The Restructuring of Sallie Mae

Rationale and Feasibility

March, 1994

SallieMae

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I. Executive Summary

The Student Loan Marketing Association ("Sallie Mae") was established in 1972 as a shareholder-owned, federally-chartered financial intermediary to provide financing and liquidity to the student loan market. Sallie Mae has been extraordinarily successful in achieving its mission. The guaranteed student loan program has attained widespread acceptance among students, lenders and schools. Student lending volumes have soared, funding is reliable, and there is active competition among a variety of institutions in the market.

The environment in which Sallie Mae operates has changed dramatically since its creation. The student loan market and the broader financial markets have undergone profound transformation. The integration of domestic and global capital markets and the application of computer technology to information and transaction processing have greatly expanded the funding and servicing options for lenders.

The student loan market will undergo further transformation in the coming years. The Omnibus Budget Reconciliation Act of 1993 ("the Act") initiated a process to replace the Federal Family Education Loan Program ("the FFELP") with direct lending by the federal government, funded through Treasury borrowing rather than private capital. By the end of a four year phase-in period, up to 60 percent of student lending will be on a direct basis without the involvement of Sallie Mae or other private sector financial intermediaries. Over a longer time period, the entire student loan market may be financed on a direct basis. Furthermore, the Act significantly reduced the profitability of FFELP investments, particularly for Sallie Mae (which is subject to a special offset fee to which its competitors are not subject).

What are the implications of these changes for Sallie Mae, a firm that derives over 80 percent of its income from student lending? With the maturation of the student loan market and the emergence of the government as a direct lender is there an on-going need for a government-sponsored enterprise ("GSE") in the student loan market? What are the options available to Sallie Mae? Are there alternatives which satisfy both the government's interests in ensuring stability in the student loan market and investor interests in Sallie Mae?

The events of the past two years have prompted Sallie Mae to assess how it can most effectively meet the government's new public policy goals in the financing of higher education while maintaining the long-term value of the franchise for its investors. This study concludes that Sallie Mae can best meet these objectives by being restructured into a private, general purpose corporation. Restructuring would allow for the orderly and gradual liquidation of the existing GSE entity. At the same time, new business activity, which is expected to remain predominately education finance-related, would be undertaken by separate affiliates in a holding company structure, financed by non-GSE capital. Through this process, Sallie Mae would be able to maintain its capabilities to ensure the flow of funds to higher education and diversify its activities and income stream.

The proposed restructuring can be accomplished without risk to the higher education system, Sallie Mae creditors, students or taxpayers, or adverse competitive consequences. Moreover, the principal beneficiaries of this restructuring are:

- *Taxpayers* who would benefit from the elimination of the implicit liability for over $45 billion in debt.
- The *federal government* which would benefit through maintenance of Sallie Mae's capabilities as a lender of last resort in the interim and ultimately through the successful transitioning of a GSE to a viable private entity.
- *Investors*, including public and private pension funds, education institutions, non-profit organizations and individual savers, who would benefit through maintenance of Sallie Mae as a strong and viable company.
- *Schools* which would benefit through expanded financial services and application of Sallie Mae's technological expertise to other campus needs.
- *Students* who would benefit through maintenance of Sallie Mae's high quality loan servicing operation.
- The *economy* which would gain through transfer of Sallie Mae's transaction processing skills to other high priority activities.
- Sallie Mae's 4,600 *employees* who would continue to provide exemplary service to its customers, both in higher education and other endeavors.

Sallie Mae believes that a restructuring can be a win-win process. The company is therefore looking forward to working with the Administration and the Congress on a legislative plan to implement a near term restructuring of its franchise.

II. What Is Sallie Mae?

Creation

Sallie Mae is one of five major financial GSEs.[1] These enterprises are unique financial institutions, chartered by the federal government to facilitate the flow of funds to areas of public policy importance: agriculture, housing and higher education. The creation of the GSEs was motivated by a perceived failure of the financial markets (more specifically, the banking system) to allocate sufficient capital for certain high priority activities. This failure is generally attributed to one of three reasons:

- characteristics of the funding sources (in particular, the lack of long-term funds for lenders);
- characteristics of the loans or borrowers (i.e., the high cost of or the lack of information necessary to underwrite credit risk);
- the lack of nationwide banking (which inhibits the ability to diversify credit risk and funding sources).

At the time Sallie Mae was chartered in 1972, student and other consumer loans were almost exclusively originated and funded by commercial banks and finance companies. Consumer lending was essentially local in nature and subject to periodic funding shortages. Despite the fact that student loans were federally insured, thus eliminating lender credit risk, lenders were reluctant to make them due to their relatively long term, lack of liquidity, and regulatory complexity.

Sallie Mae was formed to improve the flow of funds into student lending. By creating a financial intermediary with broad access to the capital markets, Congress sought to provide a source of liquidity to student loan originators, who could sell their loans to Sallie Mae or obtain funding at capital market rates using an otherwise illiquid asset as collateral.[2] The ability to sell student loans also allowed lenders to be active in the market without incurring the high costs of servicing.

Activities

As a GSE, Sallie Mae is a privately-owned, federally-chartered financial institution. It operates as a secondary market institution on a nationwide basis. Sallie Mae purchases loans from lenders (e.g., commercial banks and savings and loan institutions) and makes secured loans to such lenders ("advances") to liquefy their student loan portfolios. In addition, Sallie Mae makes loans directly to institutions of higher education for construction of facilities ("facilities financing"). Sallie Mae raises funds from the financial markets through the sale of its securities. Its securities are corporate obligations and not obligations of, or guaranteed by, the federal government.

To avoid exposure to interest rate risk, Sallie Mae matches the interest rate sensitivity of its liabilities with the interest rate sensitivity of the assets they fund. With $47 billion in assets today, Sallie Mae is not only one of the largest but one of the strongest financial institutions in the United States. In 1993, Sallie Mae reported net income of $430 million. It is also a significant corporate taxpayer. Subject to the full corporate income tax rate, Sallie Mae in 1993 paid $217 million in federal taxes.

Government Sponsorship

Like other GSEs, Sallie Mae is able to raise a large volume of funds. Its ability to do so reflects its strong balance sheet and its government sponsorship. Although there is no explicit backing, the financial markets perceive that the federal government will not let a GSE fail, given the importance of their participation in their respective markets. GSE securities generally enjoy several regulatory advantages which reduce investor-required yields and issuance costs (See Appendix 3). These benefits translate into lower borrowing costs for GSE customers. While government sponsorship was initially necessary and important for Sallie Mae to raise funds to facilitate student lending, today the mature student loan market and Sallie Mae's strong balance sheet would allow it to continue to raise such funds as a non-GSE corporate issuer (See Appendix 2).

Private Ownership

A significant feature of GSEs is their private ownership. Private investors have supplied over $1.3 billion of equity capital to support Sallie Mae's activities. Three of the GSEs (Fannie Mae, Freddie Mac and Sallie Mae) are publicly-traded, shareholder-owned corporations. The other two are mutual organizations, owned by their borrowers.[3] Private ownership brings several benefits to government efforts to facilitate the flow of funds to particular users:

- The reliance on private capital allows these activities to be "off-budget". Thus, taxpayers do not fund nor legally bear the risk of the GSE's activities. The business risks are borne by the shareholders.
- In order to attract private capital on a competitive basis, these institutions must operate efficiently. The government benefits from applying private sector management skills for designated public policy purposes.
- The GSE concept allows the leveraging of government support to a broader spectrum of borrowers than available through direct government loans, enhancing the portfolio quality and political appeal of the enterprises.

The capital structure of the three shareholder-owned GSEs facilitates their credit allocation role. Because they may sell stock directly to the public, they can raise capital from sources other than their customers, allowing greater expansion and service to a wider market. In order to attract capital, the GSEs must produce a return on investment sufficient to induce private investors, whether individuals or institutions, to invest in the financing of socially desirable activities. The introduction of private shareholders into the GSE structure broadens the political constituency of GSE's by bringing the general public and their institutional representatives (*e.g.*, pension fund, insurance company and mutual fund managers) into the picture. For example, currently over 30 percent of Sallie Mae investors are public and private pension funds. Legislative changes now affect more than just the GSE's customers and employees.

Charter Limitations

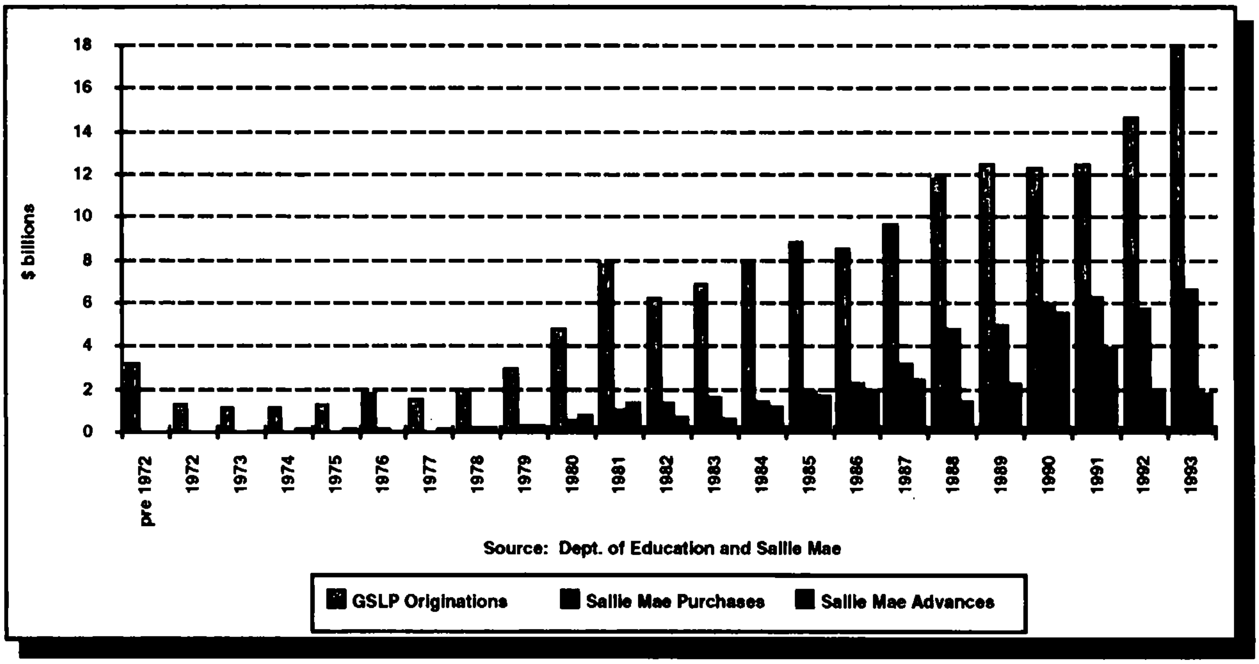
The quid pro quo for the GSEs' preferential access to capital is their limited charters. These enterprises are corporations chartered by the Congress to perform a prescribed set of activities. Unlike general purpose corporations, which can enter into any business activities not precluded by law, the GSEs can only enter into specific activities authorized by the Congress. A GSE must obtain an amendment to its charter from Congress in order to engage in activities other than those specifically allowed in its charter.

