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BY THE U.S. GENERAL ACCOUNTING OFFICE

Report To The Committee On Labor And Human Resources United States Senate

Secondary Market Activities Of The Student Loan Marketing Association

The Student Loan Marketing Association is a private, for-profit corporation created by the Congress to stimulate increased private financing for federally sponsored student loans by buying them from and making loans to private lenders, such as banks and savings and loan associations.

This report discusses the Association's secondary market activities in support of student loan programs since it began operations in 1973. The report also provides information requested by the Committee concerning the profits earned by the Association and the methods used to finance its activities.

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HUMAN RESOURCES
DIVISION

B-215066

The Honorable Orrin G. Hatch, Chairman
The Honorable Robert T. Stafford, Chairman,
Subcommittee on Education, Arts, and Humanities
The Honorable Claiborne Pell
The Honorable Jennings Randolph
Committee on Labor and Human
Resources
United States Senate

This is the report you jointly requested on the activities of the Student Loan Marketing Association (Sallie Mae). The report discusses Sallie Mae's activities from its original authority to the most recent amendments, as well as Sallie Mae's profitability and financing.

Copies of this report will be sent to the Secretary of Education, the President of Sallie Mae, and other interested parties.

Richard L. Fogel

Richard L. Fogel
Director

GENERAL ACCOUNTING OFFICE
REPORT TO THE COMMITTEE ON
LABOR AND HUMAN RESOURCES
UNITED STATES SENATE

SECONDARY MARKET ACTIVITIES
OF THE STUDENT LOAN
MARKETING ASSOCIATION

D I G E S T

The Student Loan Marketing Association is a private, for-profit corporation authorized by the Congress in 1972 to stimulate increased private financing for student loans under the federally sponsored Guaranteed Student Loan program. As such, the Association serves as a secondary market by purchasing student loans from, and making secured loans to, banks and other private lenders. This offers lenders the opportunity to sell their student loans for cash and to borrow additional funds to support their student lending activities. (See p. 1.)

The Senate Committee on Labor and Human Resources asked GAO to describe the history of the Association and, in particular, to determine whether its original purpose to provide financial support to private institutions making student loans has been deemphasized in favor of other activities, such as directly insuring or making loans to students. The Committee also asked GAO to provide information on its profitability, financing, and lending activities.

GAO reviewed the Association's legislative development and financial activities, and compared the Association's profitability to commercial banks and the other government-sponsored enterprises which provide lending and secondary market services to other programs. GAO also discussed the Association's financing activities with investment firm representatives, and its role in the student loan program with individuals having extensive experience with the program. (See pp. 4 and 5.)

LEGISLATIVE CHANGES HAVE NOT SIGNIFICANTLY ALTERED THE ASSOCIATION'S ORIGINAL PURPOSE TO ACT AS A SECONDARY MARKET

Legislation pertaining to the Association has been enacted nine times since 1972. Six of these laws expanded its authorities and functions, and three made relatively minor technical changes. Nevertheless, through December 1983, the Association had used most of its funds for secondary market activities authorized by its initial legislation. Since inception, the Association has purchased student loans totaling about $5.5 billion and made secured loans to lenders of about $4.5 billion. About 15 percent of these activities resulted from new legislative authorities granted after 1972 which the Association has used to:

--make about $390 million of loans to borrowers with student loan debt exceeding certain levels in order to ease their payment burdens by consolidating existing student loans and extending repayment terms,

--make about $893 million out of a total of $4.5 billion of secured loans to lenders (called warehousing advances) under the more liberal provision which permits lenders to maintain only the outstanding balance of student loans held at the date the advance was received rather than investing all of the advance proceeds in new loans.[1]

--make a $2.5 million warehousing advance to a university to finance noninsured student loans,

--purchase about $190 million of loans made to graduate students in the health professions, and

--purchase about $52.7 million of student loan revenue bonds from state-level secondary market programs. (See p. 11.)

The Association also exercised new financing authority by raising $104.4 million through its first public issue of nonvoting common stock in September 1983.

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[1]These advance recipients have, however, made new student loans in excess of the minimum requirements, increasing their loan levels by about $600 million.

The Association has not exercised the other new authorities the Congress granted to it. For example, it has not used the authorities--which can only be exercised with the agreement or at the request of the Secretary of Education--to make or insure student loans in states where loan demand is not being met because no such agreements or requests have been made. (See p. 12.)

PROFITABILITY OF THE ASSOCIATION

Annual net profits earned by the Association have increased each year, rising from $318,000 in 1974--its first full year of operation--to $66.6 million in 1983. During this period, the Association's activities in support of student loan programs have also increased substantially, and its profitability in relation to its increasing program size has been within the range experienced by commercial banks and by the other government-sponsored enterprises which provide financial support to the housing and farm industries.

GAO compared the Association to commercial banks using data compiled by the Federal Reserve and to the other government-sponsored enterprises using the enterprises' 1982 annual reports. The comparisons, which were made in terms of three common measures for assessing the relative performance of financial institutions on an after tax basis, showed that the Association's

--<u>return on assets</u>, which is one of the most significant indicators of profitability used in the business community, has been lower than that experienced by most commercial banks and government-sponsored enterprises (see p. 14.),

--<u>return on equity</u>, which indicates profits on shareholder resources, has been higher than the other organizations (see p. 16.), and

--<u>interest margins</u>, which indicate how well the difference between asset and debt interest rates has been managed, have been lower than commercial banks and within the range experienced by the other government-sponsored enterprises. (See p. 18.)

While the Association's return on equity has been relatively high, it has invested most of its profits in the student loan programs and, in comparison to the practices of most of these other organizations, has distributed relatively little as dividends to stockholders. (See p. 19.)

ASSOCIATION FINANCING AND LENDING ACTIVITIES

From 1974 through 1981, the Association financed its activities primarily by borrowing needed funds from the Federal Financing Bank which the Congress created in the Department of the Treasury to provide a more coordinated and cost-effective approach to federal and federally assisted borrowing. Under a 1981 agreement with the Bank, the Association could borrow up to $5 billion on a long-term, variable rate basis. As agreed with the Bank, the Association ceased such borrowings in January 1982 when its outstanding borrowings from the Bank reached $5 billion. Interest on this debt varies at a fixed rate over Treasury Department borrowing rates, and the rates have been lower than private sector financing rates. According to Bank officials, the interest paid by the Association over Treasury borrowing rates covers the Bank's cost of administering the Association's debt. (See pp. 21 and 22.)

Since it stopped borrowing from the Bank, the Association has obtained its financing exclusively in the private capital markets, increasing its outstanding private debt by about $1.9 billion in 1982 and about $1.1 billion in 1983. This borrowing has been used to increase its secondary market activities, as shown by the increase in outstanding student loans and warehousing advances held by the Association. These holdings increased from $4.8 billion in December 1981 to $7.9 billion in December 1983. In September 1983--the end of the federal fiscal year--the holdings were equivalent to 29 percent of all outstanding Guaranteed Student Loans. (See pp. 22 and 23.)

The interest rates paid by the Association on its private borrowings, although higher than those paid on its Bank debt, were lower than the average rates paid by high-quality borrowers in the private sector. Investment firm representatives told GAO that the Association's success in obtaining needed funds in the private markets reflects the confidence of financing institutions in its activities. This confidence results from several characteristics, such as the high quality of the Association's assets--most of which are directly or indirectly guaranteed by the government--and the fact that interest rate fluctuations have little effect on earnings because the Association's debt interest rates vary at levels that are lower than the variable rates earned on student loans and warehousing advances. (See pp. 23 and 24.)

Investment firm representatives indicated that the long-term financing from the Bank at favorable rates was a positive factor in the Association's initial success in the private debt markets because it demonstrated the Association's borrowing experience. They believed that the long-term debt no longer has a significant impact on the Association obtaining favorable terms on its borrowing since the Association has shown that it can successfully raise needed private capital while maintaining profitability. (See p. 24.)

ASSOCIATION COMMENTS

GAO obtained oral comments from Association officials--who generally concurred with the report--and incorporated changes where appropriate.

