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Sallie Mae and Uncle Sam:
Cronyism in Higher Education Finance

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INTRODUCTION

In the last decade total student loan debt has grown nearly fourfold, from roughly $240 billion in 2003 to nearly $1 trillion at the start of 2013.[1] Much of the focus on this growing problem has concentrated on the increasing cost of higher education, which has been a significant concern for families, students and universities themselves. This brief looks at another side of the student loan bubble: the crony capitalism of SLM Corporation—more commonly known as Sallie Mae—and how it has come to dominate student loan markets.

Congress originally founded Sallie Mae as a government-sponsored enterprise (GSE) designed to serve as a secondary market for student loans. However, over the last few decades Sallie Mae has leveraged its lobbying activities, strong ties with the federal government and its status as a GSE to emerge as the dominant force in the student loan industry.

THE HISTORY OF SALLIE MAE

Sallie Mae began life as the Student Loan Marketing Association in 1972. It was designed to serve as a secondary market for student loans, increasing their liquidity, and thereby making it more attractive for investors to finance student lending. The Nixon administration's stated aim in creating Sallie Mae was to catalyze private investment in student loans by converting relatively illiquid loans into bonds backed with an explicit guarantee from the United States Government. In addition to its government guarantee, Sallie Mae was able to secure financing from the Federal Financing Bank, allowing it to borrow more money at better terms than non-GSE financing institutions.[2] Another competitive advantage was that, as a GSE, Sallie Mae enjoyed lower capital requirements and could operate at a higher leverage than its competitors. And Sallie Mae was also exempt from state and local taxes on its franchise, capital and income.

This combination of government-conferred benefits enabled Sallie Mae to grow rapidly, transforming itself from a start-up company to a major financial institution in only a few years. Sallie Mae's growth was rapid even by comparison with the rapidly growing student loan industry, more than doubling in size every five years.[3] According to the Congressional Budget Office, by 1991 Sallie Mae held 27% of federally guaranteed student loans, dwarfing its next competitor, Citibank, which held only 4%.[4]

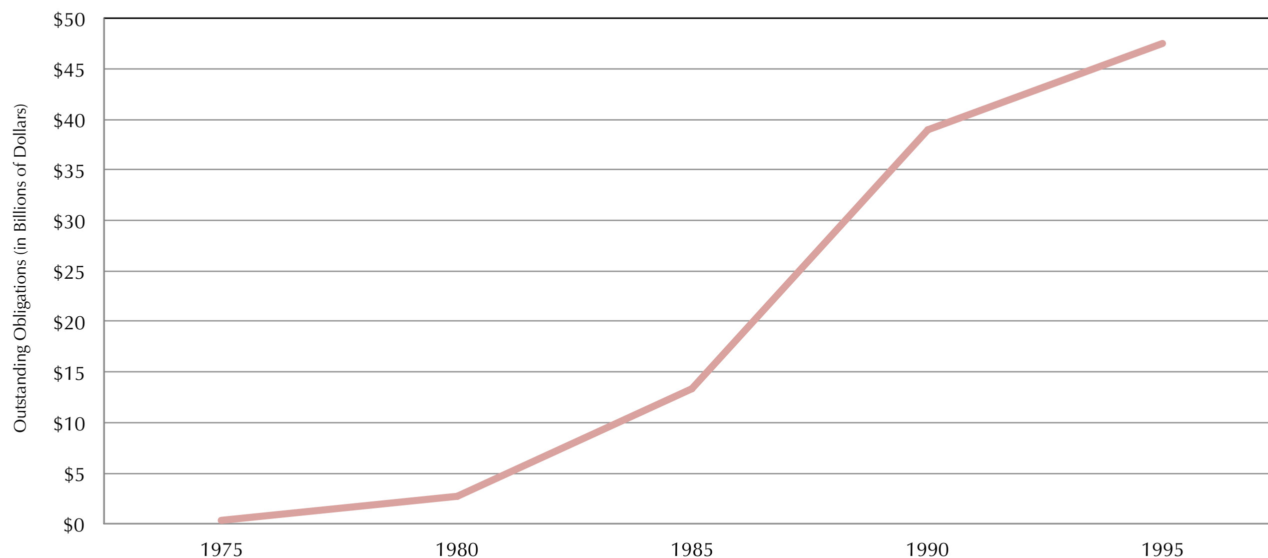
Figure 1 shows the growth in Sallie Mae over time as a GSE. Sallie Mae was able to grow from a company with $300 million dollars in outstanding obligations in 1975, to a company with over $47 billion in outstanding obligations in 20 years. In order to maintain its scale and its privileged status, Sallie Mae developed a close relationship with the federal government, and became known for its formidable lobbying presence, especially toward the education committees and subcommittees of Congress.[5]

