Privatizing a Government Sponsored Enterprise: Lessons from the Sallie Mae Experience
Michael J. Lea

Abstract: Government Sponsored Enterprises (GSEs) are government-chartered, special purpose corporations. They have been created to advance foster funding in a number of areas including housing, education and agriculture. Over the past 2 decades, the privatization has been proposed.

There are many challenges associated with privatizing large, complex and politically powerful entities. Fortunately, a model for such an action exists. The Student Loan Marketing Association (Sallie Mae) was privatized through an Act of Congress in 1996. Sallie Mae re-organized under a holding company charter with a GSE and non-GSE subsidiaries. The GSE activities were limited and terminated on December 29, 2004 almost 4 years ahead of schedule. This paper describes the rationale for privatization, the constraints to the process, the reorganization structure and the effect of privatization on Sallie Mae and the student loan market. The key elements of the privatization process and structure are highlighted with reference to the applicability to Housing GSEs today.

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Privatizing a Government Sponsored Enterprise:
Lessons from the Sallie Mae Experience

Michael J. Lea*

Summary

The topic of Government Sponsored Enterprise (GSE) privatization is at least 2 decades old.¹ In the early 1980s, HUD studied the feasibility of privatizing Fannie Mae and Freddie Mac. In 1986, Freddie Mac’s Advisory Committee (the precursor to its Board of Directors) discussed the subject. In the mid-1990s, privatization was re-visited when HUD published a series of background papers on the topic.²

There are many challenges associated with privatizing large, complex and politically powerful entities such as Fannie Mae and Freddie Mac (hereafter referred to as the housing GSEs along with the Federal Home Loan Banks). Fortunately, a model for such an action exists. The Student Loan Marketing Association (Sallie Mae) was privatized through an Act of Congress in 1996.³ Sallie Mae re-organized under a holding company charter with a GSE and non-GSE subsidiaries. The GSE activities were limited and terminated on December 29, 2004 almost 4 years ahead of schedule.

This paper will describe the rationale for privatization, the constraints to the process, the reorganization structure and the effect of privatization on Sallie Mae and the student loan market. The key elements of the privatization process and structure will be highlighted with comments offered on the applicability to Housing GSEs today.

Background

Sallie Mae was formed in 1972 to improve the flow of funds into student lending. By creating a financial intermediary with access to the capital markets, initially through the government and later through its agency status, Congress sought to provide a source of liquidity to student loan lenders, who could sell their loans to Sallie Mae or obtain funding at capital market rates using an otherwise illiquid asset as collateral⁴.

The ability to sell student loans also allowed lenders to be active in the market

* During 1993 – 1996, the author was a consultant to Sallie Mae on the privatization initiative. The material within is that of the author and does not reflect the views of Sallie Mae either during this period or subsequently. This paper was presented at the Conference on “Fixing the Housing Finance System” Wharton School, University of Pennsylvania, April 26-27, 2005.
¹ GSEs are a unique corporate form. They are Congressionally chartered, shareholder-owned, for profit companies that differ from other corporations in two important ways. First, they are granted certain legal privileges and exemptions not generally available to other corporations. Second, they are specifically limited to conducting a narrow range of business activities and required to conduct certain activities at the behest of the government.
² HUD User, Studies on Privatizing Fannie Mae and Freddie Mac, May 1996
⁴ 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's debt securities initially carried a full faith and credit guarantee. Sallie Mae ceased issuing government guaranteed debt in 1982.
without incurring the high costs of servicing. Sallie Mae's mission from the outset was to attract private capital for the financing of higher education.

By the mid-1990s, Sallie Mae was widely judged to be successful in achieving its mission. The guaranteed student loan program attained widespread acceptance among students, lenders and schools. Student lending volumes soared, funding became reliable, and active competition among a variety of institutions emerged in the market. Despite attempts to curb eligibility through needs testing in the early 1980s, annual lending volume was maintained at levels between 3 and 6 times that of the 1970s throughout the decade. 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.

The environment in which Sallie Mae operated changed dramatically since its creation. The integration of domestic and global capital markets expanded funding options for lenders and the application of computer technology to information and transaction processing greatly improved the origination and servicing options for lenders. By 1992, the major lenders in the student loan market included both money center and super-regional banks. Collectively, the top 25 originators accounted for 45 percent of originations in 1992.