Contents

ABBREVIATIONS

FCA	Farm Credit Administration
FFB	Federal Financing Bank
FHLB	Federal Home Loan Banks
FHLMC	Federal Home Loan Mortgage Corporation
GAO	General Accounting Office
GSL	Guaranteed Student Loan
HEAL	Health Education Assistance Loan

CHAPTER 1

INTRODUCTION

In a March 24, 1983, letter, the Senate Committee on Labor and Human Resources asked us to conduct a study of the activities and history of the Student Loan Marketing Association (Sallie Mae) and to obtain information concerning Sallie Mae's profits, financing, and loans to Guaranteed Student Loan (GSL) program lenders. The Committee was particularly interested in whether legislative and policy changes made since the Association was created have altered its original purpose to provide support for student loans from private lenders by diverting Association efforts to such other activities as making and insuring loans directly to students. (See app. I.)

SALLIE MAE'S ROLE IN THE STUDENT LOAN PROGRAM

Under the GSL program, eligible lenders make low-interest, long-term loans to students attending postsecondary educational institutions. Loan repayment either is guaranteed by state or private nonprofit guaranty agencies and reinsured by the Department of Education or is insured directly by the Department.

As the volume of lending under the GSL program increased rapidly from 1966 to 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, the Congress created Sallie Mae 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.

The 1972 amendments to the Higher Education Act of 1965 (Public Law 92-318, June 23, 1972) established Sallie Mae to support the federally sponsored GSL program by purchasing student loans from--and making loans to--program lenders. The Congress intended that by providing a source of liquidity for lenders, Sallie Mae would be able to enhance the attractiveness of student loans to banks and other lenders and thereby generate more private capital in the student loan market.

Organizational structure

Sallie Mae is a private, for-profit, federally chartered, stockholder-owned corporation structured along traditional corporate lines with responsibility in the hands of a Board of Directors and management team. The President of the United States appoints one-third of the 21 members of the Board, and financial and educational institutions eligible to participate in the GSL program who are Sallie Mae voting common stockholders each elect one-third. The President designates a chairman from among the full membership.

Because Sallie Mae was created by the Congress, its structure and operational authorities are subject to revision by the Congress. Further, Sallie Mae's enabling legislation requires approval of the Association's financing activities by the Secretary of the Treasury and, under some circumstances, by the Secretary of Education.

Financing

The Congress created Sallie Mae in a manner similar to the other government-sponsored enterprises which provide lending and secondary market services to other programs in that program users--in this case GSL program lenders and educational institutions--would provide equity capital by purchasing Association stock, and the Association would borrow additional needed funds. While Sallie Mae did not receive any appropriated funds, the Congress has authorized the Association to borrow through September 30, 1984, with the full faith and credit, or repayment guarantee, of the federal government supporting its debt. Sallie Mae initially raised funds to finance its operations in the private capital markets. However, 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 those entities who use the full faith and credit of the federal government to support their debt. From 1974 through 1980, Sallie Mae was required by the Secretary of the Treasury to borrow exclusively from FFB at a rate slightly higher than FFB paid for its funds.

In March 1981, Sallie Mae reached an agreement with FFB to limit its borrowing from the Bank and reenter the private capital markets. Under the agreement, Sallie Mae could borrow up to $5 billion from FFB on a long-term, variable-rate basis through September 1982. Sallie Mae reached the $5 billion limit in January 1982 and has since raised its funds primarily through nonfederally guaranteed borrowing in the private capital markets and the public issuance of stock. By December 31, 1983, the Association had issued about 12 million shares of nonvoting common stock and 5 million shares of preferred stock to the public (see pp. 9 and 23.) Dividends to common shareholders are determined periodically by management, while dividends to preferred shareholders vary at fixed rates below certain long- and short-term Treasury borrowing rates.

Sallie Mae earns revenue primarily from student loans and loans it makes to lenders (called warehousing advances). Under the GSL program, the Department of Education pays holders of insured loans a quarterly interest allowance throughout the life of the loan which, when added to the statutory rate applicable to borrowers,[1] provides lenders a return approximately equal to 3.5 percentage points above the average yield of 91-day Treasury bills auctioned during each quarter. Therefore, as a holder of GSLs, Sallie Mae receives interest income on the loans it holds. In addition, Sallie Mae also earns interest income from the warehousing advances that it makes to lenders at rates that are also generally tied to 91-day Treasury bills.

As a for-profit corporation, Sallie Mae's income is subject to federal income taxes. The Higher Education Act of 1965 exempts Sallie Mae from paying state and local income taxes and exempts income earned by investors in Sallie Mae securities from those taxes.

Program activities

Sallie Mae provides GSL program lenders with a source of liquidity by offering lenders the opportunity to sell their student loans for cash and to borrow additional funds to support their student lending activities by pledging existing student loans or government-issued or guaranteed obligations as collateral. Since inception, Sallie Mae has provided about $10 billion of liquidity to about 1,800 lenders under the GSL program and held student loans and warehousing advances equivalent to about 29 percent of the outstanding student loan volume at September 30, 1983.

Sallie Mae carries out its secondary market activities primarily through its Loan Purchase and Warehousing Advance programs. By December 31, 1983, Sallie Mae had purchased $5.5 billion of student loans under the Loan Purchase program, and made $4.5 billion of loans to GSL program lenders under the Warehousing Advance program.

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[1]The Department of Education pays lenders the interest rate applicable to borrowers (either 7, 8, or 9 percent depending on when the loan was obtained) during the time the students are in school and for a short grace period, after which the borrowers begin paying the applicable interest.

OBJECTIVES, SCOPE, AND METHODOLOGY

Pursuant to the request from the Senate Committee on Labor and Human Resources, our objectives were to:

--describe the evolution of Sallie Mae from its original authority to the most recent legislative amendments and determine whether its original purpose to serve as a secondary market for student loans has been altered;

--assess Sallie Mae's profits in comparison with other lending organizations;

--determine the impact of FFB financing on government costs, as well as the impact of Sallie Mae's transition to the private capital markets for financing on profits and student loan availability;

--identify the beneficiaries of Sallie Mae's profits and retained earnings; and

--determine the extent to which warehousing advances to GSL program lenders have been reinvested in student loans.

To accomplish our work, we studied the legislative history of Sallie Mae and reviewed financial reports and supporting information provided by the Association on its activities from 1973 to 1983. We compared Sallie Mae's profitability to commercial banks using data from the July 1983 Federal Reserve Bulletin and to the other four government-sponsored enterprises which provide lending and secondary market services to other programs using the 1982 annual reports of the Farm Credit Administration, Federal Home Loan Bank Board, Federal Home Loan Mortgage Corporation, and Fannie Mae. We also discussed Sallie Mae's involvement in the student loan program with Association and Department of Education officials, and its financing arrangements and impact on government costs with FFB officials.

To address questions concerning Sallie Mae's financing activities in the private capital markets, we interviewed representatives of the following investment firms which have had principal involvement with the Association's private financing efforts and are familiar with its activities:

--Goldman, Sachs & Co.,

--The First Boston Corporation,

--Lehman Brothers Kuhn Loeb Incorporated, and

--Salomon Brothers Inc.

Finally, to obtain a broader understanding of Sallie Mae's role in the student loan program, we met with individuals who have had extensive experience with the program. These individuals represented the Higher Education Assistance Foundation--a national student loan guarantor and servicer; Citibank--a national GSL program lender (this individual also represented the American Bankers Association, which is an organization comprised of members from about 13,000 banks); Springsted, Inc.--a financial advisor to state student loan programs; and the National Association of Student Financial Aid Administrators--an organization of college and university financial aid officers. At the suggestion of the Committee staff, we also interviewed a past Sallie Mae official.

Our work was performed in accordance with generally accepted government auditing standards.

We obtained oral comments from Sallie Mae officials, who generally concurred with our report. We considered their comments and made changes where appropriate.