As early as 1993 Sallie Mae began investigating alternatives to its GSE status. The loan giant's management decided it could not sit and watch increasing competition from major lenders and the federal government as it faced rising operating costs due to federally imposed mandates.[6] Arguing that it had achieved its mission as a GSE in providing financing and liquidity to the student loan market, Sallie Mae began lobbying for its independence, which it was granted as part of the Student Loan Marketing Association Reorganization Act of 1996. After a transition period, in December of 2004 the Treasury Department announced the removal of government sponsorship from Sallie Mae, transforming the former GSE into a wholly private company—four years ahead of schedule.[7]

During the transition phase, and as a private company, Sallie Mae continued the growth it had experienced as a GSE. Sallie Mae's alliances in Congress secured the company generous concessions when it began the process of privatization. This included avoiding an "exit fee," something discussed as a means of offsetting the substantial benefits that Sallie Mae had obtained as a GSE, which would be reflected in the market power it would now have in the private sector.[8] Sallie Mae's moves to acquire numerous guarantee, origination and collections companies under a single corporate banner had fundamentally altered the student loan marketplace and made Sallie Mae the undisputed leviathan of the student loan industry.[9]

Since the early 1990s Sallie Mae has grown to become the dominant force in the student loan market in terms of the holding and origination of federal

Figure 1: Growth of Sallie Mae as a GSE, 1975–1995 (Outstanding Obligations in $Billions)



Source:Thomas H. Stanton, "The Privatization of Sallie Mae and its Consequences," American Enterprise Institute, June 26, 2007.

student loans. One of the biggest benefits Sallie Mae enjoyed post privatization was what former SLM CEO Lawrence Hough described as the ability to acquire new sources of volume without first needing to seek the approval of external entities (i.e. federal bureaucracy), as well as the ability to acquire several related lenders and firms.[10] In 2009, flexing its post-privatization muscle, Sallie Mae held or originated nearly $175 billion in Federal Family Education Loan Program loans (FFELP)—more than Citigroup, Wachovia, Wells Fargo and JP Morgan Chase combined—by a factor of four (see Table 1). FFELP loans are federally guaranteed student loans in which the government subsidizes private lenders in order to keep interest rates on these loans artificially low.

Table 1: Largest Federal Family Education Loan Program Originators and Holders, 2009 in $Billions

Lender	Origination Volume	Holder Volume	Total Volume
Sallie Mae	$20.99	$154.10	$175.09
Citi Student Loans	$5.87	$32.50	$38.37
Wachovia Education Finance Inc.	$5.54	$13.20	$18.74
Wells Fargo Education Financial	$5.15	$14.60	$19.75
Bank of America	$4.92	$10.10	$15.02
JP Morgan Chase	$3.55	$11.10	$14.65
Pittsburgh National Corp (PNC)	$2.66	$5.30	$7.96
U.S. Bank	$2.26	$4.40	$6.66
Discover Bank	$1.73	$1.10	$2.83
EdAmerica	$1.56	$0.90	$2.46
National Education Loan Network	$1.56	$25.30	$26.86

Source: 2009 data from FinAid.org. Accessed May 13, 2013.

SALLIE MAE PLAYING UNCLE SAM LIKE A FIDDLE

Relying on its friends in Washington, the privatized Sallie Mae continued to enjoy the advantages of its history as a GSE, and leveraged its extensive political connections to maintain those advantages and to secure additional government contracts for servicing federal student loan programs. Perhaps the most significant example of Sallie Mae's influence peddling came with the passage of the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act, a sweeping bill of regulatory reforms targeting countless aspects of the finance industry, including student loans. The bill extended a provision that made federally guaranteed student loans non-dispensable in bankruptcy to privately originated student loans. This means that if students declared bankruptcy, their student loans could not be absolved. This now made it as difficult for a student to discharge a private loan as a federal loan.[11]