More importantly, the government profoundly changed the student loan market in the 1990s. 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. In addition, the law mandated interest rates instead of allowing the rates to be set by market forces. These changes effected Sallie Mae’s revenues. On the expense side the Act imposed a 30 basis point per annum offset fee on loans held or guaranteed that effectively eliminated Sallie Mae’s funding advantage. Finally, Sallie Mae was mandated to act as a lender of last resort for students who could not get guaranteed loans because of high default rates at their education institutions.

In the backdrop of these changes, Sallie Mae’s management decided it could not stand pat. Competition was increasing, both from major lenders and the federal government and Sallie Mae’s major GSE advantage, access to relatively cheap funding was seriously eroded. In addition, Sallie Mae faced rising operating costs due to federally imposed mandates. As early as 1993, Sallie Mae began investigating alternatives to GSE status – most importantly privatization.

Rationales for Privatization

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5 Sallie Mae and each of the 36 guaranty agencies were required to meet their statutory obligation to act as "lenders of last resort" if eligible students cannot obtain loans through normal channels to attend eligible schools. The offset fee was ostensibly imposed to offset the value of agency status. In reality it was imposed to offset budgetary cuts in the student loan guarantee program.
Three rationales emerged for the privatization of Sallie Mae. First, the public policy purpose for which it was created had been achieved; second, investors faced a significant threat to the value of their investment from the political uncertainty surrounding the GSL program; and third, there were significant foregone opportunities associated with Sallie Mae's restrictive charter.

**The Mission:** From its creation, Sallie Mae had a narrowly defined charter. Its primary mission was to provide liquidity for student loans, facilitate secured transactions involving student loans (through taking possession) and serve as a national secondary market and warehousing facility for student loans.

The financial markets changed dramatically after the creation of Sallie Mae. Financial deregulation and elimination of Reg Q interest rate ceilings improved the financing options and the supply of credit available to financial institutions. Deregulation of liabilities allowed banks and thrifts to compete for funds at market rates of interest and reduced the likelihood of disintermediation and shortages. Securitization and collateralized borrowing afforded financial institutions direct access to the global capital markets, expanding financing options. As a result, by the 1990s there were no major barriers to the movement of capital, either nationally or internationally.

The student loan market also changed significantly since the creation of Sallie Mae. It grew from a commercial bank "loss leader" to a large volume program with increasing competition and specialization. The growth of secondary markets improved the liquidity of student loans. The proportion of loans sold into secondary markets increased from less than 30 percent in the 1981 to 1985 period to approximately 60 percent in the 1988 to 1990 period.

As with other types of consumer loans, functional specialization developed. Fee-based third party originators and servicers emerged to provide investors with the benefits of economies of scale and the capability to respond to the ever-changing regulatory environment. On-going investment in information processing technology significantly increased the capacity to originate and service the loans. Securitization expanded the investor base in student loans beyond those institutions with in-house servicing capabilities.

The resultant size, degree of competition and sophistication of the market reflected its maturity. Originating lenders, by virtue of their investment in personnel and information processing technology, were "here to stay". They had ample access to funds from a variety of sources, including collateralized borrowing, sale to competing secondary markets and securitization. As a result, student loans were available to all qualified students. These factors strongly suggested that the primary mission of Sallie Mae, to improve the liquidity of and funding for student loans had been achieved.  

**The Threat:** Congress initiated a wide-reaching revamping of the FFELP in 1993, initiating a process to replace it with a direct lending program to be phased in over a five-year period beginning in 1994. While the goal of the direct lending program was to provide 60 percent of student loan originations by 1998, many observers believed

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6 Appendix: Life Cycle of a GSE
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 federal interest subsidy 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 student loan portfolio investments. In addition, the Secretary of Education could require Sallie Mae to serve as a lender-of-last-resort in the student loan market.

The changes in the FFELP and the introduction of direct lending had a major effect 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.

The market reaction reflected Sallie Mae’s narrowly defined charter. As a GSE, Sallie Mae could only engage in activities enhancing the flow of credit to students and other narrowly defined higher education activities. As a result, it had an undiversified income stream with approximately 80 percent of its income derived from student loan related activities.

More importantly, the reaction reflected the political risk to which Sallie Mae’s was subject. This risk is difficult to manage or diversify and therefore exceedingly difficult for investors to price. Reflecting these risks, Sallie Mae’s stock at passage of the Act traded at liquidation value with no value accorded to the franchise (i.e., its servicing and financing capabilities, and name recognition within higher education and the investment communities).