CHAPTER 2

EVOLUTION OF SALLIE MAE

Since Sallie Mae was established in 1972 to create liquidity for student loans by providing secondary market services for GSL program lenders, legislation pertaining to the Association has been enacted nine times. Three of the laws made technical changes, while the others expanded Sallie Mae's authorities and functions. Sallie Mae has exercised some, but not all, of the new authorities.

Sallie Mae's secondary market activities supporting student loans have grown substantially since 1973. By December 1983, the Association had purchased student loans and made warehousing advances to eligible GSL program lenders totaling about $10.0 billion, increasing the outstanding balances in these accounts from about $76 million at the end of 1973 to $7.9 billion at the end of 1983. Most of the expansion has resulted from activities authorized in Sallie Mae's initial legislation.

LEGISLATIVE DEVELOPMENT

The Education Amendments of 1972 established Sallie Mae as a government-sponsored, private, for-profit corporation. It was to be financed by private capital and was to serve as a secondary market and warehousing facility for federally insured student loans. The Association was authorized to issue common stock to GSL program lenders (educational institutions, banks, or other financial institutions), preferred stock to the public, and debt obligations whose principal and interest payments were initially guaranteed by the Secretary of Health, Education, and Welfare and, after establishment of the Department of Education in 1980, the Secretary of Education.

Sallie Mae was authorized to make warehousing advances to eligible GSL program lenders, who could use student loans insured by the Department of Education or a state or nonprofit private organization as collateral. The legislation limited warehousing advances to 80 percent of the face value of the guaranteed student loans pledged as collateral, and all of the proceeds of the advances had to be invested in additional student loans. The Association was also authorized to purchase guaranteed student loans from, and sell such loans to, eligible lenders and to service student loans.

Expansion of Sallie Mae's program authorities

Several laws enacted after Sallie Mae's initial legislation have provided the Association new or expanded authorities for conducting activities designed to support the GSL program. Sallie Mae has initiated certain activities implementing the new authorities; however, it has not exercised others, some of which are contingent on certain adverse conditions regarding student loan availability.

The legislation provided Sallie Mae with the following new or expanded authorities.

1. Purchase and warehouse loans to graduate students for the health professions.

   The Health Professions Educational Assistance Act of 1976 (Public Law 94-484, October 12, 1976) expanded Sallie Mae's secondary market authority by providing that Health Education Assistance Loans (HEALs) made by private lenders to graduate students in health professions were eligible for purchase or as security for warehousing advances by Sallie Mae.

2. Make and insure loans to students in shortage areas.

   The Education Amendments of 1980 (Public Law 96-374, October 3, 1980) and the Omnibus Budget Reconciliation Act of 1981 (Public Law 97-35, August 13, 1981) contained provisions authorizing Sallie Mae to make and insure loans directly to students under certain specific conditions. The 1980 Amendments gave Sallie Mae the authority to operate as a direct lender in areas where a severe shortage of student loan capital was found to exist; that is, where students could not obtain insured loans from commercial lenders. This authority can only be exercised when sufficient funds are not available for loans and only at the request of the Secretary of Education after consultation with and agreement of state representatives. Also at the request of the Secretary, Sallie Mae could make direct loans in states which have not established a guaranty agency or an agency to act as a direct lender to students who have been unable to obtain guaranteed student loans. The stated intent of the amendments was that the Association's direct lending role only be temporary until either a state agency was established or private lenders entered the student loan market to increase the availability of loan capital.

The Omnibus Budget Reconciliation Act granted Sallie Mae the responsibility for assuring nationwide coverage of loan insurance and the authority to insure loans--which would be reinsured by the Department of Education--in states where the demand is not being met. This new authority can be exercised only with the agreement of the Secretary of Education and only in states where (1) there is no state guaranty or non-profit agency, (2) an agency exists but is unable or unwilling to make or insure student loans, or (3) students are unable to obtain loans. The stated congressional intent of this standby authority was to assure that loans were available to all eligible borrowers, regardless of geographic location, but under no circumstances was it to diminish the strength and viability of new or existing state guaranty or nonprofit agencies.

3. Consolidate student loans.

The Education Amendments of 1980 authorized Sallie Mae's loan consolidation program under which certain borrowers could, if they desired, combine certain existing student loans into one loan and extend the repayment terms. The act provided that Sallie Mae could consolidate loans for students with debt exceeding $5,000 to more than one lender or loan program or exceeding $7,500 to one lender or program. The purpose of the consolidation program was to ease the repayment burden on borrowers by providing extended repayment periods and lower monthly payments on relatively high student loan indebtedness. In addition, the Omnibus Budget Reconciliation Act of 1981 granted Sallie Mae the authority to include HEALs in its consolidation program.

The Association's authority to consolidate existing student loan debt--which was to expire on August 1, 1983, as provided by the Student Financial Assistance Technical Amendments Act of 1982 (Public Law 97-301, October 13, 1982)--was extended to November 1, 1983, by the Student Loan Consolidation and Technical Amendments Act of 1983 (Public Law 98-79, August 15, 1983). As of March 31, 1984, the program had not been extended further, and no loans have been consolidated since November 1, 1983.

4. Trade in noninsured loans.

The Omnibus Budget Reconciliation Act of 1981 granted Sallie Mae the authority to include non-federally insured loans in its loan purchase and warehousing advance programs. The Association's authority to deal in these loans would enable it to support loans by private lenders to students who do not meet the income requirements for federally insured loans.

5. Modify its capital structure and financing activities.

The Education Amendments of 1980 and the Omnibus Budget Reconciliation Act of 1981 authorized changes to Sallie Mae's capital structure and financing activities in order to facilitate the Association's efforts to raise private capital to support its secondary market programs.

The 1980 Amendments gave Sallie Mae additional flexibility in issuing and marketing its stock by providing the Association's Board of Directors with the authority to fix the par value of common and preferred stock in line with normal par values of such stock and eliminating the requirement that the Secretary of Education approve stock issues. In addition, the amendments authorized a nonvoting class of common stock which would enable Sallie Mae to obtain equity financing from the public to supplement the financing from common stockholders, who are limited to eligible GSL program lenders.

The 1980 Amendments also made changes to Sallie Mae's debt financing authorities by (1) prohibiting the Secretary of the Treasury from requiring the Association to use FFB as a condition for Treasury approval of Sallie Mae's financing terms and (2) limiting the Secretary of Education's approval authority over Sallie Mae's debt financing to government-guaranteed borrowings. The stated intent of these modifications was to provide the Association stability and efficiency in debt financing in order to prepare it for the transition to private funding.

Finally, the 1980 Amendments extended the government's authority to guarantee Sallie Mae's debt obligations from June 30, 1982, through September 30, 1984, and provided the Association with a $1 billion backup line-of-credit with the Treasury if needed as a source of funds.

The Omnibus Budget Reconciliation Act of 1981 gave Sallie Mae the authority to deal in obligations issued by state agencies or eligible lenders involved in the GSL program. There are 46 state-operated or sponsored nonprofit organizations--most of which were created after Sallie Mae was established--that serve as secondary markets for GSLs and/or make loans directly to students who have been unable to obtain adequate financing. Most of the organizations finance their activities by issuing tax-exempt revenue bonds. In commenting on this legislation before the Congress in 1982, Sallie Mae's President said that the authority to deal in such obligations would provide an additional source of support for tax-exempt revenue bond financing for student loans by enabling Sallie Mae to purchase such bonds.

The 1981 Reconciliation Act also provided that all Sallie Mae creditors would have equal claim to its assets in the event of liquidation. The amendment was made in response to concerns that federal law (31 U.S.C. 3713) giving the government first priority in payment of debts owed would--because of Sallie Mae's extensive borrowings from FFB--inhibit private funding sources from providing nonguaranteed debt financing to the Association and thus adversely affect its transition to the private capital markets. The provision was subsequently clarified and limited to debt issued prior to certain dates, most recently to September 30, 1988, by the Older Americans Act Amendments of 1981 (Public Law 97-115, December 29, 1981), the Student Financial Assistance Technical Amendments Act of 1982, and the Student Loan Consolidation and Technical Amendments Act of 1983.

6. <u>Offer warehousing advances under more liberal conditions</u>.