III. Mission Accomplished: Development of the Student Loan Market

Growth

In terms of volume of loans financed and lender participation, Sallie Mae's efforts have been most successful. Student lending has grown from a commercial bank "loss leader" to a large volume program with increasing competition and specialization. The evolution of the student loan market is shown in Exhibit 1. Both originations and Sallie Mae purchases have grown significantly since the late 1970s. Relaxation of eligibility standards between 1978 and 1981 led to a large increase in originations, a demand increase that lenders aided by Sallie Mae were able to fund. Despite reduced eligibility through application of needs testing in the early 1980s, annual lending volume was maintained at levels between three and six times that of the 1970s throughout the decade. The Higher Education Act of 1992 expanded eligibility and loan size. Forecasts predict substantial increases in student loan volumes through the end of the 1990s.

Exhibit 1
Student Loan Originations and Sallie Mae Activity

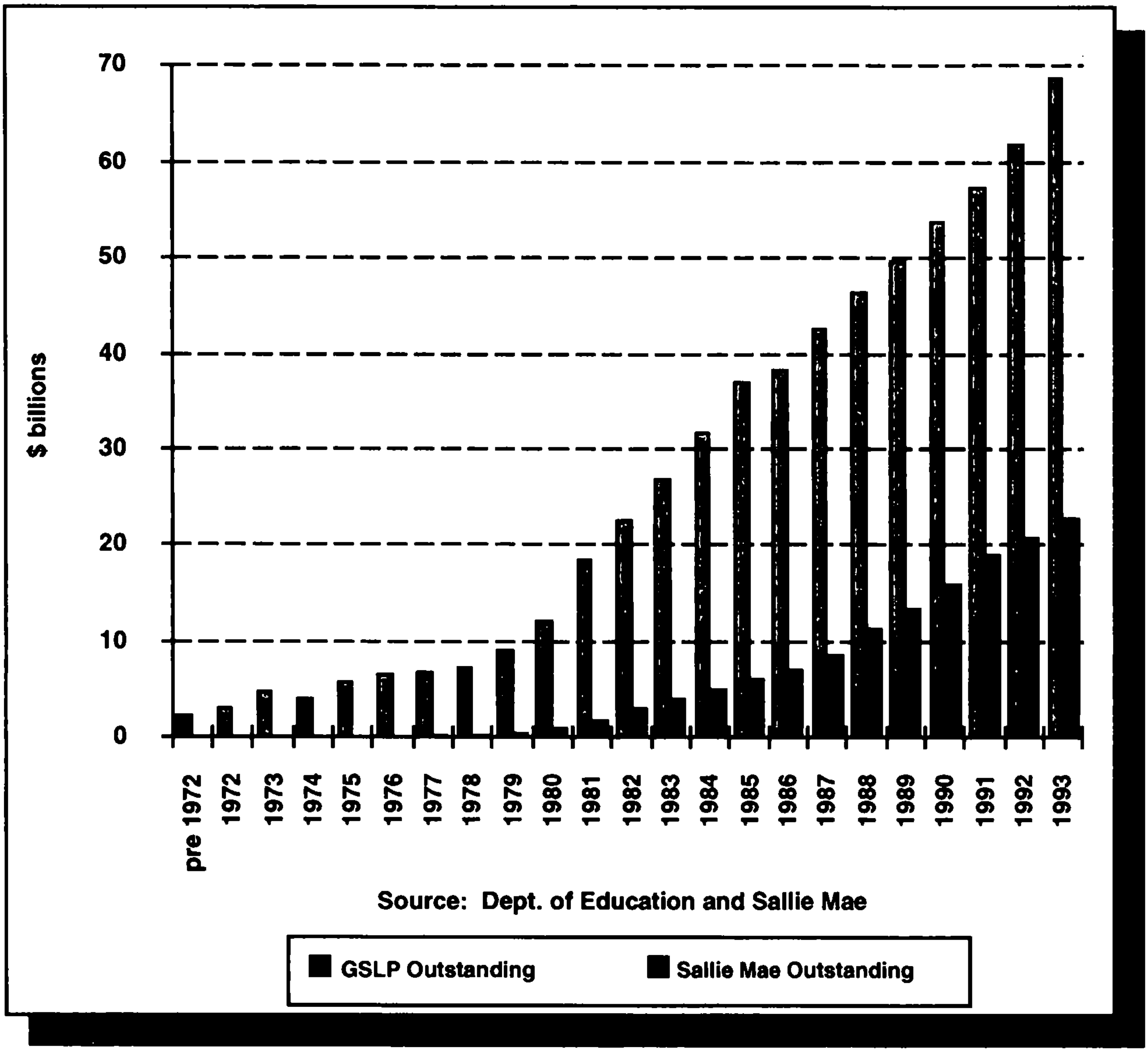


Participation

The government insured student loan program has become the major source of financial aid for students attending post-secondary schools in the 29 years since its inception. In fiscal year 1993, over $17.9 billion of loans were originated to

5.8 million borrowers. By the end of that fiscal year, more than 27 million loans totaling $68.7 billion were outstanding (Exhibit 2). The number of lenders participating in the program increased from approximately 4,000 in the early 1970s to more than 11,000 in the mid-1980s. Participation fell to approximately 7,500 lenders at the end of FY1992, reflecting increased servicing complexity and consolidation in the banking industry. The major lenders in the student loan market include both money center and super-regional banks. Collectively, the top 25 originators accounted for 45 percent of originations in 1992.

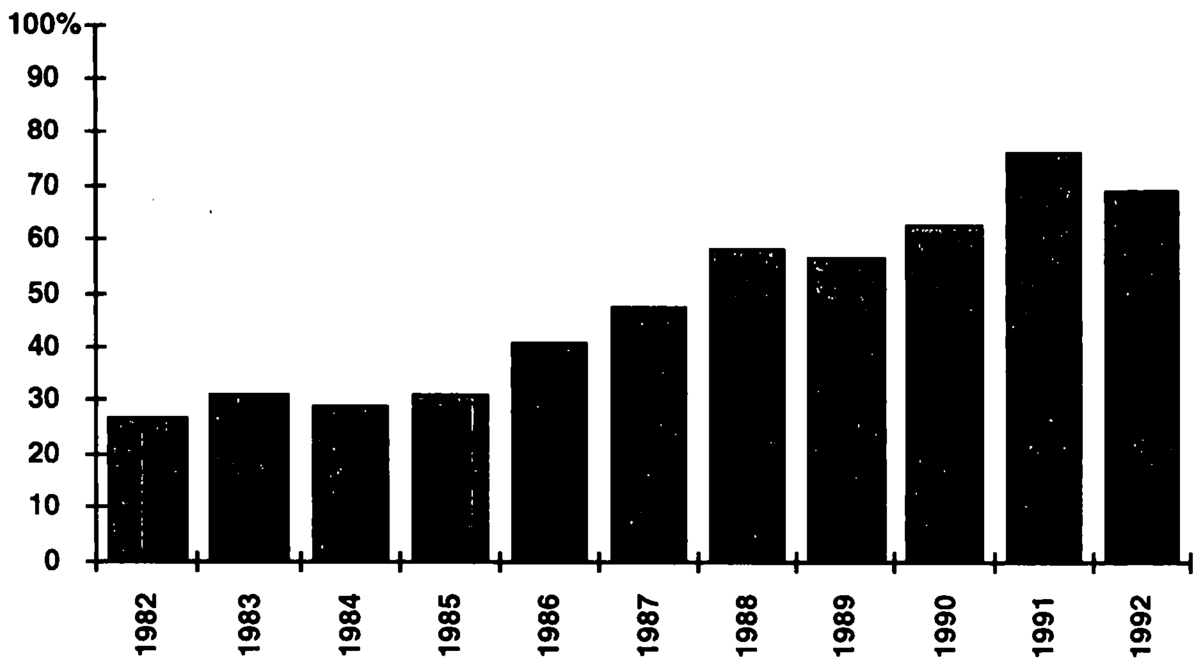
Exhibit 2
Student Loans Outstanding and Held by Sallie Mae



Competition

As student loans have become more attractive investments, competition in funding has also increased. The proportion of loans sold to secondary markets increased from under 30 percent of originations in the 1981 to 1985 period to over 69 percent by FY1992 (Exhibit 3). Sallie Mae is the largest secondary market institution but actively competes with state secondary markets for the purchase of student loans. The market share of secondary markets excluding Sallie Mae was 35 percent in FY1992. The growth of secondary markets has improved the funding options for student loan originators.

Exhibit 3
Estimated Student Loan Sales to State and National Secondary Markets
(as percentage of originations)



Source: Sallie Mae

Financial Market Development

The financial markets have undergone dramatic change since the creation of Sallie Mae. Deregulation and technological advances in the processing and communication of information have revolutionized the delivery of financial services over the past decade. Functional and geographic barriers to the delivery and funding of all forms of loans have been lowered. Competition has intensified both within the U.S. and worldwide.

As a result, lending markets are no longer local in nature and segmented from the broader capital markets. The development of collateralized debt and asset-backed securities markets has greatly improved funding options for lenders, particularly their access to long-term funds through the domestic and international capital markets. The accumulation and dissemination of enhanced information about borrower repayment performance has led to a better understanding of the default risk potential of different borrower groups. The gradual breakdown of barriers to interstate banking has facilitated the flow of capital between regions and sectors of the economy. The forces of competition, technology and innovation have created a truly global financial market capable of providing funds efficiently for virtually all segments of the market.

Two recent trends particularly impact the student loan market. As with other types of consumer loans, *functional specialization* has developed in student lending. Third-party originators and servicers provide lenders with the benefits of economies of scale and the capability of responding to the ever-changing regulatory environment. On-going investment in information processing technology has significantly increased the capacity and competition to originate and service student loans. *Securitization* has the potential to increase the investor base and greatly expand the potential funding base for student loans. Securitization involves taking an illiquid loan, such as a residential mortgage or automobile loan, packaging it into a pool of like assets and then issuing securities backed by the pool. This technique has been widely used in the mortgage and consumer loan markets to separate funding of assets from the origination and servicing of those assets and has greatly expanded the investor base supporting those markets.[4] Introduced to student lending in 1991, securitization in the form of taxable, SEC-registered offerings is expected to become a widespread vehicle for funding investment in student credit. Moreover, it is expected to attract different investment sources from those which now fund Sallie Mae and the various non-profit secondary markets.

Maturation

The growth in the size, degree of competition, and sophistication of the student loan market indicate that it has matured. Originating lenders have ample access to funds from a variety of sources, including collateralized borrowing, sale to competing secondary markets, and securitization. Major servicers have made substantial investments in personnel and information processing technology. As a result, student loans are now available to all qualified students, trade at premiums in the secondary market and their servicing performance has developed a competitive, customer-oriented focus. These factors underscore the conclusion that the primary mission of Sallie Mae, to improve the liquidity of and funding for student loans and so enhance their attractiveness to lenders, has been achieved.