**Foregone Opportunities:** Sallie Mae believed that privatization would enhance its core student loan business by enabling it to compete more effectively on campus through its network of lenders and by becoming a more independent participant in the student loan program. Sallie Mae had developed an effective school-based strategy before the Act to influence loan product flows at the source. The goal of the strategy was to shift the primary customer focus of the company from bank lenders (selling it loans) to colleges and universities with lenders becoming business partners and distributors for a Sallie Mae branded set of student loan-related products and services.

As a privatized entity, Sallie Mae would be able to engage in a broader array of campus-based services to protect and increase its student loan market share and develop new sources of revenue. A private Sallie Mae would be able to more effectively compete against the federal direct student lending program than as a GSE with one third of its Board and its Chairman appointed by the President, its charter subject to amendment by Congress and its business regulated by the Department of Education.

Privatization was viewed as opening up business opportunities outside of higher education. New lines of business could be undertaken, building upon Sallie Mae’s established market presence and expertise. Promising areas for incremental
expansion included servicing for other forms of consumer loans and health care administration. One of the main opportunities created by privatization was leveraging the company’s multimillion borrower database to sell financial products, including insurance and savings products directly to students.

An important by-product of privatization was increased control of the firm by its owners and increased focus of management on core business issues. As a GSE, many of the important decisions regarding Sallie Mae’s current and future activities were taken by Congress with a vastly different agenda and priorities from the owners of Sallie Mae. Privatization would reduce the control of Congress over Sallie Mae. As a result, an inordinate proportion of senior management’s time and energy was taken up in governmental relations. Privatization would sharpen the focus of the management of Sallie Mae on current operations and strategic development, with less time and energy spent on political issues.

An unspoken (at the time of the debate) advantage of privatization was the opportunity to become a primary lender, competing directly with banks and other sellers of loans to Sallie Mae. Not surprisingly the lender community was suspicious of this possibility and both the Consumer Bankers and American Banking Associations opposed the bill. This rationale was later acknowledged. As stated in Sallie Mae’s 2003 10K, “The principal benefit of shedding our GSE status is the ability to originate student loans directly, reducing our dependence on other student loan originators. Privatization has also facilitated our entry into other credit and fee-based businesses within and beyond the student loan industry.”

Costs and Constraints

From the beginning privatization faced a number of obstacles. The most important were financial. Privatization would involve both up-front costs and a reduction of Sallie Mae’s financing advantage over time. In turn the higher costs would reduce or eliminate certain business lines dependent on agency financing. It was also likely that the government would require an on-going commitment to the student loan market to support its policy objectives.

**Financing Costs:** The principal cost of privatization was the elimination of access to the federal agency funding market and low cost funding through the implicit guarantee of the federal government. The spreads and issuance costs on its financing would be higher than that as a GSE, and the private company would be subject to state taxes. The implicit federal guarantee of a GSE’s debt obligations allows both a lower cost of debt (relative to corporate borrowers) and a high degree of liquidity (i.e., the ability to tap the capital markets on short notice for immediate cash flow needs). However, Sallie Mae had already lost much of the GSE funding advantage due to the imposition of the 30 basis point offset fee on student loans it holds, effectively raising funding costs by 32 basis points (reflecting the quarterly compounding effect).

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*Sallie Mae [2003]. Shortly after passage of the privatization act, a dissident group of shareholders, led by Al Lord, a former official in the company, gained control of the company from previous management. They argued that Sallie Mae would become more profitable if it began making loans itself. Previous management believed the plan would lead banks to stop selling loans to Sallie Mae.*
In addition, the private company would operate with lower leverage than the GSE, reducing shareholder return on equity for the student loan business. Ultimately, it was hoped that the higher costs would be offset by the income from new business activities and the benefits of diversification and reduction of political risk. Securitization would reduce the impact of higher capital requirements.

**Up-Front Costs:** The up-front costs derived from Congressional interest to impose an exit fee on Sallie Mae. 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. Sallie Mae argued against such a fee, pointing out that this value had been lost prior to privatization. Shareholders had already experienced a 40 percent decline in the value of their investment, 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 (e.g., securities and tax exemptions) upon restructuring. The concept of an exit fee raised distributional issues as well. Past shareholders had reaped many of the benefits of GSE status whereas current shareholders were paying the cost of the exit.

In addition to a possible exit tax, Sallie Mae would also bear the costs of creating the privatization structure.

