing student loans from the lenders. By virtue of this influx of capital, lenders could then make new loans. The confluence of these federally funded programs and related subsidies, coupled with the rising costs of college, the economic benefits of attending college, and events that precipitated in the economy-at-large, have forever altered the student loan industry. The following section analyzes the results of this convergence of events by analyzing the results of the subsidies and charges on the biggest single entity in the industry, Sallie Mae.

In response to a growing need to provide liquidity to a burgeoning student aid industry, the federal government looked outside of its own coffers and began to employ the assistance of various entities. Sallie Mae was chartered as a Government Sponsored Entity in 1972 to serve just such a need. A for-profit, publicly traded entity, Sallie Mae is the largest holder of student loans in the United States. Sallie Mae’s self-described mission is to operate as a business partner to the higher education industry. To this extent, Sallie Mae plays numerous key, and ever expanding, roles in the web of the student loan industry. The company not only provides federally insured funds for students and parents by acting as a secondary market purchaser, it also provides origination services to many lenders and capital funds to colleges and universities. The following sections analyze the impact of some of the subsidies and charges to which Sallie Mae has historically been exposed.

**III.b.2 Government-Sponsored Entity (GSE)**

“Government-sponsored entities (GSEs) are privately owned instrumentalities of the federal government, established and accorded favored regulatory treatment to increase capital market access by those sectors thought to be served inadequately by fully private lenders.”

Prior to the completion of its privatization effort, Sallie Mae was one of five GSEs operating to ensure a continuous source of liquidity in industries as diverse as education, agriculture, and housing. Because of its special “agency status,” numerous benefits accrued to Sallie Mae.

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47 [SallieMae.com](http://www.SallieMae.com)
For instance, debt obligations issued by Sallie Mae were exempt from state taxation. In fact, as a GSE, Sallie Mae was exempt from all taxation by any state or country, municipality or local taxing agency except with respect to property taxes.

Because of its status as a GSE, Sallie Mae has received operating economies. Interestingly, and perhaps counter-intuitively, Sallie Mae was permitted to hold a public offering. Typically, a public offering is used to raise capital and to allow founders of a successful business to gain access to equity. However, Sallie Mae has substantial access to funding and was intrinsically tied to the federal government. Consider: Sallie Mae was established by an act of Congress; it is governed by boards of directors appointed by the President of the United States; it is exempt from federal, “blue sky” securities regulation requirements; it had been granted a line of credit with the U.S. Treasury; and their debt enjoys a “preferred status” that allows Sallie Mae to earn core revenues based upon this relationship.

True, the public offering did raise money. However, fundamentally, this means that the business is owned by individual shareholders, and it is precisely these shareholders who benefited from the entity’s relationship with the federal government. Consider: As evidenced by Sallie Mae’s stock performance, the single best indicator of current and potential returns to shareholders, Sallie Mae has been successful. Between fiscal years 1994 and 2005, Sallie Mae’s stock price has soared more than 1,500% from $2.98 to the latest close of $53.68! By comparison, the S&P 500 achieved less than 100% growth during the same period. Better still, unlike the tech boom of the late 1990s, this exhilarating rise in value has been driven off of a likewise strong performance in fundamentals.

The data below is culled from Hoover’s and provides highlights of Sallie Mae’s financial performance from December, 1994 through December, 2003.

<table>
<thead>
<tr>
<th>Year</th>
<th>Revenue ($mil.)</th>
<th>Net Income ($mil.)</th>
<th>Net Profit Margin</th>
<th>Employees</th>
</tr>
</thead>
</table>