The Education Amendments of 1980 modified the collateral requirements for Sallie Mae's warehousing advance program by (1) eliminating the 80-percent collateral requirement (see p. 6), thereby giving the Association the authority to determine specific requirements, and (2) providing lending institutions the option of using government-guaranteed or backed obligations, rather than GSLs, as collateral to secure advances from Sallie Mae. The change permitting government-guaranteed or backed obligations to be used as collateral enables lenders who are not currently participating in the GSL program--and thus have no such loans to pledge as collateral--to obtain warehousing advances from Sallie Mae. All advances secured by such obligations must be invested in student loans within specified time frames. The changes were intended to facilitate lender participation in the student loan program.

Regarding warehousing advances secured by GSLs, the 1980 Amendments liberalized the prior requirement that all advance proceeds be invested in student loans by permitting recipients to maintain during the period of the borrowing only the level of loans outstanding at the date of the advances (these are called "maintenance of effort" advances). The stated congressional intent for this change was to encourage lender participation in the program.

In addition to the above specific new authorities given to Sallie Mae by the various amendments, the Omnibus Budget Reconciliation Act of 1981 granted Sallie Mae's Board of Directors the general authority to pursue activities deemed necessary for the furtherance of insured student loan programs.

LEGISLATIVE IMPACT ON SECONDARY MARKET AND FINANCING ACTIVITIES

Since it began operations in 1973, Sallie Mae has purchased $5.5 billion of student loans and made $4.5 billion in warehousing advances to GSL program lenders, increasing the total outstanding balance in these accounts after borrower repayments, claims, and resales from about $76 million at December 31, 1973, following its first 3 months of secondary market activities, to about $7.9 billion at December 31, 1983. While most of the program expansion occurred in activities authorized by the Association's initial legislation, some of the increases resulted from new authorities added by the legislation described above. Under the new authorities, which accounted for about 15 percent of these secondary market activities by the end of 1983, Sallie Mae had

--made about $390 million of loans to borrowers to consolidate their existing GSLs,

--purchased about $190 million of HEALs from program lenders,

--purchased about $52.7 million of student loan revenue bonds from state-level secondary market programs,

--made a warehousing advance of $2.5 million to a university to finance noninsured student loans, and

--made warehousing advances of about $893 million secured by GSLs to lenders under the maintenance of effort provision, which allows the lenders to maintain the balance of student loans held at the date of the advance, rather than reinvesting all advance proceeds in new loans.

The maintenance of effort advances appear to have been used to make additional student loans. Sallie Mae began making these advances in 1981, and at the dates the advances were made, lenders held outstanding student loans of about $1.7 billion. By 1983--or earlier in those cases where advances had been repaid--lenders had increased the outstanding balances to about $2.3 billion, thereby exceeding the required loan levels by about $600 million.

On the financing side of its operations, Sallie Mae sold its first issue of nonvoting common stock to the public in September 1983, as authorized by the Education Amendments of 1980. The sale provided Sallie Mae with an additional $104.4 million for operations.

The other new authorities granted to Sallie Mae--some of which have caused concern among members of the student loan community--have not been exercised. For example, representatives of nonprofit organizations which have been established to make and buy student loans at the state level have expressed concerns that both the authority provided to Sallie Mae to act as a direct lender and the authority to act as a guarantor of student loans in states where loan demand is not being met will inappropriately permit the Association to compete directly with lenders and guaranty agencies, rather than acting solely as a secondary market. However, as discussed above, these authorities can be exercised only in shortage situations at the request or with the agreement of the Secretary of Education and--in the case of most direct loans--the agreement of state representatives; no such requests or agreements have been made. In addition, Sallie Mae has not exercised authorities to use a $1 billion backup line-of-credit with the Treasury or consolidate HEALs.

Despite the concerns expressed regarding Sallie Mae's expanded authorities, representatives of the banking and other student loan-related organizations we contacted indicated that the liquidity provided to lenders by the Association through its secondary market activities has contributed significantly to increased loan availability for students, and that a national secondary market for student loans is needed to stimulate continued private financing to meet loan demands.

CHAPTER 3

SALLIE MAE PROFITABILITY AND FINANCING ACTIVITIES

Sallie Mae's profits have increased annually since it began operations in 1973 as the Association has increased its secondary market activities in support of GSL program lenders. In relation to the growth of its assets--comprised primarily of student loan purchases and warehousing advances to program lenders--Sallie Mae's profitability has been within the range experienced by commercial banks and the other government-sponsored private enterprises established to provide financial support to the housing and farm industries. The Association has reinvested most of its profits in the student loan programs, rather than distributing the profits as dividends to stockholders.

Sallie Mae's transition from financing its activities primarily by borrowing from FFB to borrowing in the private debt markets has been successful. The Association has been able to obtain needed funds at interest rates which have recently been just slightly higher than the relatively low rate paid on its FFB debt and compare favorably to other private lending rates. According to investment firm representatives, the high quality of Sallie Mae's assets and its relatively secure earnings have been among the principal reasons for its ability to obtain favorable financing terms. The Association has accomplished the transition to private financing while continuing to increase its investments in student loans.

PROFITABILITY

Sallie Mae's net income, which as used herein is after taxes, rose from $318,000 in 1974--the Association's first full year of operations--to $66.6 million in 1983. To assess Sallie Mae's profitability, we compared it to other organizations in terms of three measures commonly used to indicate the relative performance of financial institutions (direct comparisons of annual profits are misleading because earnings are affected by differences in organization size, or earning assets):

1. Return on assets. This measure is one of the most significant indicators of profitability used in the business community and depicts the level of earnings generated from assets. The measure expresses net income as a percentage of an organization's average annual assets.

2. Return on equity. This is an indicator of earnings on shareholder resources (stock and retained earnings) and expresses net income as a percentage of average annual stockholders' equity.

3. Interest margin. This measure expresses net interest income (interest revenues less interest expenses) as a percentage of average annual assets and is an indicator of how well an organization manages the spread between interest rates on earning assets and interest rates on debt.

With the absence of organizations directly comparable to Sallie Mae in terms of structure and functions, we compared the Association's return on assets, return on equity, and interest margin to those of commercial banks and to the other government-sponsored, privately owned enterprises which provide financial support to the housing and farm industries. In comparing Sallie Mae with commercial banks, we made separate analyses of (1) all banks, (2) large banks with assets of $1 billion or more (Sallie Mae had total assets of $7.5 billion at December 31, 1982), and (3) large money center banks which provide regional, national, and international banking services. Regarding government-sponsored enterprises, we compared Sallie Mae to Fannie Mae, which provides supplementary assistance to the secondary market for home mortgages by purchasing mortgages at market prices; the Federal Home Loan Banks (FHLB), which provide credit to member savings and loan-type institutions and savings banks to enhance their service as savings media and home-mortgage lenders; the Federal Home Loan Mortgage Corporation (FHLMC), which operates a secondary market for home mortgage lenders by purchasing conventional mortgages to provide funds to enable lenders to meet housing credit demand; and the Farm Credit Administration's (FCA's) Banks for Cooperatives, Federal Intermediate Credit Banks, and Federal Land Banks which provide a variety of loans and financing services to farmers and related credit organizations.[1]

We made the comparisons for calendar years 1980, 1981, and 1982. Although we obtained the 1983 measures for Sallie Mae, the measures for the other organizations for that year were not readily available as of late March 1984.

As shown in figures 1 and 2, Sallie Mae's profitability as indicated by its return on assets was somewhat lower than that for all commercial banks, money center banks (except for 1982),

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[1]While these comparisons are based on earnings after taxes, FHLB, FHLMC, and FCA are not subject to income taxes.

large banks, and government-sponsored enterprises other than Fannie Mae. Fannie Mae's relatively poor return on assets, as well as its poor return on equity and interest margins shown in figures 4 and 6, reflect the mismatched interest rate experience of home mortgage lenders in the early 1980's: interest rates paid to depositors--which vary with market conditions--exceeded the fixed rates received on long-term mortgages. In contrast, as pointed out by investment firm representatives, Sallie Mae's rate of return on assets is relatively secure because it has been able to borrow funds at variable rates that are lower than the variable rates it earns on student loans and warehousing advances. The Association's return on assets rose to 0.80 percent in 1983, an increase of about 33 percent of the return it experienced in 1982.

