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ABSTRACT

The Subcommittee heard testimony from seven witnesses and statements from three senators on whether or not it is in the Federal Government's best interest to divest itself of the Student Loan Marketing Association (Sallie Mae), and the College Construction Loan Insurance Association (Connie Lee). Lawrence A. Hough of the Student Loan Marketing Association testified that Sallie Mae is poised to move away from government sponsorship, that it would remain committed to the Federal Family Education Loan Program, and that privatization plans must be designed carefully to assure approval by shareholders. Oliver R. Stockwell of Connie Lee testified that Connie Lee was ready and willing to convert to private status. Senator Dodd appeared and spoke in support of privatization. Leo Kornfeld of the Department of Education testified in support of privatizing Connie Lee and cautioned that the current marketplace needs, offset fees, and exit fees must be considered in any Sallie Mae privatization plan. Darcy Bradbury of the Department of the Treasury argued for privatization to reduce the debt that carries some perception of government support. Senator Claiborne Pell urged caution in privatization. A member of the Congressional Research Service, a representative of the Financial Guaranty Insurers, and a representative of First Boston Corporation also testified on privatization issues. Prepared statements of senators and witnesses are included. (JB)

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S. HRG. 104-85

PRIVATIZATION OF SALLIE MAE AND CONNIE LEE

ED 386 131

HEARING

BEFORE THE

SUBCOMMITTEE ON EDUCATION, ARTS AND HUMANITIES

OF THE

COMMITTEE ON LABOR AND HUMAN RESOURCES UNITED STATES SENATE

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

ON

EXAMINING PROPOSED LEGISLATION TO ALLOW FOR AN ORDERLY TRANSITION OF THE STUDENT LOAN MARKETING ASSOCIATION (SALLIE MAE) TO PRIVATE STATUS WHILE PROTECTING THE INTERESTS OF THE FEDERAL GOVERNMENT, BORROWERS AND OTHER PARTICIPANTS IN THE STUDENT LOAN PROGRAM, THE HOLDERS OF SALLIE MAE'S DEBT, SALLIE MAE'S SHAREHOLDERS AND THE AMERICAN TAXPAYERS, AND A PROPOSAL TO PRIVATIZE THE COLLEGE CONSTRUCTION LOAN INSURANCE ASSOCIATION (CONNIE LEE)

JUNE 20, 1995

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PRIVATIZATION OF SALLIE MAE AND CONNIE LEE

TUESDAY, JUNE 20, 1995

U.S. SENATE,
SUBCOMMITTEE ON EDUCATION, ARTS AND HUMANITIES, OF THE COMMITTEE ON LABOR AND HUMAN RESOURCES,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:34 a.m., in room SD–430, Dirksen Senate Office Building, Senator Jeffords (chairman of the subcommittee) presiding.

Present: Senators Jeffords, Gorton, Pell, Kennedy, Dodd, and Simon.

OPENING STATEMENT OF SENATOR JEFFORDS

Senator JEFFORDS. I will call the hearing to order.

Senator Pell is delayed at the Foreign Relations Committee, so we will go ahead at his request.

I want to welcome Mr. Hough and Mr. Sockwell. I appreciate your coming. We will have an interesting hearing.

Today's subcommittee hearing will focus on the prospect and possibility of privatizing the Student Loan Marketing Association, Sallie Mae, and the College Construction Loan Insurance Association, Connie Lee. The testimony presented will assist us in determining whether or not it is in the Government's best interest to divest itself of these two associations and what the ramifications would be for students, schools and the marketplace.

The issue of privatization of Sallie Mae and Connie Lee is precedent-setting. Never before has any Government-sponsored entity been privatized. While each case is unique in many respects, what we do here will impact future decisions. This alone is reason enough to thoroughly investigate and understand the consequences of cutting Federal ties implicit or explicit to these two associations.

But setting precedent is not the only issue that we must occupy ourselves with here today. There are other issues of more importance. Namely, have these organizations successfully fulfilled the mission for which they were originally created, or will privatization leave a void in service?

Will there be, in the case of Sallie Mae, another viable lender of last resort or an adequate secondary market infrastructure? In the case of Connie Lee, will lower credit institutions still have access to bond insurance for the construction of educational facilities?

Another issue of concern is the budget impact of privatization. The Senate Budget Committee assumed that a significant fee could be levied on Sallie Mae upon privatization, in return for the years of financial benefits Sallie Mae has enjoyed. However, questions have arisen concerning its ability to provide such a fee. Instead, the focus is now on budget neutrality and determining a way to ensure that privatization not cost the Federal Government.

And related and also very important is the question of direct lending, its future, and what are the implications of, for instance, going to 100 percent direct lending in the near future. Is this part of the desire for privatization? Is there a need for privatization?

I say that because we are in the Budget Committee battle right now. If the House demands us to make the cuts that they have in their budget it will lead us, as one of the only reasonable solutions, to move very quickly, to direct lending.

It is thus the purpose of this hearing to provide this subcommittee with a full understanding of the implications of privatization. Our decisions must be based on sound policy and fiscal responsibility. Simultaneously, we must ensure that the original mission for these two associations not be forgotten in the debate.

I believe the witnesses before us today will assist us in answering these and other important questions, and I look forward to today's testimony.

Mr. Hough, you may proceed. I will not turn the clock on, but I hope you will keep in mind that we could have a long day if everyone takes as much time as a Senator would.

Mr. HOUGH. There is no risk in that regard, Senator. [Laughter.]

STATEMENTS OF LAWRENCE A. HOUGH, PRESIDENT AND CHIEF EXECUTIVE OFFICER, STUDENT LOAN MARKETING ASSOCIATION, WASHINGTON, DC; AND OLIVER R. SOCKWELL, PRESIDENT AND CHIEF EXECUTIVE OFFICER, COLLEGE CONSTRUCTION LOAN INSURANCE ASSOCIATION, WASHINGTON, DC

Mr. HOUGH. Good morning, Mr. Chairman and members of the subcommittee. My name is Lawrence Hough, and I am president and chief executive officer of the Student Loan Marketing Association. I have held this position for approximately 5 years. I joined Sallie Mae in its founding year, 1973.

I appear before you this morning to discuss the orderly conversion of Sallie Mae from a Government-sponsored entity to a fully private corporation. In my testimony today, I will sound four themes. First, Sallie Mae is a successful public-private partnership that has accomplished its primary mission and is now posed to begin the next phase of its life cycle, moving away from Government sponsorship.

Second, as a fully private company, Sallie Mae will remain fully committed to the Federal Family Education Loan Program. That is our core business today and will remain so.

Third, Sallie Mae can add a great deal of value to the customers it now serves—schools, students, parents, lenders—if it is free to use its technological, financial and transaction processing expertise in new and important ways.

Finally, Sallie Mae's privatization plan must be crafted carefully to assure approval by its shareholders. This includes being careful to avoid burdening of privatized Sallie Mae with unnecessary fees or other considerations.

When Sallie Mae was created in 1972, only $1 billion in federally-guaranteed student loans were originated by lenders. In contrast, in 1994, over $24 billion in such loans were provided by private sources. Sallie Mae has been instrumental in this vast expansion, and it has done so without any direct subsidies from the Federal Treasury. We have helped make education possible for 20 million students and will continue to serve these customers as a fully private company.

Today, the student loan marketplace has developed to full maturity. There are at least 40 secondary markets and a number of banks which purchase loans from other lenders. In addition, the securitization of student loans has added a new financing option for lenders making student loans.

The competition in this marketplace is healthy, and the rationale for maintaining a GSE is weak. Privatization of Sallie Mae offers an opportunity to reduce borrowing that is implicit Federal backing. Even though not a single dollar of Sallie Mae's $53 billion of outstanding debt securities carries a Federal guarantee, investors who hold these bonds and the market generally perceive them to carry the implicit backing of the United States Government. Sallie Mae's privatization, as proposed, will in time move it completely away from any implicit obligation to the Government part and cleanly sever the link back to the American taxpayer that has existed for the past two decades.

Sallie Mae's privatization is good public policy in that it allows Congress to chart a new course for prospective GSEs. That course might proceed as follows. A GSE would at first deploy its special attributes to achieve the purpose for which it was created. However, the expectation would be built in from the start that as soon as the mission had been accomplished, the GSE would move away from Government protection. Demonstrating that a GSE can be transitioned successfully to fully private status would validate that course.

Sallie Mae is now prepared to take on the challenges ahead using the financial know-how or servicing capabilities and educational expertise. We have created the strong financial balance sheet and standing with credit rating agencies that are necessary to operate in the private sector. We have done this through sound management and operation. It is not merely a side effect of our GSE status.

The privatization plan that we support is one on which we have worked together with House and Senate staff as well as the administration. This plan is currently embodied in H.R. 1720. It is designed to allow an orderly transition to private status for Sallie Mae, while protecting the interests of the Federal Government, borrowers, and other participants in the program, holders of Sallie Mae debt, Sallie Mae shareholders, and the American taxpayer.

The proposed plan creates a structure that will absolutely ensure that the existing Sallie Mae debt, issued as a GSE and in many instances not due until the next century, is unaffected by our privatization.

This bill also addresses the issue of budget neutrality. This issue arises because of the special offset fee imposed on Sallie Mae by the 1993 Student Loan Reform Act. We believe that this budget problem can be solved, and moreover, this is a burden to be borne by Sallie Mae alone. H.R. 1720 provides one solution.

In recognition of the Federal Government's involvement in the success of the GSE, our proposal includes a provision whereby the Government will receive warrants to purchase Sallie Mae stock in the future at a price fixed now. This will allow the Government to share in the growth and success of the new company.

The privatization proposal is also structured in a way that we think will be acceptable to the owners of Sallie Mae—our shareholders. I am sure you are all aware that there has been serious concern among Sallie Mae shareholders in recent months regarding the current and future path of the company. The shareholders of Sallie Mae are investors—people and firms managing their own and other retirement savings, individual Americans, and many nonprofit organizations.

Any privatization plan must be accepted by these shareholders. Since February 1993, over $4 billion of shareholder value has been lost for Sallie Mae investors. Our shareholders have already paid a huge fee—a real economic loss. Onerous exit considerations or unnecessary burdens placed on the new company will not be acceptable to the shareholders.

I look forward to working with you to fine-tune to the House version of the privatization proposal and to move toward its enactment by Congress. This will be an important step for Sallie Mae, for the taxpayers, and for privatization efforts in general.

I would be glad to respond to your questions.

Thank you.

Senator JEFFORDS. Thank you, Mr. Hough.

[The prepared statement of Mr. Hough follows:]

PREPARED STATEMENT OF LAWRENCE A. HOUGH

Good Morning Mr. Chairman and members of the subcommittee. My name is Lawrence Hough. I am president and chief executive officer of the Student Loan Marketing Association. I joined Sallie Mae in 1972, the year in which it was created by the Congress to develop a strong secondary market for federally-guaranteed student loans. The Congress hoped that, by ensuring liquidity to lenders who participate in the Federal loan program through the creation of Sallie Mae, the amount of private capital available to fund the education of America's students would increase. I am appearing before you today as the representative of that public/private partnership, a partnership that has achieved the core purpose for which it was created.

In 1972, only $1 billion in federally-guaranteed student loans were originated by lenders. In contrast, in 1994, over $24 billion in such loans were provided by private sources and a total of more than $80 billion worth of private sector capital was devoted to these loans at the end of that year. Sallie Mae has been instrumental in this vast expansion. Without any direct subsidies from the Federal Treasury, Sallie Mae has successfully tapped the private capital markets to expand its secondary market activities, and has provided other funding support to education. We have helped make education possible for 20 million students.

The corporation you created to accomplish these goals is now ready to move on and allow the government to remove itself from a market where the private sector is no longer in need of the government's assistance. When Sallie Mae was created by Congress, few lenders were willing to support the fledgling student loan program. One reason was a lack of secondary market outlets for student loans. With the creation of the GSE and its success in fulfilling its public mission, the market developed to the point that today approximately 7,200 lenders are participating in the

Federal Family Education Loan Program (the "FFELP "). A number of these lenders, including several of the largest participants, make loans and then retain ownership of them through repayment. In addition, there are at least 42 secondary markets, and a number of banks, which purchase loans from other lenders. Over the course of the past few years, some large portfolios of FFELP loans have been securitized, using the same capital market structures which support the annual securitization of tens of billions of dollars in credit card, automobile, and mortgage loans. And, of course, there is Sallie Mae, whose continuing presence as a private company would continue to provide a major source of liquidity and support to colleges and lenders alike. The competition in the marketplace is healthy. The FFELP no longer needs a GSE for liquidity purposes.

The continuing presence of a government-sponsored secondary market for federally-insured student loans is also affected by Congress' adoption, in 1993, of a new direct student loan program. Under this program, the Federal Government acts as the lender itself. Under current law, this program is scheduled to replace at least 60 percent of the student loan volume per year by 1998. Even if proposals now before Congress to cap this percentage are adopted, a portion of the market will still be covered by the public sector, rather than the private sector.

Repositioning Sallie Mae as a private corporation also offers an opportunity to reduce borrowing that has implicit Federal backing. Even though not a single dollar of Sallie Mae's $53 billion of outstanding debt securities carries a Federal guarantee, investors who hold these bonds and the market generally perceive them to carry the "implicit" backing of the U.S. Government. Sallie Mae's $53 billion in debt is part of what you have all heard referred to as the government's "off balance sheet" liability, that piece of overall taxpayer exposure not included when the "national debt" is calculated. Sallie Mae's privatization as proposed will, over time, move it completely away from any implicit obligation on the government's part and will sever the link back to the American taxpayers that has existed for over two decades.

Another reason why we believe Sallie Mae's privatization is good public policy is that it allows Congress to chart a new course for prospective GSEs. That course proceeds as follows: a GSE should at first deploy its special attributes to achieve the purpose for which it was created. However, the expectation would be built in from the start that, as soon as this mission has been accomplished, the GSE would move away from government protection.

Over the past 2 years Sallie Mae has prepared itself for the possibility of leaving its GSE status. We are prepared to take on the challenges ahead using the financial know-how, servicing capabilities and educational expertise we now possess. We have created the strong balance sheet and standing with the credit rating agencies that are necessary to operate in the private sector. We have done this through sound management and operation. It is not a mere side effect of GSE status.

The challenges facing higher education are changing, so must we. Our primary business as a private company will still be as a secondary market for student loans—we will help make education possible for the children of the 20 million former students we helped in the past. We will also use our strengths to help solve other problems facing colleges and universities.

We have worked closely with Congress and the Administration for many months in developing a privatization plan. The plan we have developed together is currently embodied in H.R. 1720. It is designed to allow an orderly transition to private status for Sallie Mae while protecting the interests of the Federal Government, borrowers and other participants in the student loan program, the holders of Sallie Mae's debt, Sallie Mae's shareholders and the American taxpayer. It includes an orderly wind-down of the GSE entity and the launching of the new, private corporation.

The proposed plan carefully addresses the critical issues in this process that require special sensitivity. It creates a structure that will absolutely ensure that existing Sallie Mae debt, issued as a GSE and in many instances not due until the next century, is unaffected by privatization.

The bill also addresses the issue of budget neutrality. This issue arises because of the special offset fee imposed on Sallie Mae by the 1993 Student Loan Reform Act. This fee will not apply to loans owned by the fully private entity which will emerge following privatization. The Budget Enforcement Act of 1990 requires that expected revenues from the fee be offset. Even though, as a recent Congressional Research Service report has said, this budget neutrality requirement has an especially perverse outcome in this case and was never intended to block the worthy national economic policy underlying privatization, we believe the budget neutrality problem can be solved. This is a burden to be borne by Sallie Mae alone. We are not asking others to share in this.

In addition to achieving budget neutrality, however, our proposal also acknowledges Federal Government participation over the years in the success of the GSE by providing that the Federal Government will receive warrants to purchase Sallie Mae stock in the future at a price fixed now. This will allow the government to share in the growth and success of the new company.

Our privatization proposal is also structured in a way that we think will be acceptable to the owners of Sallie Mae—our shareholders. I am sure you are all aware that there has been serious concern among Sallie Mae's shareholders in recent months regarding the current and future path of the company. The shareholders of Sallie Mae are investors—people and firms managing their own and others' retirement savings. They also include many mutual funds investing the savings of many Americans, as well as the endowments of major non-profit institutions. Any privatization plan will need to be accepted by these shareholders. Since February 1993, over $4 billion of shareholder value has been lost for Sallie Mae investors, principally as a result of market response to the introduction of direct lending, the Sallie Mae offset fee, and other budget cuts affecting the FFELP. Our shareholders have already paid a huge fee, a real economic loss. While they cannot be expected to pay more, they are well aware that Sallie Mae must make hard choices. We believe that privatization accomplishes the GSE transition in a rational manner, creating a healthy, private company with a bright future using all of Sallie Mae's assets and possibilities. This is the best way to maximize the value of our shareholders' investments and unlock our ability to help support higher education more broadly, working from our solid understanding of serving the millions of students whose loans we hold and service.

Senator JEFFORDS. Mr. Sockwell, please proceed.

Mr. SOCKWELL. Thank you, Mr. Chairman and members of the subcommittee. My name is Oliver Sockwell, and I am president and CEO of Connie Lee. I appreciate this opportunity to acquaint you with the history and accomplishments of Connie Lee, as well as to discuss several advantages of privatizing the corporation at this time.

Let me clearly State one key advantage as we start, however. I privatized Connie Lee will be able to provide even more support to higher education institutions.

By way of introduction, Connie Lee was authorized by Congress in 1986 to help finance the $100 billion demand for new and renovated higher education facilities. Research studies had determined that long-term, low-cost debt financing was the only realistic source of the billions of dollars needed to improve the Nation's colleges, universities and teaching hospitals. Congress concluded rightfully, therefore, that some sort of Government initiative was required.

Here is where the story gets interesting. Congress decided not to create another expensive federally-guaranteed loan program; nor did you create another traditional Government-sponsored enterprise. Rather, Congress decided on an innovative new approach and authorized Connie Lee to be a State-regulated insurance corporation that guarantees the repayment of moneys borrowed by colleges and teaching hospitals.

As a financial guarantee company, Connie Lee operates much more efficiently than a traditional Government-sponsored enterprise. For example, with proper management, every dollar of Connie Lee's capital can guarantee more than $100 of borrowings. Perhaps even more important, the level of Federal financial backing is significantly less in Connie Lee than in any other GSE. Consider that the only Federal support of Connie Lee is a $19 million equity investment—less than 15 percent of the total of more than $130 million of equity capital that was raised.

However, this $19 million was critical; it served as the venture capital to create a corporation which has provided approximately

$10 billion of guarantees of principal and interest for academic facilities financings.

It is very important to note that Connie Lee has not operated in a way that simply duplicates the efforts of private companies. Instead, Connie Lee has been true to the mission you gave us—working to expand the availability of insured financing to more colleges and teaching hospitals.

We specialize in the most complex financings as well as the smaller and less well-known institutions, which other guarantors sometimes overlook. These institutions, although not among the country's most prominent, are the key to educational opportunity and health care for millions of Americans.

With this record of apparent success, many will ask: Why would Connie Lee seek privatization? Should Congress change anything? And can Connie Lee function without Federal support?

Let us dispense with that last question right away. Unlike other GSEs, Connie Lee does not rely on a line of credit to the U.S. Treasury. Connie Lee does not use federally-backed debt to fund its operations. And Standard and Poors clearly states that Connie Lee has earned its AAA rating based purely on its prudent financial management and without any consideration of explicit or implied Federal backing.

So you can see that Connie Lee is fully prepared, ready, willing and able to be privatized.

The Federal Government achieves several important goals by privatizing Connie Lee, which would be accomplished primarily through the sale of the Government's equity interest in the company. Just like any other asset sale, it would return money to the U.S. Treasury. Also, privatization would remove the basis for any claim of Federal Government obligation for the $10 billion of Connie Lee guarantees.

From this committee's perspective, however, perhaps the key advantage might be that privatization would allow Connie Lee to generate sufficient revenues to continue, expand and improve its support of colleges and teaching hospitals, and without asking the Government for more financial support.

