

Sallie Mae Moves to Buy State Agencies, Scaring Critics

New, aggressive strategy brings warnings of monopoly and problems for students

By STEPHEN BURD

After a decade of swallowing up competitors, Sallie Mae appears to have adopted an even more aggressive strategy, producing anxiety among other players in the student-loan industry and warnings of dire consequences for students.

While most of the loan giant's previous takeovers were friendly, now it is acting like a predator, engaging in what some competitors say is a systematic effort to acquire some of the country's largest nonprofit, state-based loan agencies.

The loss of nonprofit loan providers like the state agencies could hurt students because those lenders have long offered the best deals on loans, funneling revenue back into discounts for borrowers.

"It's no secret that some for-profit loan providers have started offering borrower benefits in response to competition from nonprofits," says Kathleen Smith, president of the Education Finance Council, which lobbies on behalf of the 30 state and regional nonprofit loan agencies. "It's easy to see then how the loss of that competition could translate into higher costs for students."

Observers who fear Sallie Mae's new strategy point to Pennsylvania, where in December 2004, the company stunned the loan industry by offering the state \$1-billion to take over most of the operations of the Pennsylvania Higher Education Assistance Agency, the student-loan agency commonly known as Pheaa.

The agency's officials and their allies in the legislature fought back and last year were able to thwart — at least temporarily — what they considered to be a hostile takeover.

Now supporters of the nonprofit lenders see Sallie Mae's fingerprints on proposals made this year by the governors of Illinois and Missouri to sell the assets of the states' student-loan agencies to pay for the governors' pet projects.

While Sallie Mae denies accusations that it was behind the governors' efforts to sell the loan agencies, company officials say they are likely to bid on the agencies if the two state legislatures agree to put them up for sale.

"We're certainly going to be interested," Thomas J. Fitzpatrick, Sallie Mae's chief executive officer, told financial analysts at a conference this month held by the investment bank Credit Suisse.

Letting Go

In the decade that has passed since Sallie Mae cut its ties to the federal government, it has transformed itself into a Fortune 500 company with an annual net income that approaches \$2-billion.

The lending company, which was forbidden from making loans to students when it was under the government's control, is now the nation's largest student-loan provider, making more than \$5-billion a year in federal loans. It also owns more than \$100-billion in student debt, accounting for more than half of the total assets in the federal guaranteed student-loan program, and four times more than its leading competitor.

All that has led *Fortune* magazine to call Sallie Mae a Wall Street "superstar," noting that its stock has risen a remarkable 1,900 percent in value since 1995, compared with the benchmark Standard & Poor's 228-percent gain over the same period.

Many student-aid experts believe that Sallie Mae has gotten too big and too strong. Its growth, they argue, has led to an overconcentration of power in the student-loan marketplace.

The federal government has only itself to blame, these experts say, for unleashing Sallie Mae, a company that it had nurtured from birth and provided with special advantages, without putting any growth controls in place.

"Sallie Mae is on the march toward monopoly here," says Barmak Nassirian, associate executive director of the American Association of Collegiate Registrars and Admissions Officers. "It's important to understand that we are witnessing the inevitable outcome of legislative changes made years ago."

Congress created the Student Loan Marketing Association as a government-sponsored enterprise in 1972 because policy makers at the time feared that banks alone would not have enough money to meet student demand for loans. Sallie Mae, as the entity soon became known, was directed to use U.S. Treasury funds to purchase government-backed loans from banks, providing the banks with money to make more loans.

By the 1980s, Sallie Mae was doing so well that it no longer needed direct federal financing to purchase loans; instead it turned to Wall Street. Because of its implicit backing from the government — lowering the risk of defaults because the government would cover nearly any losses — it was able to raise enormous amounts of capital at low interest rates to buy and service student loans. In the process, it racked up tremendous profits.

Sallie Mae's assets multiplied eightfold during the early 1980s and early 90s, as federal student-loan volume soared.

But the financial success also attracted more scrutiny. Reports that the top officers of the Congressionally chartered corporation were pulling in seven-figure salaries led to charges

in Congress that Sallie Mae and other loan providers were getting fat off the loan program, at the expense of students and the government.

The Clinton administration and Democrats in Congress pushed to remove banks and other lenders from the federal loan program altogether. Congress approved legislation in 1993 to gradually replace the guaranteed-loan program with direct lending, in which the Education Department provides loans directly to students through their colleges.