FIGURE 1
COMPARISON OF RETURN ON ASSETS FOR
SALLIE MAE vs COMMERCIAL BANKS
(1980 -- 1982)

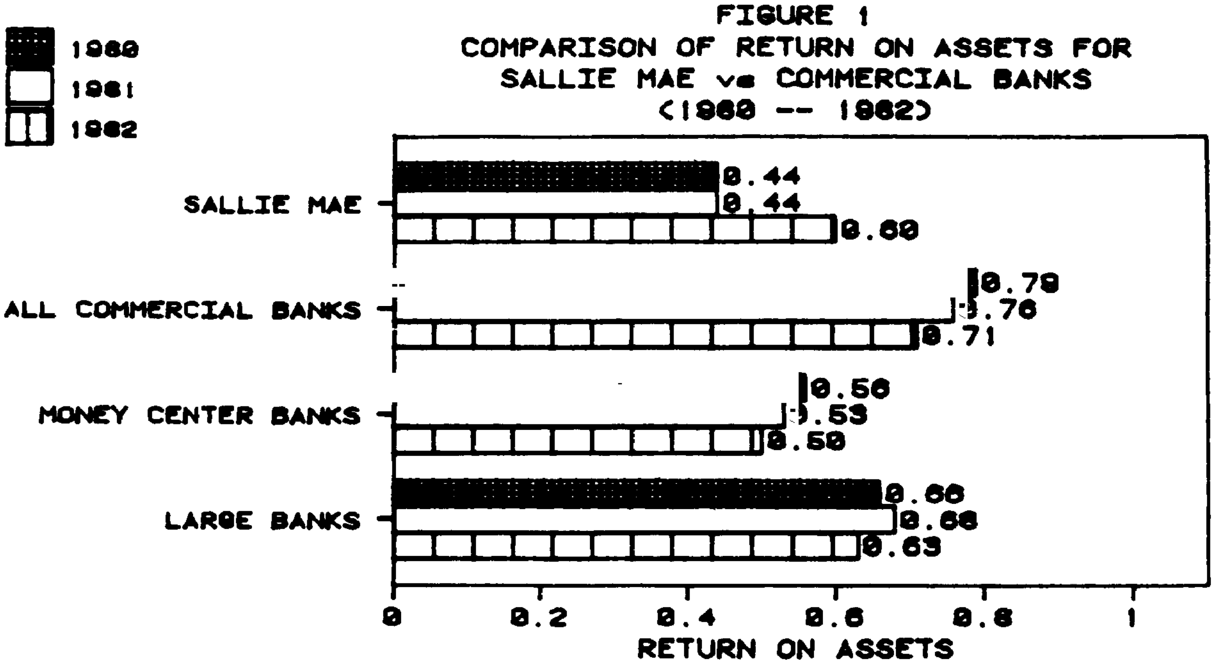
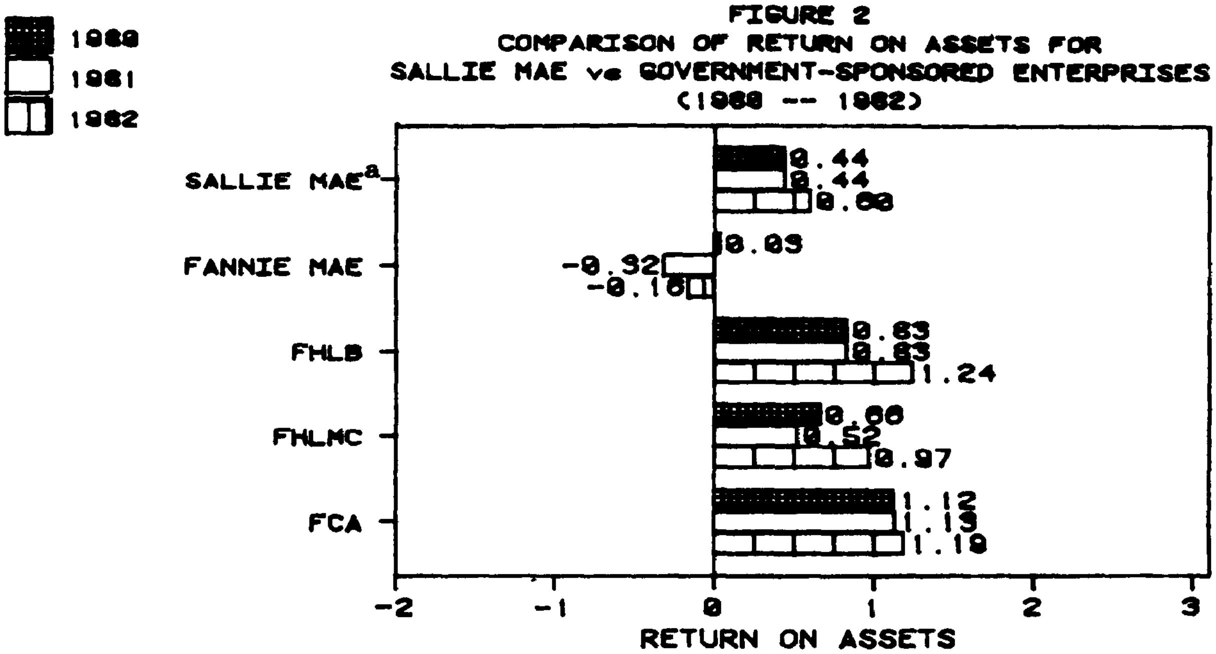


FIGURE 2
COMPARISON OF RETURN ON ASSETS FOR
SALLIE MAE vs GOVERNMENT-SPONSORED ENTERPRISES
(1980 -- 1982)



[a]On a pretax basis, Sallie Mae's returns on assets were 0.80, 0.81, and 1.10 for 1980, 1981, and 1982, respectively.

Figures 3 and 4 show that Sallie Mae's return on equity, which rose each year from 1980 to 1982, has been substantially greater than the returns of commercial banks and other government-sponsored enterprises. The Association's relatively high returns resulted in large part from its past emphasis on increasing its loan purchases and warehousing advances by financing through borrowings, while keeping its equity stable. Since income is derived from assets--in Sallie Mae's case student loans and warehousing advances--and the Association's assets have been comparatively large in relation to equity, its income as a percentage of equity has been high.

A high ratio of assets to equity can be viewed as comparatively risky because it can result from an inappropriately high level of debt. However, representatives of two of the investment firms we contacted indicated that in Sallie Mae's case the high ratio is less significant because its assets are of high quality.

Return on equity can be affected by changes in relative financing methods rather than earnings. While net income and return on assets rose, return on equity fell from 44.8 percent in 1982 to 33.8 percent in 1983, in part because the Association increased its equity base in relation to debt and assets by raising about $104.4 million through its first public issue of nonvoting common stock. An assessment of the relative merits of alternative financing methods was beyond the scope of our review.