**Constraints:** There were several principles that guided the restructuring design and process:

- Maintaining stability in the student loan market. In particular the government wanted Sallie Mae to continue as a lender of last resort.
- Taxpayers should not be exposed to any greater risk than under the status quo.
- Revenue neutrality – expected revenue from the offset fee was included in the federal revenue projections.
- 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.

**Process:** The privatization initiative coincided with the Republicans taking control of Congress in the 1994 elections. The new Republican majority, built upon the “Contract with America” had a strong interest in the concept of privatization and found an attractive candidate in Sallie Mae. During the lobbying process, Sallie Mae developed the concept of a “Life Cycle of a GSE” which played well with many Congressional representatives [Appendix 1]. Sallie Mae also worked closely with the representatives of the 4 districts in which it had servicing centers, stressing the potential employment growth benefits of privatization.

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8 At the time of the legislation, Sallie Mae was required to maintain a capital-to-assets ratio of 2 percent. Banks and finance companies were required to maintain capital-to-assets ratios of 6 percent or more to achieve high ratings on their unsecured debt. Sallie Mae planned to securitize a large portion of its student loan assets to reduce its capital requirements.
Structure

The vehicle designed to accomplish these objectives was a holding company with GSE and non-GSE subsidiaries. The structure was created through a shareholder-approved corporate re-organization approved by the GSE’s shareholders on July 31, 1997 and effected on August 7, 1997. The holding company, SLM Holding Corporation, a Delaware Corporation, was created through the re-organization. The GSE was allowed to use the name “Student Loan Marketing Association” while the private company could use the name Sallie Mae as a trademark, but not in connection with an offering of debt or other securities (subsequently issued under the holding company name, SLM Corp.). All the employees were transferred to the holding company which provided services to the GSE on a fee basis. The GSE was permitted to continue purchasing student loans through September 30, 2007. Its warehousing advance, letter of credit and standby bond purchase activity were limited to takedowns on contractual financing and guarantee commitments in place at the effective time of the Reorganization. The GSE could continue to issue debt with maturity dates through September 30, 2008 to fund its existing portfolio and permitted asset acquisitions. The GSE debt was required to be wound up through defeasance of the remaining GSE debt by September 30, 2008. The holding company was prohibited from acquiring and interest in a depository institution prior to completion of privatization.

The GSE could be required to serve as a lender of last resort and provide secondary market support for the FFELP upon the request of the Secretary of Education. If and to the extent that the GSE performed such functions, however, it would not be required to pay a statutorily imposed 30 basis point offset fee on such loans.

SLM’s non-GSE subsidiaries were not allowed to make secondary market purchases of FFELP student loans for so long as the GSE is actively acquiring insured student loans. However, the Company was permitted to and, in the third quarter of 1998, began to originate FFELP loans.

The exit fee compromise required the holding company to issue to the District of Columbia Financial Responsibility and Management Assistance Authority stock warrants in an amount equal to one percent of the share value of the company just before the date of enactment of the law. Furthermore, the company had to pay $5 million for use of the "Sallie Mae" name.

The Act increased Sallie Mae’s capital requirements (from 2% to 2.25%) and imposed restrictions on the ability to up-stream earnings from the GSE to the holding company and on inter-company relations. The Department of Treasury continued as regulator of the GSE and on a limited basis the holding company and its non-GSE subsidiaries to the extent that the activities of these entities were deemed reasonably likely to have a material impact on the financial condition of the GSE.

The holding company approach facilitated an effective separation of GSE and non-GSE activities, enabled a budget neutral outcome over the federal budgetary horizon (by allowing the GSE to continue purchasing student loans subject to the offset fee) and provided a vehicle to retire the GSE debt obligations without affecting the status of those obligations. The holding company model allowed Sallie Mae to continue its

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9 For more detail see Sallie Mae [2003].
GSE activities over a nine year time period, ensuring stability in the market. It also enabled Sallie Mae to diversify its business activities immediately, rather than after completion of the GSE wind-down, and imposed no additional constraints on the types of permissible business activities of the privatized business either within the student loan industry or outside it.

Impacts of Privatization

Market: The student loan market has experienced continued growth and competition since the privatization of Sallie Mae. The size of the federally insured student loan market more than doubled over the last ten years with student loan originations growing from $24 billion in FFY 1994 to $52 billion in FFY 2003.