IV. A Time of Transition

Program Changes

Despite the success in expanding the breadth and strength of capital market support for education loans, there has been a significant degree of dissatisfaction with the student loan program over the years. One source of dissatisfaction stemmed from the high default rates experienced in the program during the mid- to late-1980s. Another source of dissatisfaction was the program's cost to the federal government. Direct lending proponents have consistently argued that it could achieve substantial budget savings.[5] Also, the growing complexity of the program was causing problems for many schools, which have to deal with a multiplicity of lenders, guarantee agencies, and secondary markets.

These pressures led to a substantial revamping of the FFELP in 1993 as well as introduction of an alternative direct lending program. Direct lending will be phased in over a five-year period beginning in 1994. The goal of the direct lending program is to account for 60 percent of student loan originations by 1998. Many observers believe that direct lending could eventually displace the FFELP in its entirety. The Act also reduced the attractiveness of the FFELP to lenders and investors by:

- reducing the yield on loans during the in-school and deferment periods;
- imposing origination fees on lenders; and
- reducing insurance coverage ("risk sharing").

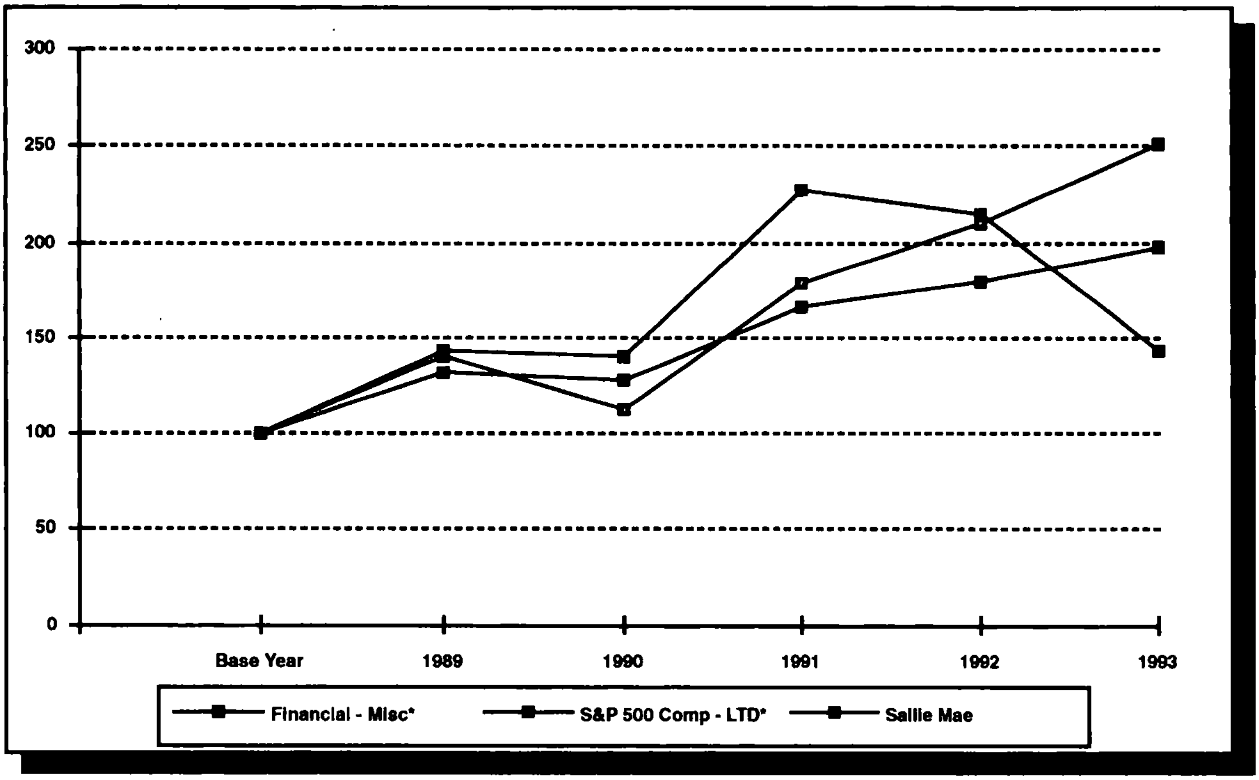
The Act was particularly harsh on Sallie Mae, imposing a 30 basis point "offset" fee on its new FFELP acquisitions. In addition, the Secretary of Education can now require Sallie Mae to serve as a lender-of-last-resort in the student loan market.

The offset fee will reduce Sallie Mae's yields (net of expenses, funding costs and expected losses) on FFELP loan purchases by 33 basis points in 1994 (reducing the pre-Act yield by up to a third). The yield reduction on FFELP loan purchases will grow to 50 to 60 basis points by 1999 reflecting the introduction of risk sharing and the phased reduction of the interim yield (which apply to all competitors). The yield reduction is even greater for refinanced or "consolidation" loans, reducing net yields by approximately 120 basis points.

Investor Reaction to Political Risk

The changes in the FFELP and the introduction of direct lending have had and will continue to have major effects on Sallie Mae. One immediate effect of the debate preceding the passage of the Act was the precipitous decline in Sallie Mae's stock price and market value. From the end of 1992 through passage of the Act on August 3, 1993, the share price fell 40 percent and the market value of the company fell by over $2.5 billion.

Exhibit 4
Comparative Share Prices (assuming $100/share common base in 1988)



The market reaction reflects in large part Sallie Mae's narrowly defined business. As a GSE, Sallie Mae can only engage in activities enhancing the flow of credit to post-secondary students and other narrowly defined higher education activities. As a result, it has an undiversified income stream. Approximately 80 percent of its income is derived from student loan-related activities.

Private sector firms can manage their core business risks through diversification. Sallie Mae is unable to do so. Sallie Mae's main business risk is political and derives from adverse changes and shifting policies in the student loan program, in particular, changes targeted specifically at the company. This risk is very difficult to manage or diversify as a GSE and therefore exceedingly difficult for investors to price. Reflecting these risks, Sallie Mae stock now trades *at liquidation value*; that is, its value is simply the discounted value of the expected future cash flows with no value accorded to the franchise (*i.e.*, its servicing and financing capabilities, customer base and name recognition within the higher education and the investment communities).

Re-examining Sallie Mae's Role

The development of the student loan industry and the changes in the FFELP raise fundamental questions about the on-going need for a GSE in the student loan market. As direct lending is implemented, the market share of the FFELP could fall to 40 percent by 1998 and could eventually fall to zero. The liquidity and financing needs of FFELP lenders will be far less in the direct lending environment. The principal advantage of a GSE is its ability to raise large amounts of capital cost-effectively. With the development of securitization and other funding sources, the needs of banks and state secondary markets for liquidity are without question only a fraction of what they were in Sallie Mae's early years, and will be reduced even further as direct lending is phased in.

The phase-in of direct lending will leave Sallie Mae with few real business options under its current charter. In the short run, it will continue to support the FFELP market and continue to grow. However, the large anticipated reduction in its market would inevitably leave it with significantly diminished opportunities. Furthermore, the character of its business may be substantially different, shifting from the mobilization of capital for which GSE attributes are well-suited, to the servicing of loans for which they are unnecessary. While it is possible that Sallie Mae might service some portion of the direct loan program for the federal government, there is no reason to maintain GSE status as a government contractor. Moreover, the limited scope of such a single contract business would result in the effective liquidation of a substantial portion of the existing company and increase the risk due to less diversification.

The situation in which Sallie Mae now finds itself is unique. In creating the various GSEs, Congress did not contemplate the need at some point to unwind or terminate their federal charters. However, Congress did not assume the perpetual existence (and continual expansion) of individual GSEs in the context of changing social and economic priorities. The missing element in the GSE concept is the notion of a life cycle for government sponsorship. GSEs are *created* to increase the flow of funds to socially desirable activities. If successful, they grow and *mature* as the market develops. At some point, the private sector may be able to meet the funding needs of the particular market segment. If so, a *sunset* may be appropriate. In the case of Sallie Mae, whose mission has been accomplished and whose original business may gradually disappear, the question of how to complete the life cycle can no longer be deferred.

V. Options for the Future

Options

Sallie Mae has reviewed several options regarding its future relationship with the government. These options include:

- maintaining the status quo;
- redirection (i.e., changing Sallie Mae's charter to allow it to engage in substantially new activities); and
- restructuring (severing charter ties with the government and rechartering the firm as a general purpose state-chartered corporation).

Interests

In conducting this review, Sallie Mae has taken into account both the interests of the government and of Sallie Mae's investors, creditors and customers. The interests of the government include:

- ensuring an orderly introduction of direct lending;
- protecting student access to credit through the FFELP;
- reducing taxpayer risk;
- minimizing the impact of any changes to Sallie Mae on other GSEs and the agency debt markets.

The interests of Sallie Mae include:

- maintaining its commitment to and preeminent role in the student loan market;
- protecting the interests of its debt holders;
- enhancing the long term value of the franchise for shareholders.

Restructuring

Sallie Mae believes that among the various options for the future of its franchise, an orderly restructuring is the most desirable path. As used here, the term "restructuring" refers to the creation of a state-chartered, general purpose corporation owned by shareholders through publicly traded stock, without government backing or special privileges. The ultimate goal of restructuring is full privatization. Restructuring would accomplish this goal while safeguarding the government's interests by transitioning an active GSE to a self-liquidating entity.

Privatization of a GSE has been raised on several occasions in recent years. A small GSE, the National Consumer Cooperative Bank, was privatized in 1981.[6] In 1991, a CBO report on GSEs discussed the concept (with reference to Sallie Mae). In 1986, the Freddie Mac Advisory Committee explored privatization, but concluded that the concept was infeasible without concomitant privatization of Fannie Mae.[7] In 1992, Congress asked for studies addressing the privatization of Fannie Mae and Freddie Mac.[8]

Restructuring of Sallie Mae would have several advantages:

- Reducing the government's risk exposure. At some point in the future, Sallie Mae would cease issuing GSE debt. Thus, the implicit taxpayer liability for the outstanding debt would decline over time as the debt was retired or matured.
- Ensuring stability in the student loan market. By maintaining Sallie Mae's competitive advantage in loan servicing and transaction processing the government retains its most effective insurance policy for its student loan program
- Freeing up the capital and expertise of Sallie Mae to respond to market opportunities. Such flexibility is a core virtue of the free enterprise system and leads to increased job and income creation. Increased competition will improve market pricing and service.

Moreover, the restructuring proposed in the next section addresses the important public policy concerns regarding Sallie Mae's ability to fully support the FFELP as a private corporation. With the assistance of the investment banking firm of Morgan Stanley & Co., Incorporated, Sallie Mae has determined that it can fund its projected volume of student loan purchases as a private company.

Before reviewing the structure that Sallie Mae believes best meets the needs of the company and the federal government, it may be helpful to frame why the status quo and redirection of mission are not desirable alternatives.