Sallie Mae's livelihood was suddenly threatened, and the company's leaders knew that its future depended on cutting ties with the government, so that it could diversify the products it offered. In 1996 the Clinton administration and Congress granted Sallie Mae its wish, allowing it to gradually become completely private.

Some of those who were involved in the Clinton administration's deliberations, however, believe that the government seriously misplayed its hand.

Thomas R. Wolanin, a longtime Democratic aide in Congress who served on a government committee that examined the possible sale, says he felt throughout the discussions that the administration was "giving the store away."

"My basic feeling," he says, "was that we were allowing Sallie Mae to privatize with very little financial return to taxpayers for the benefits they had received as a government entity, and without harnessing them to some public purpose."

Mr. Wolanin, a senior U.S. Education Department official at the time, and his allies on the committee were pushing for Sallie Mae to have to pay a substantial exit fee, and for putting limits on the company's potential growth.

But those arguments went largely unheeded. Treasury Department officials who were leading the discussions were anxious to close the deal. They wanted to set a precedent for selling a government-sponsored enterprise so they could eventually unload Fannie Mae and Freddie Mac, companies chartered by Congress to help families obtain home mortgages, which seemed headed for fiscal trouble.

In the end, because of maneuvering by Sen. James M. Jeffords, then a Vermont Republican, Congress required Sallie Mae to provide the public schools in the District of Columbia with a payment of \$5-million and 555,000 shares of stock, which were valued at about \$70 at the time.

Having received the benefits of significant amounts of start-up money from the taxpayers, exemption from taxes in the District of Columbia, where it was located, and the ability to raise money at lower costs than those of other loan providers because of its implicit backing from the government, Sallie Mae was being allowed to become a private corporation with little return to taxpayers who had fostered it for so long, its critics and competitors say.

"It was a terrible deal," says one private lender, who wishes to remain anonymous for fear of offending Sallie Mae, with which he does business regularly.

Recipe for Growth

As it privatized — a process that was completed in 2004 — Sallie Mae made acquiring nonprofit lenders and secondary markets a key part of its growth strategy.

By purchasing those entities, Sallie Mae has been able to become the dominant lender in regions across the country. For example, it was able to expand its reach into New England with its 1999 acquisition of Nellie Mae, a major lender and purchaser of loans, and into Ohio, when it bought Cincinnati-based Student Loan Funding Resources in 2000.

More recently Sallie Mae became a major force in the Northwest by acquiring Student Loan Finance Association, a Seattle student-loan servicer; and in the Southwest with its purchase of Arizona-based Southwest Student Services Corporation.

Those acquisitions did not cause much alarm among the company's competitors, because the agencies had put themselves up for sale voluntarily. And Sallie Mae is not the only loan company that has made acquiring nonprofit lenders a key part of its strategy. Nelnet, a for-profit company based in Nebraska, has been particularly aggressive, purchasing key lenders in California and Texas last year.

But Sallie Mae's \$1-billion offer to buy Pennsylvania's student-loan agency sent shock waves through the loan industry, as officials of the state agency were caught completely off guard.

Sallie Mae put on a full-court press, hiring more than 20 lobbyists to push its proposal in the state Capitol. It spent more than \$250,000 on the effort in 2004 and 2005, according to state lobbying-disclosure records. The company was also generous with campaign contributions. According to state records, it donated \$20,000 to Pennsylvania state officials in 2005, with half of that amount going to Gov. Edward G. Rendell, a Democrat, who is up for re-election this year.

The dispute became nasty as Sallie Mae pressed its case in the legislature, accusing the state agency of intimidating Pennsylvania colleges that worked with other lenders. In response the agency bashed the loan giant, accusing it of overpaying its executives and criticizing it for outsourcing jobs to India.

Although Sallie Mae ultimately withdrew its bid, Pheaa did not go unscathed. It has come under increased scrutiny, with questions raised by state legislators and news reporters about its financial practices. And its decision to increase the size of its grants to Pennsylvania students raised at least the suspicion that it was sweetening the pot only in reaction to Sallie Mae's attack.

"Pheaa won the battle," says Mark Kantrowitz, publisher of FinAid, a Web site about student aid. "But it hasn't necessarily won the war."

Cashing In

With the fight raging in Pennsylvania, policy makers in other states realized that they had potential gold mines on their hands. In Illinois and Missouri, in particular, the governors were attracted to the idea of selling student-loan agencies, in part or as a whole, to get the money for financing ambitious projects without having to raise taxes.