Now, I suspect that some observers may still be wondering why Connie Lee itself desires privatization. In that regard, we have probably all learned that it is often the case when creating something new that there may be some unforeseen and unintended consequences. In the case of Connie Lee, there is insufficient balance between the modest level of Government support and the high degree of Federal restriction on our business activities.

As an example, the company is prevented from covering the higher expense of underwriting marginal educational institutions with revenues from other types of insurance or business activities. Furthermore, it is difficult for Connie Lee to react fast enough to changes in interest rates and the economy, which occur much more rapidly than a decade ago, when our legislation was originally crafted.

Also, very important is that the Federal Government restrictions severely limit the ability of Connie Lee to provide shareholders a fair return on their equity investment. This greatly reduces Connie

Lee's ability to attract additional capital, and as you are aware, capital is the life blood of every insurance company.

I believe it would be useful at this point to recall that privatization is not a new idea at Connie Lee. From the very start, we envisioned a true public-private partnership that would work better and with less risk to the Government than previous GSEs, one that would operate through a more efficient business structure, one that would never rely on the Government for a majority of its financing, and one which would ultimately shed all vestiges of Federal support so as to stand completely on its own.

In fact, divestiture of the Federal equity is anticipated in the original language of our enabling legislation, so in effect, we are today simply asking Congress to take the final step in achieving its original vision for Connie Lee.

In closing, please consider that the privatization of Connie Lee does more than reduce Federal interference in the credit markets. A privatized Connie Lee will be able to provide even more insurance for higher education financing, but will also be able to support other much needed infrastructure improvements—elementary and secondary school construction, as one example. And just as with colleges and hospitals, our specialty will be the less well-established issuers and the more complex financial projects which are sometimes overlooked by others.

I hope this discussion will encourage you to support the privatization of Connie Lee. Thank you, and I will be pleased to answer your questions.

[The prepared statement of Mr. Sockwell follows:]

PREPARED STATEMENT OF OLIVER R. SOCKWELL

Mr. Chairman and members of the subcommittee, I appreciate this opportunity to acquaint you with the history and accomplishments of Connie Lee, as well as to discuss several advantages of privatizing the corporation at this time.

By way of introduction, Connie Lee was authorized by Congress in 1986 to help finance the $100 billion demand for new and renovated college facilities, including classroom buildings, laboratories, libraries, teaching hospitals and student housing. Research studies had determined that increased access to long-term, low cost debt financing was the only realistic source of the billions of dollars needed on a nationwide basis. Congress concluded rightfully, therefore, that some sort of Government initiative was needed.

Here is where the story gets interesting. Congress decided not to take the easy route and create another expensive federally guaranteed loan program. Nor did you create another traditional government-sponsored enterprise—which would have meant billions of dollars of new Federal debt to be relent in competition with the Nation's banking system. Rather, Congress authorized Connie Lee to be a private guarantee corporation whose mission is to insure the repayment of monies borrowed by colleges and hospitals.

As a financial guarantee company, Connie Lee operates much more efficiently than a traditional GSE. For example, with proper management, every dollar of capital can support more than $100 of guarantees. Perhaps even more important, the level of Federal financial backing is significantly less in Connie Lee than in any other GSE. Consider that the only Federal support of Connie Lee is a $19 million equity investment—less than 15 percent of the total $130 million of equity raised. However, this $19 million served as the venture capital to create a corporation which has provided approximately $10 billion of guarantees of principal and interest for academic facilities financings. Connie Lee's guarantees increase investor demand for an institution's bonds and thereby lower the interest cost, saving millions of dollars. Furthermore, because repayment of the financing is insured by Connie Lee, the repayment period can be spread over a longer term, preserving even more cash for current expenses at the school or hospital.

It is very important to note that Connie Lee has worked to expand the availability of insurance—not to take market share from private companies. To my knowledge, Connie Lee has never taken any transaction from a major insurer. Rather, we specialize in the more complex financings and smaller and less well-known institutions which other guarantors sometimes overlook. These institutions, although less prominent, are the key to educational opportunity and health care for millions of Americans. To name just a very few: Widener University in Pennsylvania; Berkshire and Middlesex Community Colleges in Massachusetts; Whittier College in California; University Medical Center in Florida; Valparaiso University in Indiana; and Incarnate Word College in Texas. Among historically black colleges and universities, Connie Lee has recently offered commitments to Clark Atlanta University in Georgia, as well as the University of the District of Columbia.

Regardless of Connie Lee's positive contribution, no one institution alone can do the job. That's why it's important to observe that Connie Lee's ability to analyze and insure college and university financings has not gone unnoticed. Since we launched our program, others have followed Connie Lee's example, and large financial institutions and major bond insurers have directed more than $50 billion of long-term capital into academic facilities investments.

With this record of apparent success, several questions seem obvious: First, why would Connie Lee seek privatization? Second, why should Congress change anything? Finally, and perhaps most important, can Connie Lee function and prosper without Federal support? Let's dispense with that last question right away. There should be no doubt of Connie Lee's ability to stand alone—we've pretty much been doing that for a decade now—from the very start. Unlike other GSE's, Connie Lee does not rely on a line of credit to the U.S. Treasury. Connie Lee does not use federally backed debt to fund its operations. Among GSE's, only Connie Lee has earned its AAA rating based purely on its prudent financial management, and without any consideration of explicit or implied Federal backing. In fact, Connie Lee already meets all industry standards and regulatory thresholds for solvency, capital and reserves—just like any private financial company. So you can see that Connie Lee is fully prepared—ready, willing and able—to be privatized.

The Federal Government achieves several important goals by privatizing Connie Lee, which would be accomplished primarily through the sale of the government's equity interest in the company. Just like any other asset sale, divestiture of government-owned stock in Connie Lee would return money to the U.S. Treasury. Also, privatization would remove the basis for any claim of an implicit Federal obligation for billions of dollars of Connie Lee guarantees. From this committee's perspective, however, the key advantage might be that privatization allows Connie Lee to generate sufficient revenues to continue, expand and improve its support of colleges and teaching hospitals.

Now, I suspect that some of you may still be wondering why Connie Lee itself desires privatization. Let's start by recognizing and applauding the innovative and precedent-setting nature of Connie Lee's enabling legislation. By any measure, $19 million of Federal investment has resulted in billions of dollars of long-term, low cost facilities financing. However, as is often the case when creating something new, there may be some unintended consequences. For example, in the case of Connie Lee, there is insufficient balance between the level of Federal support and the degree of Federal restriction on our business activities. As we have discussed, the Federal Government's direct financial support of Connie Lee is modest—less than 15 percent of a total of $130 million of start-up equity capital. On the other hand, Connie Lee's government-mandated mission is clearly the most restrictive of any GSE—so much so that it prevents us from helping all the schools that need help. As an example, Federal law prevents Connie Lee from guaranteeing stronger credits—even though favorable guarantees may not be available to them elsewhere. Currently, the company is also prevented from covering the higher expense of underwriting marginal institutions with revenues from other activities. Statutory limitations make it difficult for Connie Lee to react to changes in interest rates and the economy in a timely fashion. And, because State insurance regulators require that Connie Lee maintain the same high level of paid-in capital as fully private companies, the Federal Government restrictions on our business activities severely limit our investors' ability to realize a fair return on their investment.

I believe it would be useful to remind the committee that privatization is not a new idea at Connie Lee. From the very start, our vision was not only to support higher education facilities, but also to prove the potential for an improved model of government sponsored corporation which might have even broader application elementary and secondary school facilities, for example. We envisioned a true public-private partnership that would work better and with less risk to the government than existing GSE's—one that would operate through a more efficient business structure; that would never rely on the government for a majority of its financing; and which would ultimately shed all vestiges of Federal support so as to stand completely on its own as an independent private corporation. As a result, and at our request, divestiture of the Federal equity is considered in our original enabling legislation. So, in effect, we are here today simply to ask Congress to help Connie Lee take the final step in achieving its original vision.

In closing, I'd like you to consider that the privatization of Connie Lee does more than reduce Federal interference in the credit markets and reverse Federal intrusion into the State regulated insurance industry. A privatized Connie Lee will be free to apply its unique expertise to help rebuild all of America. Of course we will continue to provide insurance to support financings for higher education, but we will also be able to support many other kinds of much needed infrastructure improvements —elementary and secondary school construction, housing, transportation, water and sewer system financings, and others. Just as with colleges and hospitals, our specialty will be the less well-known issues and more complex financial projects which are sometimes overlooked by traditional guarantee institutions. And, with our economy slowing down, let's remember that approximately 50,000 jobs flow from every billion dollars of new infrastructure.

I hope this discussion will encourage you to support the full privatization of Connie Lee. Thank you. I will be pleased to respond to your questions.

Senator JEFFORDS. Thank you very much.

I think I will concentrate my questions on each of you individually, alternating between Senator Simon and myself. I want to give Senator Simon a chance to make an opening statement as well. He is one of the most dedicated Members of the Senate with respect to higher education and someone with whom I have worked for some 20 years now.

I deeply appreciate your contribution, and if you desire to make an opening statement, Senator Simon, please feel free to do so.

Senator SIMON. I have no opening statement, no words of wisdom. I know that will be a great disappointment to you, Mr. Chairman.

Senator JEFFORDS. Well, it is. I lay awake all last night, waiting for what you would be saying today. [Laughter.]

Fine. I will, then, start. Mr. Hough, I will first ask you what are your thoughts about the privatization bill that was referred out of the House Education Committee? What are your problems with it, and what do you think we should do?

Mr. HOUGH. Thank you, Senator.

The privatization bill that was voted out of the House committee enjoyed considerable debate prior to the vote. This is an opportunity to express a lot of appreciation to Members of both parties and their staff who worked with us, Treasury and the Department of Education.

H.R. 1720 is a solid piece of legislation. It has few, if any, issues that are open from our perspective. We in fact are very pleased with it and would welcome the opportunity to work with the Senate and your committee, sir, to address any issues or problems, working from that as a baseline.

Senator JEFFORDS. You say you will remain committed to supporting the Federal Family Education Loan Program. What assurances can you give that your commitment will persist? That presumes, I guess, that it is a profitable venture, and I think the other part of your statement was that there are many people now who engage in similar activities so you are really not needed.

What protections are contained in the privatization bill for the students and the taxpayers?

Mr. HOUGH. H.R. 1720 proposes a structure that has been a year in development, and from the outset, we, with advice and guidance of the Department of Education, have tried to respond to a number of concerns that get to that point.

In the structure of H.R. 1720, there is a significant term, "GSE liquidating entity," the so-called "GSE liquidating subsidiary." Vested in that entity is the corporation's agreement to serve as a lender of last resort, and moreover, if requested by the Secretary of Education, to serve as a secondary market of last resort. That extends for a considerable length of time.

The second order or protection is the fundamental that over the last 22 years, Sallie Mae has only had one business. The core of what we do is to provide liquidity to lenders making student loans, and it is hard to imagine that in any reasonable time frame, we would find any other endeavor that was as attractive to the corporation.

So I think there is a dual approach to giving that assurance and protection that should satisfy you.

Senator JEFFORDS. Recently, as you know, the Congress in its desire and thirst for more money has assessed you with a 30-basis-point levy. What role did that play in your decision on privatization? What would happen to those revenues?

Mr. HOUGH. The fee assessed on Sallie Mae following the 1993 legislation became effective August 1, 1993 and is assessed on all loans that we have acquired since that date. This fee is the central issue to the legislation's achievement of budget neutrality mandated, as you know, under the Credit Reform Act.

With CBO and with staff and with OMB and Treasury and the Department of Education, we have labored for a considerable period of time, trying to create the mechanism that would ensure that the Government, over the scoring period of 7 years, would be reimbursed in full for the amount of that offset fee that is projected to be borne by the corporation were it to stay as a GSE.

So the budget neutrality hurdle that House Bill 1720 overcame is a many hundreds of millions of dollars hurdle, and the bill does provide a way for the Government to be made whole on that fee, and it does so solely off the proceeds of Sallie Mae's continuing business.

Senator JEFFORDS. Forgive my ignorance, but how does that fee affect other secondary markets?

Mr. HOUGH. The offset fee applied to Sallie Mae is applied only to Sallie Mae, so I suppose that, at least from my point of view, it would not surprise you to hear that it improves their position in the market since they do not pay that fee.

Senator JEFFORDS. What would happen if we should go to direct lending very quickly, over the next 2 or 3 years? What difference would that make to Sallie Mae, now and if you privatize?

Mr. HOUGH. It is hard for me to limit my answer to just what the impact on Sallie Mae would be, but as that is your question, that would be my answer. The company would be over the barrel if direct lending goes to 100 percent. It would take literally all of our ingenuity to grapple with the major problems that any large U.S. corporation would face if the entirety of its business were removed. That in essence is the challenge that we would face with 100 percent direct lending.

Having said that, I think there is a way. It would involve very nearly a liquidation of the business as we know it. Obviously, if all you do is buy student loans, and the student loans that you buy go away, disappear over time, you are left without a business. And I believe the most prudent course for the company to proceed would be to liquidate its franchise, and in a sense, any liquidation would involve divestment of all of our assets. That would be our challenge, and we would go about doing that in as orderly a way as possible.

Senator JEFFORDS. I ask that because the in present budget fight which is going on in the conference committee, there is a huge difference between the House and Senate positions in the mandate on education to produce savings, and although there is some question on the CBO scoring aspect, there will be pressure, as we see it, anyway, to go to direct lending as soon as possible in order to save the money that may be forced upon us by the House Budget Committee. That is why I wanted your reaction to that, and I appreciate your answer.

Senator Simon.

Senator SIMON. Thank you.

As I look at the House bill just very hastily here, what you are offering the Federal Government in the House bill is stock options; is that correct?

Mr. HOUGH. That is correct, in addition to a cure on the budget neutrality, which is around a $500 to $600 million hurdle, Senator.

Senator SIMON. Now, when you talk about the budget neutrality and $500 or $600 million, how is that handled?

Mr. HOUGH. The proposal that we worked out with Treasury, Department of Education and OMB proposes that the assets of the company, the student loans we own, for some period of time following our privatization would be in a liquidating trust franchise, and in that mode, we would be required to continue to pay this 30-basis-point offset fee for some considerable period of time until we achieve a budget-neutral condition.

Senator SIMON. And when you talk about stock options, obviously, we are all guessing, but you are selling a product; why should I buy the stock option product?

Mr. HOUGH. The stock option represents the future value of this company, and if you believe that we have done well, as we have, and you look to a future in which the company and principally its human resources can leverage their talent and create value over the long-term, the options that we are providing, the warrants that we are providing, give the opportunity to the Government to share in the gain and the value of the corporation over a considerable amount of time.

In the instance of the Chrysler loan of a decade or more ago, it was a financially sound deal that was struck, and it paid off the Government handsomely. I would hope that our company, with its talent and the vitality that we can bring to the higher education market would offer the same return to the Government, and it would be realized through essentially the same mechanism.

Senator SIMON. Senator Jeffords mentioned direct lending. I do not happen to favor the administration proposal to go to 100 percent, but I also strongly oppose a 40 percent cap. Now, you have opposed direct lending, and you are defending your business—I understand that. We are defending students and looking out for their rights, as well as the taxpayers. And from our perspective, direct lending has been a huge success.

If we move ahead, is Sallie Mae going to continue to be fighting direct lending? It is kind of hard to be good to somebody who keeps slapping you around.

Mr. HOUGH. I know that feeling very well, Senator. [Laughter.] I do not wish to make light of your remark, but I feel like I have been slapped around, or the company has been slapped around, over the last few years.

You identified the conundrum for the corporation. We have a franchise. The franchise is in Federal law. We are owned by shareholders who invested in the company with the expectation that that investment increased in value, and it is the value accretion that drives fundamental growth of our economy.

As I pointed out, our shareholders—while there may be a few DuPonts and Rockefellers—I now know very closely that in large quantities, they are the pension funds of this country. For me to adopt any strategy other than to try to make the Federal Family Education Loan Program the best of the possible ways of delivering educational credit would be counter to my responsibility to help the value of our shares improve.

I think there is a way for us to be, in a sense, competing head-to-head with direct lending and align ourselves, if somewhat imperfectly, with your objectives. We too want the best possible solution for families who need educational loan access in order to attend the schools of their choice. I think the competition that has grown since the advent of direct lending has been very healthy.

While you did not ask the question, were I a policymaker, I would recommend that the founding fathers and advocates of direct lending point to the tremendous success it has had on the program overall, declare victory, and move on.

There is no question today that educational credit is being delivered in a far more responsible way through the banking FFELP program than was the case a decade ago, and much of that is due to the competitive thrust of direct lending. However, I do not know that we need more competition.

So my answer is that, privatized or as a GSE, we will continue to work to improve the FFELP program.

Senator SIMON. I am basically very sympathetic, as you know, to the idea of privatizing. I am also sympathetic to competition. I have to say that I do not want competition, however, with one hand tied behind the cap, with a cap of 40 percent.

Mr. HOUGH. In my judgment, there are certain disadvantages right now that the Federal program has vis-a-vis the direct loan program, and in consideration of those disadvantages, there is a possibility that as I view the world, the playing field would be level. If the playing field were truly level, full competition would exist, and schools would be available to make the decision one way or the other.

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Senator SIMON. And that is what I favor.

Mr. HOUGH. Is that right?

Senator SIMON. Are you saying you are for or opposed to the 40 percent cap?

Mr. HOUGH. It is not essential to our company's continued support for the FFELP program. I think the one thing you might reflect on is whether or not the investment by other sources of private capital in this program would be slowed down if all the signals that a bank might receive are signals saying that the Government is going to go to 100 percent.

In order to have a viable second alternative to direct lending, you have to continue to attract players into this program. And in some people's minds, a cap helps encourage those people to continue to participate. That would not be my view.

Senator SIMON. All right. Well, there is no question that a cap does encourage them to continue to participate and is a very substantial incentive.

Mr. Sockwell, you mentioned an exit fee. The Federal Government invested $19 million in your entity, and you are doing a remarkable job as I read about what you are doing, and the AAA rating is an indication of that.

What kind of exit fee are you talking about?

Mr. SOCKWELL. Senator, the exit fee would be derived primarily from the sale of the Government's investment in Connie Lee. The current House bill anticipates that upon passage of the legislation, the U.S. Treasury would sell the 15 percent investment in Connie Lee within a 12-month period, and it is the proceeds of that sale that would be returned to the U.S. Treasury and would be revenue-positive for the U.S. Government.

Senator SIMON. I thank you both.

Thank you, Mr. Chairman.

Senator JEFFORDS. Thank you, Senator Simon.

Senator Dodd.

Senator DODD. Mr. Chairman, first of all, let me thank you for your willingness to hold this hearing. I would ask that my opening statement be included in the record.

Senator JEFFORDS. Without objection.

[The prepared statement of Senator Dodd follows:]

PREPARED STATEMENT OF SENATOR DODD

Mr. Chairman, this hearing considers some very important efforts—important in their own right, but also important for the signal they send about government. We are looking at new ways for the government to do its business—simpler, smaller and more efficient.

Sallie Mae and Connie Lee have strong records in the higher education sector. Sallie Mae has clearly made a difference to thousands of college students in need of easy, accessible student loans and Connie Lee has assisted nearly a hundred colleges in gaining new access to the capital markets to improve their facilities and infrastructure.

As a long time supporter, I am particularly pleased that we will look today at Connie Lee, which I shepherded into law in 1986. Just last week I introduced legislation, S. 941 offered by the administration; that would accomplish the privatization of Connie Lee. So it is rewarding for me to be a part of this exciting transition for Connie Lee.

Connie Lee was created with a vital and focused mission—to assist colleges in the repair, modernization and construction of their facilities. Like many institutions, colleges and universities need multi-year financing to keep up with their construction and renovation needs. For institutions with strong financial backing and large endowments, issuing bonds and securing capital has not been a major problem. Institutions that are less secure and have a lower bond rating, however, face major obstacles in obtaining the necessary financing.

It was clear to us in 1986 that we, as a nation, have a major stake in assuring that our higher education institutions both literally and figuratively sit on a strong foundation. Connie Lee was created to address this need and, since its incorporation in 1987, it has provided increased access to the bond markets through bond insurance. Connie Lee has insured bond issues totalling more than $2.5 billion and has assisted institutions such as the University of Denver, the Massachusetts Medical School, several community colleges, and numerous other institutions in nearly every State.