Status Quo

Maintenance of the status quo has the theoretical advantage of keeping Sallie Mae's capabilities in place during a transition to direct lending. With the introduction of direct lending, there is uncertainty about the continued participation of major guarantors, lenders, and servicers in the FFELP. In the event of the failure of direct lending, there could be a return to exclusive use of the FFELP, or some variant of the program, involving origination by private sector lenders and/or purchase and servicing by secondary markets including Sallie Mae. Continuation of Sallie Mae's GSE status can be seen as an insurance policy against a collapse of the FFELP market.

But will Sallie Mae be able to maintain its capabilities indefinitely? Its ability to attract capital and its ability to attract and retain qualified personnel will be impaired if there are no meaningful growth opportunities nor any long-term vision of the company's future. Furthermore, at some point, it would be rational for the firm to forego investments in systems upgrades that would improve servicing performance. Reduced emphasis on performance and service quality will erode the notion of maintaining Sallie Mae as an insurance policy in the event of a protracted transition to direct lending. Also, the government does not need a $45 billion institution to provide the necessary stability for the student loan market during the direct lending transition.

Another disadvantage of maintaining the status quo is the message it sends to investors in current or future GSEs. If the scale and scope of Sallie Mae's activities are substantially reduced, the franchise value created by the company over the years would be permanently lost. The losses experienced by Sallie Mae's shareholders could raise the risk premium for investing in shares of other GSEs, lowering the price of existing GSE stocks or making it more difficult for a future GSE to raise capital, or for an existing GSE to raise new capital.

Redirection

If liquidation is viewed as an excessively costly alternative, the government may consider redirecting Sallie Mae into new and different lines of business under its government charter. A possible advantage of this approach is the saving of start-up costs (both out-of-pocket costs and opportunity costs of the time necessary to begin an operation) associated with creation of a new GSE. Sallie Mae has an exemplary reputation as a well-managed, risk-averse, financial services firm. Thus, it is argued, it would be able to access the capital markets immediately to raise funds for new charter authorities.[9]

However, an externally imposed redirection of Sallie Mae could have deleterious effects on its investors and the GSE concept. New substitute mandates could significantly reduce Sallie Mae's earnings performance, trapping investors who made voluntary investments in the field of higher education credit delivery based on the appeal of the mission and on the ability of the firm to deliver satisfactory return on investment. A major change in mission may signal Congress' unwillingness to privatize Sallie Mae, leading to a further decline in share price and increased losses for investors. Such a decline, if significant, could impact Sallie Mae's cost of raising debt and adversely impact operating results. It sets an unfortunate precedent for investors in existing or new GSEs as it raises the possibility of redirecting their missions in the future.

Redirection may not represent effective use of Sallie Mae's existing skills and thus may not result in savings in either cost or time for new activities. As with the academic facilities financing business, new authorities would take time to be developed into meaningful business lines. Involvement in programs exposing Sallie Mae to new forms of credit risk, would also require development of new underwriting guidelines and the engagement of new professional expertise. For these reasons, it is not clear whether it would be more efficient for the government to create a new GSE to support areas such as infrastructure finance which lie outside the traditional GSE missions.

VI. Restructuring: Design and Feasibility

Principles

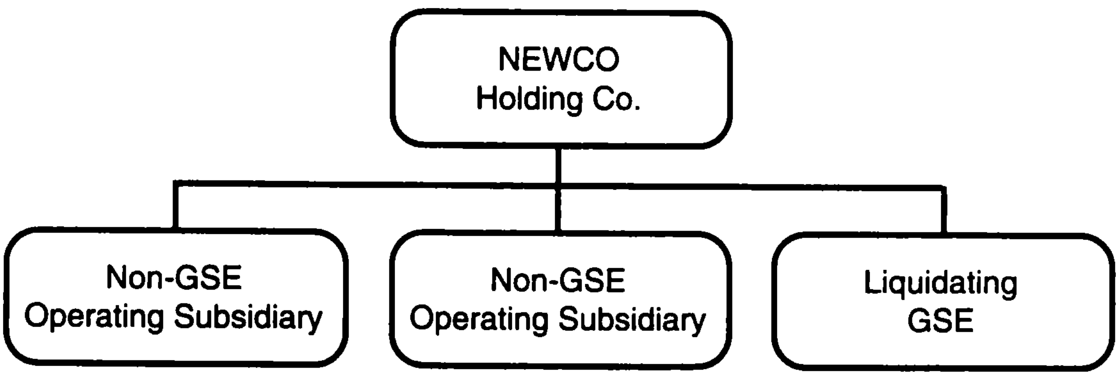
The goal in restructuring Sallie Mae is the creation of a truly private firm. Several principles should guide the restructuring design and process:

- Stability must be maintained in the student loan market.
- Taxpayers' liability should be minimized and eventually eliminated liabilities.
- Existing investors and management should neither be advantaged nor disadvantaged by restructuring.
- A private entity created from restructuring should not have any economic, legal, or regulatory advantages over its market competitors.

Design

Sallie Mae has concluded that the most effective way to meet the needs of students, schools, investors and taxpayers is for Congress to authorize a modified form of privatization. This proposal, which is included in draft legislative form in Appendix 1, involves a corporate restructuring over a transitional period during which Sallie Mae would separately operate a GSE unit and one or more non-GSE units under a common holding company umbrella ("Newco"). The GSE would gradually liquidate absent requests by the Secretary of Education to utilize it for lender of last resort purposes. The non-GSE units would be private entities, free to enter into new business activities. The organizational structure is characterized in Exhibit 5.

Exhibit 5
Holding Company Structure



On the restructuring date, Sallie Mae shares would be converted to Newco shares and Sallie Mae would transfer an appropriate amount of capital (shareholder equity above statutory thresholds) to the holding company. This capital would be used to finance and leverage the holding company and the operating subsidiaries. The servicing systems and fixed assets, as well as management and employees, would be transferred to Newco or the operating subsidiaries at that time. The GSE would contract with Newco or another subsidiary to service its assets. All management and administrative support would be provided by Newco.

The GSE would retain the current charter with its existing business limitations and capital safety and soundness requirements. On the restructuring date, Sallie Mae would cease new business activities (other than lender of last resort activities) in the GSE, and GSE debt issuances would be severely curtailed. All new business would be conducted in the non-GSE subsidiaries or Newco and would be funded by securities issued by Newco. Such securities would be obligations of the private company and not the GSE.

Neither Newco nor its subsidiaries would receive debt financing from the GSE. The GSE would, however, need cash infusions for several years to offset the fact that its liabilities mature faster than its assets. The GSE could raise cash through asset sales to Newco or the market. As the balance sheet of the GSE contracts, the capital ratio of the GSE would increase rapidly. Some portion of this capital (*e.g.*, that above statutory levels) would be dividended to Newco as sole shareholder and would help leverage Newco's borrowing activities.

An example of how the GSE and Newco balance sheets would evolve is shown in Exhibit 6. In this example, the capital-to-assets ratio of the GSE is maintained at 2 percent (the amount required under current safety and soundness regulations). Capital above that level is transferred to Newco. The amount of capital released by the GSE over the four year period indicated, can support up to $40 billion in student loan-related business (without securitization) while maintaining a capital-to-assets ratio between 5 and 8 percent. Morgan Stanley's analysis suggests that Newco would need capital in the range of 5 to 8 percent to attain a rating as a private entity in the range of "AA". Sallie Mae believes that this is a conservative estimate and that, in any event, securitization would provide considerable added flexibility for capital management purposes. Adequate capital would be maintained in the GSE to support debt issued to fund GSE lender-of-last-resort purchases if deemed necessary by the Secretary of Education.

Exhibit 6
GSE and Newco Restructured Balance Sheet ($ in millions)

GSE	*1994*	*1995*	*1996*	*1997*	*1998*
Student Loans	$29,466	$24,901	$20,750	$16,309	$6,963
Advances	8,060	7,962	3,631	0	0
Facilities	1,720	0	0	0	0
Investments	9,889	200	200	200	200
Other	1,463	681	514	347	151
Total Assets	50,600	33,744	25,095	16,856	7,314
Existing Debt (1/1/94)	26,751	16,165	9,855	3,939	771
1994 Issued Debt	21,488	16,256	14,256	12,256	6,256
Other	956	648	482	324	141
Stockholders' Equity	1,405	675	502	337	146
Total Liabilities & Equity	50,600	33,744	25,095	16,856	7,314
Capital Ratio	2.78%	2.00%	2.00%	2.00%	2.00%

Newco	*1994*	*1995*	*1996*	*1997*	*1998*
Student Loans		$7,912	$15,789	$22,686	$33,862
Advances		0	0	0	0
Facilities		1,922	2,105	2,292	2,549
Investments		2,863	3,267	2,857	2,757
Other		714	947	1,108	1,308
Total Assets		13,411	22,108	28,943	40,476
Debt		12,099	20,101	26,338	37,245
Other		244	491	688	906
Stockholders' Equity		1,068	1,516	1,917	2,325
Total Liabilities & Equity		13,411	22,108	28,943	40,476
Capital Ratio		7.96%	6.86%	6.62%	5.74%

Rationale

This structure satisfies the principles listed at the beginning of this section. As a private entity, Newco would *continue to support the FFELP market* by maintaining a large share of forecasted volume (*i.e.* a 30 percent share of Department of Education forecast of future FFELP commitments). In addition, the opportunity to gradually redeploy expertise in new markets will ensure the maintenance of high quality and technological leadership in loan servicing. By retaining a GSE with its existing capabilities, Sallie Mae would be capable, among other things, of meeting lender-of-last-resort needs in the FFELP market. Thus, stability in the student loan market would be maintained during the transition to direct lending. The GSE would purchase and/or originate loans and issue debt to finance such activities only if requested by the Secretary of Education.

Second, *taxpayer risk would be reduced* over time resulting from this arrangement. The GSE balance sheet and, thus, the implicit liability of the taxpayer would decline by 85 percent (over $42 billion) during the four-year period assuming a January 1, 1995 restructuring date. The GSE would become a liquidating entity, and the outstanding GSE debt would be steadily reduced.

Third, the securities held by *existing bondholders* would be *unaffected* by the restructuring. They would continue to be the GSE's obligations with the same attributes as before restructuring. Newco's debt obligations would explicitly not be obligations of the GSE. Equity investors would continue to have the same beneficial ownership rights. Margins on the new student loan and related businesses would be expected to decline, reflecting the increased cost of funds for the private company. However, the "sovereign risk" of GSE ownership would also decline, and new business opportunities would be available for the company.

Fourth, Newco would have *no legal or regulatory advantages* over its competitors. It would possess a general purpose state charter. At the time of restructuring, the parent corporation would forego the state income tax exemption, the SEC exemption, and the Treasury borrowing support retained only by the GSE unit. As a private entity, Newco would not have the power to issue securities with special attributes or Fedwire eligibility. The legislation would make clear that there is no guarantee, explicit or implied, with respect to Newco's debt securities. As a result, Newco would not have preferential access to capital as a private company. The amount of funds raised (and, thus, the size of the company) would be based solely on the strength of its balance sheet and operations. With the holding company structure, capital maintained in the GSE in accordance with statutory requirements would not be viewed by creditors or rating agencies as available to creditors of Newco or its non-GSE subsidiaries.