Federally guaranteed student loans had been non-dischargeable in bankruptcy since 1998, and had strict guidelines including good faith repayment in one form or another since 1976. This had generated little controversy since federal student loans offer numerous borrower protections to help avoid default.[12] According to proponents of the law, the expansion of these non-discharge provisions was designed to curtail abuse of bankruptcy proceedings to eliminate student debt, which would help increase the availability of private capital in student loan markets by decreasing the risk of loss on student loans issued.[13] The changes moved private student loans into the same category as debt obtained through fraud, drunk driving and neglected child support, substantially reducing the debtor protections enjoyed by student borrowers.[14]

Opponents of the law argued that there was no data backing up the claim used to justify the increasingly strict standards governing student loans, namely, that some students enter into student lending contracts with no intention of repaying them. Experts have argued that many restrictions have been introduced solely on the basis of "anecdotal information," without any empirical evidence supporting the claim.[15] Instead, the narrative that students are routinely graduating from college with debt and immediately declaring bankruptcy after graduation was pushed by Sallie Mae and other student lending companies in the hopes that these measures would even further reduce the risk shouldered by lenders when issuing student loans. Sallie Mae alone spent nine million dollars lobbying Congress between 1999 and 2005 when the bill was under consideration, including $130,000 in campaign contributions to members of the key committees considering the legislation.[16] The upshot was that Sallie Mae was able to secure a substantial reduction in debtor protections for student borrowers, thereby mitigating the student finance industry's exposure to risk even further.

SALLIE MAE'S COLLUSION POST-PRIVATIZATION

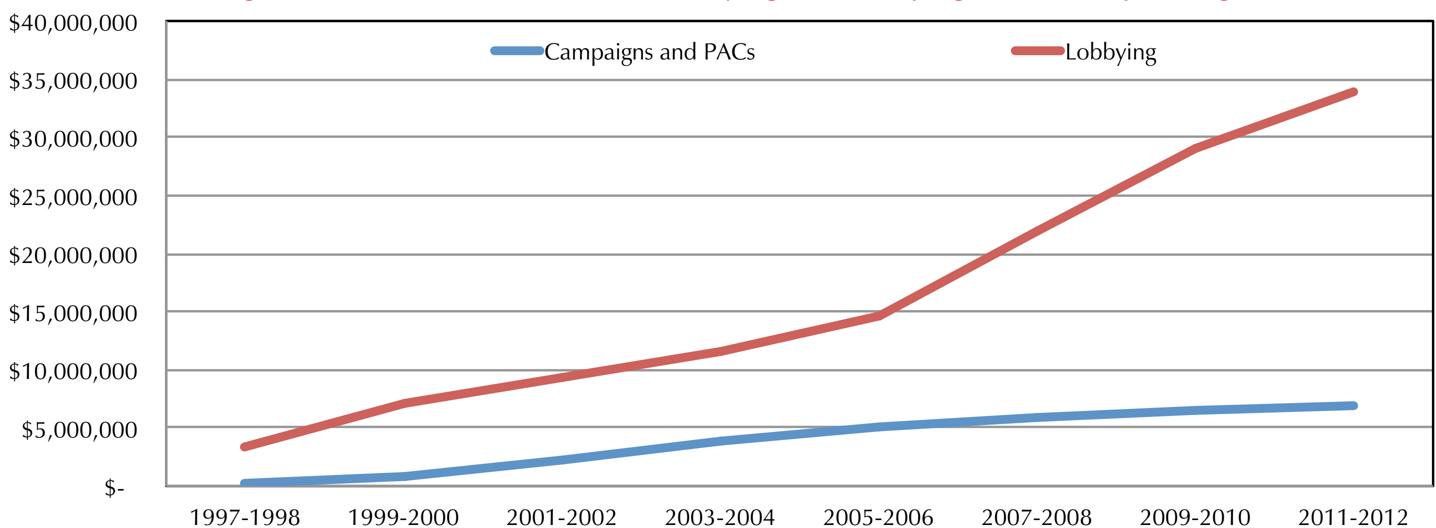
Cumulatively, Sallie Mae has spent over $40 million on lobbying and campaign donations since 1997 in an attempt to maintain itself as the top student loan corporation in the U.S. Since privatization in 2004, Sallie Mae's lobbying efforts have greatly expanded. Its lobbying expenditures rose 36% from the end of 2004 through 2006, and 171% through 2008. Since 1997 its average annual lobbying expenditures exceed $4.2 million.