For the federal fiscal year (“FFY”) ended September 30, 2003, the DOE estimated that the FFELP’s market share in federally guaranteed student loans was 75 percent, up from 73 percent in 2002. Total student loan (FFELP and the Federal Direct Lending Program (FDLP)) volume for FFY 2003 grew by 16 percent, with the FFELP portion growing 18 percent. Current industry trends indicate that federal student loan market growth will continue at 11 to 12 percent annually over the next few years.\(^\text{10}\)

The primary competitor for federally guaranteed student loans is the FDLP, which in its first four years of existence (FFYs 1994-1997) grew its market share from 4 percent to 34 percent. The FDLP market share peaked at 34 percent but has steadily declined since its peak in 1997 to a 25 percent share in 2003 for the total federally sponsored student loan market.

It is clear that the market has not suffered from Sallie Mae’s privatization. Funding is plentiful and competition is keen, both among FFELP lenders and between the FFELP and FDLP programs. Although the direct lending program is cheaper to the government, the servicing and collection efficiencies along with the strong relationships between lenders and schools has allowed the FFELP to flourish.

The Company\(^\text{11}\): Sallie Mae has established itself as the dominant player in higher education finance since privatization. It has become the largest originator of student loans ($3.2 billion in 2003) as well as the largest servicer with a portfolio of $88.8 billion at the end of 2003. It has branched out into other lines of business as well. Sallie Mae and its subsidiaries provide college-financing, debt-management, default-prevention, financial management and tuition payment advisory services higher education institutions. The company also provides collection services, as well as enrollment and retention management consulting services. The company has expanded into the mortgage, credit card, insurance, and debt-collection businesses.

Sallie Mae made several key acquisitions in 1999 and 2000 including Nellie Mae and Student Loan Funding Resources Group, both major originators, and the USA Group, then the nation’s largest guarantee agency. These acquisitions allowed the company to vertically integrate, handling origination, servicing and collections for guaranteed and private loans. The company also has private label agreements with

\(^{10}\) GAO [2003]  
\(^{11}\) Data from Sallie Mae 2003
J.P. Morgan Chase and Bank One in which it originates and services student loans in the banks’ name. The earnings from the student loan portfolio continue to be the most important component of the company’s net revenue.

Sallie Mae’s net income and share price were stagnant during the 1997 – 2001 time period but have since exhibited strong growth. Starting in 2001, net income began to grow rapidly as did the stock price which has risen to more than $50 per share by early 2005 (adjusted for a 3:1 stock split in 2003). Earnings per share exhibited a 4 fold increase between 2001 and 2003. Sallie Mae’s fee income businesses also experienced strong growth, now accounting for approximately 30% of net revenue.

Sallie Mae turned to securitization as a funding device to replace the GSE funding and leverage its capital more efficiently as early as 1995. By the end of 2003 securitized loans outstanding were more than $55 billion. These transactions were done by the private company with no government guarantee or support. In 2003, SLM issued $20.3 billion of non-GSE financing, which, combined with securitization, equaled 2.4 times its student acquisitions, indicative of the Company’s ability to finance itself in a post-GSE environment.

Sallie Mae’s acquisitions, aggressive marketing and strong growth have raised concerns of competitors. They cite its economies of scale, derived in part from its GSE status, and its control of a guarantor which some industry analysts say gives it a competitive advantage through the ability to control the entire loan process, from making the loan to processing the guarantee to collecting payments.

Bankers are concerned not only about the acquisitions, but also about Laureate, Sallie Mae's online loan-delivery system. Most of the banks offering loans through Laureate are required to sell them to Sallie Mae, which services the loans and collects delinquent payments. "Sallie Mae is the student-loan industry's Microsoft," says one lender who asked not to be identified. "Sallie Mae bundles its services to lenders. They say, 'If you want us to originate and disburse your loans, you have to sell them to us'."

**Lessons for Other GSE Privatizations**

The primary lesson is that *GSE privatization can be done*. The process and structure was a win – win for the government and the shareholders of Sallie Mae. The government reduced its contingent liability inherent in the GSE charter. It ensured stability in the student loan market and revenue through a transition period. The legislation facilitated an orderly transition from the GSE to non-GSE business over a nine year time period. The increase in financing costs for Sallie Mae was small and did not materially reduce the profitability of the student loan business. Bondholders were unaffected and the execution costs to change the charter were small. Privatization reduced the political risk and external treats to the viability of the company.