Timetable

In the example used in Exhibit 6, Newco would begin operations at the beginning of 1995 with approximately $1 billion in shareholder equity. It would begin issuing debt immediately to fund both its purchases of student loans and its academic facilities loans. The initial capital along with distributions of capital from the GSE as it liquidates will allow Sallie Mae to finance up to $40 billion in higher education activities during the first four years of the transition period through unsecured, long-term corporate debt issuances. Securitization would provide additional financing flexibility. The non-GSE subsidiaries would be free to enter new markets. In practice, such investments would be quite small during Newco's early years. The proposed legislation provides that the GSE entity could be dissolved after its assets fell below $5 billion and its remaining debt obligations were fully secured through a trust so long as the lender of last resort function is no longer needed. This would occur approximately five years after the restructuring date.

Feasibility

There are three issues in assessing the financial feasibility of the proposed restructuring:

- Can Newco support the FFELP market at desirable levels during the direct lending transition? More precisely, will Newco be able to issue sufficient debt to maintain its FFELP market share at acceptable profit margins?
- For a given debt rating, how much capital will Newco need to support this volume of debt issuance?
- How much additional financing flexibility would securitization provide?

In order to ascertain the feasibility of a restructuring, Sallie Mae retained the financial firm of Morgan Stanley to review funding alternatives and the requirements for different private ratings. Their opinion is included as Appendix 2 of this report.

Financing Capability

The private corporate debt markets today are deep and liquid. Total investment grade ("BBB" or higher rating by S&P) issuance in 1993 (a record year) was $246 billion. The majority of corporate debt issuance is fixed-rate. Only $33 billion of investment grade issuance was floating-rate debt. The largest private corporate issuer of floating-rate debt in 1993 was Merrill Lynch, which issued $2.8 billion.

By way of comparison, Sallie Mae raised $10.4 billion of debt with maturities of one year or longer in 1993, 85 percent of which was floating-rate debt. To attain the volume figures in Exhibit 6, it would have to issue $12 billion of debt in total in 1995. Its annual issuance could rise to $24 billion by 1998. The majority of this debt would have to be floating-rate in order for Newco to match fund its floating-rate assets and minimize interest rate risk. Furthermore, in order to minimize basis risk, a substantial proportion of the floating-rate debt would have to be indexed to T-Bills.[10] As a GSE, Sallie Mae dominates the T-Bill floater market, accounting for 91 percent of total issuance in 1993.

A *key* to being able to issue this volume of floating-rate debt is a *high credit rating*. Newco would need at least an A rating, and preferably a AA rating, to be able to sell its debt to large institutional investors. These investors dominate the investor base with more than $800 billion in assets as of December, 1993. However, the floating-rate debt market has been dominated by LIBOR or commercial paper based issues to date. Thus, a deep corporate T-Bill floater market would have to be developed. In Morgan Stanley's view, assuming Newco meets the financial projections in Exhibit 6, and assuming economic and financial conditions comparable to those prevailing currently, *Newco as a AA-rated issuer could obtain on balance sheet funding during the period 1995 to 1998 through the issuance of debt securities in the amounts set forth in Exhibit 6.*

Morgan Stanley's analysis indicates that, under current market conditions, a corporate T-Bill floater market deep enough to facilitate annual issuance of up to $10 billion by Newco can be developed in a relatively short time frame. Their assessment is based on the overall size of the corporate debt markets and investor interest in this type of security. Recent similar market developments include Sallie Mae's development of the agency T-Bill floater market and GMAC's significant expansion of the commercial paper market. As a non-GSE, however, Newco would be required to pay higher spreads than Sallie Mae in order to attract this volume of funds. The higher spreads would be necessary to compensate for the lower credit rating, the smaller pool of money that invests in non-GSE, as opposed to GSE, securities, and the need to attract new, non-traditional investors. This analysis extends to the issuance of LIBOR floaters and fixed-rate debt. These markets are considerably deeper than the T-Bill floater market and Newco's financing demands would be much more modest.

Securitization

Securitization has the potential of greatly expanding Newco's funding capabilities. Through the end of 1993, more than $270 billion of asset-backed securities ("ABS") had been issued, including over $2 billion in taxable securities backed by student loans. Over $93 billion of ABS were issued in 1993. Morgan Stanley believes that a private Sallie Mae could establish a market for large ($1 billion or larger) and frequent issues of taxable student loan-backed securities. Securitization would give Newco the ability to meet surges in loan demand without causing stress to its capital structure. Securitization would allow Newco to attain AAA financing rates regardless of its rating as a company, as the rating is based on the collateral and the security structure. Because securitization is off-balance sheet, it would free up capital and would reduce Newco's T-Bill funding requirements. In addition, the development of this market could benefit other potential issuers (by expanding the investor base and liquidity).

It is important to note that the economic conditions for making a transition from GSE to non-GSE from a funding perspective are currently quite favorable. There is a plentiful supply of funds for investment in highly rated corporate debt and credit spreads (the difference between yields on comparable maturity corporate and Treasury securities) are historically tight. At other points in the economic cycle, such as in 1989, funding was not as plentiful and spreads were considerably wider than today. A restructuring of Sallie Mae under the current conditions would facilitate the development of a corporate floating rate debt and/or student loan asset-backed securities market.

Capitalization

A *critical assumption* behind this analysis is a *AA rating for Newco*. Morgan Stanley has analyzed Newco's potential credit rating by considering elements typically reviewed by the rating agencies. Their analysis, based on a review of current and projected asset composition, quality, size, capitalization, and liquidity, suggests that Newco would need a capital ratio in the 5 to 8 percent range to achieve a rating in the AA range.[11] Comparisons to other highly rated private financial corporations and competitors suggest that Newco would need a capital-to-assets ratio in the 7 to 8 percent range to achieve a solid AA rating. While the rating agencies' need to benchmark companies is well understood, Sallie Mae intends to work with such agencies to secure relatively lower capital requirements given the superior credit quality of its balance sheet.

If Newco attains a AA rating, the $1 billion of initial capital could support $12.5 to $14 billion of debt-financed student loans and related assets in its first year of operation. Securitization could significantly increase this capacity. Morgan Stanley has not expressed a view as to Newco's ability to issue as large a volume of debt as an A-rated company. However, it has noted that the markets for A-rated corporate debt are not as deep as those for AA-rated debt. Morgan Stanley has advised that, as a practical matter, it would not be possible for Newco to attain a AAA status upon creation.

Costs

Restructuring would increase Sallie Mae's costs in the near term. The spreads and issuance costs on Newco's financing would be higher than those of a GSE, and the private company would be subject to state taxes. In addition, Newco would operate with lower leverage than Sallie Mae, reducing shareholder return on equity for its projected student loan business. Ultimately, the higher costs would be offset by the income from new business activities and the benefits of diversification and reduction of political risk.

The concept of an "exit fee" also has been mentioned. In theory, this fee (paid by investors to the government upon restructuring) would reward the government for its role in creating value through granting of the GSE franchise to Sallie Mae. In reality, this value has been lost through the planned reduction in Sallie Mae's market. Shareholders have already experienced a 40 percent decline in the value of their investment -- a $2.5 billion total loss of market capital -- reflecting the introduction of direct lending and the imposition of the offset fee. Shareholders would also lose the value of the benefits of GSE status upon restructuring. From a shareholder perspective, the imposition of an exit fee could render the restructuring financially infeasible if the costs were judged to outweigh the benefits. Moreover, an exit fee would deplete capital or take the form of a claim on future earnings, thereby reducing the new entity's ability to leverage its resources in continued support of the FFELP.

VII. The Benefits of Restructuring

A proper restructuring can benefit all the parties to the transaction. This includes both the immediate parties (*i.e.*, Sallie Mae's employees, investors, taxpayers and the government), its constituents (*i.e.*, borrowers, financial institutions, higher education institutions), and the broader economy.

Higher Education

The principal immediate concern of schools is the availability of student loans. For schools continuing to be served by the FFELP, the continuation of student loan purchases by Newco will ensure availability. If desired by the Department of Education, Newco's support of the FFELP can be contractually maintained. Preserving the GSE as a lender-of-last-resort would also provide an insurance policy for the FFELP. Restructuring will facilitate maintenance of Sallie Mae's servicing operation, benefiting schools, students and the government.

Schools would continue to be served by Sallie Mae's facilities financing program. In fact, restructuring would allow a larger group of schools to benefit from Sallie Mae's financing expertise (as it is now concentrated on schools with credit ratings of A or less). Higher education institutions may also benefit from applying Sallie Mae's technological skills to an expanded menu of needs including development of campus-wide information networks and automated forms processing. Such activities can lower college and university costs, improve the quality of education, and increase university fee income.

As a private concern, Sallie Mae can improve higher education's access to and cost of funds by providing a wider array of financial services for colleges and universities. A logical extension of its business would be financing elementary and secondary school facilities and private sector worker training facilities.

The Government and Taxpayer

Restructuring would have several benefits for the government and taxpayer. Over time, government-sponsored borrowing would be reduced as privately-issued debt replaced agency debt financing of Sallie Mae's operations and portfolio. Privatization would eventually eliminate the taxpayer's implicit liability for over $45 billion of outstanding Sallie Mae debt.

A second significant advantage for the government is maintaining a healthy and capable Sallie Mae. By retaining staff and upgrading its systems, Sallie Mae would be better positioned to assist the Department of Education in maintaining stability in the student loan program. Also, a successful restructuring can serve as a role model for current and future

GSEs, enhancing their ability to raise capital for socially desirable activities.

A third advantage for government is increased tax revenue. At a federal level, higher funding costs will result in higher interest income to taxable investors. With more flexibility to pursue business activities in line with its expertise, Sallie Mae is likely to be more efficient and profitable and thus pay higher corporate income taxes. State governments would also benefit from the elimination of the GSE state tax exemption.

The Economy

As a private entity, Sallie Mae has the potential to add considerable value to the economy. Sallie Mae has achieved significant economies of scale through its investment in processing systems. Its competitive advantage is in high volume transaction processing in a highly regulated market. This expertise is transferable to other regulated servicing activities such as consumer finance or health care administration. Application of Sallie Mae's capabilities in new areas has the possibility for significant gains in efficiency and, therefore, cost reduction. In addition, Sallie Mae can be an important source of innovation, for example in the application of new technology (*e.g.*, imaging systems) to a variety of tasks.

The essence of value creation in a market economy is the ability to refocus to changing market conditions and opportunities. Under Sallie Mae's current charter, its ability to focus on those activities that make the most sense economically is severely limited. By redeploying resources in response to changing market conditions (*i.e.*, the reduction of the FFELP) Sallie Mae can make a greater contribution to the economy.