A 2010 article in the *American Bankruptcy Law Journal* (*ABLJ*) found that through its lobbying operations Sallie Mae has specifically sought to penetrate 'first-tier' congressional offices, hire Democrat-affiliated lobbying firms to build relationships with congressional Democrats, and continue to work with Republicans to combat proposals which challenged the company's ability to turn a profit.[17] Particularly revealing were Sallie Mae's efforts against legislation proposed by Senator Dick Durbin which would allow for the discharge of private student loans in bankruptcy, a move that would effectively undo the changes made applicable to student loans in the bankruptcy code as part of the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act. The *ABLJ* article suggests that the Durbin bill failed because of interest group capture, noting that the history of the bankruptcy code's student-loan discharge provisions are indicative that Congress has been bowing to the lender lobby.[18] Such behavior reflects "crony capitalism," the collusion of government with the private sector to provide economic benefits to a narrow interest group.

In more recent years, Sallie Mae has used its lobbying power to maneuver around numerous challenges that the company has faced. When the financial crisis struck, Sallie Mae was a prime beneficiary of the Ensuring Continued Access to Student Loans Act of 2008 (ECASLA). This act, signed into law by President Bush in 2008, expanded funding for federal student loan programs in an attempt to provide additional liquidity to the student loan finance market. Sallie Mae supported the initiative, releasing a statement claiming that ECASLA comes at no cost to taxpayers and provides a comprehensive solution to the credit crunch facing the student loan market.[19]

Ironically, the bill sought to achieve this through the initiation of a loan purchase program in which the Department of Education would provide a secondary market for student loans held by private lenders, the same purpose for which Sallie Mae was created during the 1970s. This secondary market would help shore up the availability of private capital in student loan markets, preventing the financial crisis from interrupting the availability of federally backed but privately originated student loans.[20]

Figure 2: Sallie Mae Cumulative Lobbying and Campaign Finance Spending



Source: influenceexplorer.com

Although Congress had the opportunity to expand the Direct Loan Program, private lenders including Sallie Mae pushed for a bailout of the FFELP program and insulation from market forces which challenged their profitability. Testifying before Congress, Sallie Mae Vice-Chairman and Chief Financial Officer Jack Remondi lobbied for reforms which would allow the Federal Financing Bank to purchase loans originated by private lenders, saying that such "budget-neutral steps" would provide liquidity to the FFELP program and ensure student access is uninterrupted.[21]

At the same time, Sallie Mae positioned itself to win the contract to service much of the newly acquired debt from ECASLA. Sallie Mae's lobbying efforts even included bringing back two thousand jobs it had previously outsourced to overseas operations to enhance the company's appeal.[22] It paid off, with the company ultimately servicing over 40% of the total volume of loans purchased by the Treasury under the program.[23] Sallie Mae's lobbying for ECASLA did not end with the bill's passage, however, as the ascent of President Obama to the White House once again brought student loan reform to the forefront of the discussion.

President Obama's election could have been seen by Sallie Mae as a threat to the status quo, as the president's promise to reform the student finance industry put the company's profits in danger. President Obama's proposed reforms, contained within the Student Aid and Fiscal Responsibility Act (SAFRA), sought to reform the way the government issues federally backed loans. It would have eliminated the FFELP program and transitioned all federally guaranteed loans into an expanded Direct Loan Program. SAFRA was promoted as a means to achieve savings by ending subsidies to private lenders who originate federally backed loans under the FFEL program, which would then be transferred toward an increase in funding for the Pell grant program (federal, need-based higher education grants administered through the Department of Education). Sallie Mae immediately began preparing to oppose the measure, with the firm's lobbyists focusing on senators regarded as fiscal conservatives and senators in states that were home to lending centers with jobs at stake, states including Florida, Illinois, Nebraska, New York and Pennsylvania, in order to drum up enough opposition to sink the bill.[24] Officials from the company claimed that the legislation would result in the layoffs of 30% of their workforce, a key component of their public outreach and grassroots lobbying efforts.[25] Sallie Mae and other lenders also pushed the narrative that SAFRA was a government takeover of the student loan industry, despite the fact that the FFELP program, like the direct loan program SAFRA sought to expand, was a federal program.[26]