With its significant record, Connie Lee has clearly proven its maturity, strength and commitment. Since its founding, Connie Lee has maintained its Triple-A financial rating, and a recent Standard and Poor's report confirmed its strong financial position.

In addition, privatization offers some potential savings for the government—even though the original Federal investment of $19 million was small, every dollar is clearly needed in our effort to eliminate the deficit.

I do think there are some issues that we should look carefully at during this hearing regarding the actual details of the privatization—including issues such as the timing of the sale of the Federal shares and the repeal of the statutory restrictions, and a possible limitation of the purchase of the Federal shares by another government entity. I look forward to exploring these and other areas with today's witnesses.

Senator DODD. These are both very important issues, and I have a particular interest in Connie Lee because I was one of the authors of it back in 1986——

Senator SIMON. If I may correct the record, not "one of the authors"; I remember Chris Dodd being the only person who was out there championing the cause. He is the creator.

Senator DODD. Thank you.

Senator JEFFORDS. You stand corrected.

Senator DODD. I was waiting to see whether or not you liked the idea. [Laughter.] It is with some trepidation that I am stepping out into the open field here.

But at the time, we felt very strongly that this was a very important gap that needed to be filled for institutions that were having serious infrastructure problems, as a way of attracting capital to them. And it was a heated discussion—I remember Congressman Ford in the House had some strong feelings about this issue.

And I am now also the author of the bill, along with others, to privatize. There are separate issues here. There is a tendency for people to think of Sallie Mae and Connie Lee as exactly alike. There are obviously significant differences, and obviously a history that is different as well, with Sallie Mae going back to 1972—and in a very strong position, by the way. Connie Lee is in good shape, but obviously, as a newer institution and given different needs, has faced some other concerns.

So I clearly believe that we ought to try with Connie Lee to move in the direction of privatization. This is something that I do not think it takes a great deal of awareness about Connie Lee to appreciate and understand the value of it.

Sallie Mae is a bit more complicated, and again, I am optimistic about the possibility of privatization here, but because there are some other issues involved with it, I think we ought to proceed with some degree of caution in both cases. Nonetheless there are differences.

I am interested in hearing from both Mr. Hough and Mr. Sockwell about what other areas you intend to move into. Both of you have indicated that you want to move into other areas, and I understand that, but I think it might be worthwhile to put some specifics on that general understanding. Obviously, the private sector out there is uneasy.

Maybe I ought to start by asking for the record what percentage of the marketplace are we talking about here today that Sallie Mae or Connie Lee would be getting into. When we hear about the others in the private sector who are nervous about Sallie Mae and Connie Lee coming in, it might be worthwhile to put this in some perspective so we can get some idea of how much of a threat both of you actually pose.

Then I would like to hear specifically about what some of your ideas are. What other areas would you move into should the legislation to privatize be passed?

Mr. Sockwell.

Mr. SOCKWELL. Senator, let me start. At present, Connie Lee enjoys approximately a one percent market share of the entire insured municipal bond market. The key, however, is that—at least, the last time that I looked—Connie Lee accounted for about 50 percent of all insurance to marginal educational institutions. So that while we are not a very large share of the overall municipal market, we are critical to the access to financing of the smaller and more marginally financed institutions.

The secret to Connie Lee is simply a recognition that with proper underwriting, a lower level of credit can be successful insured. For example, unlike any other guarantor, Connie Lee makes a site audit of every institution that it insures.

We believe that, as opposed to taking market share from other insurers, we expand the market. As a matter of fact, to my knowledge, we have never taken away from another insurer any transaction that it desired to insure. Just the opposite has happened. The level of insurance to educational institutions of the major insurers has grown dramatically following Connie Lee's example.

We believe that there are other segments of our Nation's economic structure that could also benefit from improved access to low-cost debt financing. For example, elementary and secondary schools have a need for new buildings and new equipment that is approximately double that of colleges and universities. There is a need for rural communities to comply with State and Federal clean water requirements. We need to rebuild the roads and bridges of our country. In all of these cases, we believe that with proper underwriting, there are literally billions of dollars of incremental financing that could be done if there is a Connie Lee to stand up as a surrogate for the credit quality of these institutions.

So we believe that any additional financing or insurance that Connie Lee would provide would add to the overall insurance market, certainly not take away from what others are doing. We have never taken a deal from anyone in our entire history, and it would not be our intent to do that in the future.

Frankly, on the larger and easier transactions, we simply would not be able to price competitively given our much more onerous underwriting procedures so as to compete with the other institutions. That is just not our market, and we certainly would not, again, hesitate to say that we would be expanding the market, other infrastructure needs, if we were privatized.

Senator DODD. Just before turning to Mr. Hough, you have been involved in some 93 institutions; is that right?

Mr. SOCKWELL. Right.

Senator DODD. And today, there is $2 billion?

Mr. SOCKWELL. Since inception, we have guaranteed approximately $10 billion of principal and interest for educational institutions.

Senator DODD. And how much of that is higher education? It is almost exclusively higher education, is it not?

Mr. SOCKWELL. It is exclusively higher education, yes.

Senator DODD. Your comments earlier, though, indicated that when you talk about new activities, you may expand into elementary and secondary schools.

Mr. SOCKWELL. That is correct.

Senator DODD. And how much does that jeopardize what the intent of Connie Lee is and the gap it tries to fill, given the still serious demands that exist in the higher education area?

Mr. SOCKWELL. Senator, that is a very good question, and the answer is that Connie Lee's expansion into other fields has the exact opposite effect. The challenge now is simply that higher education institutions, and particularly the lower credit quality institutions, require an extremely expensive underwriting process.

We make an onsite audit of every institution. It takes us about a month to 6 weeks to do each deal, and the regular insurance transactions are often approved in a matter of hours.

We simply cannot derive the revenues in this totally specialized market sufficient to continue that high level of expense and underwriting activity, so we are challenged with a very small staff, a very modest revenue base, to find the revenues to continue serving higher education.

If we were able to take our expertise and help lower credit quality transportation issuers and elementary and secondary education issuers, we would be able to spread our expenses over a larger revenue base and do more for higher education.

Senator DODD. I appreciate that—and I do not want to go over my time, Mr. Chairman—and again, the pride of authorship aside, there is a real need in this higher education area, and I am not minimizing the need at all. But we put up $19 million—15 percent of the $19 million is taxpayers' money, 35 percent came from Sallie Mae—to get you going, and I am a strong advocate of it. And there are the issues of the shares and so on. I am uneasy about you sailing off into other waters and leaving the original intent unmet, not that you are necessarily going to serve it all, but I am uneasy about that, and I do not want to constrain you as you are looking at other areas, but I get nervous about all of a sudden abandoning—and maybe "abandon" is too strong a word here, but I will use it anyway—abandoning that constituency that was behind the original intent that created the legislation which established this institution.

Mr. SOCKWELL. Senator, in the House bill, we have agreed to change our articles of incorporation to specify explicitly that one role of the corporation will be to insure higher education issues. We have also agreed in that legislation to report to the Congress for an extended period of time not only on all of our activity in detail with regard to insurance of higher education institutions, but in particular on the insurance of lower credit quality and HBCU colleges and universities.

So we are absolutely committed to higher education. The challenge to us is to do the Congress' work, but not to craft the legislation in a way that anyone can say that we are so Government-mandated that there continues to exist a Federal obligation for our guarantees.

Senator DODD. I understand.

Mr. SOCKWELL. Outside of that, we are willing to make the strongest possible commitment to higher education.

Senator DODD. Mr. Hough, to quote you, you talked about "providing new financial and technical resources to colleges and universities," as well as "building upon partnerships" that you have with lenders. I wonder what services this might lead you to offer that you are currently restricted from offering?

Mr. HOUGH. Senator, the evolution of student loan delivery is moving ahead very quickly. As I mentioned earlier to Senator Simon, the advent of direct lending has led to a very rapid ramp-up of technology-based student loan delivery systems where the critical customer need is the college and university.

To the credit of our industry, the progress toward speeding delivery, ensuring virtually a 24-hour loan approval process and the electronic transmission of funds has come along very quickly. A driving force behind that improvement has been our ability to work within the industry as well as the innovations that our own staff have brought in looking at ways of improving credit delivery.

When we look ahead, we see a delivery system that has as smaller number of choices, a smaller number of delivery mechanisms. We want to be able to do everything possible to lead the innovation in that area. We will necessarily be constrained from advances our competitors would be able to make as they apply the full range of technology, supported by the full set of different businesses that they may enter into or may acquire alliances with.

The most efficient way for us to drive that process and to gain the service increments that we can extend to families and higher education institutions is to be freed from the constraints in our Federal charter. More specifically, I envision us as extending the modest array of computer software products that we today are able to offer consistent with our statute and to move horizontally into the university student services area, providing both hardware and software support in the student services area, such as the admissions, the registrar, the bursar and development. All of those bring the benefits of more standard approaches to colleges and universities, which today are really struggling with the one of a kind legacy systems that are very prevalent in those areas.

In further respect, we think that the responsible use of educational credit, advising families on what is proper use and what is not, where are the opportunities and where those opportunities are not, is going to be more and more a function of the quality of communication at earlier ages of intervention than is today the case. The way one can conceive and market to that interest, to the interest of more responsibly providing the resources for higher education, is both a business opportunity for us and a responsibility that I think we could deliver to the American public.

Again, we would be running into the limits of our charter as we extend that in an number of areas. There is nothing in our business plan for the future that takes us away from the higher education market that we have come to understand. We have over 4,000 employees located in many small communities in the United States who have made their professional career one of providing advice and counsel to students in a very difficult part of their experience, the part of their experience where they are borrowing and repaying their loans.

That is an expertise that is easily extended into other areas, and we do it very well with the aid of the most advanced technologies in the marketplace today. It is inevitable that as we attempt to leverage that capability as a GSE, we will run into the restrictions in our charter.

There was one further part of your question initially, and that is the market share that we have today and what would be the consequence of a privatized Sallie Mae. Today we buy approximately 15 to 20 percent of the loans outstanding that we do not own. There are some $80 billion; we own about $30 billion, $35 billion, and we will buy some $8 to $9 billion this year.

Looking at it from a different cut, there will be about $25 billion originated, and we will buy $8 to $9 billion, so one-third or more of the new originations.

Privatization of Sallie Mae would allow us to increase that market share, but it would increase it in modest increments. But modest incremental growth of a $50 billion market is very significant to our shareholders, and I think that is sort of the promise of this opportunity—certainly, some growth in market share; absolute, continued dependence on our lenders that do business with us, some 2,000; and our ability to leverage their presence in the marketplace by the applications of technology that we are perfecting.

Senator DODD. Thank you very much.

Thank you, Mr. Chairman.

Senator JEFFORDS. Thank you. Those were excellent questions.

Mr. Sockwell, I want to follow up on Senator Dodd's questions. I am more concerned about your privatization than I am of Sallie Mae's because there is a huge need out there, some $60 billion of backlog in infrastructure repairs, technology improvements, lab improvements, and obviously, those institutions that are not up in the highly-endowed categories have a very difficult time finding it.

Although you say you are dedicated to continuing to service them, if you become profit-oriented, with stockholders, and you have a huge ability to provide to low-risk institutions versus high-risk institutions, how can we be assured that the high-risk institutions will be serviced as well as they are now?

Mr. SOCKWELL. Senator, from a pragmatic standpoint, we currently have about one percent of the annual market in all guarantees. And if you go back in time—and the bond insurance industry goes back about 20 or 30 years—we have an infinitesimal presence among investors in terms of bond insurance. So the fact is that, on a practical basis, our market will continue to be education issuers who have trouble getting guarantees elsewhere. It is just a practical reality that, at one percent of the market, we will have to stick to what we know best. We will really be prohibited in the market from expanding into the higher-credit institutions.

Senator JEFFORDS. Well, I would have no problem with expanding your charter to allow you to move into the lower-risk markets, but only if it were to enhance the ability to take care of the high-risk markets. Now, you say you are going to do that. If you have the pressure of stockholders to maximize your profit, how can we be sure that you will be taking care of the lower profit projects?

Mr. SOCKWELL. Well, I would start by noting that in the House legislation—and certainly we would have no problem if the Senate legislation mirrored that—we are directed to continue serving higher education institutions, and we are furthermore required to report in detail on our activity with higher education institutions and specifically with historically black colleges and specifically with institutions that are below the top three credit qualities. So there is a directive and a reporting mechanism in the House legislation that we are comfortable with.

Senator JEFFORDS. Are there any sanctions?

Mr. SOCKWELL. I think the sanctions are, frankly, that the Congress has the ability to change our legislation at will.

I might say that we had explored the idea of some sort of expansion or some sort of additional Government support, and we were unsuccessful, and the private companies are not anxious or not supportive of a Connie Lee expanded, while remaining in a Government-sponsored enterprise mode.

So in effect, privatization removes the objections of the currently private insurers and at the same time allows Connie Lee to realize the revenues to continue its education mission.

Senator JEFFORDS. Well, I hope to explore that aspect. I do not share their worry about that aspect of it. My goal and I think that of others on this committee would be to try to enhance your ability to service the high-risk institutions and somehow minimize that risk by perhaps enabling you to expand into more profitable areas. I do not know how other members feel, but I would like to look at that option; I am not so sure that I am as against it as the House may have been.

Senator Simon.

Senator SIMON. Just a couple more questions for Mr. Hough. As I glance through the legislation, I see constantly the reorganization effective date referred to. I do not find any reorganization effective date designated. You have a dissolution date and other dates, but not the reorganization effective date. That would be up to your board of directors, or how do you define the reorganization effective date?

Mr. HOUGH. Senator, the intent of H.R. 1720 is to provide an 18-month period following the signature of the President on the law. During that 18-month period, the shareholders would vote to privatize the corporation, and with their affirmative vote, from that point the company would then be privatized, and at the end of 18 months, the provisions of the law would sunset.

Senator SIMON. Let me just add here that I think if we can move ahead and have that level playing field that you are talking about, without a 40 percent cap, then I think we ought to go ahead with this privatization. If we end up with a 40 percent cap, then I think I will have to take another look at the legislation. I think that is kind of where I am, and I speak just for myself and not for anyone else.

Thank you.

Senator JEFFORDS. Senator Dodd.

Senator DODD. I just want to underscore what the chairman has said as well. I want to make sure that if we look at this, we do not abandon the underlying purposes that were behind the legislation initially.

Second, obviously, one of the great motivations in all of this, at least in some people's minds—I think there is a broader argument—but I get the sense from reading your testimony and listening to you here that neither one of you are terribly optimistic about the idea that this is going to be a greater savings to the Federal Government, which is the motivation, I think, behind some people's support for the privatization effort.

Am I wrong in my impressions—and I do not think that that has to be the only reason, but it seems to me there is some lack of enthusiasm for that notion.

Mr. HOUGH. I would be happy to comment. I think there is tremendous difference between the way the two companies would look over the long-term, but I would agree that in a 24- to 36-month period, there is not a lot of evidence. You are really describing a Government-sponsored enterprise whose future market is somewhat uncertain. As Senator Simon and Senator Jeffords noted, direct lending is a factor in defining our marketplace. This company pays Federal income taxes at virtually the highest rate one could imagine in that there are not the kinds of taxable or tax-sheltering events in the way of losses, etc, so we pay at a high income tax rate, the point being that if you look at two income streams side-by-side, a GSE trapped in a box where its future is very uncertain, and a privatized Sallie Mae with a future that it can craft over the long-term, I have every confidence that the management and employees of our company will find room for growth, and in that growth come new revenues and new tax sources to the Federal Government.

I think you are also aware, Senator, that one of the GSE attributes that we would be giving up is the fact that we do not pay State taxes, and we would be creating tax revenue sources in the States in which we operate. And at last count, I think we are now an operating entity with domiciled employees in 12 States.

So I would point to both of those—the prospect for growth and the expansion of the tax payments of the corporation—as the best way to deal with the issue of what is the benefit to the taxpayer. Others will turn to the fact that some $50 billion of implicit guaranteed debt will in time roll off the off-balance sheet books of the Federal Government and ascribe to that significant value as well, and I would be among them.

Senator DODD. Mr. Sockwell.

Mr. SOCKWELL. Senator, we are at Connie Lee sort of between a rock and a hard place. The $19 million Federal investment, while it was sufficient to be the seed capital to draw in other investors, is not, compared to the other GSEs like Fannie Mae or Freddie Mac or even Sallie Mae, significant at all; it is just a drop in the bucket. So that when we go out on the marketplace, we are not treated like a true Government-sponsored enterprise. We are treated as a small, private corporation that is limited to doing only the highest-risk credits in industries, health care and higher education, that themselves are considered to be the highest-risk industries for guarantors.

So therefore, we are unable to compete successfully for low-risk credits. There are really only two choices. One is to give us access to high-risk credits in addition to higher education and health care, such as the higher risk transportation, higher risk elementary and secondary, or to give us more Federal support so that we can go, for example, and do more for the lower-risk education institutions.

Senator DODD. More for the higher-risk education institutions.

Mr. SOCKWELL. No; we are already doing the high-risk education institutions. We cannot compete successfully for the lower-risk education institutions. We are competing against companies that are wholly-owned by Citicorp, wholly owned by General Electric, majority owned by USF&G, and the $19 million of Federal capital just does not carry very much weight at all. We are one one-hundredth the size of these other companies.

So that we have to find a way to derive additional revenues. Privatization is one source of that, and it seems to work for lots of different constituencies. Otherwise we are simply going to wither on the vine, as we are now, because we are truly between a rock and a hard place and have been so for some time.

Senator DODD. Thank you very much.

Thank you, Mr. Chairman.

Senator JEFFORDS. We thank both of you very much.

Our next panel consists of Ms. Darcy Bradbury, deputy assistant secretary for Federal Finance at the U.S. Department of the Treasury in Washington, DC, and Mr. Leo Kornfeld, senior advisor to the Secretary, U.S. Department of Education, Washington, DC.

I appreciate your attendance here this morning, and we will now proceed into other aspects of the privatization discussion.

Mr. Kornfeld, please proceed.

STATEMENTS OF LEO KORNFELD, SENIOR ADVISOR TO THE SECRETARY, U.S. DEPARTMENT OF EDUCATION, WASHINGTON, DC; AND DARCY BRADBURY, DEPUTY ASSISTANT SECRETARY FOR FEDERAL FINANCE, U.S. DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. KORNFELD. Senator Jeffords, members of the committee, I am pleased to appear at this Senate subcommittee hearing to present the views of the Department of Education with respect to the privatization of Connie Lee and Sallie Mae. First, I would like to talk about Connie Lee and then go on to Sallie Mae.

Connie Lee, as you know, was established by the Higher Education Amendments of 1986. Since then, Connie Lee has provided insurance and reinsurance for almost $10 billion of construction financing, supporting more than 1,000 higher education institutions.

The administration believes that full privatization of Connie Lee at this time would be in the best interest of the Government. Connie Lee and the educational institutions are now in a position where we feel that privatization is appropriate.

The legislation we have submitted, which has been referred to by Senator Dodd, would allow market forces to operate, and we do believe that the market forces would prevent some of the concerns that have already been expressed. It is obviously important to all of us that the high-risk institutions continue to obtain this reinsurance, and hopefully, Mr. Sockwell will continue to provide and do what he says he plans to do.

We feel that privatizing Connie Lee would be in the best interests of the public.

Regarding Sallie Mae, Sallie Mae was created by the Education Amendments of 1972 to provide a secondary market for guaranteed student loans. Sallie Mae's board of directors has announced that they would prefer and have proposed privatization. We do support the privatization of Sallie Mae.

However, there are three aspects that I would like to discuss regarding Sallie Mae, and they will be in our legislation which we will be submitting for your consideration very soon. Some of these are somewhat different than the House legislation.

The three points I would like to talk about regarding our legislation, which will be forthcoming very soon, are, first, the need for a GSE at this time in the marketplace; second, the offset fee; and third, the exit fee.

As has already been expressed many times, there have been significant changes in the student loan market. There has also been a growth of the secondary market. When you include those companies that are already in the secondary market business in this country, as well as lenders who also perform secondary market entities, there are probably about 90 different activities that provide secondary market type activities in this country.