Investors

The holding company restructuring proposal safeguards the interests of existing bondholders. They would maintain all rights and attributes of the securities they now hold. The securities would continue to be obligations of the GSE with the implicit support of the government. As a result, it is unlikely that the rating agencies would change their opinions on the securities. Bondholders would be kept well informed about any restructuring initiatives to minimize the potential for sales based on uncertainty regarding their interests.

Shareholders would benefit from privatization if the perceived value of Sallie Mae's franchise as a private entity is greater than as a GSE. The major benefit for investors would be the mitigation of political risk and the development of revenue sources other than student lending, which would ultimately replace the decline in income resulting from the loss in student loan business. Development of new revenue sources would diversify the income base and reduce the political volatility of the stock price. Restructuring would also reduce the risk of future reductions in the profitability of FFELP investment through program changes. These benefits must be weighed against the costs of giving up agency status (higher debt costs and taxes, and lower leverage). While the benefits of diversification would not be recognized immediately, research and development activities and investing in new ventures would become higher priorities if Sallie Mae's future were more secure.

Employees

As of September 30, 1993, Sallie Mae employed over 4,600 individuals in six states and the District of Columbia. Sallie Mae is the major employer in most of the communities where it operates loan servicing centers. Under the status quo, many Sallie Mae employees would eventually depart the firm. A restructuring would enhance their on-going job prospects as well as their ability to focus on the long-term development of the company and higher education. Also, it would preserve the core competence of the firm, a valuable attribute in maintaining the quality of service delivery and potential for innovation.

Competitors

As a private concern, Sallie Mae would have no agency-related fund-raising advantages. In the current environment, Morgan Stanley believes it could fund its purchases of student loans with unsecured AA-rated debt. Because spreads on corporate debt are higher than agency debt, Sallie Mae's relative competitiveness in the student loan market would be reduced.

The more important question is whether Sallie Mae's size and name confer upon it any significant advantages outside the student loan market. Under the terms of the restructuring proposal put forth herein, Sallie Mae would not benefit from its retained portfolio. The capital supporting this portfolio would not be available to support new borrowing or investment by Newco. This capital would be released only gradually as the retained GSE portfolio was reduced. Measured by either its anticipated initial asset size or capitalization, Sallie Mae would be of modest size for a highly rated financial services company.

If Newco is to support the student loan market during the transition to direct lending, it is important that it have sufficient capital available. Insufficient capital levels could seriously handicap the firm in its efforts to support the market. In addition, the firm should have the resources necessary to continue to operate as a national secondary market.

Although restructuring will allow Sallie Mae to enter new business lines, the focus of its activities by choice will be in the field of education for some time. Sallie Mae has been a monoline company. Thus, its systems, customer lists, and knowledge base are all specific to education credit delivery. It is logical for the company to move incrementally in fields in which it already has name recognition and expertise.

Completing the Life Cycle

A sunset of a successful GSE would be useful public policy. If the original mission of a GSE has been successfully completed and funding from the private sector is available, the need for government sponsorship may be past. Providing a sunset for a GSE whose mission has been accomplished creates a role model for a government concerned with reinventing itself -- a theme consistent with Vice President Gore's National Performance Review of 1993.

A successful sunset could set an important precedent for new and existing GSEs. Capital raising by current and future GSEs may be easier if it were possible upon fulfillment of the mission to convert to fully private, stockholder owned companies. This would allow investors to plan for and realize the benefits of developing a franchise and would remove a potential disincentive associated with the successful achievement of the mission (*i.e.*, the uncertainty as to the future of the company).

Finally, a sunset provision could alleviate concerns of potential investors about their on-going ability to realize a market return on their investment. In addition, it could reduce the concern of critics that a GSE could eventually dominate and force private sector players out of the market.

VIII. Conclusion

The evolution of the student loan market and the introduction of direct lending have prompted Sallie Mae to assess how it can most effectively meet the government's public policy goals in financing higher education while maintaining the long-term value of the franchise for the benefit of the economy and its investors. This study concludes that Sallie Mae can best meet these objectives by being restructured into a private, general purpose corporation. Through this process, Sallie Mae will be able to maintain its capabilities to ensure the flow of funds to higher education and diversify its activities and income stream.

Sallie Mae believes that an orderly restructuring could provide significant benefits to higher education, the economy, and the government, while safeguarding the interests of investors and taxpayers. Allowing Sallie Mae to restructure and diversify would keep the corporation strong and its operating capacity intact, benefiting taxpayers and the student loan market. Restructuring can eliminate, over time, up to $45 billion in implicit taxpayer liability for Sallie Mae's debt. Restructuring Sallie Mae can serve as a useful role model for current and future GSEs, reducing investor uncertainty and improving their ability to issue capital. Redeployment of Sallie Mae's expertise would benefit the economy and be a source of increased tax revenue in the future.

Restructuring along the lines proposed in this report would also represent an equitable treatment of the investors that put up the capital to support Sallie Mae's public policy mission. Allowing investors to redeploy the firm's capital and expertise would benefit the economy and provide an offset to the loss in GSE privileges. A commitment to a continuing role in the FFELP market and maintaining capital in the GSE to support lender-of-last-resort activities can provide an effective insurance policy for continuing the smooth flow of credit to higher education.

Endnotes

1. The others are the Farm Credit System, the Federal Agricultural Mortgage Corporation (Farmer Mac), the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Home Loan Bank (FHLB) System. *See* Congressional Budget Office, *Controlling the Risks of Government-Sponsored Enterprises*, April 1991. *See also* U.S. Department of the Treasury, *Report of the Secretary on Government-Sponsored Enterprises*, April 1991.

2. GSE debt securities are frequently referred to as agency securities despite the fact that the enterprises are not agencies of the federal government. Sallie Mae initially funded itself through the Federal Financing Bank ("FFB") with a full faith and credit guarantee. Sallie Mae ceased issuing debt through the FFB in 1982.

3. Recent studies of the Federal Home Loan Bank System, have recommended a restructuring of their capital along more private lines. *See* Congressional Budget Office, *The Federal Home Loan Banks in the Housing Finance System*, July 1993. *See also*, U.S. General Accounting Office, *Federal Home Loan Bank System: Reforms Needed to Promote Its Safety, Soundness and Effectiveness*, December 1993.

4. A form of securitization has been used extensively by state secondary markets for tax-exempt financing. The recent adoption of Rule 3a-7 under the Investment Company Act by the Securities and Exchange Commission is expected to expand the use of student loan asset-backed securities beyond the municipal bond market.

5. The primary source of potential savings is the elimination of the spread between private sector borrowing rates and Treasury rates. These parameters are set by the FFELP legislation. The magnitude of these savings is a source of controversy. *See* U.S. General Accounting Office, *Student Loans: Direct Loans Could Save Billions in First 5 Years with Proper Implementation*, November 1992. *See also* Miles B. and D. Zimmerman, *Federal Family Loans: Reduced Costs. Direct Lending and National Income*, CRS Report 93-247 E, February 22, 1993.

6. The National Cooperative Bank, as it is now called, spent only two years as a GSE. Unlike other GSEs, the government held stock in the Bank. This stock was converted into long-term notes at privatization. *See* Richter, J., *Where Credit Was Due: The Creation of the National Consumer Cooperative Bank*, (1985).

7. Winger, A.R., *Splitting Up Is Hard To Do*, Secondary Mortgage Markets, Vol. 4, No. 1. (Spring 1987). At that time, Fannie Mae was not strong enough financially to consider privatization without substantial government assistance. Privatization as referred to here differs from the past restructuring of Fannie Mae (in 1968) and Freddie Mac (in 1989). In both cases, ownership of the company passed to shareholders and the stock became publicly traded. However, the companies retained their Congressional charters and GSE privileges.

8. The Federal Housing Enterprises Financial Safety and Soundness Act of 1992. The reports are to be done by HUD, GAO, and CBO, but are not due until October 1994.

9. Two recent areas of attention have been small business loans and commercial real estate loans. Legislation proposed by Representative LaFalce would create a GSE known as Velda Sue to develop a secondary market in uninsured small business loans. A proposal by Representative Kanjorski would allow existing GSEs to set up separate subsidiaries for the securitization of commercial real estate and business loans.

10. Basis risk arises when the characteristics of the indices underlying assets and liabilities differs. Divergence in the movement of the indices can affect spread income.

11. Based on 9/30/93 balance sheet composition and typical AA-rated financial company capitalization for the different asset categories (*e.g.*, capitalization of 4 percent for student loans, 2 percent for investment securities, 25 percent for facilities loans).

APPENDIX 1

PROPOSED LEGISLATION

SUMMARY OF SALLIE MAE REORGANIZATION LEGISLATION

Findings:

The proposed legislation acknowledges that (1) the Student Loan Marketing Association (the "Association") has achieved its legislative purpose to develop a national student loan secondary market and (2) there is no long-term need for the Association to remain a government sponsored enterprise ("GSE").

State-Chartered Holding Company:

The proposed legislation amends the Higher Education Act to allow the Association to be reorganized as a state-chartered, separately capitalized holding company which would hold the GSE as a liquidating subsidiary. The non-financial assets of the Association would be transferred to non-GSE subsidiaries of the holding company (the "Reorganization"). This structure allows the Association to compete in its existing and new markets as a non-GSE entity, while continuing to provide stability to the student loan market and to serve as lender-of-last resort during the transition to direct lending. The holding company and its non-GSE subsidiaries are allowed to act as eligible lenders for purposes of secondary market activity in the Federal Family Education Loan Program.

5-Year Transition Period:

Over a five year transition period, the Association would be maintained as a GSE subsidiary of the holding company. However, during this period the Association's GSE debt would be reduced from a current level of $45 billion to $5 billion or less. Once the $5 billion level is achieved, the GSE could be liquidated unless the Secretary of Education determines that the GSE's continuing support of the lender-of-last resort program is necessary. The liquidation would be effected by transferring remaining assets and obligations into a trust structure.

The obligations of the Association would continue to have GSE attributes regardless of whether such debt obligations were incurred before or after the reorganization. Funding in the GSE would continue only for lender-of-last resort activities and, at a minimal level, to match GSE debt maturities with GSE assets. Funding of new activities, including non-lender-of-last resort student loan secondary market activity, would occur at the holding company or non-GSE subsidiary level. There would be no implicit or explicit liability of the Federal government for the holding company or its non-GSE subsidiaries.

Capital Adequacy:

To ensure that the Association maintains adequate capital to support its continuing operations during the transition period, it would be required, as under current law, to maintain a minimum capital ratio of 2.00 percent or meet capital ratio safe harbor requirements. The Association's authority to pay dividends would be restricted to ensure the capital requirements are met.

Furthermore, any distribution of non-cash assets by the Association to the holding company must be valued at net book value. A fairness test is imposed on inter-company contracts and transactions.

Mechanics:

The proposed legislation provides for the effective time of the Reorganization (the "Effective Time") to take place within 18-months of the enactment of the legislation. During that period, the Association would submit the Reorganization to shareholders for approval. After such approval is obtained, the Association would be merged with a newly formed state-chartered corporation ("Mergerco"), a wholly owned subsidiary of the holding company, with the Association being the surviving corporation in the merger.