Sallie Mae developed a counterproposal to the president's plan, which would have maintained the FFELP program in a modified form. Essentially, Sallie Mae's proposal constituted the permanent institutionalization of the ECASLA bailout, with some modifications, allowing for the sale of FFELP loans to the Department of Education, which would contract loan servicing through the lenders originating the loan, or a competing contractor. The proposal would also have modified the way in which lending institutions were compensated, so that lenders no longer had to remit excess borrower payments to the government when the commercial paper rate plus the special allowance of 1.19 percentage points dipped below the interest rate charged on FFELP loans, guaranteeing compensation for lenders. Additionally, lenders would have the option to retain the rights to service loans sold to the Department of Education, a major modification from ECASLA provisions under which the lender lost all servicing rights upon sale of the loan to the Department of Education.[27]

The company hired Tony Podesta and Jamie Gorelick, both of whom have deep connections within the Democratic Party, to lobby for the plan and oppose the Obama administration's proposal.[28] Although SAFRA was ultimately signed into law, Sallie Mae's lobbyists were able to secure a number of key concessions and contracts, ensuring Sallie Mae's viability under the new framework for federal student loans.

Part of that came in the form of a $50 million grant to Sallie Mae and other FFELP loan originators to "retrain and redeploy workers" as a component of a job retention program.[29] Sallie Mae was also one of four companies selected to service new loans issued under the Direct Loan Program as well as over $550 billion in loans currently outstanding.[30] The expansion of Direct Loan Servicing and increases in private loan origination have allowed Sallie Mae to achieve record profits and consistently exceed expectations as

the business continues to grow.[31] Despite the relatively lucrative nature of the new outlook for the student loan industry, and the job retention money that Sallie Mae received, the company still eliminated 2,500 jobs that year.[32] The Department of Education disputed Sallie Mae's claim that the job cuts were all due to the change in the law.[33] Is this just another example of Sallie Mae playing Uncle Sam like a fiddle? Or has SAFRA actually delivered a blow to the student loan giant?

It's hard to tell. In May 2013 Sallie Mae announced it was splitting into two separate publicly traded entities.[34] One entity would be a legacy company focusing on collecting on loans it has already issued, including loans issued in the past through FFELP. This company would hold 95% of Sallie Mae's current assets.[35] The second company would act like a consumer bank, issuing new loans as well as expanding the traditional banking services Sallie Mae provides.

Why split? The move is likely in response to the changing landscape in the student loan industry since the implementation of SAFRA. But has SAFRA really crippled Sallie Mae? Not likely, as the company's profits continue to soar. Rather than crippling Sallie Mae, SAFRA has just forced the company to restructure the way it does business. In April of 2013 the company reported that its first-quarter earnings had more than tripled from the previous quarter, a sign that the company is not in any serious trouble at the moment.[36]

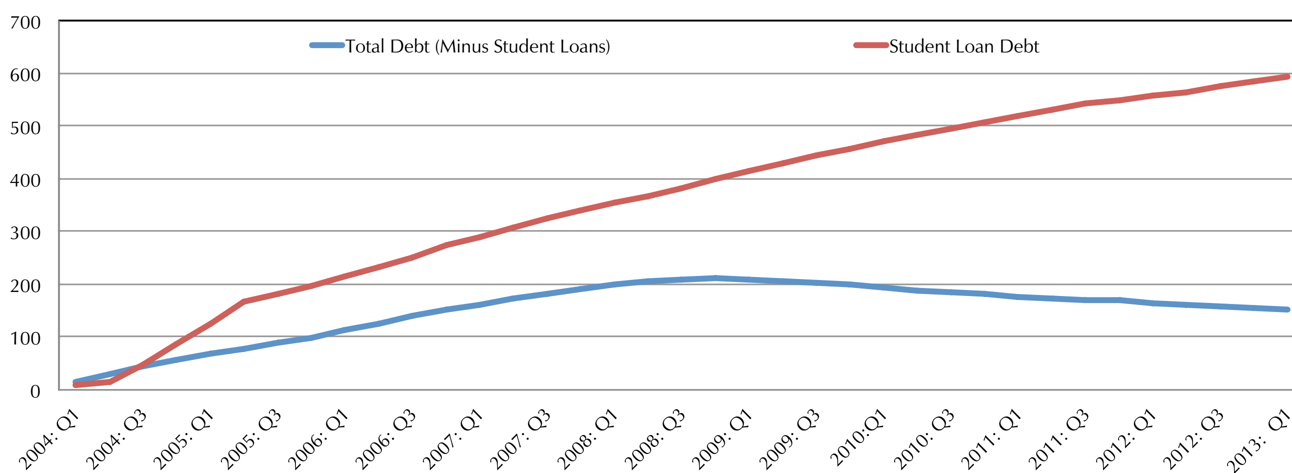
Sallie Mae contends that the split provides the company the best opportunity for future growth. However, it could also be seen as a means of hedging against damage the company might sustain from the risk of greater student loan defaults and delinquencies, since the government is no longer subsidizing Sallie Mae's loans through FFELP. But with all the advantages Uncle Sam has provided Sallie Mae over the years, its new lending entity is in a good position to maintain dominance in the private student loan market.