FIGURE 3
COMPARISON OF RETURN ON EQUITY FOR
SALLIE MAE vs COMMERCIAL BANKS
(1980 -- 1982)

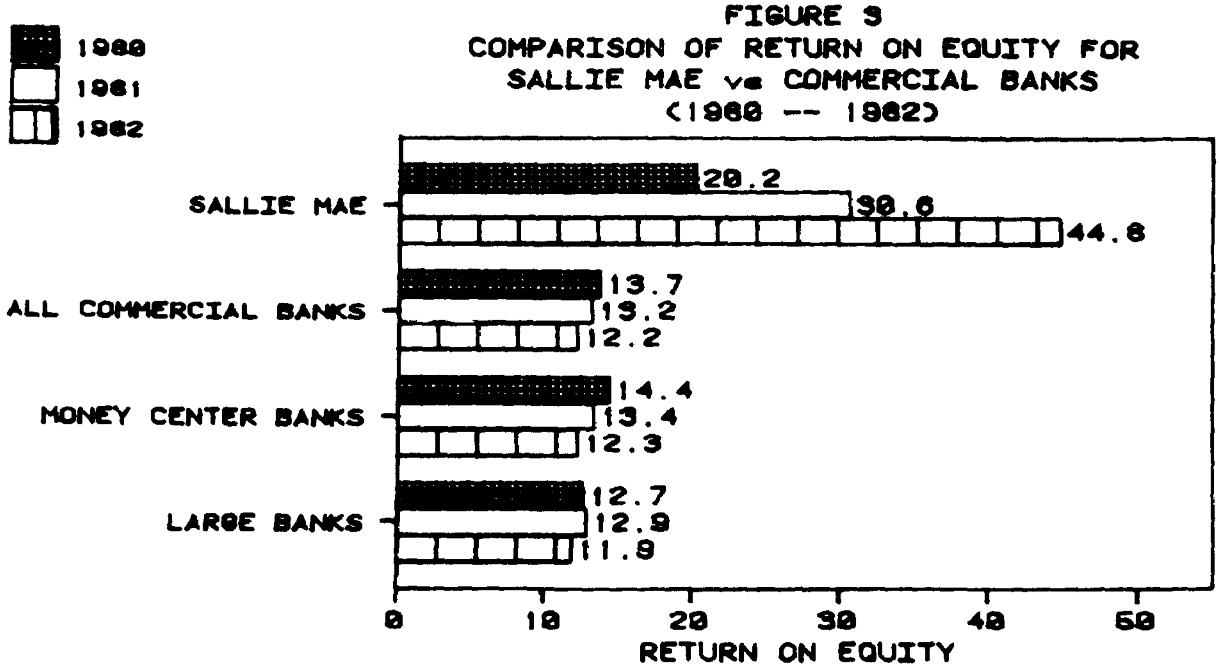
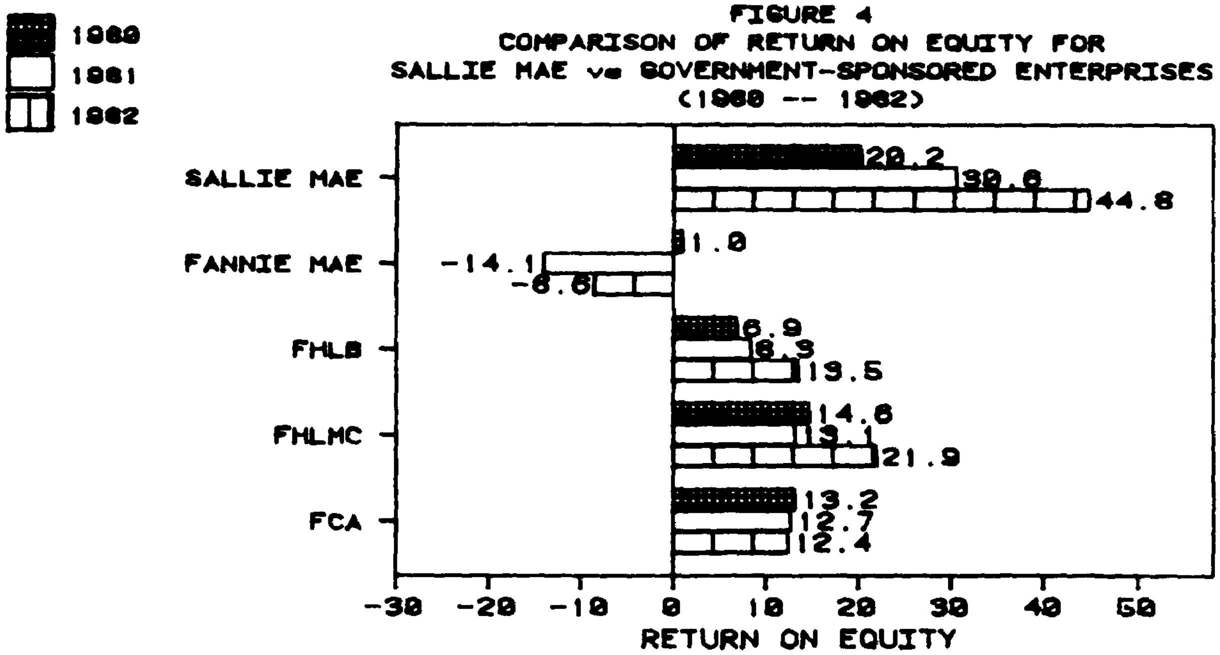


FIGURE 4
COMPARISON OF RETURN ON EQUITY FOR
SALLIE MAE vs GOVERNMENT-SPONSORED ENTERPRISES
(1980 -- 1982)



Sallie Mae's interest margins shown in figures 5 and 6 have been lower than commercial banks and, except for Fannie Mae for reasons discussed above, have been similar to other government-sponsored enterprises. The higher commercial bank margins could be expected because banks have higher operating expenses and must allow for losses on defaulted loans, while Sallie Mae incurs no such losses because its loans are directly or indirectly guaranteed by the government. During 1982, commercial banks charged off defaulted loans amounting to about one-half percent of average loans outstanding. In 1983, Sallie Mae's net interest margin increased to 1.77 percent.

FIGURE 5
COMPARISON OF NET INTEREST MARGIN FOR
SALLIE MAE vs COMMERCIAL BANKS
(1980 -- 1982)

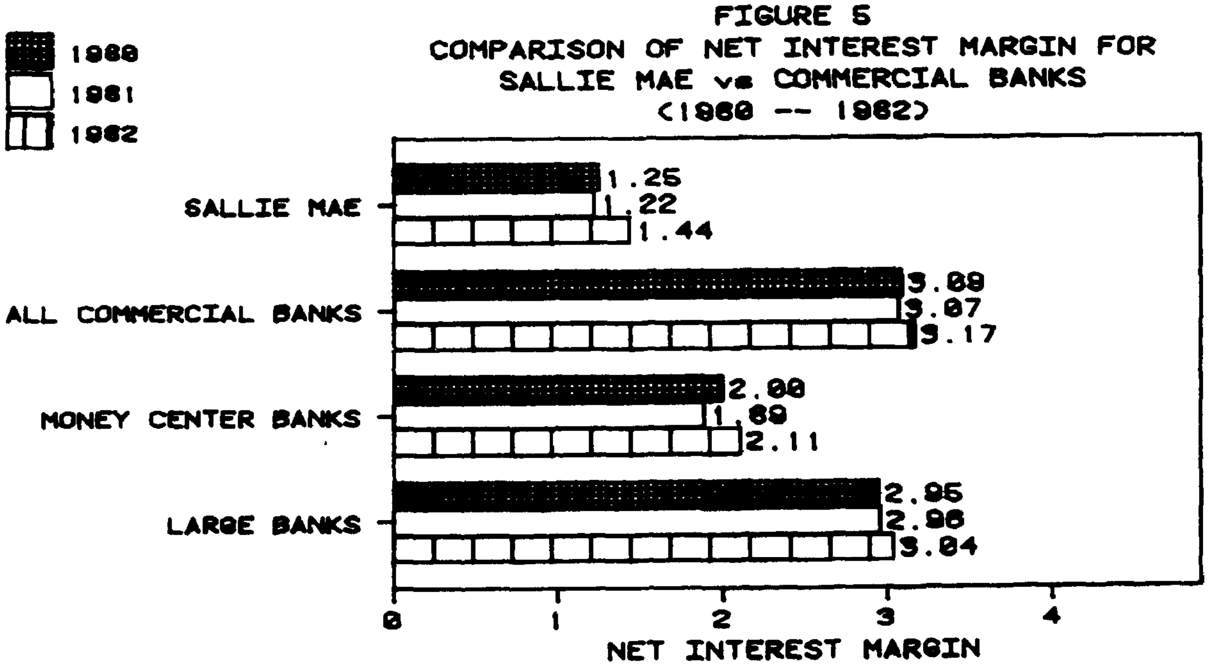
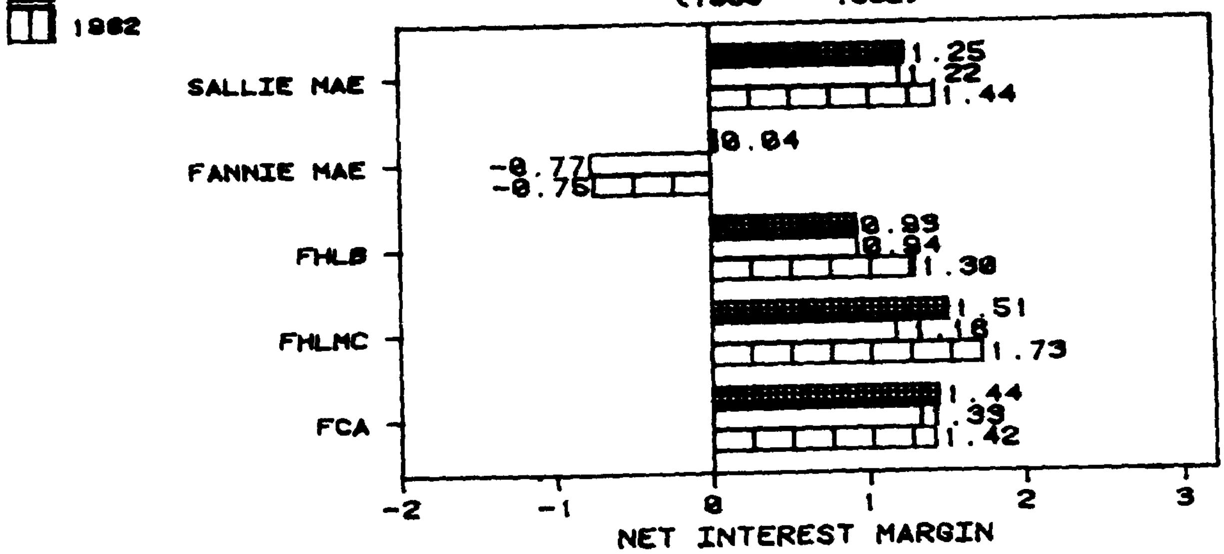