49 Ibid.
<table>
<thead>
<tr>
<th>Date</th>
<th>Revenue</th>
<th>Expenses</th>
<th>Profit Margin</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/03</td>
<td>4,160.2</td>
<td>1,533.6</td>
<td>36.9%</td>
<td>7,500</td>
</tr>
<tr>
<td>12/02</td>
<td>3,436.3</td>
<td>792.0</td>
<td>23.0%</td>
<td>6,705</td>
</tr>
<tr>
<td>12/01</td>
<td>3,967.6</td>
<td>384.0</td>
<td>9.7%</td>
<td>6,011</td>
</tr>
<tr>
<td>12/00</td>
<td>4,166.3</td>
<td>465.0</td>
<td>11.2%</td>
<td>6,712</td>
</tr>
<tr>
<td>12/99</td>
<td>3,259.4</td>
<td>500.8</td>
<td>15.4%</td>
<td>3,753</td>
</tr>
<tr>
<td>12/98</td>
<td>3,064.6</td>
<td>501.5</td>
<td>16.4%</td>
<td>3,966</td>
</tr>
<tr>
<td>12/97</td>
<td>3,784.7</td>
<td>507.9</td>
<td>13.4%</td>
<td>4,608</td>
</tr>
<tr>
<td>12/96</td>
<td>3,590.1</td>
<td>419.4</td>
<td>11.7%</td>
<td>4,792</td>
</tr>
<tr>
<td>12/95</td>
<td>3,693.7</td>
<td>496.4</td>
<td>13.4%</td>
<td>4,737</td>
</tr>
<tr>
<td>12/94</td>
<td>2,851.6</td>
<td>402.8</td>
<td>14.1%</td>
<td>4,948</td>
</tr>
</tbody>
</table>

Such powerful results would be a wonderful example of capitalism in action, except for Sallie Mae’s historically close and arguably unfair relationship with the federal government.

Sallie Mae’s dominance of the market stems largely from cost factors. Its management has aggressively controlled costs through such means as product specialization and economies of scale. In addition, the firm has been managed to the highest standards of commercial credit. Sallie Mae’s internal financial strength, combined with the guarantee of its debt, has enabled the firm to borrow at near-Treasury interest rates. Through its advantages in operating economies and low funding costs, Sallie Mae is able to carry on its activities at a lower cost than its competitors.50

### III.b.3 Low Cost of Funds

Sallie Mae historically “earned” core revenues from a variety of streams emanating from the same wellspring, students. Each year Sallie Mae raises billions of dollars through underwritten notes purchased by investors around the world. Sallie Mae’s cost of borrowing this money is cheaper than other, fully private entities for two primary reasons. First, because Sallie Mae’s investment portfolio is comprised of underlying investments (student loans) which are guaranteed by the federal government, they have historically been near risk-less investment. Second, because Sallie Mae’s asset yields and debt costs are both tied to the same metric, the 91-day T-bill, they are effectively insulated against interest rate risk: They have financed their floating-rate assets with floating-rate debt so that their investment

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50 Congress of the United States Congressional Budget Office, Controlling the Risks of Government-Sponsored Enterprises. Pg. 249
portfolio adjusts automatically to open-market interest-rate changes. On the basis of these two factors, Sallie Mae raises private capital at the lowest possible cost. Sallie Mae then loans these funds at a 91-day T-bill market rate plus a stated percentage (historically between 2.5 to 3.5 percent, currently 2.3 percent for Stafford Loans and 3.1% for PLUS loans). The net effect of these transactions is a transfer of wealth from students to stockholders resulting in part because of scale and scope operating efficiencies of Sallie Mae but also due to their affiliation with the federal government.

III.b.4 Special Allowance Payments: A “Make-Whole” Arrangement

Federally insured student loans, which typically have a five to ten year repayment period, obligate the borrower to pay interest at either a fixed rate or a variable rate that is reset annually. Both rates are tied to an underlying T-bill rate, plus the 2.3 to 3.5 percent mentioned earlier, and are capped as of 2004 at 8.25 percent. If the operating environment were allowed to fluctuate as a free-market, Sallie Mae would be exposed to market rate fluctuation risk as follows. Assuming that the underlying T-bill rate on a student’s fixed rate loan was 5 percent and the additional rate paid by the student was 2.3 percent, the total yield to Sallie Mae would be 7.3 percent. If the interest rates on the underlying T-Bill later rose, Sallie Mae would lose the benefit of the additional yield: Their money would no longer be earning a market rate of return. However, if the market rate on current T-bills were to dip below that of the underlying T-bill rate, Sallie Mae would recognize a gain based on the fact that the return on Sallie Mae’s investment would exceed the current cost of money to Sallie Mae. The student and/or parent would be re-paying Sallie Mae in more expensive dollars. Even if the loan were a variable one and the current T-bill rates dipped, the student would still be re-paying his/her loans in more expensive dollars for the remainder of the year. Either way, a gain accrues to Sallie Mae.