In Missouri, Gov. Matt Blunt, a Republican, has proposed selling at least half of the state's loan portfolio to finance construction and renovation at state universities. In Illinois, Gov. Rod R. Blagojevich, a Democrat, would use the proceeds from a sale of the Illinois Student Aid Commission to pay for his plan to create a tuition tax credit for college freshmen and sophomores and to increase the budgets of public universities for the first time in four years.

With state dollars on the line, university leaders are supporting the plans, which are pending before their respective state legislatures. But students and financial-aid administrators in the two states have been less receptive.

In Illinois, for example, both the student senate of the University of Illinois and the group representing financial-aid administrators oppose the plan because they are skeptical that a for-profit company would provide the same level of benefits and services to borrowers that the commission does.

If Sallie Mae succeeds in buying the agency, as many expect it will, those fears may be justified. In at least two cases, after Sallie Mae purchased nonprofit lenders, it reduced the borrower benefits that those agencies had offered.

For example, before Sallie Mae bought Student Loan Funding Resources, in Ohio, the agency offered interest-rate reductions to borrowers as long as they kept making their payments on time. In other words, borrowers would continue to benefit from the rebates until they became delinquent on their loans. Sallie Mae, however, offers the rebate to borrowers only after they make 33 on-time payments.

In Arizona, borrowers whose loans were held by Southwest Student Services could qualify for interest-rate reductions if they made 44 payments on time. And they could remain qualified even if they were late with a payment for up to 60 days.

After taking over the agency, Sallie Mae reduced that amount of time to six days.

Sallie Mae announced in November that it would, for the first time nationally, cover the 3-percent origination fees that borrowers must pay to obtain their loans.

In its filing with the U.S. Securities and Exchange Commission, Sallie Mae alerted shareholders that it was offering the discounts "to compete more effectively" with nonprofit loan providers, many of which have covered the fees for years. The change could increase loan volume, the company said, but "will reduce our margins on the affected student loans."

Advocates for nonprofit lenders jumped on that admission, saying it showed that Sallie Mae had acted only out of necessity and would abandon the policy when it no longer felt compelled to do so.

"Sallie Mae did not go to a zero-fee loan until they were literally forced to by the marketplace and by the competition from Pheaa and from nonprofit agencies across the country," says Scott Miller, the Pennsylvania agency's chief lobbyist in Washington.

Speaking at the Credit Suisse conference, Mr. Fitzpatrick, Sallie Mae's chief executive officer, acknowledged to analysts that "we certainly weren't the market leader" in providing upfront discounts to students.

But Sallie Mae officials reject the notion that a reduction in the number of nonprofit agencies will make the guaranteed-loan program less competitive. "So long as students and schools demand cheaper loans and better services, innovation and price competition will continue," said Tom Joyce, a spokesman for the company.

Possible Intervention

Some of Sallie Mae's competitors say they may ask the federal government to intervene if the loan giant makes successful bids for the Illinois and Missouri agencies.

"Taxpayers have been propping up this company since its inception," says John Peters, vice chairman of the U.S. Education Finance Corporation, a loan company based in Florida. "The government needs to examine whether Sallie Mae is a monopoly and needs to be broken up for the good of consumers."

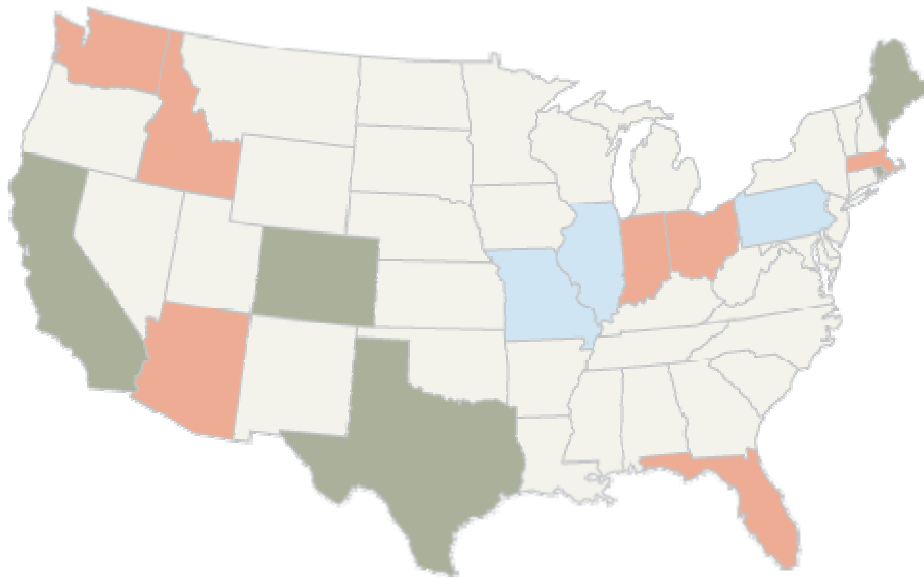
At least, others say, policy makers ought to examine the effect on consumers of Sallie Mae's growth.