FIGURE 8
COMPARISON OF NET INTEREST MARGIN FOR
SALLIE MAE vs GOVERNMENT-SPONSORED ENTERPRISES
(1980 -- 1982)



PROFIT DISTRIBUTIONS

Sallie Mae has used most of its earnings since it began operations for program activities--primarily student loan purchases and warehousing advances to GSL program lenders--and relatively little for dividend distributions to common stockholders. The Association's net income after taxes totaled $152.9 million from 1973 through 1983, of which $126.9 million (83 percent) was used to finance activities, $9.9 million (6 percent) was distributed to common stockholders, and $16.2 million (11 percent) was distributed to preferred stockholders. Since it began paying dividends in 1977, the distributions to common stockholders have averaged 9.3 percent of annual profits, ranging from a low of 4.5 percent in 1983 to a high of 15.8 percent in 1979.

While Sallie Mae has used most of its profits for program activities, these funds have comprised a relatively small portion of total funding. Of $14.2 billion used to finance activities from 1973 through 1983, $11.1 billion (78 percent) was obtained from borrowings, $381.0 million (2.7 percent) from stock issues, and $126.9 million (1 percent) from profits. Most of the remaining funds were obtained from borrower repayments, claims, and loan sales.

In comparison to commercial banks and most other government-sponsored enterprises, dividends to Sallie Mae stockholders as a percentage of net income have been low. Table 1 compares recent dividends paid to Sallie Mae shareholders in proportion to net income with those paid to shareholders by commercial banks and other government-sponsored enterprises.

Table 1

Comparison of Dividend Distributions to Shareholders as a Percent of Net Income

	1980	1981	1982
Sallie Mae	14.1	8.5	5.6
All commercial banks	36.5	39.6	43.7
Large banks	43.9	45.6	47.6
Money center banks	39.3	39.6	44.0
Fannie Mae	471.1	(a)	(a)
FHLB	73.0	52.7	59.9
FHLMC	148.9	6.5	23.4
FCA	5.9	8.0	6.0

[a]While Fannie Mae experienced net losses during these years, it distributed dividends to stockholders.

As discussed above, Sallie Mae's return on equity--or earnings in proportion to average annual stockholders' equity--has been relatively high (see p. 16). However, because the Association has used most of its earnings for program activities, its dividend distributions to shareholders in proportion to average annual stockholders' equity, as shown in table 2, have been lower than commercial banks and generally within the range of the other government-sponsored enterprises.

Table 2

Comparison of Dividend Distributions to Shareholders as a Percent of Average Annual Stockholders' Equity

	1980	1981	1982
Sallie Mae	2.9	2.6	2.5
All commercial banks	5.0	5.2	5.3
Large banks	5.6	5.9	5.7
Money center banks	5.7	5.3	5.4
Fannie Mae	4.5	1.8	.8
FHLB	5.0	4.4	8.1
FHLMC	21.8	.9	5.1
FCA	.8	1.0	.7

During 1983, Sallie Mae paid dividends to shareholders of $19.2 million, or 28.9 percent of net income and 5.4 percent of average stockholders' equity. These were comprised of dividends to common shareholders of $3.0 million (4.5 percent of net income and 2.0 percent of average common stockholders' equity) and $16.2 million to preferred stockholders (24.4 percent of net income and 7.7 percent of average preferred stockholders' equity). Comparable information for commercial banks and the other government-sponsored enterprises was not readily available as of late March 1984.

FINANCING ACTIVITIES

After financing its activities from 1974 to 1981 primarily by borrowing from FFB, Sallie Mae agreed with FFB to cease borrowing from the Bank and obtain its borrowings from the private capital markets. In anticipation of the transition, the Association began borrowing in the private markets in 1981, and since January 1982 has borrowed exclusively in those markets at increasingly favorable rates. The private borrowings have provided most of the funds used by Sallie Mae to increase its secondary market activities in 1982 and 1983.

Financing activities: 1973-1981

Sallie Mae began secondary market operations in October 1973, and in that year borrowed $200 million in the private capital markets. It used the funds primarily to make warehousing advances to GSL program lenders ($76 million) and short-term investments ($118 million).

Sallie Mae began borrowing exclusively from FFB in 1974 and at December 31, 1981, had an outstanding balance of $4.6 billion in long-term loans from the Bank. During this period, the Association purchased $2.5 billion of GSLs and made warehousing advances to lenders totaling $3.0 billion, increasing the outstanding balances in these accounts from $75.9 million at December 31, 1973, to $4.8 billion at December 31, 1981.

In March 1981, Sallie Mae agreed with FFB to discontinue borrowing from the Bank when the outstanding debt reached $5 billion, or by September 30, 1982, whichever occurred first. According to FFB and Sallie Mae, the agreement was made to remove the Association from federally guaranteed and sponsored financing--thereby reducing federal credit activities--and to enable it to achieve its goal of becoming financially independent. In order to gain recognition in the private capital markets before the agreement took effect, Sallie Mae sold about $4.5 billion of short-term debt notes in 1981, of which about $419 million was outstanding at December 31, 1981.

Sallie Mae reached the $5 billion FFB borrowing limit in January 1982. The debt is long-term--$300 million matures between 1986 and 1995 and $4.7 billion matures between 1995 and 1997--and bears interest at 0.125 percent above the average yield of 91-day Treasury bills. This rate compares favorably to interest rates in the private sector. For example, the interest rate paid by Sallie Mae on the FFB debt during 1982 averaged 11.3 percent, while the rate paid by commercial banks on total domestic debt averaged 11.5 percent, the rate on the most highly rated long-term corporate bonds averaged 13.8 percent, and the prime rate charged by banks to their most preferred business customers for short-term loans averaged almost 14.9 percent.