Immediately following the Effective Time, all of the outstanding shares of the Association's common stock will be owned by the holding company and all of the outstanding shares of the holding company's common stock will be owned by the owners of the Association's common stock immediately prior to the Effective Time.

Federal Tax Consequences:

The Reorganization would be structured so as to be a tax-free event to all stockholders and debtholders of the Association.

SALLIE MAE
DRAFT REORGANIZATION LEGISLATION

103D CONGRESS
2d Session H.R._____

To amend Part B of Title IV of the Higher Education Act of 1965 to provide for the reorganization of the Student Loan Marketing Association.

IN THE HOUSE OF REPRESENTATIVES
[ ], 1994

Mr(s) introduced the following bill; which was referred to the Committee on

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A BILL

To amend Part B of Title IV of the Higher Education Act of 1965 to provide for the reorganization of the Student Loan Marketing Association.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as "The Student Loan Marketing Association Transition Act of 1994".

SEC. 2. FINDINGS AND PURPOSES:

(a) FINDINGS -- The Congress hereby finds that:

(1) The Student Loan Marketing Association, since its creation by Congress in 1972, has successfully developed a national secondary market in guaranteed student loans, providing stability and liquidity to the market for student loans and facilitating access to loans for all eligible borrowers.

(2) Today, because (a) student loans are bought and sold in secondary markets in a competitive environment and (b) the federal government plans to engage in direct lending to students in amounts representing up to 60% of aggregate federal student loan volumes by 1998, there is not a continuing need to maintain the Student Loan Marketing Association as a federally chartered government-sponsored enterprise on a long term basis.

(3) The risk to taxpayers that arises from any implicit government guarantee that government-sponsored enterprise liabilities may carry should be limited following the transition provided for herein.

(4) It is desirable (i) to maintain the Student Loan Marketing Association as a government-sponsored enterprise on a short-term transitional basis and to facilitate the federal government's transition to direct lending and (ii) to ensure an orderly wind down of the Student Loan Marketing Association's charter that preserves the reasonable expectations of the Company's investors, creditors, customers and other business relations.

(b) PURPOSES -- The purposes of this Act are as follows:

(1) to terminate, in an orderly manner, the U.S. government sponsorship of the Student Loan Marketing Association, a successful federally chartered entity, thereby eliminating implicit taxpayer liability for the obligations of the Student Loan Marketing Association, which obligations currently total $45 billion; and

(2) to permit the Student Loan Marketing Association to become a subsidiary of a holding company that would be authorized to engage in any acts or activities for which corporations may be organized under the laws of any State of the United States or the District of Columbia; thereby (A) enabling such holding company to engage in activities as its board of directors deems appropriate and (B) maintaining the Student Loan Marketing Association as a government-sponsored enterprise and a wholly owned subsidiary of such holding company during the transition provided for herein.

SEC. 3.
THE STUDENT LOAN MARKETING ASSOCIATION TRANSITION.

(a) Purpose - it is the purpose of this section to provide for the transition of the operations of the Association from a government-sponsored enterprise to a corporation organized under the laws of any State of the United States or the District of Columbia;

(b) The Higher Education Act of 1965 [20 U.S.C. §1071 et seq. (1988)] is amended by inserting after section 1087-2 [20 U.S.C.] the following new section:

"-- REORGANIZATION OF THE STUDENT LOAN MARKETING ASSOCIATION THROUGH THE FORMATION OF A HOLDING COMPANY

"**Sec. 1987-2A.(a)Establishment, Powers and Organization of the Association - - Establishment** - The Board of Directors of the Association shall take or cause to be taken all such action as it deems necessary or appropriate to establish the Holding Company and Mergerco and to effect the Reorganization in accordance with the following:

"**(1) Formation of the Holding Company and Mergerco** - The Association shall cause the formation, under the laws of any State of the United States or the District of Columbia, of the Holding Company and the Holding Company shall cause the formation, under the laws of any State of the United States or the District of Columbia, of Mergerco, and Mergerco shall be a wholly owned subsidiary of the Holding Company. The Association may contribute to the capital of the Holding Company any existing subsidiaries of the Association and any subsidiaries of the Association hereinafter existing.

"**(2) Registration Statement** - The Holding Company shall file a registration statement, which shall include a proxy statement of the Association and a prospectus of the Holding Company with the Securities and Exchange Commission to (i) register, pursuant to the Securities Act of 1933, as amended [15 U.S.C. § 77a-77aa (1988)], the common stock of the Holding Company into which the common stock of the Association shall be converted at the Effective Time and (ii) to solicit the approval of the Reorganization by the Association's common stockholders.

"**(3) Stockholder Approval** - Upon the approval of the holders of a majority of the issued and outstanding shares of the Association's common stock, the Association shall cause the merger of Mergerco with and into the Association at the Effective Time.

"**(4) Actions at the Effective Time** -

"**(i)** Mergerco shall, in accordance with and subject to the terms and conditions of this section, be merged with and into the Association, effective at the Effective Time, and, following such merger, the Association shall be a wholly owned subsidiary of the Holding Company;

"**(ii)** At the Effective Time, each share of the Association's common stock issued and outstanding immediately prior to the Effective Time (other than shares held in the treasury of the Association) shall be converted into the right to receive one share of common stock of the Holding Company;

"**(iii)** At the Effective Time, each share of Mergerco's common stock issued and outstanding immediately prior to the Effective Time shall be converted into one share of the Association's common stock;

"**(iv)** At the Effective Time, the separate existence of Mergerco shall cease;

"**(v)** At the Effective Time, each share of the Holding Company's common stock issued and outstanding immediately prior to the Effective time shall be retired and cancelled.

"**(5) Ownership** - Immediately after the Effective Time and as a result of the Reorganization, all of the common stock of the Association shall be owned by the Holding Company. All shares of preferred stock of the Association issued and outstanding immediately prior to the Effective Time shall remain the issued and outstanding preferred stock of the Association immediately after the Effective Time.

"**(6) Association Board of Directors** - Notwithstanding any other provision of Part B of Title IV of the Higher Education Act [20 U.S.C. § 1071 et seq.], after the Effective Time, the Association shall have a Board of Directors which shall consist of 21 persons, 7 of whom shall be appointed by the President and shall be representatives of the general public. The remaining 14 directors, who need not be affiliated with an eligible institution or an eligible lender, shall be elected by the shareholder or shareholders of the Association, which immediately after the Effective Time shall be the Holding Company. The President shall appoint the Chairman of the Board.

"**(b) Transition** - Except as specifically provided herein, the Association shall continue to have all of the rights, privileges and obligations set forth in, and shall be subject to all of the limitations and restrictions of, Section 439 of the Higher Education Act [20 U.S.C. § 1087-2] as in effect on the effective date of this Act.

"**(1) Dividends** - The Association may pay dividends in the form of cash or noncash distributions so long as at the time of the declaration of such dividends, after giving effect to the payment of such dividends as of the date of such declaration by the Board of Directors of the Association, the Association's capital would be in compliance with § 1087-2(r)(4) or (11).

"**(2) Valuation of Non-Cash Distributions** - After the effective date of this Act, any distribution of non-cash assets by the Association to the Holding Company shall be valued at net book value on the date the Association's Board of Directors approved such distribution for purposes of the distribution and calculating compliance with § 1087-2(r)(4).

"(3) **Discharge and Liquidation** - In the event the net book value of all assets of the Association fall below [$5 billion], the Association may provide notice to the Secretary of Education of the Association's intent to discharge its remaining debt obligations and liquidate pursuant to this subsection, and unless within 60 days of receipt of such notice the Secretary of Education shall provide notice to the Association that the Association continues to be needed to serve as a lender of last resort pursuant to Section 439(q) of the Higher Education Act [20 U.S.C. § 1087-2(q)], the Association may irrevocably transfer its remaining debt obligations to a trustee and irrevocably deposit or cause to be deposited with such trustee, as trust funds solely for the benefit of holders of the Association's remaining debt obligations, (i) money or direct non-callable obligations of the United States of America for which payment the full faith and credit of the United States is pledged, maturing as to principal and interest in such amounts and at such times as are sufficient without consideration of any reinvestment of such interest to pay the principal of and interest on such remaining monetary obligations to stated maturity, (ii) financial assets (which may include student loans) in such amounts and of such kind as to ensure the highest credit rating from a nationally recognized bond rating agency for such trust, and as to which, the Holding Company shall agree to take all actions necessary to maintain such rating, or (iii) a combination of (i) and (ii). All money, obligations or financial assets deposited with the trustee pursuant to this subsection shall be held in trust and applied by the trustee to the payment to the persons entitled thereto for whose payment such money, obligations or financial assets have been deposited with the Trustee. Upon the fulfillment of the trustee's obligations under the trust, any remaining assets of the trust shall be returned to the Holding Company. Upon the deposit of such money, obligations or financial assets with the trustee and the payment of or the making of proper provision under applicable state law [(which, in the absence of other applicable law shall be deemed to be District of Columbia law)] for all other obligations of the Association (including the repurchase or redemption or the making of proper provision for the repurchase or redemption of any preferred stock of the Association then outstanding), the Association shall be deemed to have dissolved and the separate existence of the Association shall cease to exist. All remaining assets of the Association not deposited to the trust shall become assets of the Holding Company.

"(4) **Unconsolidated Reporting** - After the Effective Time, the Association shall continue to report to the Secretary of the Treasury on an unconsolidated basis for purposes of financial reporting and calculating the capital adequacy ratios contained in Section 439(r) of Part B of Title IV of the Higher Education Act [20 U.S.C. § 1071 et seq.] until establishment of the trust and dissolution of the Association referred to in subsection 2A(b)(3) hereof.

"(5) **Reduction of Association Indebtedness** - With the exception of any indebtedness incurred by the Association in connection with its serving as a lender-of-last-resort as provided in Section 439 of Part B of Title IV of the Higher Education

Act [20 U.S.C. § 1087-2], after the Effective Time, the Association shall not incur indebtedness such that Association's total indebtedness at any one time shall exceed the following amounts[1]: on or after December 31, 1995, [$38 billion]; on or after December 31, 1996, [$28 billion]; on or after December 31, 1997, [$18 billion]; on or after December 31, 1998, [$10 billion]; on or after December 31, 1999, [$5 billion]. Notwithstanding the foregoing, nothing in this subsection shall in any way whatsoever modify the attributes accorded the debt obligations of the Association by Section 439 of Part B of Title IV of the Higher Education Act [20 U.S.C. § 1087-2], regardless of whether such debt obligations are incurred prior to or at any time following the Effective Time.