THE NEGATIVE EFFECT ON AMERICANS OF HIGHER EDUCATION CRONYISM

A well-educated populace has many benefits. But it does not automatically follow that the federal government should use its powers and taxpayers' money to increase access to student loans beyond what would otherwise be available through private lenders, philanthropists and educational establishments.

And while government subsidies to student loans have increased demand for higher education, the supply of higher education has not increased commensurately. As a result, the cost of tuition has risen dramatically. In the last 10 years alone, the tuition costs of attending a four-year public or private university have

Figure 3: Total Household Debt vs. Student Loan Debt from 2004 to 2012 (Percentage Increase Since 2004)



Source: *Quarterly Report on Household Debt and Credit, Federal Reserve Bank of New York,* June 2013. http://www.newyorkfed.org/householdcredit

both risen over 60%.[37] And as tuition fees have risen, so has the amount of debt assumed by students.

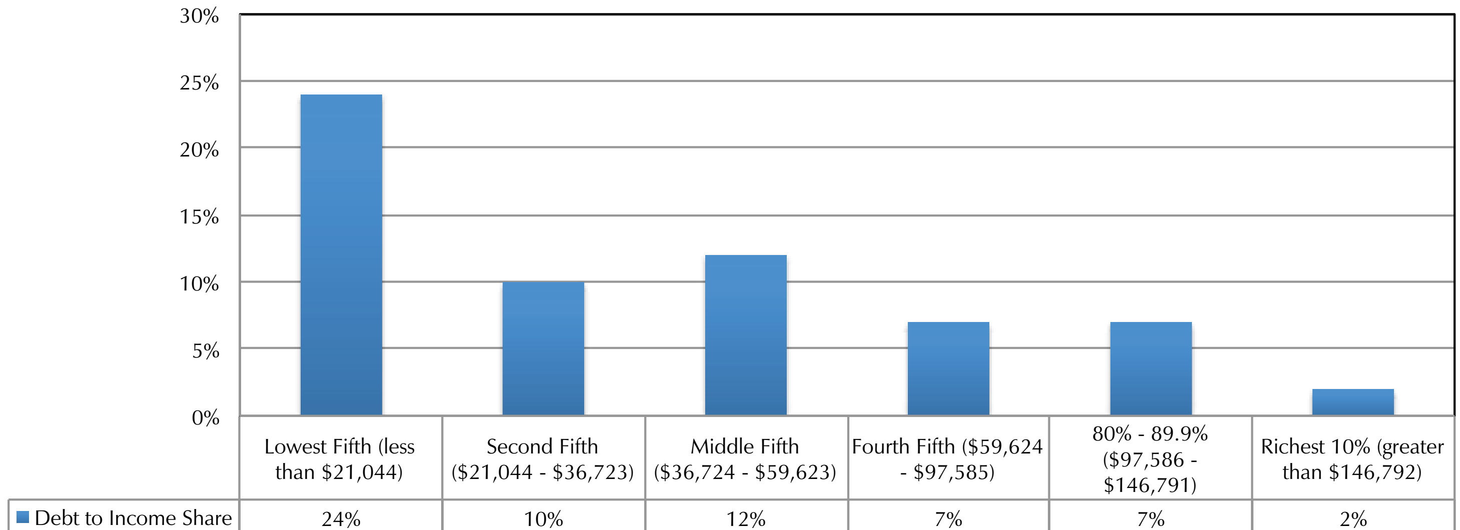
The recession from 2007-2009 did lead to a historically higher than average increase in enrollment in higher education, but it's not likely to have been a major contributing factor in the rising cost of education over time. In 2009, undergrad enrollment increased 7% from the previous year—that's 3% higher than the 10-year average annual increase. That spike also hasn't lasted post recession and cannot explain the increase in tuition over the last couple decades.