53 Ibid
Fortunately for lenders, the federal government implemented a policy called the Special Allowance Payment (SAP) in 1969. As a result, Sallie Mae, and all other primary and secondary lenders, were effectively insulated against any potential increases in the current T-bill rate. Under the SAP, the government pays a subsidy to holders of FFEL loans whenever the average of all the 91-day T-Bill rates in a calendar year, plus a spread of between 2.3 to 3.5 percentage points in order cover operating costs, exceeds the rate of interest that the borrower is obligated to pay. "Since a loan can be serviced for about 1.0 percentage point, the special allowance arguably means that they government is paying around three times more to the banks that it would cost to run a direct federal student loan program." 54 In this manner, the government insures Sallie Mae stockholders against standard market fluctuations. No such subsidy is paid to the students, however, when current market interest rates dip below that of the underlying T-Bill on their loan.

Our portfolio of FFELP student loans generally earns interest at the higher (emphasis added) of a floating rate based on the Special Allowance Payment formula set by the DOE and the borrower rate, which is fixed over time. We generally finance our student portfolio with floating rate debt over all interest levels. In low and/or declining interest rate environments, when our student loans are earning at the fixed borrower rate and the interest on our floating rate debt is continuing to decline, we 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, we 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, we may earn Floor Income to the next reset date. 55

Through this series of subsidies, the government created a floor for lenders and would pay for any interest rate fluctuation that caused the lenders to lose money. It was a no-lose situation. As Robert Shireman, director of the Institute for College Access and Success, explained: "By insulating lenders from both default and interest-rate risk, the guaranteed

54 Statement of Alfred B. Fitt, General Counsel, Congressional Budget Office before the Subcommittee of Postsecondary Education, Committee on Education and Labor, U.S. House of Representatives, May 30, 1979
55 United States Securities and Exchange Commission, Form 10-K Filing, SLM Corporation, page 3
program makes lending under it ‘essentially an arbitrage operation’ or borrowing at a lower rate and lending at a higher one.”  

III.b.5 The Offset Fee and Securitization

Under President Clinton, in 1993 the federal government made changes to the FFEL Program to lower the profitability on all loans of this type. Included in these changes was the implementation of a 30 basis point annual “offset fee” unique to Sallie Mae on student loans purchased and held on or after August 10, 1993. In an effort to stay profitable, Sallie Mae evaluated alternatives. Using models developed by another GSE, Freddie Mac, “lenders of various sorts were increasingly able to pool loans they owned and sell securities based upon those pools. The effect was to enable the lender to recover a large portion of its loan, allowing it to make more loans while shifting some risks, particularly interest rate changes, to the buyers of the securities.” Using Freddie Mac as an example, Sallie Mae established a subsidiary. Through a process called “securitization,” Sallie Mae sold student loans to this subsidiary, which, in turn, sold the loans to trusts that issue asset-backed securities to fund the student loans.

Sallie Mae recognized two benefits through this process. First, when loans were securitized, a gain is recorded on the sale which is equal to the net present value of the expected net cash flows, including principal, interest, and SAP less the underlying costs associated with Sallie Mae’s debt. This transaction effectively accelerates recognition of earnings of student loans. As opposed to receiving payments over the life of the loan, Sallie Mae has use of these funds immediately.

Up until their recent privatization, Sallie Mae benefited from securitization in a second way. In 1995, the U.S. District Court for the District of Columbia ruled that student loans owned by the securitization trusts, even though they are a related party, are not subject to the

http://www.aacrao.org/transcript.  
http://www.Washingtonpost.com
30 basis point annual offset fee. In a later appeal by the Department of Education, U.S. Court of Appeals re-affirmed this decision. As a result, by transferring the loans to the securitization trusts, Sallie Mae could circumvent the 30 basis point offset fee.

III.b.6 A New Threat

Finally, one last area in which Sallie Mae used to gain significant operating economies as a direct result of its relationship with the federal government is through the absence of a competitive marketplace. Because Sallie Mae’s cost of funds have historically been significantly below that of fully private peers and because it already has a significant share of the market, Sallie Mae has, until recently, faced little in the form of competition. This landscape has changed dramatically in recent years however. Interestingly, competition has come in the only viable form that could potentially pose a major threat to Sallie Mae, the federal government itself. With the introduction of the Federal Direct Student Loan Program in 1994, the federal government at last determined that perhaps . “Our primary competitor for federally guaranteed student loans is the FDLP, which in its first four years of existence (FFYs 1994 – 1997) grew market share from 4 percent to 34 percent.”