"(6) **Affiliate Transactions** - No contract, license or other transaction or arrangement between the Association and its affiliates shall be void or voidable solely because of such reason if (i) the material facts as to the relationship or interest and as to the contract, transaction or arrangement are disclosed to or are known by the Board of Directors of the Association or a committee thereof and the Board or committee authorizes the contract, transaction or arrangement by the affirmative vote of a majority of disinterested directors (even though the disinterested directors are less than a quorum) (ii) the material facts as to the relationship or interest and as to the contract, transaction or arrangement are disclosed or are known to the shareholders entitled to vote thereon, and the contract, transaction or arrangement is specifically approved in good faith by vote of the shareholders, or (iii) the contract, transaction or arrangement is fair to the Association as of the time it is authorized, approved or ratified by the Board or a committee thereof. Common or interested directors may be counted in determining the presence of a quorum at a meeting of the Board or a committee thereof which authorizes the contract, transaction or arrangement. Notwithstanding the foregoing, any contract or transaction or arrangement between the Association and any of its affiliates providing for the provision of goods or services or the sale of assets at their net book value to or from the Association at cost shall be deemed fair to the Association.

"(c) Operation of the Holding Company and Mergerco

"(1) **Registration Statement** - For the purposes of determining whether the Holding Company is a registrant entitled under 17 C.F.R. §239.13, or any successor regulation, to use SEC Form S-3, or any successor form, for registration of its securities under the Securities Act of 1933, as amended [15 U.S.C. § 77a-77aa (1988)], the Holding Company shall be deemed to have met the conditions set forth in Instruction

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[1] The bracketed amounts reflect estimates based upon current expectations of debt issuances by the Association prior to the restructuring date. Prior to enactment of the legislation, the amounts should be reviewed and revised to reflect the then current levels and maturities of debt issuances.

I(A)(3) of 17 C.F.R. § 239.13.

"**(2) Holding Company Board of Directors** - After the Effective Time, the directors of the Association elected pursuant to § 1087-2(e)(1)(A)(i) and (ii) or who were appointed by the Association's Board of Directors pursuant to § 1087-2(e)(2) shall be directors of the Holding Company (subject to the right of such directors to fill any vacancies) until the first annual meeting of stockholders of the Holding Company, and, thereafter, the number and composition of the Board of Directors of the Holding Company shall be determined as set forth in the Holding Company's charter or like instrument (as amended from time to time) or by-laws (as amended from time to time) and as permissible under the laws of the jurisdiction of its incorporation.

"**(3) Holding Company Name** - The names of the Holding Company and Mergerco may be (to the extent permitted by the applicable State or District of Columbia law), or contain, "Student Loan Marketing Association", or "Sallie Mae", or variations thereof or such other name as the Board of Directors of the Association or the Holding Company shall deem appropriate.

"**(d) Reorganization.**

"**(1) Effect of the Reorganization** - The Reorganization will have the legal effect as set forth in the applicable law of the jurisdiction of incorporation of the Holding Company and Mergerco.

"**(e) Deadline for Effective Time.**

"**(1) Deadline for Effective Time** - Section § 1087-2A shall be of no further force and effect in the event that the Effective Time does not occur on or before 18 months after the effective date of this Act.

"**(f) Technical Amendments.**

As of the Effective Time, the Higher Education Act [20 U.S.C. § 1071 et seq.] shall be amended by:

(1) Inserting after "Student Loan Marketing Association" in both Subsections 435(d)(1)(F) and (G) [20 U.S.C. §§ 1085 (d)(1)(F) and (G)] the following:

> "or the Holding Company of the Student Loan Marketing Association, including all majority-owned and controlled subsidiaries of such Holding Company, created pursuant to the Student Loan Marketing Association Transition Act of 1994."

(2) Deleting from Subsection 438(b)(5)(A)(ii) [20 U.S.C. § 1087-1(b)(5)(A)(ii)], "or 439(o)" and adding, "or" between "428B" and 428C".

(3) Deleting from Subsection 438(c)(2) [20 U.S.C. § 1087-1(c)(2)], "and 439(o)" and adding, "and" between 428B and 428C.

(4) Deleting from Subsection 485(A) [20 U.S.C. § 1092a(a)] the following: "(and section 439(o) of this Act as in effect prior to the enactment of the section 428C)".

"**(g) Definitions.**

For purposes of this Act -

(1) The term "Association" means the Student Loan Marketing Association;

(2) The term "Holding Company" means the new business corporation formed by the Association under the laws of any State of the United States or the District of Columbia;

(3) The term "Mergerco" means the new business corporation formed by the Holding Company under the laws of any State of the United States or the District of Columbia to be merged into the Association;

(4) The term "Reorganization" means the merger of Mergerco into the Association;

(5) The term "Effective Time" means the effective time of the merger of Mergerco into the Association as determined by the Board of Directors of the Association, which shall not be earlier than the date that stockholder approval is obtained pursuant to § 1987-2A(a)(3) hereof and shall not be later than the date that is 18 months after the effective date of this Act; and

SEC. 4. EFFECTIVE DATE.

Except as otherwise explicitly provided in any provision of this Act, this Act and the amendments made by this Act shall take effect on the date of enactment of this Act.

APPENDIX 2

MORGAN STANLEY OPINION

MORGAN STANLEY

MORGAN STANLEY & CO.
INCORPORATED
1251 AVENUE OF THE AMERICAS
NEW YORK, NEW YORK 10020
(212) 703-4000

January 19, 1994

PRELIMINARY DRAFT

Board of Directors
Student Loan Marketing Association
1050 Thomas Jefferson Street, N.W.
Washington, D.C. 20007

Members of the Board:

We understand that management of the Student Loan Marketing Association ("SLM" or the "Company") is beginning a study concerning whether SLM could operate profitability at currently projected levels of activity without its current government-sponsored enterprise ("GSE") status. In conjunction with this study, management has asked for our view as to (i) whether SLM, without GSE status, should be able to obtain a rating for its long-term unsecured debt securities in the range of AA or the equivalent from the two principal nationally recognized statistical rating organizations in 1995 and (ii) whether, assuming the Company meets its financial projections and ratings in the range described above are obtained by SLM and maintained over the period from 1995 through 1998, and assuming that securities market, economic and general business and financial conditions comparable to those prevailing as of the date hereof continue to exist throughout such period, SLM could obtain financing in such years through the issuance of long-term unsecured debt securities in the aggregate principal amounts set forth in the Company's projections attached hereto as Appendix A.

In conducting our analysis, we have:

(i) analyzed SLM's potential credit rating as a non-GSE entity considering elements typically reviewed by the rating agencies including: business overview, asset composition, quality and size, asset and liability management, funding, liquidity, capital and profitability;

(ii) analyzed certain internal financial statements and other financial operating data concerning SLM, prepared by management of the Company;

(iii) reviewed the Company's projections for 1995 through 1998 which were prepared by management of the Company, including the projections of debt issuances by the Company attached hereto as Appendix A;

(iv) compared the capitalization and financial performance of the Company with those of certain finance companies;

(v) analyzed total current non-GSE debt market capacity for issues rated A, AA and AAA and, in addition, reviewed the largest existing corporate issuers in each of these markets;

(vi) analyzed the potential development of the securitization market for student loans;

(vii) analyzed the potential development of various debt markets required by SLM to fund its assets including the treasury bill-based floating rate note market; and

(viii) performed such other analysis as we have deemed appropriate.

We have assumed and relied upon without independent verification the accuracy and completeness of the information reviewed by us for the purposes of this letter. With respect to the financial projections, we have assumed that they have been reasonably prepared on bases reflecting the best currently available estimates and judgments of the future financial performance of the Company and, with your consent, we have assumed that such projections are correct. We have not made any independent valuation or appraisal of the assets or liabilities of the Company, nor have we been furnished with any such appraisals. We have also assumed a transition to non-GSE status in the manner outlined to us by management.

Our views with respect to the assignment of ratings and the issuance of debt securities by the Company are subject to substantial contingencies and uncertainties which are not within the control of the Company or Morgan Stanley & Co. Incorporated. We note in this regard that the assignment of ratings by a statistical rating organization is entirely within the discretion of such rating organization and that we have not made any presentation to any rating organization in connection with the preparation of this letter. We also note that, to our knowledge, no restructuring of a major GSE comparable to that contemplated for the Company has ever occurred. As a result, it has not been possible to consider any such comparable restructuring for purposes of our analysis. We further note that of the finance companies we have analyzed for comparison purposes, the largest floating rate debt issuer completed floating rate debt financings totalling $2.8 billion in 1993. This is significantly less than the amount of floating rate debt financing per annum projected by the Company and, as a result, it has not been possible to consider any comparable private sector issuer in terms of magnitude of floating rate debt issuances.

Further our views are based on the conditions and prospects, financial and otherwise, of the Company as they are represented to us as of the date hereof or as they were reflected in the information and documents reviewed by us. Future changes in market or other conditions may affect the degree of debt market access, the relative level of funding spreads and the pricing terms available to the Company. There can be no assurance that any funding will be available to the Company at any given time in the future or as to the pricing terms of any funding that may be available.

We have been retained by the management of SLM to prepare and deliver this letter and will receive a fee for our services. In the past, Morgan Stanley & Co. Incorporated and its affiliates have provided financial advisory and financing services for the Company, and have received customary fees for the rendering of these services.

It is understood that this letter is for the information of the management and Board of Directors of the Company only and may not be used for any other purpose without our prior written consent.

Based upon and subject to the foregoing, it is our view on the date hereof that as a non-GSE, (i) the Company should be able to obtain a rating for its long-term unsecured debt securities in the range of AA or the equivalent from the two principal nationally recognized statistical rating organizations in 1995 and (ii) assuming the Company meets its financial projections and ratings in the range described above are obtained by the Company and maintained over the period from 1995 through 1998 and assuming that securities market, economic and general business and financial conditions comparable to those prevailing as of the date hereof continue to exist throughout such period, the Company could obtain financing in such years through the issuance of long-term unsecured debt securities in the aggregate principal amounts set forth in the Company's projections attached hereto as Appendix A.

Very truly yours,

MORGAN STANLEY & CO. INCORPORATED

By: Draft
O. Griffith Sexton
Managing Director

APPENDIX A

Total Projected Debt Issuance
($MM)

Year	Floating Rate Debt: T-Bill Floaters: Maturity 1 Year or Less	Floating Rate Debt: T-Bill Floaters: Maturity Greater than 1 Year	Floating Rate Debt: LIBOR Floaters: Maturity 1 Year or Less	Floating Rate Debt: LIBOR Floaters: Maturity Greater than 1 Year	Fixed Rate Debt	Total Debt
1995	$5,000	$5,000	$555	$1,045	$642	$12,242
1996	5,000	5,000	1,885	5,015	448	17,348
1997	5,000	5,000	1,096	8,004	221	19,321
1998	5,000	5,000	4,789	8,011	1,200	24,000

APPENDIX 3

ATTRIBUTES OF GSE SECURITIES

The following constitute the major attributes or GSE status for Sallie Mae debt securities:

- Exemption from SEC registration
- Interest income on debt exempt from state taxation
- Fedwire book-entry eligibility
- Legal investment for federal- and state-regulated entities (e.g., banks and thrifts)
- Money market fund eligibility of long-term floating-rate bonds
- Repo eligibility
- Eligibility for Federal Reserve Open-Market purchases