"At some point, we're going to reach a tipping point where there's a preponderance of loan volume in a small number of entities," says Brett E. Lief, president of the National Council of Higher Education Loan Programs, which lobbies on behalf of guarantee agencies and nonprofit lenders. "And that's not going to be good for students."

STRATEGIC GROWTH

When Congress voted to privatize Sallie Mae, in 1996, the company made acquiring other lenders a key part of its strategy for becoming the nation's largest student-loan provider. The company, however, faces competition for new acquisitions from Nelnet, a

national student-loan provider based in Lincoln, Neb., that has modeled itself largely on Sallie Mae.



States where Sallie Mae has purchased nonprofit lenders and other loan providers.

States where Nelnet has purchased nonprofit lenders and other loan providers.

States where policy makers have considered putting their nonprofit lenders up for sale.

NONPROFIT STUDENT-LOAN AGENCIES THAT MIGHT BE SOLD

Pennsylvania Higher Education Assistance Agency

What is it? Created by the legislature in 1964 to help provide liquidity to banks offering student loans, as well as to provide state grants to students, Pheaa is the largest state-based nonprofit lender of federally backed student loans in the country and the second-largest guarantee agency. It holds about \$6.8-billion in outstanding loans.

Proposal: In December 2004, Sallie Mae stunned the student-loan industry by offering the state \$1-billion to take over most of the operations of Pheaa.

Status: Facing resistance from the legislature, Sallie Mae withdrew its bid in August 2005. However, the company left open the possibility that it would revive its bid at a later date, and is waging a fierce campaign to break Pheaa's domination of the student-loan market in the state.

Missouri Higher Education Loan Authority

What is it? Since it was created by the legislature in 1981, Mohela has grown into the 12th-largest holder of federal student loans in the country, with \$4.3-

billion outstanding.

Proposal: In January, Gov. Matt Blunt, a Republican, unveiled a plan to sell Mohela to a private, for-profit student-loan company for \$425-million. The governor proposed using the bulk of the proceeds to finance capital improvements at state universities, particularly for building and repairing science-and-technology-research facilities.

Status: The loan agency's board has developed an alternative proposal, endorsed by the governor, that would keep the agency alive. Under this plan, the agency would sell about half of its loan portfolio this year, and would continue selling loans over the next four years to generate the rest of the savings the governor is seeking. The outlook is uncertain, as public-university leaders support the plan but some legislators and advocates for students oppose any sale. They fear that a for-profit entity would not be able to offer the same types of deals to students that Mohela provides.

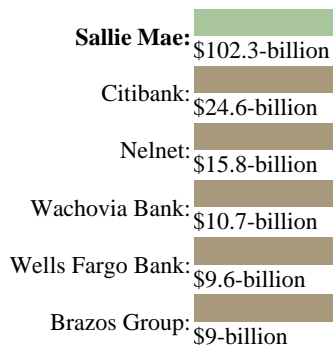
Illinois Student Aid Commission

What is it? Created by the legislature in 1977, ISAC has become the 18th-largest holder of federal student loans in the country, with \$2.8-billion outstanding.

Proposal: In February, Gov. Rod R. Blagojevich, a Democrat, proposed selling all or part of the commission's loan portfolio to pay for his plan to create a tuition tax credit for college freshmen and sophomores who maintain a B average. He also proposed spending some of the proceeds to provide budget increases for the state universities for the first time in four years.

Status: ISAC has hired an accounting firm to determine the loan agency's worth. The outlook for the proposal is unclear. State-university leaders are supportive of the plan, but the University of Illinois Student Senate and the organization representing student-aid administrators in the state have expressed opposition to it.

TOP 10 HOLDERS OF FEDERAL STUDENT LOANS, 2005



College Loan Corporation:	\$7.8-billion
Pennsylvania Higher Education Assistance Agency:	\$6.8-billion
Collegiate Funding Services:	\$5.5-billion
Goal Financial:	\$5.3-billion
SOURCE: U.S. Department of Education	

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