IV. Section III

It should be clear from the above section that the federal government, through its confusing and, and at time contradictory, series of incentives and disincentives, has created an environment with a veneer of free-market sensibilities but one that has historically been artificially manipulated. So, as Sallie Mae has entered a new era by completing its privatization effort and thus having substantially changed the playing field, the question remains: What are/ should be the hallmarks of a successful policy? Further, what alternatives are available to the federal government to incorporate these strategic criteria?

58 United States Securities and Exchange Commission, Form 10-K Filing, SLM Corporation, page 12
IV.a The Objectives of the Student Loan Industry

As mentioned in Section I of this paper, there were two primary reasons for the genesis of the student loan industry: accessibility and affordability. The federal government’s goal was – and still is - to allow students to attend colleges and universities that they could otherwise not afford. With the advent of the federally funded student loan program, students could make an investment based on the premise that their future returns would more than pay for the costs incurred. Additionally, the formulation of the student loan program enhanced choice. Federal loans, as opposed to some federal and most institutional grants, are portable. Students can “shop around” and use them at the institution of their choice. Decades later, these objectives are still valid and should necessarily remain the cornerstones of the industry.

IV.a.1 The Hallmarks of a Successful Policy

The following four recommendations are targeted at creating a more streamlined environment.

1. Simplify Federal Rules and Regulations

Part of the problem with the student loan industry is the tangle of federally mandated rules and regulations that are costly and time consuming to comply with. Of course, a baseline level of regulations is essential. Yet under current federal regulatory guidelines, some 7000 sections of the Code of Federal Regulations relate to post-secondary student loans. In fact, “during one 12-month period in the early 1990s, institutions received, on average, a new federal directive every other day.” 59 Additionally, the available means of financing a higher education are so numerous as to be over-bearing, from tax incentives, to pre-tax savings plans, to loans, grants, scholarships, etc… To further complicate matters, higher education’s accrediting bodies, which have historically been charged with enforcing the industry’s own quality standards, are themselves coming under federal regulation. As a result, these newly quasi-governmental agencies are now enforcing not only higher education’s quality standards, but federal standards and mandates as well. The result is a series of oversight agencies that “‘have gone far beyond accounting for federal funds into core areas of higher education

59 Condemning Students to Debt: College Loans and Public Policy, Richard Fossey and Mark Bateman, pg. 179
policy, including “time-to-degree, job placement and tuition and fees.”60 These new agencies and new areas have caused significant, and in many case, unwarranted and unwanted burdens on the administrative structures of higher education entities. The rules and regulations surrounding higher education must be streamlined.

2. Create a Marketplace with Profitability, Marketing Signaling, and Competition

To avoid undue reliance upon any single source of funding, it is important that alternatives include a self-financing marketplace, one which can ensure the necessary liquidity. One of the issues with Sallie Mae in its previous existence as a GSE is that a small number of shareholders profited greatly not just from its operating economies but also from its relationship with the federal government. In other words, Sallie Mae earned revenue and recorded profitability not simply via streamlined operations, but also through the web of subsidies, both explicit and implicit, discussed earlier. While, it is important to appropriately incentivize private capital markets, otherwise they will simply look for alternative investments, it is likewise critical that the lenders receive the appropriate signal from the market. Free-market companies earn revenues in a competitive environment by: 1) providing exemplary service and 2) achieving operational excellence and passing those savings back to the customer. It would be refreshing to witness this in the student loan industry.

Related to the above point of profitability, historically the government has muted the effects of signaling so frequently leveraged in the competitive marketplace. Through its subsidies, it has hedged not only both the students’ and the lenders’ losses, but also the lenders’ potential gains. In doing so, it has created both a floor and a ceiling. While it is necessary to protect the students’ interest, it is perhaps less important to provide lenders with a guaranteed return. Within the guidelines of accessibility and affordability, to the extent possible, the best case scenario would be to create a vehicle that relies on market signals. At its core, this would fundamentally limit the government’s intervention in the market. Further, it would encourage competition in the market space, which generally leads to a positive net result for consumers. Lenders should be forced to compete for students, especially

60 Ibid, pg. 3
considering the current volume of borrowing. They would compete on product offerings, service, quality, and other criteria generally witnessed in successful, for-profit corporations.