In the legislation that we are going to submit, however, we are proposing the following: First, that Sallie Mae make a decision to go private within 18 months after the legislation is enacted. If they choose not to go private within the 18 months, we are proposing in our legislation that Sallie Mae have another 6 months to liquidate the corporation.

As you know, there has been some difference of opinion in the press. There is a dissident board, and we feel that it is already important, related to the question that Senator Simon asked, that there be specific dates as to when Sallie Mae goes private, and it is the Government's decision as to whether a GSE is needed, and not the Sallie Mae board. We feel that the GSE has served its purpose; Sallie Mae has done an extraordinarily good job in meeting its mission, but because of the marketplace does, we do not need a GSE any longer.

If Sallie Mae's board at this point changes its mind and chooses not to go private, we feel that the corporation should be liquidated.

We also feel there should be a "drop dead date" by which time we run off the portfolio that Sallie Mae has, and in our legislation, we are proposing that that date be the year 2004.

There is a concern, just as we expressed with Connie Lee, about what would happen without a Sallie Mae in the marketplace. Seventy percent of all the GS loans in this country today are sold, and secondary markets acquire those loans. Sallie Mae acquires 50 percent of that marketplace. They are obviously the major player in this market.

What we are proposing in our legislation, in order to make sure that access continues in the FFEL program, which at least at this point is certainly going to be around for some time, is that Congress give the Department the authority to provide Federal funds to the secondary market in order to ensure access if that becomes a problem. That is primarily an insurance, as we see it, to ensure the fact that we do not destroy the access problem to the FFEL program as long as that exists.

As far as the offset fee, as you know, the offset fee is .3 percent, which was enacted in the Student Loan Reform Act of 1993. In the next 5 years, that offset fee will amount to approximately, based on our projections, about $250 million. In our legislation, to avoid a PAYGO issue, we propose that payment come forth from Sallie Mae to make sure we maintain revenue neutrality.

Regarding the exit fee, one of the major ingredients in Sallie Mae's success has been the leverage that they have been able to obtain through the GSE. As an example, indicators that exist today, Sallie Mae's equity-to-asset is about 2.75 compared to the other secondary market companies in this country, which is approximately 8.8 percent. Furthermore, the major lender in this country's equity-to-asset ratio is about 4.6. We feel that because of the leverage that Sallie Mae has achieved over the years as a GSE and the leverage that they have been able to obtain as these ratios indicate, that exit fee is certainly warranted, and we will be describing such an exit feel in our legislation which we are going to submit to you.

As a former president in my previous life of two private corporations, I certainly am very sensitive to the need of taking care of shareholders and boards of directors. That is a president's role and responsibility; if he does not do that, he gets fired. However, in this particular case, we feel the Government is a major player and has been a major player in the success of Sallie Mae and warrants an appropriate exit fee.

The Department of Education, the Department of the Treasury, OMB and the White House have now concluded our deliberations, and we will be sending you legislation very soon and hope you will consider it appropriately.

Thank you very much.

[The prepared statement of Mr. Kornfeld follows:]

PREPARED STATEMENT OF LEO KORNFELD

Mr. Chairman and members of the subcommittee, I am pleased to appear at this Senate subcommittee hearing to present the views of the Department of Education with respect to privatization of the College Construction Loan Insurance Association (Connie Lee) and the Student Loan Marketing Association (Sallie Mae).

In principle, the Administration supports the privatization of government-sponsored enterprises (GSEs) when the special privileges that have been bestowed upon them as part of that status are no longer necessary to perform the functions for which they were created, or the functions for which the GSE was created are no longer necessary.

First, I will discuss Connie Lee, the less federally-connected of the two enterprises, where the Administration has submitted a legislative proposal to Congress, and then turn to Sallie Mae. Before doing so, however, I would like to put these actions in the larger context of the Administration's commitment to Reinventing Government. The privatization of Connie Lee and Sallie Mae are consistent with the President's efforts to improve the way Government does business, to cut bureaucracy and regulation. Moving forward on this agenda is the right thing to do not because privatization is a popular idea, but because it is the smart thing to do.

CONNIE LEE

Connie Lee was established by the Higher Education Amendments of 1986 to assist in the financing of postsecondary education facilities. Since then, Connie Lee has provided insurance and reinsurance for almost $10 billion of construction financing, supporting more than 1,000 higher education facilities projects.

The Administration has submitted a legislative proposal to Congress to privatize Connie Lee in a manner that protects the interest of the taxpayer. The Administration believes that full privatization of Connie Lee would be in the best interests of the Government, Connie Lee, and educational institutions—a position with which Connie Lee concurs.

Privatizing Connie Lee would signal an important shift in the way the Government does business. It would eliminate a Federal presence where the operation of market forces would be more suitable, and it would contribute toward reducing the scope of Government. It would remove restrictions on Connie Lee's operations, and it would return funds to the U.S. Treasury through the sale of the Secretary of Education's holdings of Connie Lee voting common stock.

In order to protect the taxpayer's investment in Connie Lee, the Government's representation on the Corporation's Board and certain audit and reporting requirements would remain in effect until the stock is sold.

Connie Lee is generally restricted by the HEA to serving only postsecondary institutions with relatively low financial ratings.However, Connie Lee has had to maintain a balanced portfolio in order to support its own good rating. As a result, Connie Lee's insurance and reinsurance business among the lowest-rated schools has been limited. By repealing the current authorization, Connie Lee believes it would be able to serve those schools better.

Furthermore, restricting Connie Lee's business to the postsecondary education sector (including teaching hospitals) prevents the association from serving elementary and secondary education institutions, as well as many other public service entities that may require construction financing insurance or reinsurance. An expansion of Connie Lee's business beyond postsecondary education, but without any actual or perceived government tie, could contribute to the public benefit.

Enacting the Administration's legislation would allow market forces to operate free of statutory impediments and bureaucratic oversight. The Department looks forward to working with you to pass this legislation.

SALLIE MAE

Sallie Mae was created by the Education Amendments of 1972 to provide a secondary market for guaranteed student loans.

The authorization and successful launching of the Federal Direct Loan Program has raised the question of the extent to which the functions currently assigned to Sallie Mae under the FFEL program will be necessary in the future. Obviously, the Administration's proposal to accelerate implementation of direct lending would result in the elimination of new guaranteed loan volume for Sallie Mae and other secondary markets to purchase or to fund through warehousing advances. Thus, privatization, with the accompanying ability to engage in other business activities, is the logical result of 100 percent direct lending. Even under current law, however, the volume of new guaranteed loans, and thus the need for Sallie Mae to support that program, will be substantially diminished. Some 40 percent of all new loan volume will be handled by direct rather than guaranteed lending in the next academic year, increasing under current law to 60 percent by the 1997-98 academic year.

In recognition of these developments, last autumn the Secretary of Education and the Secretary of the Treasury wrote the then Chairmen of the House Education and Labor Committee and the Senate Labor and Human Resources Committee that "the most promising approach now under consideration is to use the transition period (from guaranteed to direct loans) to restructure Sallie Mae from a GSE that has certain ties to the Federal Government into a completely private enterprise." Since then, an interagency working group composed of representatives of the two Departments, the Domestic Policy Council, the National Economic Council, and the Office of Management and Budget has been meeting on a regular basis to develop the Administration's approach to the privatization of Sallie Mae. Sallie Mae has worked closely with the working group.

We are now convinced that privatization of Sallie Mae is both necessary and desirable. The sheer size of Sallie Mae (over $50 billion in assets and nearly 5,000 employees) makes its potential privatization a particularly challenging undertaking. The interagency group has made very good progress. We anticipate forwarding to the Congress the Administration's proposal in the very near future.

In considering the potential privatization of Sallie Mae, the interagency group has attempted to balance the often competing interests of students, the stockholders of Sallie Mae, and the taxpayer. There are also a number of special issues that the interagency group is addressing:

1. *Continuing need*. Even if all new guaranteed loan volume were to cease today, there would still be a portfolio of $113 billion, measured in original principal amount of outstanding guaranteed loans. Therefore, our legislation will take into account the protection of these student borrowers and ensure that privatization happens in an orderly manner. It is clear, however, that GSE status is not central to the ability of a company to manage student loan holdings efficiently and effectively.

2. *Offset fee*. The Student Loan Reform Act of 1993 requires Sallie Mae to pay the Government an annual offset fee of 0.3 percent of the loans that Sallie Mae holds that entered its portfolio since enactment of that statute. This offset fee has been estimated to generate $251 million of revenue over the next five years. In order to avoid a PAYGO issue under the Budget Enforcement Act, our legislation will provide for payment in the equivalent amount by Sallie Mae to the Federal Government.

3. *Exit fee*. There also should be reasonable compensation to the Federal Government for the enormous financial benefits that Sallie Mae and its shareholders have enjoyed as a result of Sallie Mae's status as a GSE. Most important among these are its ability to borrow money at lower rates and to maintain much greater financial leverage (assets per dollar of equity) than private financial institutions, its exemption from State and local taxes, as well as its exemption from those taxes on the interest from its debt securities. Our current thinking on the matter of an exit fee is explained by my colleague from the Treasury Department.

As I have stated, the interagency working group is in the final stages of its work. We anticipate completing the development of a specific legislative proposal for the privatization of Sallie Mae and submitting it to Congress in the near future.

With or without a change in current law to the pace of the transition to direct lending, we have concluded that the Federal Government no longer requires a GSE for the student loan program. We are proposing an orderly multiyear phase out to privatization, or if shareholders reject privatization, an equally orderly multiyear dissolution of the GSE.

I would be happy to answer any questions that you might have at this time.

Senator JEFFORDS. Ms. Bradbury.

Ms. BRADBURY. Chairman Jeffords and members of the subcommittee, on behalf of Secretary Rubin, I welcome the opportunity to appear before you today to discuss the administration's proposal to cut the ties to the Federal Government of two GSEs, Sallie Mae and Connie Lee.

The Treasury has for a number of years, in both Democratic and Republican administrations, believed that it is appropriate to wean a GSE from Federal sponsorship once the GSE becomes economically viable and successfully fulfills the purpose for which it was created, or when the purpose for which it was created ceases to exist.

The GSEs expose the Government to the market perception of implicit risk that legislation would be enacted to prevent the GSE from defaulting on its obligations. As the Treasury said in its 1990 report on GSEs, "The market perception of Federal backing for GSEs weakens the normal relationship between the availability and cost of funds to the GSEs and the risks that these enterprises assume."

As part of the 1991 Treasury report, Standard and Poors, the rating agency, assessed the likelihood that a GSE would be able to meet its future obligations from its own resources. S and P gave an AAA credit rating to Sallie Mae. Connie Lee had obtained a stand-alone AAA credit rating from S and P previously; thus, they meet the test of economic viability.

As a general principle, we believe that the Government and these GSEs would benefit from the removal of Government ties because privatizing the GSEs would reduce the amount of GSE debt over time that carries some perception of U.S. Government support; demonstrate our commitment to moving from creating effective public-private partnerships to then enabling complete privatization when Government support for an activity is no longer needed; show the financial markets that the Government respects the interests of private bond-and shareholders; and support Federal efforts to create new GSEs in the future, when appropriate, by demonstrating that the Federal relationship can be severed when the time is right.

Let me first speak to Sallie Mae. Under a statute enacted in 1992, the Treasury has a special relationship with Sallie Mae as its financial safety and soundness regulator. We have reviewed Sallie Mae's financial condition, and we can see their successes to date and challenges for the future.

The financial environment for Sallie Mae has changed since the enactment of the Student Loan Reform Act of 1993, which amended the Higher Education Act to reduce the returns on all guaranteed student loans and imposed a 30-basis-point fee on all guaranteed student loans purchased by Sallie Mae. Even more significantly, the Act established the Federal Direct Student Loan Program.

The Direct Student Loan Program is one of the President's top priorities. The administration, in the budget for fiscal year96, proposed implementation of 100 percent direct lending. Consistent with the implementation of direct lending under current law, the administration has been studying options for the future of Sallie Mae, including in particular restructuring the company into a fully private company.

In any restructuring, currently outstanding Sallie Mae debt would retain the characteristics of GSE debt, and customers with preexisting commitments with the GSE would not be affected. Any due debt issued by a private company successor to Sallie Mae would not possess the characteristics of GSE debt.

The administration believes the benefits to be gained by the Government and Sallie Mae from privatization, in the context of continued expansion of the Direct Student Loan Program, are such that Congress should favorably consider legislation. In this connection, we have been working within the administration, with Sallie Mae and with congressional staff to develop legislation. Leo and I testified on May 3 in support of privatization in the House and were encouraged that the House Committee on Economic and Educational Opportunities voted on June 8th to report a bill that provides for privatizing Sallie Mae.

The administration supports many of the provisions of the reported bill, which we understand may be amended before the bill is sent to the floor. Nonetheless, I believe there are some differences which should be worked out to the satisfaction of the administration, Congress and Sallie Mae.

The administration is working on a draft bill, and we promise we will share it with you in the near future. The key elements of our privatization proposal are that the Sallie Mae board of directors would be authorized to carry out a reorganization voted by their shareholders, under which Sallie Mae the GSE would become a wholly-owned subsidiary of a private company whose other subsidiaries could engage in other businesses. If the shareholders choose not to proceed with a reorganization, Sallie Mae would prepare a plan for an orderly termination of the association; it is the plan which Leo was referring to which occurs 6 months after the 18-month privatization vote. That plan would ensure that the GSE would meet its ongoing capital requirements and have adequate assets to transfer to a trust at the end to ensure payment of outstanding GSE debt.

After the decision by the shareholders, Sallie Mae would enter a wind-down period in which new business activities and new debt of the GSE would be restricted. During the wind-down, excess capital of the GSE could be transferred to the new private holding company or paid out to shareholders subject to continued compliance with their statutory capital.

The GSE would be protected from the financial failure of the holding company or its other subsidiaries in the event of reorganization, and the GSE would cease to exist at a certain point in time, and its remaining assets and liabilities would be liquidated.

The bill must be deficit-neutral; and as a form of exit fee, the legislation would enable the United States to participate in the success of the company.

The administration will also propose that certain provisions be included in the bill to facilitate Government oversight during the wind-down period.

Now let me briefly mention Connie Lee. Congress structured Connie Lee as a private for-profit corporation, but provided for a limited infusion of Federal capital in the form of stock purchases by the Secretary of Education in order to get the corporation started.

Congress clearly intended the Federal Government's direct interest in Connie Lee to diminish and eventually terminate, as evidenced by the statutory limitations on the purchase of stock by the Secretary of Education and the authorization of the sale of such stock.

The administration's legislation, which was transmitted in May and, I understand, introduced by Senator Dodd and others last week, severs all Federal ties with Connie Lee largely by requiring that the Connie Lee stock that is held by the Department of Education be sold by a date to be specified in the bill. The legislation would eliminate Federal appointment of directors as well as all business restrictions. In marketing securities, Connie Lee would have to notify potential investors of these changes to reduce the risk of confusion regarding its status. Thus Connie Lee would be permitted to pursue business opportunities, and the Federal Government would be free of any perception of implied risk.

We appreciate the opportunity to testify. We believe that privatization, if implemented in a careful and deliberate manner, can benefit the U.S. Government and taxpayers, as well as Sallie Mae's and Connie Lee's stockholders, and the students and schools we are all trying to serve.

I would be glad to answer any questions.

[The prepared statement of Ms. Bradbury follows:]

PREPARED STATEMENT OF DARCY BRADBURY

Chairman Jeffords and members of the subcommittee, on behalf of Secretary Rubin, I welcome the opportunity to appear before you today to discuss the Administration's proposals to cut the ties to the Federal Government of two Government-sponsored Enterprises (GSEs)—the Student Loan Marketing Association (Sallie Mae) and the College Construction Loan Insurance Association (Connie Lee). The Treasury has for a number of years, in Democratic and Republican Administrations, believed that it is appropriate to wean a GSE from Federal sponsorship once the GSE becomes economically viable and successfully fulfills the purpose for which it was created with Federal sponsorship, or when the purpose for which it was created ceases to exist.

The GSEs expose the Government to the market perception of implicit risk that legislation would be enacted to prevent a GSE from defaulting on its obligations. As the Treasury said in its 1990 Report on GSEs[1]:

The market perception of Federal backing for GSEs weakens the normal relationship between the availability and cost of funds to the GSEs and the risks that these enterprises assume . . . The prospect that Congress would use taxpayer funds to prevent the failure of a GSE is perceived in the securities markets as protecting investors in GSE debt securities or GSE guaranteed securities from loss . . .

In April 1991, as required by FIRREA and the Omnibus Budget Reconciliation Act of 1990[2], the Treasury followed up with a further report on the GSEs.[3] The *1991 Report* reiterated statements of concern about the Government's risk exposure to the GSEs. At the Treasury's request, as part of the *1991 Report*, Standard and Poors (S&P) assessed the likelihood that a GSE would be able to meet its future obligations *from its own resources* and expressed that likelihood as a traditional credit rating. S&P gave a triple-A credit rating to Sallie Mae. Connie Lee had obtained a triple-A credit rating from S&P previously, and in March 1990, S&P indicated to the

[1] *Report of the Secretary of the Treasury on Government-sponsored Enterprises*, May 1990, page 1. This *1990 Report* was required under section 1404 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) (P.L. 101-73).

[2] Public Law 101-508, section 13501.

[3] *Report of the Secretary of the Treasury on Government-sponsored Enterprises*, April 1991, or the *1991 Report*.

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Treasury that Connie Lee's status as a GSE was not a factor in granting the triple-A rating to Connie Lee as a bond reinsurer.

In 1992, legislation was enacted to provide for Federal financial safety and soundness oversight of the housing-related GSEs—the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation—and Sallie Mae to mitigate the perception of implicit risks to the Government. Federal oversight of the Farm Credit System had been tightened earlier as a result of problems that arose and required Federal assistance in the mid-1980s.

As a general principle, we believe that the Government and the GSEs would benefit from removal of the Government ties because privatizing the GSEs would:

—Reduce the amount of GSE debt, over time, that carries some perception of U.S. Government support;

—Demonstrate our commitment to moving from creating effective public-private partnerships to then enabling complete privatization when Government support for an activity is no longer needed;

—Show the financial markets that the Government respects the interests of private bond- and shareholders; and

—Support Federal efforts to create new GSEs in the future, when appropriate, by demonstrating that the Federal relationship can be severed when the time is right. A business operation that starts as a GSE with a limited charter can be freed to operate in other markets once it has fulfilled the purpose for which it was created.

Sallie Mae

Under a statute enacted in 1992,[4] the Treasury has a special relationship with Sallie Mae as its financial safety and soundness regulator. We have reviewed Sallie Mae's financial condition and can see their successes to date and challenges for the future. Sallie Mae increased its use of leverage and its balance sheet grew rapidly in the 1980s, when it expanded market share in response to opportunities arising from amendments to its charter. Sallie Mae benefited from relatively low-cost GSE funding through the early 1990s. The company's earnings record was especially strong in 1992, 1993, and early 1994, when market interest rates were bow and Sallie Mae was able to capture windfall profits as a result of a floor on the interest rate on most of its student loan assets. Since then, however, return on assets and net interest margin have been negatively impacted by a rise in market rates of interest and shifts toward lower yielding assets.

The financial environment for Sallie Mae has changed since enactment of the Student Loan Reform Act of 1993[5], which amended the Higher Education Act to reduce the returns on all guaranteed student loans and to impose a 30 basis point fee on all guaranteed student loans purchased by Sallie Mae after August 10, 1993. Even more significantly, the Act also established the Federal Direct Student Loan Program (now the William D. Ford Federal Direct Loan Program), under which loan capital is provided directly to student and parent borrowers by the Federal Government rather than through private lenders.