Figure 3 above demonstrates the seriousness of the student loan debt situation. Since 2004, student loan debt has grown by 594%. In contrast, over the same period total household debt (which includes things like mortgage, auto loan and credit card debt) has grown by 152%. Again, unlike mortgage, auto loan and credit card debt, which can go away if you declare bankruptcy, student loan debt does not. The amount of student loan debt created, in part because of the relationship between private lenders and the federal government, is and will continue to be a significant drag on the economy.

In minutes released from the Federal Reserve's Federal Open Market Committee meeting from March 2013, FOMC members expressed concern over the high level of student debt and the negative effects it could be having on the economy, mentioning it among the factors limiting increases in aggregate household spending.[38] The reason why student loan debt can negatively effect the economy is because the payments on the interest and principal of the debt can easily constitute a substantial portion of one's personal income—money that could otherwise be invested elsewhere.

A 2012 Pew Research Center survey found that 19% of households (1 in 5) owe student loan debt, with the average balance being $25,682.[39] The survey found that the cohorts bearing the greatest burden of student loan debt are the young and the poor. Forty percent of households headed by someone younger than 35 are holding student loan debt, and student loan debt as a percentage of household income is greatest among the lowest one-fifth income group, which bears a 24% debt-to-income ratio.[40] Figure 4 below shows household student debt-to-income ratios for the various cohorts, which trend downward as household income starts to rise.

The survey found that every income cohort saw a rise in the its respective student loan debt-to-income ratios from 2007, with the greatest increases among the lowest fifth and highest fifth income groups.[41] It makes sense that households in the lowest one-fifth of income groups face the highest student loan debt-to-income



Source: Richard Fry, "Burden Greatest on Young, Poor," Pew Research Center, September 26, 2012. http://www.pewsocialtrends.org/files/2012/09/09-26-12-Student_Debt.pdf

burden, as this cohort is likely to consist of many recent grads who are just starting out their careers and haven't been able to pay off much of their debt.

The takeaway from Figure 4 should be the illustration of the uphill climb that new graduates face, and how the climb is only going to get steeper over time if Sallie Mae continues its manipulation of the student loan market. While tuition and student loan debt has been steadily increasing over time, wages and incomes haven't. Household income has fallen over 8% since the year 2000.[42] While the report finds that those at the upper end of the income scale are more likely than others to owe student loan debt, the relative burden is greatest when the purse strings of a household are the tightest—and the relative burden is expected to rise in the lowest income cohort over time despite the fact that that this cohort is less likely to attend college than the others.[43]

Finally, the cronyism in higher education finance has prevented a private sector student loan market from firmly establishing itself. Figure 5 shows how federal support for student loans has crowded out true private supply. Especially following the financial crisis, federal money has all but killed off the nascent private market that emerged in the mid-1990s. Today, private student loans account for less that 2% of the total.