3. Provide Oversight

Noticeably lacking in the student loan industry is a formal, independent oversight body. A formal group comprised of college and university executives, public policy experts, lenders, government representatives, students, and external executives (banking, software, etc.) must be created. This group should bear the responsibility for quarterly reviews based upon objectives. Is the current strategy providing the necessary liquidity? Are costs outweighing the benefits? What are liquidity levels? What trends are occurring in the industry (e.g. tuition) that merit further consideration? In other words, the group should examine relevant causal factors that are either positively or negatively impacting the industry. Currently, the federal government sponsors a large number of committees, yet continuously staffs these with higher education executives or political pundits.

4. Encourage/ Enforce Participation by Colleges and Universities

“Tuition has been climbing at two or three times the inflation rate for three decades, and public-university prices rose at least 10% in eight of the past 22 years, says the College Board. Now, the question isn’t whether tuition will continue to rise, but by how much. Based upon this and other facts presented earlier in this paper, it would be remiss not to consider the role of colleges and universities when questions of access and affordability are being considered. Colleges and universities should be forced to re-examine their own bear some culpability/ responsibility with respect to student loans. First, they must truly examine their cost structure. Do their costs merit such extraordinary tuition growth levels when compared with the economy? Why? This topic is perhaps the subject of another thesis altogether. Yet, it would be foolhardy to consider approaches to the student loan industry without at least mentioning the role of the primary cost driver, institutions of higher learning. “Still, with demand for college seats high, the college has little incentive to be too stingy with

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61 Wall Street Journal, Monday January 31, 2005, pg R4
themselves. “No one is pushing for efficiency very hard,” says Ohio University economist Richard Vedder.62

IV.b Alternatives

In light of the re-affirmation of the objectives and hallmarks, this final section begins the process of identifying and analyzing alternatives for the student loan industry. The following section examines a series of these alternatives.

1. The Federal Direct Student Loan Program (FDSLP)

As the federal government analyzed the cost of doing business in the student loan industry, it decided that it could initiate and process the loans faster than the private marketplace that had provided this service for 40 years. Because of the subsidies mentioned above, coupled with the industry’s knack for circumventing charges, the Department of Education (ED) believed that it would be cheaper to “cut out” the middlemen and provide federally funded money directly to the students. Established by the Student Loan Reform Act (SLRA), the FDSLP began with 1994 and since that time has grown to include approximately 25% of new loan volume. Targeted at simplifying and reducing the costs associated with the increasingly complex and difficult to regulate student loan industry, the FDSLP has experienced both varied degrees of success and widespread opposition.

Benefits/ Drawbacks of the FDSLP

With equal fervor supporters and detractors alike have voiced their opinions about the FDSLP. There were numerous substantive arguments levied against supporters of the program. First, it was argued that the ED could not manage a direct loan program, especially in light of negative reviews by the General Accounting Office (GAO), the ED Inspector General, and the Office of Management and Budget (OMB) for its mismanagement of the FFEL and other student aid programs. Second, some called into question the ability of the Federal government to fund the requisite billions in direct loans annually. Third, there was concern about student access to loans during a transition period. Finally, there was the threat

62 Ibid
of failure: What would happen if the current iteration of the guaranteed student loan industry was dismantled and the FDSLP failed?

Supporters of the FDSLP, on the other hand, decried these criticisms and instead focused on proposed efficiencies. An Advisory Committee was enabled by Congress and charged with examining aspects of the student loan industry that would be positively affected. The Committee identified six primary sources of complexity that could be addressed by a single, centralized loan process:

1. Multiple, overlapping loans programs exist, none of which have sufficient annual limits to discourage multiple program borrowing.
2. Terms and conditions conflict among the loan programs
3. The programs operate under burdensome legislative and regulatory requirements, most of which have been created to control program costs and default rates
4. Lender and guarantor policies are inconsistent.
5. Loan processes and forms are not standard.
6. The existing data and network infrastructure is inconsistent.