The Student Loan Reform Act authorizes the Department of Education to fund as direct loans up to 60 percent of the total of new guaranteed and direct loan volume combined in the 1998 academic year. The Act further provides that the proportion of direct loans may rise above 60 percent, if the Secretary of Education "determines that a higher percentage is warranted by the number of institutions of higher education that desire to participate in the program . . . and that meet the eligibility requirements for such participation."[6]

The Direct Student Loan Program is one of the President's top priorities. The Administration, in the Budget for FY 1996, proposed implementation of 100 percent direct lending (new loan volume) in 1997. Consistent with the implementation of direct lending under current law, the Administration has been studying options for the future of Sallie Mae, including in particular, restructuring the company into a fully private company. As noted above, privatizing Sallie Mae would significantly benefit the U.S. Government. In addition, removing Federal ties would mean that the restrictions on Sallie Mae's business operations under its current charter would cease to exist and that Sallie Mae could engage in profit-making activities that it cannot enter into as a GSE.

In any restructuring, currently outstanding Sallie Mae debt would retain the characteristics of GSE debt, and customers with pre-existing commitments with the

[4] P.L. 102–325, enacted on July 23, 1992, added subsection 439(r) to the Sallie Mae charter in the Higher Education Act of 1965 (20 U.S.C. 1087-2(r)), providing a capital standard for Sallie Mae and for Treasury financial safety and soundness oversight.

[5] P.L. 103–66. Subtitle A of the Omnibus Budget Reconciliation Act of 1993.

[6] Subsection 453(a) of the HEA of 1965, as amended (20 U.S.C. 1087c(a)).

GSE would not be affected. Any new debt issued by a private company successor to Sallie Mae would not possess the characteristics of GSE debt.

The Administration believes that the benefits to be gained by the Government and Sallie Mae from privatization, in the context of continued expansion of the Direct Student Loan Program, are such that Congress should favorably consider legislation to authorize Sallie Mae's management to form a fully private company and to wind down the GSE during a transition period.

In this connection, we have been working with the Department of Education, the Office of Management and Budget, the Domestic Policy Council, the National Economic Council, Sallie Mae, and Congressional staff to develop legislation to privatize Sallie Mae. Moreover, on May 3, I testified in general support of privatization before two subcommittees of the House.[7]

I am encouraged that the House Committee on Economic and Educational Opportunities voted on June 8 to report a bill that provides for privatizing Sallie Mae. The Administration supports many of the provisions of the reported bill, which we understand may be amended before the bill is sent to the floor. Nonetheless, I also believe there are some differences which should be worked out to the satisfaction of the Administration, Congress, and Sallie Mae.

As I indicated at that time, we are working on an Administration draft bill, which we look forward to sharing with Congress in the near future. The key elements of our privatization proposal are:

—The Sallie Mae Board of Directors would be authorized to carry out a reorganization—which would be voted upon by the holders of Sallie Mae common shares—under which Sallie Mae the GSE would become a wholly-owned subsidiary of an ordinary state-chartered holding company whose other subsidiaries could engage in other businesses;

—If the shareholders choose not to proceed with a reorganization, Sallie Mae would prepare a plan for an orderly termination of the Association that would ensure that the GSE will meet its ongoing capital requirements and have adequate assets to transfer to a trust to ensure payment of outstanding GSE debt obligations.

—After the decision by the shareholders, Sallie Mae would enter a wind down period during which new business activities of the GSE would be restricted and new debt issued by the GSE would be restricted as to purpose and maturity;

—During the wind down, excess capital of the GSE could be transferred to the new private holding company or paid out to shareholders subject to continued compliance with the GSE's statutory capital requirements;

—The GSE would be protected from the financial failure of the holding company or its other subsidiaries in the event of reorganization;

—The GSE would cease to exist at a certain point in time and its remaining assets and liabilities would be liquidated;

—The bill would be deficit-neutral; and

—As a form of "exit fee", to recognize the benefits Sallie Mae has received because of its GSE status, the legislation would enable the United States to participate in the success of the company, for example through the issuance of stock warrants.

The Administration will also propose that certain provisions be included in the privatization bill to facilitate Government oversight of the relationship between the GSE and, if applicable,the new private company during the wind down period. The Administration bill will provide that:

—The reorganization plan and other actions of the GSE during the wind down period be subject to certain reviews by the Departments of Education and Treasury;

—The Government's financial safety and soundness oversight and enforcement authorities over the GSE be enhanced and the minimum capital ratio of the GSE be increased gradually during the wind down period;

—The Secretary of the Treasury be authorized to collect an annual assessment to pay the Treasury's reasonable costs and expenses for carrying out its oversight responsibilities over the GSE during the wind down; and

—The new company and any of its nonGSE subsidiaries be prohibited from using the name Student Loan Marketing Association1 Sallie Mae, or any variation on that name in securities offerings in order to prevent confusion in the financial markets.

Connie Lee

The Administration transmitted legislation in May to convert Connie Lee to a fully private enterprise. Congress structured Connie Lee as a private, for-profit corporation, but provided for a limited infusion of Federal capital in the form of stock

[7] Subcommittee on Postsecondary Education, Training and Lifelong Learning of the Committee on Economic and Educational Opportunities and the Subcommittee on National Economic Growth, Natural Resources and Regulatory Affairs of the Committee on Government Reform and Oversight.

So it has to be done carefully, but we think certainty is important here.

Mr. KORNFELD. All the parties, including the administration, are unanimous in the deliberations, so that by next week, we do feel we can get the bill up before you.

The important point that Darcy makes is a very important point. We feel that it is Congress' decision as to whether a GSE is needed, not the stockholders or Sallie Mae, and therefore, that is the major difference, I believe, in what we are proposing and what the House now has.

Senator JEFFORDS. It is my understanding that the Department of Education was advocating a link between Sallie Mae's privatization and 100 percent direct lending. When did this position change?

Mr. KORNFELD. Well, as we started to think about it, and as we reviewed it more carefully, it became clear to us that we can risk the fact that the marketplace will pick up the gap.

Furthermore, by adding this proviso which is in our bill, that if the access does become a problem, if Congress authorizes the Department of Education to provide funds to the secondary market so that they can buy up the loans where there might not be funds available, we think that would be a better way to accomplish it than maintaining the linkage, and therefore we changed our decision on that aspect.

Senator JEFFORDS. Your goal, however, is still to go to 100 percent direct lending?

Mr. KORNFELD. The goal of this administration is to go to 100 percent direct lending, yes, sir. And obviously, if that occurs, there certainly is not the need for a secondary market.

Senator JEFFORDS. Senator Pell, welcome. I understand you had a previous commitment. Please feel free to make an opening statement if you so desire.

Senator PELL. Thank you very much indeed. I am personally neither opposed to nor in favor of privatization and will look at the matter closely and look forward to reading the testimony today.

I would ask unanimous consent that I be allowed to insert my statement in full in the record.

Senator JEFFORDS. So ordered.

[The prepared statement of Senator Pell follows:]

PREPARED STATEMENT OF SENATOR PELL

Mr. Chairman, I commend you for holding this hearing. The question of privatization for both Sallie Mae and Connie Lee are matters of considerable importance. They should be given serious and careful consideration.

While Sallie Mae, Connie Lee, and the Administration all favor privatization, my own view is that we should not rush a decision. We created these organizations in order to serve a purpose, one to provide support and stability for the Federal loan program and the other to provide financial support for colleges that found it difficult to obtain help from the private sector. The reasons we created them are reasons that must not be forgotten.

With respect to Sallie Mae, it is critical that concerns such as the presence of a lender and guarantor of last resort be addressed in a satisfactory manner. With regard to Connie Lee, we must have some assurance that institutions who need their services and have nowhere else to turn will be served.

I am neither opposed to nor in favor of privatization. I want to look at the matter closely and then try to reach a decision that is truly in the public interest. I look forward to the testimony we will receive and to giving this issue the most thorough and complete consideration we can.

Senator JEFFORDS. Senator Dodd.

Senator DODD. Thank you very much, Mr. Chairman.

I have just a couple of questions, if I may, beginning with you, Mr. Kornfeld, and Ms. Bradbury, please feel free to respond as well if you care to.

Beyond Sallie Mae's role as a national secondary market which remains profitable and which other private interests are involved in, Sallie Mae also has some very special responsibilities in the Guaranteed Student Loan Program, as you pointed out, such as the lender of last resort, which is a very important issue to many of us. I wonder if you might express some views to this committee on how you think that particular function will be protected if this move is adopted?

Mr. KORNFELD. In our proposed legislation, we do propose that Sallie Mae continue that requirement of being a lender of last resort. That is a very important requirement because even in today's marketplace, we have already called on Sallie Mae, and Sallie Mae has been very supportive in serving as a lender of last resort.

The key concern in privatization clearly has to be as long as there is an FFEL program, that we must maintain access, and the lender of last resort becomes a very important part of that program, as well as the proviso that we are suggesting in our legislation, that if the secondary market does not have adequate funds or cannot raise adequate funds to purchase loans from lenders, that the Federal Government will provide the funds to those secondary markets to accomplish that task.

Senator DODD. Ms. Bradbury.

Ms. BRADBURY. I do not think I have anything to add beyond that we view the 8-year time period, together with the continued growth in the Direct Student Loan Program, will provide an adequate transition period. Sallie Mae during those 8 years will still be playing the role they have played for some time now, and in addition, as Leo mentioned, the expansion of the Department of Education's authority to provide moneys directly to other secondary market participants.

Senator DODD. Let me turn to Connie Lee very quickly. Again, as you pointed out, this is an issue that is broadly supported for privatization by the administration and the private sectors.

Two legitimate questions that have been raised deal with the timing of the sale of the stock and the repeal of the statutory restrictions. I am just wondering whether you think there is a reason to look at a way to accomplish the sale of these shares of stock more quickly. Some have expressed some concern about the timing, and I wonder if you might share with us some thoughts on how that might be achieved more quickly.

Ms. BRADBURY. We had proposed that we endeavor to sell the shares in the private markets in a one-year period, which we believe will be adequate. We will certainly endeavor to do it as quickly as possible, but given both the uncertainties about how long it might take to retain a financial advisor through the procurement process and a few other things, we thought that a 12-month period was the most reasonable we could come up with.

At the end of that time period, if we have not been able to satisfactorily sell that stock on the private markets, then we would turn to Connie Lee and negotiate with them to buy out the stock.

Senator DODD. So you are looking at a maximum of 1 year?

Ms. BRADBURY. Yes.

Senator DODD. Thank you, Mr. Chairman.

Senator JEFFORDS. Senator Kennedy.

Senator KENNEDY. Thank you, Mr. Chairman. I apologize to our witnesses for being late.

Let me just pick up on Senator Dodd's question about protecting the students and their interests. Obviously, with privatization, you are going to maximize profits; that is going to be inherent. And the real question is how are we going to get protection for the fees and the loans for students.

Some have suggested, although it is an issue that we have gone around and around on, that prior to the time of the Direct Student Loan Program, that when the interest rates went down, the savings were not always passed on to the students, and the fees were not lowered. This has been debated and discussed at an earlier time, and I am not interested in getting into that so much now, but if you are looking into a purely profit operation, you are talking about having a mechanism so the procedures would still be out there.

But I think the more fundamental issue is how do we know, when you are moving toward privatization and moving toward profits on this thing, that there is going to be someone down there who is going to say, Look, with regard the students, we have a different kind of responsibility. Who is that going to be, and how is that process going to be set up? That is something that I think we would be interested in.

Mr. KORNFELD. Yes, and that is obviously our concern as well, Senator, the danger, or the risk, I should say, of a large segment of the marketplace being removed, which the privatization of Sallie Mae would certainly cause. We must have some kind of insurance that access continues in the FFEL program.

We do feel that the present 90 secondary markets can accommodate the gap. However, to make sure that access is continued to the students and to the institutions in this country, so that loans are provided where necessary, we are proposing in our bill that the Government have the authority to provide Federal funds to the secondary markets, so that the secondary markets, the other companies that would be remaining, including Sallie Mae, could acquire the loans that the lenders want to sell and do not want to service themselves. And as I mentioned before, 70 percent of the loan volume in this country is sold; lenders do not service their own loans. And Sallie Mae acquires 50 percent, so this is a significant volume. As Mr. Hough pointed out, approximately one-third of all the loan volume in this country is purchased by Sallie Mae.

Senator KENNEDY. Well, it is certainly something that we want to look at, because we have a situation where—I might have my own views about the direct loan program, but we made an agreement, and I think myself that we ought to stick with it. If there are going to be changes on one side of the equation, then I think we will have to reconsider it.

But there is no question that there are efforts out there to cap the direct loan program. So that on the one hand, you are capping the direct loan program, and on the other hand, you are going to have a demand for profit within these private agencies, and I think it is fair to ask who is going to be watching how you establish the kind of structure there to make sure that the students and their interests, and fees and loans, will be protected, because we have seen at other times that that has been a serious issue.

I think you have indicated, Mr. Kornfeld, that Sallie Mae should pay an exit fee over and above the amount required for budget neutrality; is that right?

Mr. KORNFELD. Yes, Senator.

Senator KENNEDY. And how should that capability or lack of capability be measured, and how much should that fee be?

Mr. KORNFELD. We are working on it, and in our proposed bill, we will have some proposed suggestions as to how that exit fee should be calculated and determined.

We do feel very strongly, and as I mentioned before, although shareholders and stockholders and the board of directors need to be taken care of, it is of interest that Sallie Mae just saw fit, just a few months ago, to issue a stock buyout which would pay the shareholders of Sallie Mae on the order of magnitude of $1 billion. Well, they are able to do this in large measure because of their GSE status and their notable accomplishments.

We feel that the Government is a major player there and also deserves to be a recipient of some of the rewards and accomplishments that Sallie Mae has been able to achieve over the years.

Senator KENNEDY. Ms. Bradbury.

Ms. BRADBURY. Our legislation would probably be somewhat more general than the bill that was voted out of the House committee last week. We would like to have the opportunity to negotiate either something like stock warrants or some other form of consideration with the association, in part because of the uncertainty surrounding their plans—whether in fact they do vote to reorganize as a private company, or whether they choose instead to liquidate the association in an orderly fashion. So we are less comfortable with having a specified formula in statute that may not reflect the realities of the association in 18 months' time.

Senator KENNEDY. I remember when the direct loan issue was coming up, and Sallie Mae and others said, Look, if you are going to go to direct loans, we are in business, and we ought to be able to be free to try to privatize and move out there and get into some other kinds of things. I think there is a logic to that kind of process.

Now the issue of evaluation between the loan and the direct loan program has been the subject of a good deal of attention. But now, we have the situation where you may move on to privatization and still have a significant amount in terms of guarantees. So I think we have to ensure that in the natural drive toward profits, which is a legitimate, worthwhile and valuable desire, that we retain the protection in terms of that element of the student loan programs so that they are really going to be serviced in the interest of the students so that their interests are protected.

I thank the chair.

Mr. KORNFELD. Senator, if I may comment, I agree with you. Obviously, with the administration's proposal for 100 percent, we certainly do not need secondary markets, we certainly do not need Sallie Mae. We even feel that under present law, there are enough players that the secondary market will play. Obviously, if you start capping it, depending upon where it gets capped,the problem gets exaggerated.

As mentioned previously, there is also an inconsistency in saying that you want competition, but you want a cap. The level playing field, we are addressing; it is overstated. The issues are not nearly as significant as some people make out, and the fact is that whatever we can do to level the playing, we are very happy to do, and we are very happy if 100 percent does not get legislated. We are certainly very happy to compete in the marketplace.

Senator KENNEDY. Thank you, Mr. Chairman.

Senator JEFFORDS. Let me go to Connie Lee for a minute. I am more concerned about making sure there that the present market is being serviced, and I am concerned as to what kind of guarantees will exist and want to hear what you would recommend to ensure that that market is being serviced. It seems to be working well, yet there is huge need for money out there for the infrastructure.

Do you have concerns about privatization with respect to that, and how do you ensure that the market for which they were created is serviced, if not expanded?

Ms. BRADBURY. If I may, Senator, last year, the administration negotiated with both Connie Lee and a number of players in the private markets as well as Members of Congress and their staff on an expansion of Connie Lee's charter. We were not successful in that effort, and it was our view that in order to support the rather narrow market that is mandated for them in their current charter, it is going to become increasingly difficult to do that in a meaningful fashion given the constraints.

So if they are unable to get an expansion of their charter which allows them to have a more balanced portfolio, if I could put it that way, it may just be best to privatize them. They have expressed their own intentions, and I cannot speak for them, but it certainly seems reasonable to us that they would continue to grow in the business they know best; but they probably will over time have a more balanced portfolio. They are regulated by a number of State insurance regulators as well as needing to have their credit reviewed by the rating agencies to make their insurance valuable to the market, and the rating agencies and the insurance regulators are uncomfortable and require much higher capital levels of a firm which only insures certain kinds of institutions. So they will probably be able to expand their service to lower-rated institutions if they are also able to have a somewhat more balanced portfolio.

Senator JEFFORDS. Well, I understand that, but will there be a requirement to do that in your legislation? I mean, if they are making a whole bunch of money on the lower-risk portfolio, what is to presume that they are going to go out of their way to try to service the high-risk market?

Ms. BRADBURY. I think if we together make the decision to privatize Connie Lee, they will be a private company, and at that point, in fact, we cannot require them to do certain things or not do other things. They either are a GSE or they are not.

Senator JEFFORDS. Well, that is what worries me. We created it for the purpose which is working well, but the gal of stockholders, traditionally, is to make more profit, so we decide to privatize them, and then we will have to set up another organization to fill the need which now reemerges because there is more profit. I get concerned when I look at it that way.

Ms. BRADBURY. We would be happy to discuss a variety of options with you; if you and the other members of the committee want to explore that, we are happy to assist you in those efforts.

Senator DODD. Let me just say, Jim, that I agree with your concerns about this, but I think they can be accommodate. Clearly, if we are going to have them serve that higher-risk market, and there is a demand out there, they are going to have to have the needed capital to do it. And striking that balance here is the challenge.

They are clearly not going to be able to serve that higher-risk market and the demand out there under the present circumstances; that much, we do know. The question is now can we reconfigure this in a way that allows for a greater flow of capital to come in, while simultaneously keeping the target that was behind the creation of the legislation in the first place. I do not think that is an impossible hill to climb. I think we can do it. I do not think we have much choice but to try, quite candidly. If I thought there were some other way of doing it, I would be an advocate of it, but I do not know of any other way.

So I think we have got to move in that direction, but it is not just the chairman who has that concern. I have introduced the legislation on behalf of the administration, and I am committed to it, but I think you are going to find a lot of us up here who want to make sure that is the case.

This was the concerned raised, I might point out, historically, when we fought hard to create Connie Lee. There were those out there who said, We see what you are going to do, and almost predicted what would happen down the road in some cases—you get this thing going, and then all of a sudden, you have the advantage of having a Government-created institution that then becomes the competition for those who are out there and do not have that advantage, and in effect, that self-fulfilling prophecy is arriving if we in effect allow it to operate unfettered.

Now, we heard from Mr. Sockwell and others that that is not going to be the case, and we are going to make sure legislatively that that is not the case. I will just say that very bluntly to those out there who may have some notion that they are going to slip one by here and end up having something that, as the chairman has pointed out, just mandates down the road the creation of yet another GSE or something like it to fill the gap of the high-risk institutions. So that is not going to happen.

Mr. KORNFELD. And it clearly is a concern of ours, too, Senator. Connie Lee right now is not really servicing the high-risk market to the degree that it ought to——

Senator JEFFORDS. No; I agree with you.

Mr. Kornfeld. [continuing]. And we think that perhaps, by letting them expand their portfolio, all of us might benefit.

Senator JEFFORDS. Now, it is my understanding that the new budget projections of the President presume 100 percent direct lending.

Mr. KORNFELD. Yes, sir.

Senator JEFFORDS. Thank you.

Senator Gorton.

Senator GORTON. No questions.

Senator JEFFORDS. Senator Simon?

Senator SIMON. Mr. Kornfeld, when we talk about these things, we are talking about two different kinds of options. One is if there should be a cap of 40 percent, then we are facing a very different world. Then I think we have to take another look at the whole question of privatizing. Is that a fair statement?

Mr. KORNFELD. Yes, Senator, I believe it is a fair statement. However, at this point, if direct loans do in fact get capped; if we also have the additional proviso that the Federal Government can provide additional funding into the secondary marketplace, we think we can overcome that problem and still provide the adequate funds so the secondary market will purchase the FFEL loans that are made by the lenders in this country.

Without that proviso, the risk is increased dramatically, and there is a concern.