The second lesson is that *it takes motivated parties*. Sallie Mae shareholders and management were motivated by the threat of government competition in its core business along with the reduction in its funding advantage through imposition of the offset fee. The Congress had an ideological interest in reducing the role of

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government in the economy and found an ideal candidate in Sallie Mae. The Administration wanted an example for its Reinventing Government initiative.

The third lesson is that the sky does not fall when the government involvement is removed. The student loan market remained competitive and liquid. Lenders continued to have access to ample funds and student lending (and the FFELP) continued to grow.

There are some major differences between the privatization of Sallie Mae and the housing GSEs, however.

- **Size and complexity:** At the time of privatization, Sallie Mae was a $50 billion company with a simple business model purchasing government guaranteed, variable-rate assets matched funded with variable-rate debt. By way of contrast, Fannie Mae and Freddie Mac are huge – with over $1.8 trillion in assets and an additional $2 trillion in securities guarantees [2003, OHFEO]. They are highly complex financial institutions managing mortgage credit, interest rate and prepayment risk with huge counterparty risk exposure from their portfolio hedging activities.

- **Mortgage end-user rates** that are market determined as opposed to administratively set. The federal government effectively sets the rates on student loans – thus the value of agency status is not reflected in costs to the end user. By contrast, a portion of the GSE benefits accruing to Fannie Mae and Freddie Mac result in lower mortgage rates – an outcome heavily publicized by the GSEs and housing related interest groups.

- **Looser regulation:** The Departments of Treasury (safety and soundness) and Education were more assertive in their oversight of Sallie Mae than HUD and OFHEO have been for Housing GSEs (until recently).

- **Greater political support** for the status quo: The entire housing industry (Realtors, homebuilders, mortgage bankers, affordable housing activists etc.) rallies around the GSEs to defend their privileges as a way to lower mortgage rates. Fannie Mae and Freddie Mac aggressively lobby Congress to protect and expand their charter {WSJ reference}.

The political clout of the housing GSEs and the complexities of winding down the GSE activities suggest that any privatization initiatives can realistically take place with the acceptance and active participation by the companies. As in the case of Sallie Mae, the Board and management must decide that privatization is in the shareholders’ best interest and actively pursue it. As long as the GSE charter is more valuable than that of a purely private company, the housing GSEs are likely to keep it. However, the Sallie Mae experience suggests that a reduction in benefits and

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13 The federal government insures FFELP loans against default and assures lenders of a specified yield that adjusts with interest rates. Borrowers pay interest at a variable rate up to a maximum rate established by law. The federal government pays a special allowance to lenders. The difference between a borrower’s rate and the specified yield when the borrower’s rate is lower. The Congress occasionally adjusts both the borrower’s rate and the lender’s yield.

14 The magnitude of this benefit is a matter of debate but has undoubtedly been falling over time. See Ambrose and Sanders [2003] and Passmore [2004].
increase in regulation can reduce the value of the federal backing to the point that privatization becomes the most attractive option.

There are some reasons for concern with respect to market domination post privatization. Sallie Mae has aggressively moved into loan origination and is now the largest student loan lender. It has significant economies of scale from its portfolio and investment in a vertically integrated technology platform. With a fixed, government set and guaranteed yield on its assets and a low cost base, the company is well positioned to expand its market share vis-à-vis its bank competitors. Both lenders and policy makers have voiced concern that the FFELP market is becoming less competitive as a result of Sallie Mae’s vertical integration.

A private Fannie Mae and Freddie Mac could, in theory, leverage their investment in technology to enter the primary mortgage market. Unlike Sallie Mae, however, they are not primary servicers as present as they perform only a master (investor) servicing function. Thus they would have to purchase an existing servicing operation. The Sallie Mae brand was well-known among its target customer base, institutions of higher education. Therefore it was relatively easy to expand into origination and expanded fee based services. Fannie Mae and Freddie Mac have a well known and regarded brand among smaller lenders and mortgage brokers. These entities could provide a distribution source for loans – albeit a rather expensive one.

Fannie Mae and Freddie Mac securities are the benchmark for the mortgage securities market – an advantage Sallie Mae never enjoyed. Security holders would experience a loss in relative value as the liquidity in their securities declined. In order to reduce the impact on bond investors and ensure a stable transition to a private market, a privatization bill could allow for continued purchases and mortgage-backed securities issuance (for their guarantee business but not for portfolio) for a limited time period. Tom Stanton has proposed a model for removing government sponsorship for the housing GSEs along these lines [2004].