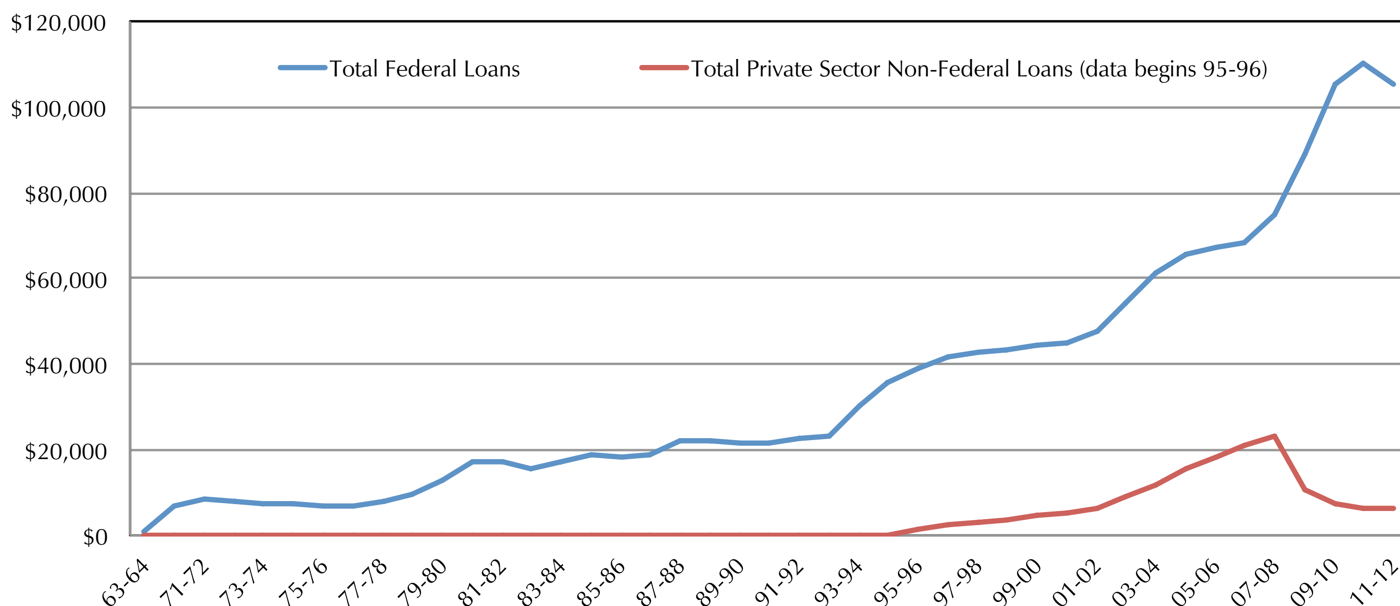
CONCLUSION

Sallie Mae has used its political influence to build and maintain its profitability in spite of the financial crisis and throughout numerous attempts to reform the industry. It has used this influence recently to secure massive servicing contracts from the expanded Direct Loan Program, acquire a multi-billion dollar bailout of the student loan industry, and to procure the removal of significant debtor protections from privately issued student loans, of which the company is the largest originator.

It will be interesting to see if Sallie Mae's new lending entity can maintain the dominance over the industry that Sallie Mae has traditionally had now that the federal government has ended the FFELP program.

Influence peddling has become an integral part of Sallie Mae's business model. The resulting situation is unfair to students and taxpayers alike: students end up paying higher college tuition fees and are saddled with more debt; taxpayers are left sitting on a ticking time bomb of accumulated government-backed debt. When the student loan bubble bursts and Uncle Sam is called upon to bail out Sallie Mae, the cost could run into the billions. What is the solution? Ideally, the federal

Figure 5: Federal Student Loans vs. Private Student Loans (in $2011 Millions)



Source: *Trends in Student Aid 2012*, CollegeBoard, http://trends.collegeboard.org/student-aid.

government should exit higher education finance altogether. This would not only stop the cronyism rampant in the system, it would also lay the ground work for a more robust private sector student loan industry—with no federal guarantee, no protection against the bankruptcy of borrowers, and no competition from the federal government through the expanded Direct Loan program. Such an industry would likely establish a vetting process to reduce the risk of default. Most likely several competing models would emerge. The result would almost certainly be a reduction in the total number of students—and consequently a decrease in the cost of tuition, as colleges compete for a declining pool of students.

ABOUT THE AUTHORS

Victor Nava is a research assistant at Reason Foundation, where his work focuses on crony capitalism, financial regulation and monetary policy. Victor is also participating in the 2012–2013 Koch Associate Program. His work has appeared on Reason.org and RealClearMarkets.com, as well as in the *Orange County Register* and Reason Foundation's 2013 *Annual Privatization Report*. He previously worked on monetary policy and regulatory issues as an intern at Reason Foundation and the Cato Institute. Victor holds a B.A. with a double major in Economics and Philosophy from Florida International University.

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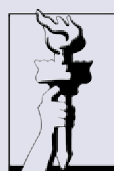

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