Senator SIMON. I think there will be a very real concern.

Your suggestion that Sallie Mae privatize or liquidate is a little more stark than what Mr. Hough or the House have suggested. I see that Mr. Hough is still here. If I may, Mr. Chairman——

Senator JEFFORDS. Certainly.

Senator Simon. [continuing]. What is your reaction, Mr. Hough, to this idea of privatize or liquidate?

Mr. HOUGH. It would be unacceptable.

Senator SIMON. I see we are in agreement there.

Mr. KORNFELD. I guess it gets down to, Senator, that we feel very strongly it is Congress' decision as to whether there is a need for GSE—not a board of directors or the shareholders of a company.

Senator SIMON. I understand, but I also think we ought to get their input on this when we weigh it.

Then, a question to both Ms. Bradbury and Mr. Kornfeld. When Congressman Petri first suggested direct lending, and when the Senator from Minnesota and I introduced the legislation, the idea was that the most efficient way of collection would be through the IRS. And I met twice with the IRS Commissioner, and she indicated a willingness and felt they had a capability to do that. That has not moved ahead.

Do either of you have any comment on why this is not moving ahead and where we are on that?

Mr. KORNFELD. This was another division in Treasury, not Darcy's area.

Senator SIMON. OK.

Mr. KORNFELD. There was an extensive study done by Education and Treasury as to the practicality of the IRS getting into the collection business. The report will be forthcoming any day, which is long overdue, which fundamentally indicates that at this point, it does not seem practical and that it should be a future consideration.

IRS is being very supportive and cooperative with us right now. For example, we now do a default matching with IRS which will increase the collections dramatically as far as collecting money. They are providing us not only with the tax refunds which we now obtain if the defaulter has a tax refund, but they are also providing us with names and addresses of defaulters; and again, thanks to Congress, we now have garnishment rights without going through an administrative law judge. We anticipate, at least at this point, that we can significantly increase the default collections and decrease defaults in this country through the cooperation of IRS. So that at this point, we are suggesting that we do not proceed with the IRS collections.

Senator SIMON. Ms. Bradbury.

Ms. BRADBURY. In anticipation of this question, Senator, I was told this morning that in fact the report is in final review in our building, and we hope to have it transmitted very promptly—and we apologize for the delay.

Senator SIMON. Mr. Chairman, once we have that report, we may want to have a hearing on that, too.

Let me just reiterate that I am very sympathetic to privatizing Sallie Mae. I have to say that I am much more cautious about moving ahead on that if we have a cap of 40 percent. If that cap goes on, then I am going to be a very reluctant warrior in terms of approving any privatization of Sallie Mae.

Thank you both very much. Thank you, Mr. Chairman.

Senator JEFFORDS. Thank you, Senator Simon.

Senator Kennedy.

Senator KENNEDY. If I may, I missed the earlier panel, Mr. Chairman. Have you reviewed with Mr. Hough what happens if the shareholders vote against privatization?

Senator JEFFORDS. I do not believe that specific question was asked. I am sure Mr. Hough would be happy to come forward.

Senator KENNEDY. Where does that put this whole issue? I apologize for not being here earlier. Could you please address that?

Mr. HOUGH. Certainly, Senator Kennedy. I have been encouraged to elaborate on my last answer. [Laughter.]

Senator KENNEDY. Have you got the votes? That is the real question I wanted to ask. [Laughter.]

Senator JEFFORDS. I thought you might like to repeat your answer.

Mr. HOUGH. Sir, there is no question that I will be able to get the votes, but the issue is the votes for what. Fundamental to the creation of a Government-sponsored enterprise is the Federal Government's pledge to the investors in that enterprise and the commitment that is set forth at the outset that defines the terms that one is investing in.

Nowhere in the record in 1972 that led to the creation of Sallie Mae were the shareholders ever put on notice that a preemptive act by the Federal Government could cause the liquidation of the franchise; nowhere.

To go forward, to my great surprise and shock, as the U.S. Treasury and OMB have suggested this morning, to preemptively remove from the owners' authority and violate the charter and trust of 1972 and remove their right to determine the outcome of this company, to me is inexplicable. The legislation passed by the House, with bipartisan support, carefully crafted after a year of work with the Secretary of the Treasury, OMB, and the Secretary of Education, provided for an 18-month vote. Over the time, the shareholders would see the merits in privatization and the opportunity and would vote for privatization; and if they did not see the merit, they as owners would restore the company to its Government-sponsored enterprise franchise, and life for this GSE would go along as it does for other Government-sponsored enterprises.

There is merit in the Government-sponsored enterprise model. I believe there is enormous merit. We cannot today, looking forward, decide that there is not some other occasion in which the usefulness of the Government-sponsored enterprise attributes might solve in a very meaningful way, as quickly as in fact we were able to address the liquidity problem of the early seventies, and when that opportunity comes, there has to be a very supportive and pure record of how the Federal Government treated those early investors.

To preempt the investors' right to control the outcome of the corporation would undo what has been very carefully created in this trust that surrounds what one can expect when one makes a decision to invest in any of our very healthy GSEs.

Finally, I would note that on the board of Sallie Mae, there are seven members appointed by the President of the United States; there are seven members appointed by President Clinton. That is a further measure of direction, and I think their voice and this decision on our board's part to pursue privatization is was very clearly heard, and they will have a continuing role.

Foremost among their responsibilities, however, is the fiduciary responsibility to the shareholders. I cannot imagine that in keeping with that fiduciary responsibility, they could sit still to a preemptive act by the Government to rescind this element of the trust.

I apologize for a long answer, Senator.

Senator KENNEDY. No; that is helpful. I am just wondering where the public's interest is served. I mean, are we saying that these decisions in terms of public policy questions are going to be decided only by the stockholders?

Mr. HOUGH. I think the public policy questions have been decided—in essence, this has been the history of the program, sir, and the almost annual now debate with regard to eligibility, borrowing limits, and subsidies of the student loan program.

In contrast to the housing market, the student loan rate of return to the investor is set by your law, so that the privatization of Sallie Mae in no way changes the interest rate to the student or to a family borrowing under the parent loan program. There is no change to the cost to the student, and I would submit there is also no change to the cost to the taxpayer. If anything, as I indicated, we have removed $50 billion of taxpayer liability, and I think we have encouraged a much brighter long-term promise for the corporation going forward.

There is no transfer of incremental cost to the student through this mechanism.

Mr. KORNFELD. Can I say something, Senator?

Senator KENNEDY. Yes.

Senator JEFFORDS. Go ahead.

Mr. KORNFELD. Yes, I would like to add something. As I mentioned before, in my former life having been president of two private, nonGovernment corporations, I am certainly very sensitive to what Mr. Hough is saying, and certainly the shareholders have to be taken care of.

However, I contend that the shareholders of Sallie Mae have been taken care of and that, again, it gets back to the fact that GSE decisions are clearly the Government's. For example, the historic earnings of Sallie Mae have been $3 billion. They have declared dividends and stock buyouts on the order of magnitude of two and one-quarter billion dollars, which is a very significant dividend and buyback policy in the financial marketplace.

So I do not think that pleading poverty of the shareholders is appropriate at this point.

Ms. BRADBURY. If I might add, I think it would be disappointing if we believed we could never create another GSE because once it was created, it could never be ended. Presumably, a GSE is created to fulfill specific purposes. I think Sallie Mae, as we view it, and in fact, as they titled their presentation they made to their investors last year, is "mission accomplished." The liquidity of the student loan market has been established. The private sector, which we hope Sallie Mae joins, has shown a great vibrancy in response to a variety of subsidies which the Federal Government makes available to support that market.

The kinds of advantages that Sallie Mae enjoys which relate to a lower cost of capital, not paying State and local taxes, freedom from registration of securities, and some other things, have helped them to be a leader in developing the student loan market; but with the developments in, for example, securitization which allow large banks to underwrite portfolios of student loans at very low capital levels, it may be that this particular aspect of support for the student loan market is not necessary anymore, and the combination of the continued growth in the direct loan program, as well as the continued 98 percent guarantee on the guaranteed loans, we think should be sufficient to provide a vibrant student loan market.

Senator KENNEDY. Thank you very much.

Senator JEFFORDS. Mr. Hough, did you wish to respond?

Mr. HOUGH. No, I do not have any further comment. I think there is a fundamental view here that we need to address with staff work, that recognizes who owns the company and in a sense the obligation going forward to create a presence of the Federal Government sponsorship that is honored and encourages in the future, because I am sure there will be a future in which people are asked to invest in Government-sponsored enterprises, and the capital to get them started is going to have to come from private sources.

Senator JEFFORDS. Thank you all for very helpful testimony.

The first witness on our third and final panel will be Ms. Barbara Miles, a specialist in financial institutions with the economic division of the Congressional Research Service, Library of Congress, Washington, DC.

Next will be Janet Corcoran, filling in for Ann Stern, who had to leave. She is senior vice president for the Financial Guaranty Insurance company and is here representing the Association of Financial Guaranty Insurors.

And the third and final witness will be Dr. David Mulford, vice president of CS First Boston Corporation in New York, NY.

Ms. Miles, please proceed.

STATEMENTS OF BARBARA MILES, SPECIALIST IN FINANCIAL INSTITUTIONS, ECONOMICS DIVISION, CONGRESSIONAL RESEARCH SERVICE, LIBRARY OF CONGRESS, WASHINGTON, DC; JANET CORCORAN, SENIOR VICE PRESIDENT, FINANCIAL GUARANTY INSURANCE COMPANY, NEW YORK, NY, ON BEHALF OF THE ASSOCIATION OF FINANCIAL GUARANTY INSURORS; AND DAVID C. MULFORD, VICE CHAIRMAN, CS FIRST BOSTON CORPORATION, NEW YORK, NY

Ms. MILES. Mr. Chairman and members of the subcommittee, thank you for inviting me to appear before you today to talk about issues surrounding GSE privatization.

My discussion this morning will be strictly from the point of view of the economics of GSEs and their role in fulfilling public policy, and without any regard to the noneconomic considerations that I know will in fact play a major role in the legislation. Whatever happens in this case, the precedents that we set may affect how GSEs are to be established and used in the future.

There are three basic observations that derive from this perspective. The first is that there is an economic policy logic to moving Sallie Mae out of GSE status; the second, economic efficiency considerations run counter to requiring that Sallie Mae make good the budget impact of charter rescission; and third, should the Government decide to recoup some of the value of its initial sponsorship from Sallie Mae, precedent does exist for using warrants for that purpose.

Government-sponsored enterprises are clearly a hybrid arrangement in our economy. Shareholder-owned and for profit companies, they carry special, federally-granted charters and a variety of legal privileges in order to remedy some identified market failure or market inefficiency. We currently have five major GSEs operating in financial markets in addition to Sallie Mae and Connie Lee.

At some point, a successful GSE will have accomplished the basics of its mission—that is, the assigned market will be operational and, presumably, profitable. Now the economics task turns from making a market to making that same market competitive. Normally, high profitability would signal competitors to enter the market, but in this case, enticing competition requires lessening the

GSE's advantage over would-be competitors, and it could be accomplished by removing some charter privileges, by making some privileges or exemptions more generally available, by imposing a fee on the GSE for its use of its charter, or by some combination of the three. This should ultimately result in a level playing field, at which point there is no longer an advantage to being a GSE, and more to the point, there is no longer much reason to have a GSE.

Thus, charter rescission is the logical outcome to a successful policy.

Sallie Mae's history fits well into this economic progression. At present, Sallie Mae is paying the equivalent of a user fee, and the secondary market appears to be attracting genuinely effective competition, in particular from securitization, which is a very powerful means of achieving capital market integration.

In addition, the Government now is a competitor with direct loans and, being a GSE, is apparently no longer quite so attractive to Sallie Mae. Again more to the point, having a GSE is no longer so important to Federal policy in this area. The economics of a GSE life cycle indicate that the time has indeed come for charter rescission.

The issues surrounding Sallie Mae's exit from GSE status involve the impact on the Federal budget, first of all from loss of the offset fee which is included in the current baseline—for 5 years in the opposite chamber, for 10 years in this chamber. But requiring a budget impact fee from Sallie Mae raises serious issues from the standpoint of GSE policy, and that is true whether the corporation believes it can handle it or not.

The fee provides a powerful disincentive to charter rescission which is precisely the reverse of what a user fee is supposed to bring about. In addition, in this instance, the only reason Sallie Mae is expected to cure the loss to the budget is that they have already been paying a fee recorded in the budget. Under this precedent, none of the other current GSEs would owe anything to the Government for their charters on exit because none has been paying any fee. Yet, arguably, appropriate user fees on the other GSEs would be far larger than Sallie Mae's in their budget impact, and if ultimately such fees are imposed, under this precedent they could present a major setback to exit of those GSEs no matter how ready their markets might be for it.

Sallie Mae is, of course, expected to make good on the offset fees for loans already held or committed to as a GSE, and that is provided for in the House legislation.

The notion of an exit fee apart from the budget offset fee raises the same issue—it presents a barrier to exit. Nonetheless, if the Government indeed has given Sallie Mae a lasting legacy which will translate into profits for a future, nonGSE corporation, it may well be appropriate to go along for the ride and share in that future profitability. This can be achieved through the use of warrants, a device we used, as you have heard, in the case of Chrysler Corporation and also, I believe, Continental Bank. The drawback to using warrants is that the Government is bearing some of the risk of the future company's success and as a result, warrants may be difficult to score for Federal budget purposes.

Finally, I would like to note, based on today's testimony to this point, that this exercise is leading to one rather clear outcome for future deliberations concerning setting up new GSEs, and that is that future charters might do very well to include guidelines for what will happen at each stage in a GSE's development, including their ultimate exit.

I stand ready to answer your questions.

Senator JEFFORDS. Thank you very much.

[The prepared statement of Ms. Miles follows:]

PREPARED STATEMENT OF BARBARA MILES

Mr. Chairman and members of the subcommittee.

Good morning and thank you for inviting me to appear before you to discuss the proposed charter rescission of the Student Loan Marketing Association (Sallie Mae). My discussion will start with the general concept of Government Sponsored Enterprises and then turn to the specific case of Sallie Mae. I will limit my discussion to my area of expertise, which is economic analysis and my statement should not be construed as making policy recommendations. Rather, my comments are based on the insights of economic analysis without regard to the noneconomic considerations which play a major role in legislative decisions. There are three basic observations which derive from this economic perspective.

First, there is an economic policy logic to moving Sallie Mae out of GSE status.

Second, economic efficiency considerations run counter to requiring that Sallie Mae make up the budget impact of charter. rescission.

Third, if the Government wishes to recoup some of the value of its initial sponsorship of Sallie Mae, precedent exists for using warrants for that purpose.

GOVERNMENT-SPONSORED ENTERPRISES

Government sponsored enterprises (GSEs) are a hybrid corporate arrangement in our economy. In general, they are federally chartered, shareholder-owned, for-profit companies which are granted certain legal privileges and exemptions in order to correct a market failure and thereby achieve an allocation of resources which is more advantageous for the economy as a whole. The public policy importance of any GSE's mission, which is usually fairly narrowly defined, and the backing of the Federal charters imply that the Government will not allow them to fail such that investors will lose their money. As a result, the GSEs are able to attract private market capital at costs below that of non-GSEs, thus adding to their ability to remedy their assigned market failure.[1]

At some point, either a GSE is successful in overcoming whatever obstacle existed to market efficiency, or it becomes clear that the intended correction cannot be made in this fashion. In the latter case, if the public purpose is still deemed to be important, it may need to be addressed by direct governmental programs or subsidies: for example, the true nature of the problem may be found to require income or wealth transfers, or surmounting uninsurable risks. If the GSE has accomplished the basics of its mission, however, continued maintenance of the full special charter implies that the Government is granting privileges no longer necessary to the original public purpose. Maintaining full privileges is apt to result in large returns to the GSE shareholders more than continued improvement in the target market. No one should be surprised at this. Indeed, if a GSE earns high returns to investor equity, it is an indication that policy makers were correct in using the mechanism to address the market problem. What is needed at this juncture is competitive participation in the market.

Enticing competitive participation is likely to require that the advantages of the GSE be lessened. To the extent potential competitors cannot match the cost advantages of the GSEs, the Government may also be creating a new market failure—and a return to less than optimal allocation of resources in the economy—in the form of a federally protected monopoly. Lessening GSE advantages can be accom-

[1] The largest GSEs are those operating markets for residential mortgages, the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Home Loan Banks. Other GSEs include The Federal Agricultural Mortgage Corporation (Farmer Mac) and the Farm Credit System for agricultural loans and the College Construction Loan Insurance Association (Connie Lee) for college mortgage financing.

plished by removing some of the charter advantages or by making some of the "breakthrough" privileges or exemptions more generally available.[2] As a practical matter, and to ensure that markets are not disrupted by sudden changes, a commonly suggested change is imposition of a fee on the GSE for use of the charter. When fully in place such a fee should result in a "level playing field" for non-GSE competitors. Ultimately, the GSE could reasonably be expected to want to exchange its charter. With such a passage, the Federal policy may be said to have fully accomplished its task of creating an efficient competitive market. The economic well-being of the Nation should be improved as a result.

THE CASE OF SALLIE MAE

Sallie Mae's history from 1972 into 1995 fits well into the economic progression of a successful GSE policy. Sallie Mae was the first institution to provide significant liquidity to guaranteed student loans through a secondary purchase market and warehousing arrangements. Subsequently, Sallie Mae has become subject to competition from major commercial banks and from certain agencies and non-profit institutions, but remains the dominant force in the market. As of 1993, Sallie Mae held about a third of outstanding student loans, while commercial banks accounted for close to half and State designated agencies the remainder.[3] By all accounts, Sallie Mae was then a successful, safely operated GSE in what had become a mature market for student loans.[4]

In 1994, Sallie Mae entered into a new phase of its GSE existence when it became subject to a GSE-only "offset fee" of 0.30 percent of the outstanding volume of its student loan holdings. Although scored for budget purposes as an offsetting receipt to the loan program, its size and exclusivity make the offset fee in practice a user fee. While such a fee would normally be considered an enticement to private sector competition, and new competition did come from the private sector, the Federal Government also entered the field as direct lender. Consequently, the attractiveness of GSE status and being held captive to a future student loan market which may be characterized by heavy competition for guaranteed loans and for direct loans has diminished. More to the point, the economic rationale for the Federal interest in maintaining a GSE in this market, is gone.

CHARTER RESCISSION ISSUES

The charter rescission plan of H.R. 1720 proposes to transform Sallie Mae into a holding company with a State charter, and two subsidiaries. One subsidiary would be the liquidating GSE and would have responsibility for repaying all indebtedness incurred under GSE status, including the continuing user or offset fee for loans purchased or committed to by the GSE prior to rescission for so long as they remain outstanding. The other subsidiary would be a new, "privatized" Sallie Mae which would undertake all new business and incur all new debt. Because the new subsidiary would not be a GSE, it would not be subject to the user fee. It would, however, be subject to laws from which the GSE is exempt, including State and local income taxes and registration requirements of the SEC, and would not have the other privileges of the GSE charter. The weight of the corporation would shift gradually to the new Sallie Mae and transformation would be completed by the end of 2004. The transformation plan requires agreement by the Federal Government and by a majority of the shareholders of the corporation.

Except for assuring continued payment of the offset fee, there is no particular economic policy reason for segregating the liquidating GSE from the rest of the new Sallie Mae so rigidly as contemplated in the House reported legislation. The Government has made no explicit assurances to creditors of the GSE even though some may believe that was implied. Sallie Mae may well have a business interest in this arrangement, however. The liquidating GSE will continue to have some need to roll over and raise debt, and the proposed arrangement will probably act to hold the costs of financing down even while capital is being gradually withdrawn into the new company.

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[2] Passage of the Secondary Mortgage Market Improvement Act of 1984 and development of shelf registration by the Securities and Exchange Commission are two examples of making advantages enjoyed by Fannie Mae and Freddie Mac generally available to all would-be competitors in the secondary mortgage market.

[3] Sallie Mae's share of loans in repayment was higher—about half. Most of that constituted purchases from banks.