As a direct result of recommendations issued by this group, the FDSLP began operations in 1994. As noted earlier, in its first four years of existence (FFYs 1994-1997), it grew market share from 4 percent to a peak of 34% in 1997.63 The FDSLP’s market share has since steadily declined to 25% in 2004.64 While the question remains of whether the federal government can manage as efficiently and as effectively as the for-profit sector, it is clear that the FDSLP is on the radar of Sallie Mae, who consider it their “primary competitor.”65

2. Privatization of Sallie Mae

The privatization of Sallie Mae has several advantages. First, because its affiliation with the federal government will cease, it will no longer receive the implicit subsidy that allows it to borrow money cheaply. As a result, competition in the marketplace should increase because no entity in the student loan secondary market will have government agency status. Second, Sallie Mae will be free to continue to evolve and develop as an organization.

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63 United States Securities and Exchange Commission, Form 10-K Filing, SLM Corporation, page 13
64 Ibid
65 Ibid
Specifically, it can now venture into additional territories such competing in the primary lender market.

By law, as a GSE, Sallie Mae was required to act solely as a secondary market purchaser of student loan. As of December 2004, this legally binding charter is no longer effective. Considering this, the first significant disadvantage to the privatization of Sallie Mae is that if the executive team were to suddenly choose to invest in alternative industries, it is within their right to do so. Ultimately, the cost of doing business for Sallie Mae will no longer be strictly limited to costs relating to servicing student loans, but will now include the opportunity cost of earning a rate of return significantly below that which could be earned elsewhere. In short, Sallie Mae is no longer required to service student loans, and is therefore free to pursue the industry of its choice. It’s possible that this reality could leave the student loan marketplace under funded.

A second possible disadvantage is that the cost of money to Sallie Mae might increase. As a result of the loss of its affiliation with the federal government, the implicit subsidy discussed above related to the lower cost of funds will disappear. Sallie Mae’s attempts to raise capital will meet the same limitations of any other large, publicly traded, for-profit company: If the stock price is strong and the market outlook is good, the cost of capital should be limited. If, however, the company falters, of if the tastes and preferences of the consumers change, the stock price will falter, likely driving up the cost of capital.

The privatization of Sallie Mae is a reality. While we can forecast results, in actuality there is little that we can do but wait and see what happens. However, it is prudent to note that the privatization of Sallie Mae could have significant impacts upon the accessibility and affordability of college. If Sallie Mae chooses to alter its business strategy and look to other, more attractive investments, this could significantly impact accessibility to loans. Additionally, if the cost of capital should increase, Sallie Mae will merely do what all other for-profit companies do, pass the costs on to their consumers. In this case, however, their consumers are students. Ultimately, this would have an adverse impact on both accessibility and affordability.
3. Maintain and Improve the FFEL Program

A third strategic alternative is to reinvest in the FFEL program. In his essay entitled “Improving the FFEL Program”, Joseph Cronin, the one-time president of the Massachusetts Higher Education Assistance Corporation, offers some keen insights into the student loan industry. As is evident from the title, Cronin is a strong supporter of the FFEL program. It is, however, he admits, an industry whose “present situation...is not perfect.”  

Specifically, Cronin points to four flaws in the program.

- Some students can and do accumulate excessive debt. Specifically, students who tend to stray from the business, engineering, and law professions face debt burdens that future returns may not support.
- A second problem that Cronin points to is the lack of parent’ financial contributions to their children’s education, a situation which is exacerbated by the absence of a subsidized parental loan. As indicated earlier, all parental (PLUS) loans, are unsubsidized.
- Third is the issue of student loan defaults. The government, who provides 100% insurance against student loan defaults, has paid out tens of billions of dollars on behalf of these students to the holders of the loan.
- Fourth is the excessive number of regulations that the federal government imposes upon the industry. “Lenders are severely restricted by a congressional policy that aims at making the education loan program uniform, predictable, and universally available.” In short, Cronin postulates that the tangle of federal regulations has historically hindered the ability of all involved in the student loan industry to be creative and proactively address obstacles.