Fannie Mae and Freddie Mac are the market standard in automated underwriting (AU). The Stanton model would require a spin-off of their AUs and mortgage databases into independent companies. There are a number of significant competitors in this space, however, and it is not clear whether their market dominance would remain if they were private. The volume of use would likely follow sales volume – thus the GSE’s market share may fall in concert with a lower market share of loan sales generally. This requirement is somewhat punitive. Depriving shareholders of a major asset could undermine the impetus for privatization.

In conclusion, the Sallie Mae privatization model appears to be a sound blueprint for privatization of the housing GSEs. Although the housing GSEs are larger and financially more complex organizations, the same approach can safeguard the interests of bondholders, owners, the market and the government. The US primary mortgage and mortgage securities markets are deep, liquid and highly competitive. Although there would be an increase in mortgage rates, most observers believe it would be quite small. The defeasance approach will protect existing bondholders and regulatory oversight and adequate capital requirements would protect the government throughout the process. The owners of the housing GSEs would have to believe that their returns would be higher post-privatization – an outcome Sallie Mae has appeared to achieve.
References


9. Sallie Mae, SEC Form 10k, 1999 and 2003


Appendix: The Life Cycle of a GSE

Creation: At the time of privatization, Sallie Mae was one of five major financial GSEs. 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); or the lack of nationwide banking (which inhibits the ability to diversify credit risk and funding sources).

The enterprises are privately-owned, federally-chartered financial institutions. They generally operate as wholesale or secondary market institutions on a nationwide basis. The GSEs access the financial markets to raise large amounts of capital at attractive rates through the sale of securities. They use these funds to purchase loans from primary market lenders or make collateralized loans to such lenders. A major rationale for the creation of GSEs is their ability to operate on a national basis, thereby facilitating the flow of capital from surplus (excess of saving over borrowing) to deficit (excess of borrowing over saving) regions and sectors.

The GSEs’ preferential access to capital stems in part from government sponsorship. Although there is no explicit government backing, the financial markets perceive that the federal government will not let one of these enterprises fail. Thus, as a general proposition, they can finance large volumes of debt and enjoy favorable cost of funds. In addition, their securities enjoy advantages which reduce investor required yields and issuance costs. These benefits translate into lower rates for borrowers.

A significant feature of GSEs is their private ownership. Three of the GSEs (Fannie Mae, Freddie Mac and Sallie Mae) are publicly-traded, shareholder-owned corporations. The other two are co-operative organizations, owned by their borrowers. The GSE organizational structures bring 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 directly fund the GSE activities. In attracting 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. Also, the GSE concept allows the provision of credit to a broader spectrum of borrowers than available through direct government loans, enhancing the portfolio quality and political appeal of the enterprises.

The quid pro quo for the GSEs’ preferential access to capital are their limited charters. These enterprises are corporations chartered by the Congress to perform a

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15 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.
16 A major reason is the GSE’s ability to borrow from the US Treasury.
17 The federal credit budget requires that the subsidy costs of federal loan and loan guarantees be measured and reported. However, the cost of the implicit federal support of the GSEs is not included in the federal budget.
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.

The GSEs were originally structured as mutual organizations. The two earliest GSEs, the Farm Credit System and the Federal Home Loan Banks, are, in fact, still a form of mutual. The mutual organization facilitates adaptation to changes in the underlying markets served by the enterprises. Specifically, the institutions can expand and contract to meet their members’ needs, with the members providing the additional capital for expansion or redeeming their shares as their use shrinks.

Private ownership of GSEs did not appear until 1968, when Fannie Mae was "reorganized". Sallie Mae was created in 1972 as a private, shareholder-owned corporation from the outset. Freddie Mac was owned by the Federal Home Loan Banks (and thus, indirectly, by the savings and loan industry) until 1989, when its ownership was expanded through redemption of its FHLB stock and issuance of common stock (initially to the savings and loan industry and subsequently to the general public).

The capital structure of these three 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 growth. In order to attract capital, the GSEs must produce a return on investment sufficient to induce private investors, whether individuals or institutions, to invest their savings in the financing of socially desirable activities. In the absence of a specific sunset, private investors expect the enterprise to be an on-going franchise maximizing its return on and safeguarding shareholder equity consistent with their public purpose.