[4] See, for examples, Congressional Budget Office, *Controlling the Risks of Government-Sponsored Enterprises*, April 1991; Department of the Treasury, *Report of the Secretary of the Treasury on Government-Sponsored Enterprises*, May 1990 and April 1991.

EXIT FEE

The argument has also been put forward that, in addition to paying for the presumed budget impact, Sallie Mae should have to pay an exit fee. The basic point already made holds, that such a fee would act as a barrier to exit and thus may be counter-indicated from an economic point of view. Nonetheless, there are two possible rationales for an exit (as opposed to a budget impact) fee.

First, there might be concern that charter conversion would unleash a competitor who could immediately dominate the market. Certainly this could happen and would be a danger especially in cases where GSE status remained in place long beyond the time when the basic mission was accomplished with no user fee ever levied to offset the capital market advantage of the GSE. In such cases, would-be competitors might well perceive the GSEs as barriers to their own entry, even after a charter change, simply because of their long term dominance of the targeted market. An exit fee could take the place of the more traditional antitrust approach of breaking up the monopoly company into smaller parts. This would require some careful calibration so that the fee did not result in a financially weakened corporation which might still be considered "too-big-to-fail" in its market. While Sallie Mae currently does dominate the secondary market for student loans, however, it is not clear that this would necessarily continue, because of the large State agency participation, the apparent increase in commercial banks participating in the market since the advent of Sallie Mae's offset fee, and successful securitization efforts by participants other than Sallie Mae.

The second concern is that the Government has given something of value to shareholders through its GSE charter grant that provides a continuing legacy to a converted corporation and for which the Government should be compensated. This argument also holds that Sallie Mae has been paying the offset fee for too short a time to have made appropriate compensation. Perhaps the largest problem with the exit fee, however, is that, because it was not known that it would be imposed, it has a harsh effect on current shareholders of the corporation who are not necessarily the original shareholders. To the extent Sallie Mae has reaped very high returns and paid them out as dividends to shareholders of record in earlier years,those moneys are simply gone and not available to repay the Government. To the extent large capital gains were made and taken by previous shareholders, those gains are gone and not available for Government "recapture." It also seems that most current shareholders have taken losses since early 1993, thus throwing into doubt the extent to which they have reaped excessive GSE-related returns.

WARRANTS

Regardless of justification, if an exit fee is to be imposed, from an economic perspective, its form and size should presumably not inhibit charter rescission for which there appears to be consensus, nor should it cripple the converted corporation such that it cannot operate effectively. In addition, an exit fee should take into account any need for the converted company to increase its capital base to maintain an acceptable investment grade rating. For Sallie Mae, there is some likelihood that equity capital may have to be doubled to regain market standing once the GSE subsidiary is separated from the ongoing corporation. While its capital base has been acceptable for a GSE, or even for a non-GSE operating mainly in a market for fully guaranteed student loans, as a financial corporation with a broader asset base, it would surely require a larger capital buffer for would-be investors in corporate securities. Commercial banks, for example generally have capital closer to eight percent than Sallie Mae's 2.8 percent, and finance companies tend toward 12 to 15 percent.

With these considerations, it is possible to extract some value from Sallie Mae's charter rescission if the Government is willing to bear some risk about the availability or amount of the fees. In previous cases, where the Government has assisted a corporation, it has occasionally shared in the subsequent corporate success through warrants. Warrants are rights to purchase some number of shares of stock in the corporation in the future at a price which is set when the warrants are issued. If the corporation is successful, its shares will increase in value. The warrant holder can purchase the shares at the earlier price, resell them at the higher market price, and pocket the gain. If, of course, the company does not succeed, share prices might fall and the warrants would be worthless. In this case, if there is in fact a continu-

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were only half of the advantage in capital costs that the two GSEs are generally thought to gain from their charters and still would have required payments from the two of about $700 million a year. The revenue over five years to the budget would have totalled $3.5 billion.

ing legacy of value to Sallie Mae from the GSE charter, it could be expected to be reflected in future share value in the near term.

Warrants were required by the Government in exchange for other assistance in the case of Chrysler Corporation, for example. In that instance, the warrants were equal to about 12 percent of Chrysler stock, about all that could be issued without significantly diluting private shareholders' stake whenever the warrants would be exercised. Very large amounts of warrants outstanding can also depress stock prices and impede a corporation's ability to attract new capital, which was a concern in the Chrysler case. The warrants were issued at a time when Chrysler's stock was trading at under $7 a share, and granted the right to purchase shares at $13. The warrants were time limited and had to be exercised within a 12-year period. Chrysler's subsequent success made it profitable for the warrants to be exercised after about four years. Rather than get the necessary appropriation to actually purchase shares from Chrysler at the warrant price and then resell them, however, the U.S. Treasury sold the warrants themselves to the highest bidder (which was Chrysler). Were warrants to be employed as an appropriate form of exit fee in the case of Sallie Mae, the details as to amount, exercise price, and time limit would be an appropriate subject of negotiation between the Treasury and the corporation.

CONCLUSION

There appear to be no economic reasons to impede Sallie Mae's conversion to non-GSE status, whether or not the future student loan market continues for guaranteed loans. Competition is more likely to be enhanced than harmed, given the recent growth in securitization. And a converted Sallie Mae would no longer present any implied responsibility for its viability to the Government, a benefit to both the Government and the market.

The issues surrounding recapturing something of value for the Government's original sponsorship have been raised late in the life-cycle of this particular GSE so that actions taken need to be carefully calibrated to avoid possible market disruptions or the risk of jeopardizing conversion altogether. In particular, exit fees to meet presumed budget revenues that would not otherwise be owed create incentives that could be perverse in their effects for both the current and any future GSE conversions. Whatever path is followed in this particular case, it will have implications for Federal policy in establishing new GSEs and in maintaining those currently in existence.

EXCERPTS FROM CONGRESSIONAL RESEARCH SERVICE PAPER

ON PRIVATIZATION OF SALLIE MAE

- "It would appear that there is no longer a need for a specialized, federally chartered and privileged corporation for Sallie Mae's assigned purpose."

- "Either payment (for budget neutrality or as an additional exit fee), if required, would constitute a barrier to exit from GSE status for the corporation and could, perversely, result in neither the charter change nor any significant revenues for the Government in the future."

- "The exit fee, which might be indicated if certain circumstances were true, would be most defensible from an economic perspective if in the form of warrants."

- Attempting "to collect the present value of estimated future fees as a price of converting would likely have adverse consequences for future GSE policy. The collection provides a formidable disincentive to exit and, thus, works against the fundamental logic of user fees for GSEs."

- The "incentives generated by requiring Sallie Mae to ensure the budget neutrality of terminating its charter appear perverse."

- "(An exit) fee would act as a barrier to exit and thus may be counter-indicated from an economic point of view."

- "Perhaps the largest problem with the exit fee, however, is that, because it was not known to be imposed, it has a harsh effect on current shareholders of the corporation who are not necessarily the original shareholders. (. . .) Further, most current shareholders have taken losses since early 1993 and many may not really be said to have reaped any great GSE-related returns."

- "The fundamental conclusions of the Sallie Mae charter rescission case are that there appear to be no economic reasons to impede the corporation's conversion to non-GSE status. . . "

- A "converted Sallie Mae would no longer present any implied responsibility for its viability to the Government, a benefit to both the Government and the market."

- Exit fees "to meet presumed budget revenues that would not otherwise be owed create incentives that could be perverse in their effects."

American Banker
May 26, 1995
Sallie Mae

Sallie Mae Shareholders Elect Foes of Privatization

By JOSEPH B. CAHILL
Special to the American Banker

WASHINGTON — In a stinging rebuke to the management of the Student Loan Marketing Association, shareholders elected at least six of the eight insurgent board candidates led by former executive Albert Lord.

"The vote is in, the election is over, and the battle is over," said Mr. Lord, the company's former chief operating officer. "I think the owners of the company have spoken with clarity."

Lawrence Hough, Sallie's president and Mr. Lord's adversary in a long-running struggle over the future of the company, conceded that the dissident slate had gained a beachhead on the 21-member board.

"We do expect the Sallie Mae board to include new faces when all the votes are counted," he said Thursday, noting that the results had not yet been verified.

Mr. Lord has questioned both Mr. Hough's management skills and his plan to shed the government charter that helps the company dominate the secondary market for student loans but keeps it from diversifying.

Mr. Lord predicted that his group will have at least six and possibly seven seats when the final tally is recorded. But even with seven seats, the dissidents will not control the board. Sallie Mae is chartered by the federal government and owned by public shareholders, who elect 14 of the directors. The President appoints the rest.

Still, Mr. Lord's team, which includes other former board members and executives of the company, have the savvy to influence the outcome on many issues and to make life difficult for Mr. Hough, according to individuals familiar with the situation.

The shareholder vote comes as changes in government policies on student lending are squeezing profits at Sallie Mae and casting doubt on growth prospects.

In 1993, Congress imposed a 30-basis-point fee on the company's student loan purchases and introduced a direct government loan program that shrinks the share of the loan market open to the private lenders who sell to Sallie Mae.

Mr. Hough says the solution is to drop the government charter and pursue new businesses. Mr. Lord contends that better management of the loan portfolio would restore profit margins.

Both Mr. Lord and Mr. Hough pledged to put aside their differences and work together to boost the stock price, which has plunged dramatically since the rules of the student loan business changed.

Albert Lord
Former chief operating officer, Sallie Mae

"I'm committed to having a friendly relationship [with the board], and if it takes going to charm school, I'll go to charm school," Mr. Lord said.

At least one analyst was unpressed with the conciliatory tone struck by Mr. Lord and Mr. Hough following the meeting. "Peace broke out between the two factions," said Thomas O'Donnell, an analyst for Smith Barney Inc.

Mr. O'Donnell said Mr Lord's victory will help the stock price, which climbed 25 cents to $46.88.

Mr. Cahill writes for the Medill News Service.

Washington Post
May 22, 1995
Sallie Mae

The Problems of Privatization at Sallie Mae

By Albert B. Crenshaw
Washington Post Staff Writer

From time to time over the years, Congress has enlisted private enterprise to try to solve certain social or economic problems.

It has created special kinds of companies, with special links to the government but owned by private investors who put up the money, to reap the benefits of success and pay the price of failure.

These companies, known as government-sponsored enterprises (GSEs), have generally provided excellent investment returns for their private investor-owners as they have helped pump lower-cost funds into such diverse markets as home buying, agriculture and education.

But now, for the first time, the government and GSE shareholders face these big questions: What becomes of one of these companies if the problem it was meant to solve goes away or if the government's approach to it changes so fundamentally that the enterprise is no longer needed? Further, is there a way to extricate the government from the company that is both fair to the government and fair to the company's shareholders?

Holders of Student Loan Marketing Association (Sallie Mae) stock are about to find out.

They already have taken a hair-curling beating. Since 1993, when the Clinton administration first indicated it intended to have the government take over the student loan market—the company's main business—Sallie Mae's stock has plunged by roughly half, from a high of about $76 in September 1992. The nose dive has cost stockholders $4.4 billion.

"This enormous evaporation of the shareholders' money exceeds by nearly 50 percent all of the earnings that Sallie Mae has reported over the course of its 21-year existence," said Robert E. Torray, who heads Robert E. Torray & Co., an investment management firm in Bethesda that holds about 1.5 million Sallie Mae shares.

Sallie Mae's management, perhaps making virtue of necessity, has embraced privatization. It has opened negotiations with the Treasury and Education departments to surrender its congressional charter so that it can seek new and profitable lines of business.

Sallie Mae chief executive Lawrence A. Hough said there is a range of endeavors that the company could successfully undertake, given its expertise and relationships. Not only could it service loans to students and others, it also could offer educational institutions a way of contracting out many of their financial and student aid operations, he said.

Other areas where highly efficient data-processing is important, such as health care, also offer opportunities, Hough said.

However, the strategy has not made all the stockholders happy. A dissident group led by former Sallie Mae executives has launched a proxy fight to elect to the company's board an eight-member slate pledged to adopt different tactics.

Although they say they are "philosophically committed to privatization . . . we believe the company is not ready yet" for it, said Paul Carey, a business partner of Albert L. Lord, a leader of the dissident group.

The dissidents note that Sallie Mae stock has bounced back to $47.50 recently from $35.37½ on April 10. It closed Friday at $46.

The dissidents complain that the management approach is hasty, will fail to achieve the best value, and doesn't consider shareholder interests enough. The battle comes to a head Thursday at the annual shareholder meeting here.

Whatever the outcome, however, the fundamental questions surrounding the endgame of a government-sponsored enterprise are far from answered. Different political winds are blowing on Capitol Hill from a year ago, and what the government ultimately will need or demand from Sallie Mae remains unclear.

A House committee is at work on a bill that would set the terms for Sallie Mae's privatization, and may vote on it as early as this week.

The Clinton administration wants the company to pay an "exit fee" meant "to recognize the benefits Sallie Mae has received because of its GSE status."

The amount or form of this fee is not yet determined. But Deputy Assistant Treasury Secretary Darcy Bradbury told a House hearing earlier this month the company could be required to issue warrants the government could later convert into stock if the

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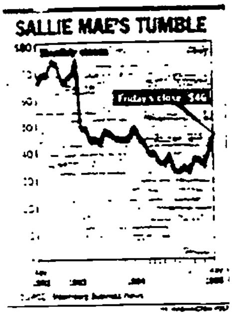

privatized company is successful. This would enable the United States to participate in the success of the privatized company, she said.

At the same time, the Education Department, despite its professed confidence in direct government lending to students, is clearly worried that something might go wrong. It would like to be sure students would still be able to get loans.

In the past, Sallie Mae has been the lender of last resort, and the department wants to make sure it would continue to be available in an emergency, according to Education officials.

In fact, that is what Sallie Mae was created to do—and has done.

When Congress chartered Sallie Mae in 1972, its mission was to create a secondary market for government-guaranteed student loans. The government was anxious to make these loans more available. Banks and other lenders were more willing to make the loans if they knew there was a ready market in case they decided to get the loans off their books.

By most accounts, Sallie Mae carried out its mission admirably. And, as the exploding cost of education drove up the need for student loans, the company and its shareholders have known that wave of handsome profits.

But even as its profits ballooned, problems dogged the government's guaranteed student-loan program. Default rates soared, particularly among students at some for-profit trade schools, costing the government billions. At the same time, the increases in tuition and other costs at colleges provoked complaints from middle-class parents.

Sallie Mae stuck to its knitting, concentrating on running its operations as efficiently as possible and letting the government worry about policy questions.

In early 1993, Sallie Mae officials awoke to find the president of the United States describing their company as part of the problem, not part of the solution. Clinton accused lenders and others of making excessive profits, and called Sallie Mae "the biggest middleman in the whole thing."

Making good on his word, Clinton pressed Congress to allow the government to take over student lending itself. If this were done, or so the theory went, interest payments would go to make new loans instead of to the banks, Sallie Mae and other players in the system, and student loans would be cheaper.

Congress agreed, at least partially. It enacted a law that would have the government take over as much as 60 percent of the student loan market by the 1998-99 academic year. That takeover has begun.

Sallie Mae's Hough insists the company will remain committed to student lending, and will work with the government on new programs, if needed. "It's our business, we have decades of experience," he said.

But he warned the House hearing that if Congress or the administration insists on exit terms that the company's stockholders consider unfair, the stockholders will reject them. The company will not agree, for example, if the exit fee is too high, if the company is forced to make up for the revenue that would be lost from privatization or if there are serious restrictions on the businesses it can get into. Since last year, Sallie Mae has been required to pay the government an "offset fee" of three-tenths of 1 percent on all the loans it purchases—a total of $251 million over five years.

"At the end of the day, our shareholders are going to vote up or down," Hough said. "So, we are on our way. Down, we are back to the drawing boards and confronting some very difficult alternatives to try and make this thing work."

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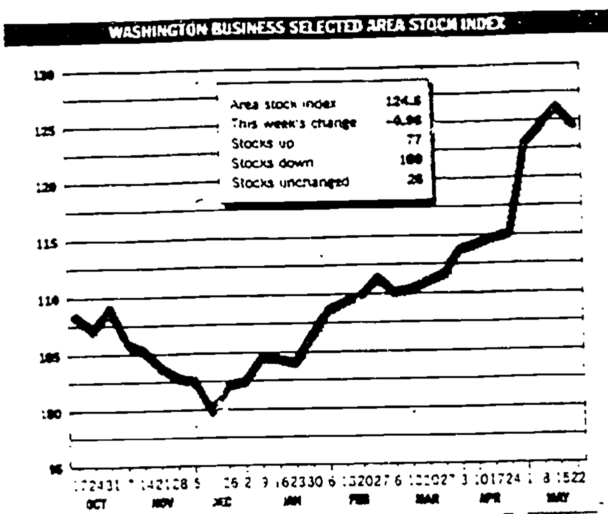


Connie's Prizefight

Congress set up Connie Lee, the College Construction Loan Insurance Association, to help finance campus buildings. But now Connie wants to insure bonds for roads, bridges and other infrastructure projects. Private bond insurers are crying foul.

BY PAUL STAROBIN

Take a ringside seat at a Washington brawl. In one corner: Oliver R. Sockwell, president of the College Construction Loan Insurance Association, a congressionally created, for-profit firm whose cutesy nickname, Connie Lee, belies its fighting spirit. In the other corner: Ann C. Stern, president of the Financial Guaranty Insurance Co. (FGIC), a Wall Street bond insurer owned by a corporate colossus, the General Electric Capital Corp.

The fracas is over Sockwell's bid to expand Connie Lee's legislative charter to permit it to insure bonds to finance not only the construction of educational facilities, as now allowed, but also the building of roads, bridges and many other public works projects.

Sockwell says his plan would cost taxpayers nothing while helping to rebuild America. Stern says it could cost taxpayers plenty and would unfairly take business away from FGIC and other purely private bond insurers. Equally determined to prevail, both combatants are taking their cases to the highest levels of government.

Sockwell has hired a superbly well-connected lobbyist—Betsey Wright, who served for seven years as Bill Clinton's chief of staff in the Arkansas statehouse and recently joined the Wexler Group, a Washington lobbying firm—to lean on the White House to adopt the Connie Lee plan. Wright has made her presence felt. "If we're going to say no, we're going to be saying no to Betsey Wright," a Clinton Administration policy maker said. And Sockwell has friends in high places. He's an old buddy of Commerce Secretary Ronald H. Brown, who has given him tips on peddling the Connie Lee proposal in Washington.

Stern counterpunched by having FGIC's public relations firm, New York City-based Ogilvy, Adams & Rinehart, acquaint journalists with her arguments and Sockwell's every move. Nearly nine months pregnant, she flew down from Wall Street for the sole purpose of briefing a reporter at the PR firm's Washington office.

Stern is no stranger to Washington. She has already met with a bevy of Administration and Capitol Hill decision makers. "If Sen. Moynihan is ready to talk about this, I'll come out of maternity leave," she vowed, referring to Finance Committee chairman Daniel Patrick Moynihan, D-N.Y., her home-state Senator and a key player in the infrastructure financing debate.

This is, in fact, just the latest round of a spat that began in 1986, when Congress passed legislation to create Connie Lee. There are two good reasons why it now deserves attention, apart from its sporting value as a classic example of pugilism, Washington style.

The first has to do with infrastructure financing. In the era of budget deficits, there is not a lot of federal money to spend on public works projects. If Sockwell is talking sense—and some infrastructure analysts and bond-market players say that he is—then the White House should be taking the Connie Lee plan seriously.

"I support Oliver all the way," said Daniel V. Flanagan Jr., a lobbyist who has represented electric utilities and other interests and who chaired the congressionally created Commission to Promote Investment in America's Infrastructure and is a close friend of Moynihan's. In its recent final report, the commission cited Connie Lee's assistance to issuers of higher-education bonds as a model of how the government can spur investment in infrastructure.

The other point of interest is whether government-established firms such as Connie Lee are competing unfairly with private firms. Stern contends that Sockwell's expansion drive is born of a structural defect in Connie Lee's charter. The charter was too narrow, the argument goes, and so Connie Lee must diversify to earn a decent return for its shareholders. But if this is permitted, Stern says, Connie Lee will push private bond insurers out of the market and hold the implicit guarantor, the federal government, liable for any losses.