Based upon the issues with the FFEL program, Cronin constructs a recommendation for improving, as opposed to dismantling the FFEL program. Cronin’s first solution is to expand federal grants and scholarships. He argues that “Congress should expand grants and

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66 Radical Reform or Incremental Change? Student Loan Policy Alternatives for the Federal Government, Lawrence Gladieux, pg. 57 - 73
67 Ibid
public scholarship programs for the service professions, especially health, education, and social services.” 68 Next, Cronin suggests that Congress such strike some of its overly aggressive mandates. The third step would be to strengthen the parents’ incentive to borrow. This could be accomplished via a subsidized parental loan program. If parents have a readily available and subsidized form of capital, they would likely participate more proactively in the funding of their child’s education. Fourth, Cronin suggests deregulation of unsubsidized loan rates, thereby freeing any cap on repayment rates. Finally, he recommends endowment lending. Many colleges and universities, especially those that charge the highest tuitions, have substantial endowments.

V. Conclusion

‘Oh Gosh No, We Are Just Getting Started” …

It is a fact that certain student loan entities, their executives, and investors have grown rich as a result of government intervention in what would otherwise be a risky marketplace. Further, of concern to many is the fact that the underlying transactions represent a transfer of wealth from students, parents and, ultimately, tax payers who shoulder the burden for defaulted loans as well as the special allowance payment.

However, from a purely business standpoint, Sallie Mae is performing remarkably well in its role as a for-profit, stockholder owned company. The executives are maximizing shareholder returns and minimizing shareholder risk by leveraging operating economies and by pursuing strategy alternatives. In fact, it is the federal government’s double standard that has perpetuated inefficiencies in the student loan industry. By subsidizing and insuring all federal student loans while simultaneously chartering a publicly held company with special “agency status” to service the loans, the government sent an erroneous market signal which Sallie Mae’s executives and shareholders have read accurately.

68 Ibid
Further, it would appear that the student’s themselves are not necessarily suffering. Intuitively, one might assume that facts presented earlier, namely: 1) an increasing number of students enrolled in post-secondary education; 2) the rapid rise in the costs affiliated with attending colleges; and 3) the concomitant growth in education lending, would have resulted in a substantially greater default rate in student loans. Yet, that assumption would be wrong. In fact, on September 21, 2004, the National Association of College and University Business Officers issued a press release indicating that, according to the Department of Education, student loan default rates were the lowest in history!

![Default Rate Chart]

Source: Department of Education, 2004 2-year trailing analysis

With the advent of the FDSL, the federal government appears to have recognized the issue and is attempting to remedy it. Curiously, however, rather than attacking the source of the problem directly and addressing the current formation of Sallie Mae, the government created a source of competition, and then damaged the private marketplace by fundamentally altering its profit base with the 30 basis point fee. Sallie Mae responded by privatizing. The combined effects of these forces have not yet been fully felt. Recent years have proven that indeed the FDSL may not be the panacea for the industry. In fact, the FDSL is operating significantly below the Congressionally-mandated levels.

While the results of Sallie Mae operating as a fully privatized entity will no doubt bear watching, the federal government can still exert significant influence on the industry. As outlined in the “Hallmarks” section, the following four recommendations should play a significant role in the oversight of the industry. The purpose of these recommendations is to address shortcoming in the current approach of the federal government to the industry:
1. Simplify Rules and Regulations  
2. Create a Marketplace  
3. Provide Oversight  
4. Encourage/Enforce Participation by Colleges and Universities

In summary, the student loan industry is evolving towards a more market-based approach. The federal government has begun to encourage the appropriate behavior by eliminating numerous subsidies and benefits, while simultaneously creating a new source of competition, the FDSLFP. These actions suggest the federal government is indeed on the right track to encourage the appropriate behavior. Next, it needs to turn its attention more fully to the above recommendations. Admittedly, these recommendations are greatly simplified, yet, as we say in the software business, occasionally the most elegant solutions are also the simplest. The U.S. federal government would do well to follow that approach.

Recently, Sallie Mae, in further pursuing growth options, submitted an unsolicited $1 billion bid to purchase some of The Pennsylvania Higher Education Assistance Agency’s operations. Although the bid was rejected, when asked whether Sallie Mae was giving up its PHEAA bid as a result, Mr. Lord (Sallie Mae’s Chairman and Chief Executive Officer) said: “Oh gosh no, we’re just getting started.”

It is good to see that the competitive spirit is alive and well!

\(^{69}\) Wall Street Journal, Thursday, December 30, 2004, pg C3