Maturation: From the perspective of credit availability, the GSE concept has been a major success. With exception of agriculture and the Farm Credit System, the GSEs and the markets they serve have experienced substantial growth over the past two decades. In addition, GSE activities have led to increased standardization and efficiency in the credit markets they serve. Thus, farmers, homebuyers, and students all have ample access to the nation’s financial markets at attractive rates.

The growth in the enterprises and the markets they serve also reflect the changes in the financial markets in recent years. No longer are lending markets 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

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18 Under the Housing and Urban Development Act of 1968, the assets, liabilities and management of Fannie Mae's secondary market operations were transferred to a private corporation. The function of supporting federal housing programs was given to the newly created Government National Mortgage Association which is a department of HUD. A primary purpose of the reorganization was budgetary. Privatization was necessary to avoid having agency purchases counted as budget outlays. For more information see Weicher [1990].
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 demands.

The GSEs have contributed to and benefited from these changes. The major GSEs have been at the forefront of securitization, creation of financial derivatives for risk management and application of technology to the servicing of large volumes of transactions. By expanding their product mix and improving the quality of their service, the GSEs have been able to increase their market share. They have also benefited from the increased regulation and consolidation of depository institutions which has forced more loan sales and off-balance sheet financing techniques.

Recently, however, the success of the GSEs has created controversy. Their large size and rapid growth has raised concern about the displacement of primary market lenders. Some critics have asked whether GSE activities have led to overinvestment in certain areas of the economy. Questions have been raised about the high rates of return on equity investment earned by their shareholders. These issues all reflect a growing skepticism about whether a federal presence is still necessary in some of the markets served by GSEs.

Sunset: The charters of all the GSEs refer to the inability of capital markets to allocate sufficient credit to particular activities. The GSEs were created to facilitate the flow of private capital to these markets. What is conspicuously absent from their charters is the concept of a sunset; that is, what to do with a GSE once the private market is capable of allocating credit to meet the demand for a desired activity.

The lack of a planned GSE sunset may reflect doubts on the part of their creators that they would succeed in their mission. Or it may reflect the wish of their creators to influence the institutions and the markets they serve on an on-going basis. One form of sunset, privatization, has been raised on several occasions in recent years. A small GSE, the National Consumer Cooperative Bank, was privatized in 1981. 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. In 1992, Congress asked for studies addressing the privatization of Fannie Mae and Freddie Mac.

There are a number of reasons why a sunset provision in GSE charters could be useful public policy. First, it would allow reconsideration of a GSE’s role in light of market and technological development. For example, in light of the development of financial markets, the need for a GSE as source of liquidity for lenders in individual markets may be less. If so, the original mission of a GSE may have been successfully

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19 See Mills [1987].
20 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. For more detail, see Richter [1985].
21 CBO [1985].
22 Winger [1987]. At that time Fannie Mae was not strong enough financially to consider privatization without substantial government assistance.
completed. Providing a sunset for a GSE whose mission has been accomplished is a role model for a government reinventing itself.

A second benefit of a sunset would be reduced taxpayer risk. The government has a significant contingent liability through its GSE sponsorship. As they grow, the GSEs increase the aggregate risk of the government. A sunset for a GSE would entail a reduction and eventual elimination of the risk of its activities to the taxpayer. A further benefit would be the substitution of the private market for the government in the monitoring of risk. The private market is typically better able to monitor the risk of these enterprises. A sunset would reduce the government's cost of monitoring as well.

Third, a successful sunset could set an important precedent for new and existing GSEs. A sunset provision could alleviate concerns of potential investors about their ability to realize a market return on and eventual return of capital. In addition, it could reduce the concern of critics that a GSE could eventually dominate and force private sector players out of the market.

A final justification for a sunset is consideration of current GSE investors. At the core of the GSE concept is using private sector capital to support GSE borrowing. For the most part, providers of the capital are no different from investors in other corporations. They have ownership rights to the net after-tax income stream of the company and expect a market return on their investment. Their equity investment is at risk; unlike bondholders, there is no implicit guarantee against loss. The capital they invest is used to develop a franchise consisting of the systems and expertise necessary to develop a market where, before the GSE, the market was weak or non-existent. Capital raising by current and future GSEs may be easier if it were possible upon fulfillment of the mission to convert to fully private, stock-holder owned companies. This would allow investors to realize the benefits of creating a franchise and remove a potential disincentive associated with the successful achievement of the mission (i.e., the uncertainty as to the future of the company).