According to FFB officials, the interest paid by Sallie Mae in excess of the 91-day Treasury borrowing rate is sufficient to cover the Bank's costs of administering the Association's debt, and thus there are no direct costs to the government as a result of Sallie Mae's borrowings. In fact, the officials said that FFB usually returns money to the Treasury, indicating that the payments by Sallie Mae more than cover the Bank's costs. On the other hand, the officials pointed out that in theory--due to increased competition for limited funds--the additional borrowings by the Treasury Department to meet Sallie Mae's needs could have increased the overall interest rates on the other borrowings made by the Department at that time. However, the officials stated that it is not feasible to measure the increased interest costs--if any--that may have resulted from Sallie Mae's FFB borrowings.

Private financing: 1982 and 1983

Since entering the private capital markets, Sallie Mae has been successful in raising the funds needed to finance increasing support for the GSL program through its secondary market activities while maintaining its profitability. According to investment firm representatives, Sallie Mae's ability to raise needed funds at favorable terms reflects the confidence of financing sources in the Association, which the representatives believe is derived principally from such factors as the high quality of Sallie Mae's assets and its success in minimizing the potential impact of interest rate fluctuations on its profitability.

Sallie Mae increased its outstanding debt from private sources by almost $1.9 billion during 1982. Along with the final $400 million borrowing from FFB, these financings provided most of the funds used for program operations, including student loan purchases of about $1.4 billion and warehousing advances to GSL program lenders of over $700 million. As a result, the outstanding balance of loans purchased and warehousing advances after borrower repayments, sales, and claims rose from $4.8 billion at December 31, 1981, to $6.4 billion at December 31, 1982--an increase of about 33 percent. The student loans held by Sallie Mae at September 30, 1982 (the end of the federal fiscal year), comprised about 13 percent of all GSL program loans outstanding and, if warehousing advances are included, total student loan program assets were equivalent to about 26 percent of all outstanding loans under the GSL program.

During 1983, Sallie Mae increased its outstanding private debt by about $1.1 billion. These borrowings--along with almost $357 million raised through the Association's first public issues of preferred and nonvoting common stock and $791 million from repayments on warehousing advances and student loans--provided most of the funds used for operations, comprised principally of student loan purchases ($1.7 billion) and warehousing advances ($676 million). The outstanding student loans and warehousing advances held by Sallie Mae at December 31, 1983, totaled almost $7.9 billion--an increase of about 23 percent from 1982. At September 30, 1983, the holdings were equivalent to about 29 percent of the estimated outstanding balance of all loans under the GSL program.

The interest rates paid by Sallie Mae on private borrowings have been somewhat higher than the rate it pays on the FFB debt, but are lower than other private sector rates. Compared to the FFB interest rate, which varies at a fixed spread of 0.125 percent above the 91-day Treasury bill rate, Sallie Mae's private financing rates--which are also generally variable--have declined steadily from about 0.75 percent above the Treasury bill rate in 1981 to about 0.32 percent above the rate in 1983. Interest rates paid by Sallie Mae on its total debt during 1982 and 1983 averaged 11.2 percent and 9.3 percent, respectively, which were lower than the average rates for high-quality long-term corporate bonds of 13.8 percent and 12.0 percent, respectively; the average prime rates charged by banks to their most preferred business customers for short-term loans of about 14.9 percent and 10.8 percent, respectively; and--regarding 1982--the average rate paid by commercial banks on total domestic debt of 11.5 percent. While information on the average rate paid by commercial banks on total domestic debt during 1983 was not readily available as of late March 1984, information was available on average rates paid on total domestic and foreign debt for the 6-month period ended June 30, 1983.[2] The interest rate paid by Sallie Mae on its total debt during this period averaged 8.8 percent, which was slightly lower than the average rate paid by commercial banks on total domestic and foreign debt of 9.1 percent during the period.

Representatives of the four investment firms we visited expressed the opinion that Sallie Mae's success in obtaining needed private financing at favorable rates has been primarily attributable to the confidence instilled in private lending sources by the following Sallie Mae characteristics.

--High asset quality: Sallie Mae's program assets are either guaranteed by the government (student loans purchased) or secured by collateral which is guaranteed by the government (warehousing advances).

--Secure interest earnings: Sallie Mae's net interest income--or interest margin--is relatively free from risks associated with market interest rate fluctuations because of the Association's success in arranging debt interest rates which vary at fixed spreads over Treasury borrowing rates that are lower than the fixed spreads earned on student loans and warehousing advances.

--Backup credit availability: The Secretary of the Treasury is authorized to purchase Sallie Mae debt obligations up to an outstanding principal amount at any one time of $1 billion; this authority has not yet been exercised.

--Profitability: Sallie Mae's net income has increased each year since it began operations.

Regarding profitability, the investment firm representatives advised us that while it is important for Sallie Mae to show continued and preferably increasing profits in order to obtain favorable financing, there is no particular level of profits or measure of profitability--such as return on assets--that determines Sallie Mae's specific borrowing terms.

The investment firm representatives also believed that the $5 billion of FFB debt was a factor which contributed to Sallie Mae's initial success in entering the private debt markets because it demonstrated borrowing experience and provided a long-term financing base at favorable interest rates. However, the

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[2]Foreign debt rates have been higher than domestic debt rates, and thus the average rates paid by commercial banks on total domestic and foreign debt have been somewhat higher than that paid on domestic debt only.

representatives indicated that the FFB debt no longer significantly affects Sallie Mae's private financing terms because the Association has now demonstrated that it can raise needed capital in the private markets while maintaining its profitability. While they pointed out that it is not feasible to predict Sallie Mae's financial position when the FFB debt becomes due--because the student loan programs and market conditions are subject to change--the investment firm representatives foresee no repayment difficulties.

United States Senate

COMMITTEE ON LABOR AND
HUMAN RESOURCES
WASHINGTON D C 20510

March 24, 1983

Honorable Charles Bowsher
Comptroller General of the United States
General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Comptroller General:

As we indicated to you in our letter of December 10, 1982, and as suggested in the Conference Report accompanying S. 2852 (PL 97-301), we are hereby requesting that the General Accounting Office conduct an extensive study of the activities of the Student Loan Marketing Association.

The Conference Report on S. 2852 specifies that the "report shall focus on the evolution of Sallie Mae, from the original authority under which it was established, through the most recent amendments continued in the Omnibus Budget Reconciliation Act. The Conferees are particularly interested in an analysis of whether Sallie Mae's original purpose, to provide additional capital for student loans from the private sector, has, through legislative changes or policy redirection, been significantly eroded or altered, and whether or not Sallie Mae lessened its commitment to act as a secondary market in favor of its ability to serve as a direct lender or guarantor."

To complement this broad analysis, we would like the GAO study to address the following questions:

1) does Sallie Mae's entry into the private capital markets help serve the purposes of the Guaranteed Student Loan program, that is, to meet the credit needs of students?

2) what is the level of financial return Sallie Mae needs to maintain to be successful in entering the private capital markets?

3) to what extent does the agreement among the Department of the Treasury, the Department of Education, and Sallie Mae to use \$5 billion in long-term financing authority, in the form of a 15-year variable rate note with interest at 1/8th of 1 percent above the Treasury bill rate, improve Sallie Mae's profitability?

4) does the agreement improve Sallie Mae's access to private capital? When the 15-year variable rate note becomes due, what is likely to be Sallie Mae's position in the private markets?

Mr. Comptroller General
Page Two
March 24, 1983

5) what is the cost of the agreement to the Federal government, relative to a financing arrangement at market rates?

6) does Sallie Mae's profitability help increase access to loan capital for students? who benefits from Sallie Mae's profits and retained earnings?

7) have Sallie Mae's warehouse advances to lenders been used to make student loans, or have they been used for other purposes?

We also expect that the questions addressed on pages 13 and 14 of the Conference Report will be addressed in your study.

As noted in the Conference Report, we would like this report to be completed and submitted to us by December 31, 1983. We anticipate that Sallie Mae will cooperate with you in the study.

We very much appreciate your cooperation in this matter. Please let us know if we may provide any further information which will help you in conducting this study.

Sincerely,

Claiborne Pell
United States Senator

Robert T. Stafford
United States Senator

Jennings Randolph
Jennings Randolph
United States Senator

Orrin G. Hatch
United States Senator

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