If Connie Lee is allowed to expand,

they [illegible] until," Stern declared. As evidence, she pointed to the massive growth of the Student Loan Marketing Association (Sallie Mae), the government-created enterprise that competes with financial services firms on some investment products. Stern contends that Connie Lee has an advantage over private insurers because of its government parentage.

Connie Lee has no legal authority to borrow from the Treasury, and market analysts note that Connie Lee-insured bonds tend to trade at lower prices than do bonds insured by major private insurers. Some analysts suggest that private insurers are simply trying to keep competitors out of a business arena in which they reap big profits. Still, Stern's often falls on politically fertile soil in Washington amid widespread concerns that so-called government-sponsored enterprises (GSEs) such as Sallie Mae have gotten out of hand.

Sockwell's proposal is being scrutinized by an interagency group on infrastructure financing set up by the White House's National Economic Council. The group, led by council aide Michael Deich, is trying to answer two basic questions: whether Connie Lee derives a business advantage from its government ties and whether private insurers are failing to meet the demand for insurance on infrastructure bonds.

SQUARING OFF

Nobody could accuse Connie Lee of being a giant today. The Washington-based company is strictly a bantamweight, with about 50 employees and less than a [illegible] per cent share of the bond-insurance market.

FGIC, by comparison, is a colossus. It has a 25 per cent share of the $79 billion annual market in bond insurance. In fact, FGIC and just two other large firms, AMBAC Indemnity Corp. and Municipal Bond Investors Assurance Corp. (MBIA), command 90 per cent of this market. It's this trio of firms that has led the charge against Connie Lee's proposal to expand its charter.

How does bond insurance work? Suppose a city wants to issue a tax-exempt bond to raise funds to build a sewer. Suppose the city doesn't have the best of credit ratings from the Wall Street rating companies, such as Standard & Poor's Corp. (S&P). If that's the case, investors are going to insist on an interest-rate surcharge to compensate for the riskiness of the bond.

Enter the bond insurer. For a premium paid by the city, the insurer will guarantee that investors receive the full value of the bond's promised principal and interest payments. Bond insurance, also called credit enhancement, makes economic sense for the city if the premium amounts to less than the added interest-rate cost of issuing the bond without any insurance.

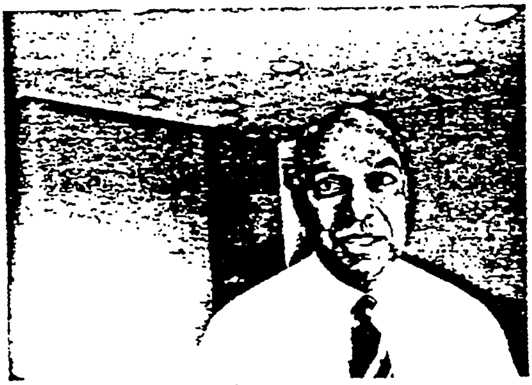
The insurance business boomed in the 1980s as many municipalities experienced financial problems. But there was grumbling that private insurers weren't meeting all the needs of issuers. Higher education institutions, for example, said that private insurers were refusing to insure bonds for projects such as dormitories and teaching hospitals. They took their complaints to Congress, and in 1986 Connie Lee was born.

Sallie Mae and the Education Department provided seed capital of $72 million for the new enterprise; in 1991, Connie Lee raised an additional $65 million from private investors, including several universities. Sallie Mae now owns 36 per cent of Connie Lee's stock, and the department owns 14 per cent; the other 50 per cent is held by the private investors. Sallie Mae appoints three board directors; the Treasury and Education Departments each appoint two.

Connie Lee's longtime champion is Rep. William D. Ford, D-Mich., now chairman of the Education and Labor Committee. "The idea for Connie Lee was Bill Ford's," Sockwell said. "Bill Ford is the mover and shaker in this process."

Also helping to create Connie Lee and boost its growth was the powerhouse Washington law firm of Williams & Jensen, headed by big-gun lobbyist J. D. Williams. The firm, which enjoyed close ties to Ford, had long represented Sallie Mae and acquired Connie Lee as a new client.

FGIC and other bond insurers opposed the creation of Connie Lee from the start, and by lobbying sympathetic Senators put clamps on its operations. The legislative deal cut in 1986 barred Connie Lee from insuring higher-education bonds rated in the top three investment categories. According to the S&P rating system, for example, Connie Lee was restricted to bonds rated BBB or lower; it could not insure bonds in any of the A-rated tiers.



Connie Lee president Oliver R. Sockwell
Is he trying to rebuild America—or shore up a sagging foundation at his own firm?

Last year, the combatants squared off once again. Ford, Sockwell and Williams & Jensen lobbyists tucked a Connie Lee provision into a broad piece of higher-education legislation. The provision would have let Connie Lee write insurance on higher-grade bonds, above the BBB level. No hearings were held; it was quietly adopted by voice vote as part of a committee amendment Ford offered on the House floor.

When FGIC and the other firms discovered the provision after the House vote, they went on the warpath. A nasty fight ensued, with insinuations about Connie Lee's cozy ties with the Williams & Jensen firm, whose ranks include Mary Whalen, Ford's wife. (Whalen, however, was not working on the Connie Lee account, according to Sockwell and Capitol Hill sources.)

Sockwell countered by getting Louis H. Katz, the George Washington University treasurer, to pitch Connie Lee's case to Orrin G. Hatch of Utah, the ranking Republican on the Senate Labor and Human Resources Committee. But the

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House provision was killed back. Connie Lee was allowed to write insurance for bonds above the BBB level—but only if the issuer had been turned down by all other insurers.

RUNNING WITH THE BALL

A new opportunity for Sockwell cropped up when the infrastructure commission chaired by lobbyist Flanagan published its report in February.

The commission's chief task was to create incentives for pension funds—a multimillion-dollar pool of capital—to invest in infrastructure projects. For example, if a developer or a public authority wanted to build a toll road but was having trouble getting financing, the commission suggested, a government-created entity could sell insurance for a bond issue. Fees from the toll road would cover the premiums, as well as repayment on interest and principal. The insurance would make the bonds safe for purchase by conservative pension fund managers and other investors. The commission cited Connie Lee as the model for such an entity, although it didn't recommend that Connie Lee take on the job.

The beauty, its advocates saw it, was that a small down payment—the seed capital for a bond-insurance entity—would free up large volumes of project financing. The plan also seemed to fit with the interests of commission member Ralph L. Stanley, manager of infrastructure development at Bechtel Enterprises Inc. and head of the Urban Mass Transportation Administration under President Reagan. Bechtel, a big builder, is just the sort of company that might be involved in speculative projects that could benefit from bond insurance. Bechtel is now spearheading the formation of a lobbying group, the Infrastructure Alliance, to promote action on the issue. Proponents hope to get a boost from another commission member who was just elected to the Senate—Republican Kay Bailey Hutchison, who was Texas's state treasurer.

Ann C. Stern of Financial Guaranty Insurance Co. She's put her PR apparatus to work against Connie.

Sockwell took the report and ran with it. His pitch: Why create a new bond insurer modeled on Connie Lee when Connie Lee already existed? In a paper that he has circulated around Washington, Sockwell maintained that Connie Lee, starting immediately, could insure $1 billion annually in infrastructure bonds without any additional federal capital "now or ever." Connie Lee has "proven management and staff," he added, and expanding its mission would require only a "minor change to existing legislation."

Wright, who joined the Wexler firm soon after Clinton's election, was retained to help shop the proposal. Sockwell severed Connie Lee's tie with Williams & Jensen. Asked why, he said Connie Lee had inherited Williams & Jensen from the lobbying firm's more prominent client, Sallie Mae, and that it was time for Connie Lee to obtain separate representation.

Why, when there are already well-capitalized private bond insurers, is there a need for a government-created insurer? The short answer, according to advocates, is "market imperfection." According to David W. Seizer, a senior vice president with the Lehman Brothers investment banking firm who was an adviser to the Flanagan commission, private bond insurers generally restrict their guarantees to projects undertaken by issuers with proven track records—a road extension by a state turnpike authority, say.

This means that start-up projects by developers or untested public authorities frequently can't get insurance. "These are the ones that need new sources of credit enhancement," Seizer said. Moreover, even established issuers are sometimes denied insurance for BBB-rated projects because of bond insurers' excessively conservative policies, said Denver-based investment banker Lee White, a municipal bond specialist who regularly deals with bond insurers. White, a former budget director for Colorado's state government, currently works at George K. Baum & Co.

Katz, the George Washington University treasurer, also sees a market gap that Connie Lee could fill. Even though George Washington had a better-than-BBB rating, private bond insurers turned down its appeal for insurance on an $18 million bond issue. "They have their own underwriting criteria that doesn't necessarily meet the needs of the marketplace, and we directly experienced that," Katz said.

But bond insurers say that rejected projects represent poor risks that can't be profitably insured. They also point out that some projects can get off the ground even without bond insurance: the San Joaquin Hills Transportation Corridor Agency in California, for example, recently sold about $1 billion in bonds to finance a toll road without bond insurance. The real problem, the insurers argue, is the increased unwillingness or inability of state and local governments to raise taxes to back bond issues.

BROADENING ITS BASE

In an interview, Sockwell insisted that Connie Lee is seeking to insure only lower-grade infrastructure bonds, not the higher-grade bonds that represent the meat of the private insurers' business.

And what if Connie Lee is not allowed to expand its charter? "We're fine," Sockwell said. "If we did nothing else besides higher-education bond insurance, our investors would be well rewarded." The Education Department's original stock purchase of $19 million in Connie Lee is now worth "significantly more" than that, he said.

But David Levack, an analyst at Fitch Investors Service Inc., a Wall Street rating agency, estimated that the government's $19 million share would fetch no more than $7 million in the open marketplace.

Because Connie Lee stock is not publicly traded, no one really knows its price. But the logic of the bond insurance business suggests that Connie Lee may not be able to achieve a decent rate of profit unless it can broaden its business base. Indeed, Sockwell's recent pavement pounding fits with the picture of a businessman in a bind.

Here's why: Higher-education bonds are riskier than bonds for garden-variety infrastructure projects. Also, it's generally advantageous for an insurance firm to have a diversified portfolio to protect

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against a downturn in any one business area. Because Connie Lee is limited to insurance in one area, and a relatively risky one at that, it is restricted by its Wall Street rating agency, S&P, in the amount of insurance it can safely write. (If Connie Lee ignored the ratings agency, it would lose its AAA rating, and then bond issuers wouldn't want to do any business with it.) This is known as leverage—the amount of insurance that can be written relative to the capital that a firm must keep to maintain its ability to pay off losses.

Leverage is the key to high profits, measured by return on shareholders' equity. Last year Connie Lee had a 50-1 leverage ratio and returned 5 per cent on equity. Much-more-diversified FGIC, on the other hand, had a 165-1 leverage ratio and returned 15 per cent on equity. If Connie Lee was able to diversify into infrastructure, it might increase its leverage ratio and make more profits. And, because of the advantages of diversification, it could write more insurance in the higher-education area than it can now.

Congress, in short, dealt Connie Lee a lousy deck of cards—if the goal was maximizing profits. Although Sockwell won't say that, Connie Lee's friends will. "If they're not able to expand their powers, I don't see them existing for long," George Washington's Katz said.

FGIC and the other private insurers understand Sockwell's predicament—and they have long said that Connie Lee would never be satisfied with its original charter. Sockwell, after all, is a Columbia Business School graduate and former Sallie Mae executive who aims to make money for his shareholders. It's no surprise to the industry that even as FGIC tries to block the infrastructure threat, a new bill offered by Sen. Jeff Bingaman, D-N.M., would expand Connie Lee's charter to let it insure bonds issued by secondary and elementary schools. "The problem is not Oliver—it's in essence the structure," said James E. Mailing, executive vice president of MBIA.

COMPETING WITH CONNIE

But even if the private insurers have correctly identified a structural flaw in Connie Lee's charter, that doesn't necessarily mean that they would face unfair competition from an expanded Connie Lee.

In many respects, Connie Lee is the most "private" of all the GSEs that Congress has created. Unlike Sallie Mae and unlike the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corp. (Freddie Mac), Connie Lee does not have a legally authorized line of credit to the Treasury. The Internal Revenue Service, moreover, has ruled that bonds insured by Connie Lee are not guaranteed by the federal government.

FGIC's argument is that Connie Lee has implied, if not explicit, backing by the federal government. It's not a preposterous argument. Suppose marginal investment-grade bonds insured by Connie Lee went sour. Connie Lee couldn't pay off all the claims and investors who purchased the bonds (undoubtedly including a few grandmothers who would make nice witnesses at a congressional hearing) waited for help from the government. It's reasonable to expect that their case would be strengthened by the fact that Connie Lee owed its existence to Congress. If the federal government wants to spur infrastructure investment, private bond insurers argue, it should do so directly through the appropriations process, and not through the backdoor means of a GSE.

And yet, if Connie Lee enjoyed a competitive advantage, then its insured bonds ought to trade at higher prices than bonds insured by purely private firms. This would be a sign that traders viewed the Connie-insured bonds as less risky. But this apparently isn't the case. FGIC's own corporate brochure says that "on a trading value basis," the seven existing bond insurers fall into two categories, a "first tier" made up of FGIC, MBIA and AMBAC, the market heavyweights, and a second tier made up of Connie Lee and three small private insurers.

Indeed, analysts say, it's the Big Three that actually have a trading advantage, stemming from their name recognition and dominance in the market. Also, Connie Lee may be hampered because it has an AAA rating from only one rating house—S&P—while each Big Three firm has an AAA-equivalent rating from at least two rating houses.

"I don't think there is an implied federal guarantee at all," investment banker White said of Connie Lee-insured bonds. Because Connie Lee is so small, its insured bonds trade "at lower prices" than Big Three-insured bonds, S&P ratings analyst G. Kris Rao said. And, Rao added, Connie Lee's AAA rating from S&P was not awarded on the basis of implied federal backing.

So what are the Big Three so worried about? "Another entrant in the business means more competition, and sometimes more competition means greater pressure on pricing—and greater pressure on pricing helps the consumer and hurts the insurance company," said Robert Meyer, a Wall Street insurance broker who formerly headed a bond insurance firm.

"These folks want no competition," Sockwell said of the Big Three. "It is pure market power and preservation of their dominance."

Nonsense, FGIC executives say. Their nightmare goes likes this: First Connie Lee gets an expanded charter, then it goes to Wall Street and gets an AAA-equivalent rating from another rating house. "You look at the history of GSEs," Richard A. Price, an FGIC managing director, said. "They can start out small and become very powerful. I think it would be a shame if a GSE in our sector pushed out a private bond insurance company." ■

Betsey Wright of the Wexler Group
A former chief of staff to Bill Clinton, she's now on Connie Lee's lobbying team.

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Senator JEFFORDS. Ms. Corcoran, please proceed.

Ms. CORCORAN. Senator Jeffords, ladies and gentlemen, my name is Janet Corcoran, and I am director of public policy and legislative affairs of Financial Guaranty Insurance Company, one of the Nation's leading insurers of bonds issued by State and local governments and agencies to finance investments in public facilities. I will be speaking today on behalf of the Subcommittee on Government-Sponsored Enterprises of the Federal Legislative Affairs Committee of the Association of Financial Guaranty Insurors, or AFGI.

I should point out that Connie Lee is a member of the association, but is not a member of the particular subcommittee on whose behalf I am speaking.

The association's nine members are U.S.-based companies that insure or reinsure municipal bonds, as well as asset-backed and mortgage-backed securities. All of AGFI's members are State-chartered and regulated, and all have claims-paying ability that is rated AAA by one or more of the major rating agencies.

On behalf of AFGI's members, I would like to thank you for inviting us here today to discuss the proposed privatization of Sallie Mae and Connie Lee. My remarks will focus primarily on Connie Lee, but some of the issues I will be raising are relevant to Sallie Mae as well, and indeed to the privatization of any Government-sponsored enterprise.

Let me begin by stating clearly that the Association of Financial Guaranty Insurors strongly supports the concept of fully-privatizing the College Construction Loan Insurance Association, or Connie Lee. We believe that the privatization proposal now before Congress implicitly recognizes the validity of a position to which AFGI has long adhered—that the private market for bond insurance now works efficiently and effectively, to the benefit of both issuers and investors, and that there is no need for Federal Government involvement, either direct or indirect, in the provision of this service. In the 20-year history of our industry, no investor has ever failed to receive timely payment on a bond insured by an AFGI member.

Indeed, Oliver Sockwell, a fellow AFGI member and president and chief executive officer of Connie Lee, recently testified that as a fully-privatized company, Connie Lee will be able to respond much more quickly and effectively to the rapidly evolving need of municipal issuers. And I would like to add that as a private company, Connie Lee will be able to service customers more effectively, even as the implicit taxpayer liability created by its relationship with the Federal Government is eliminated.

Since a fully-privatized Connie Lee will be free to compete with other AFGI members over a much wider range of markets than it does now, some might wonder why we are so firmly in favor of privatization. The answer is that we have never been afraid to compete. Vigorous competition is one of the great strengths of our industry, so we have no hesitation about inviting Connie Lee to compete with us over a wider range of business.

At the same time, the highly competitive nature of our industry, as well as current market conditions, must be taken into account in structuring Connie Lee's transition to a fully-privatized company. The bill's provisions relating to the sale of the Department of Education's shares of Connie Lee's stock must be flexible enough to permit the Federal Government to maximize its return, while at the same time specific enough to assure that the privatization can be accomplished.

While our subcommittee strongly supports privatization of Connie Lee, we do have some concerns about the timing and transition requirements as set forth in Senate 941. We are particularly concerned that while the bill would give the administration 1 year from the date of enactment to complete the sale of the Department of Education's shares, it would eliminate immediately the restrictions Congress had previously imposed on Connie Lee's business operations. Our subcommittee urges that the language contained in the Senate bill be revised to provide that these restrictions be removed only upon completion of the sale of the Department's shares.

From our viewpoint, there are both reasons of principle and pragmatic ones for requiring that these two changes occur simultaneously. First, as presently structured, there is a real risk that the full privatization of Connie Lee might not be accomplished. In lifting the restrictions previously imposed on the lines of business in which Connie Lee can engage, Congress will be allowing it to compete fully in a market whose historically high barriers to entry have only grown higher; record low premiums and struggles to maintain profitability have become dominant features of our business.

It is in the face of these market realities that the Treasury Department would have up to 1 year in which to dispose of the Department of Education's shares. But what absolute assurances can be given that the sale can be accomplished in this time period? By having allowed the charter restrictions to be lifted prior to having structured the terms of the sale, the Treasury Department will have given away, up front, a major bargaining point with the likely ultimate purchaser of the shares, Connie Lee itself.

Second, it simply does not make sense to begin the process of Federal disengagement by expanding the range of transactions in which Connie Lee is authorized to engage and for which the Federal Government is implicitly liable. By letting the sale of DOE's shares lag the removal of Connie Lee's charter restrictions by as much as 1 year, Congress would in effect be opening a one-year window in which the taxpayers' implicit liabilities could be increased—an outcome that seems precisely the opposite of what Congress and the administration are seeking to achieve. Ironically, any new business written as a consequence will increase the Federal Government's involvement with Connie Lee because the market will continue to see the Federal Government's implied backing of Connie Lee issues.

Finally, since this legislation will be seen as a precedent for how to privatize other GSEs, we believe that it is essential that the guiding principles be unequivocally clear and consistent; charter restrictions should not be lifted until ties to the Federal Government have been completely severed.

The proposed transition might be of less consequence if there were compelling practical reasons for lifting Connie Lee's charter restrictions immediately, or for letting as much as a year lapse before the Government's shares are sold. But there are not. Even under the most optimistic scenario, Connie Lee will need several months to gear up for entry into new market segments, and it should be possible to complete the sale of the Department's shares in less than a year. We strongly urge, therefore, that the bill be revised so that the restrictions on Connie Lee's activities remain in place until its ties to the Federal Government are completely severed.

Our subcommittee believes that S. 941 can be improved in other ways as well. AFGI recommends that the language of S. 941 be revised to preclude the sale or issuance to any other Government agency or Government-sponsored enterprise of any Connie Lee shares, including those now held by the Department of Education and Sallie Mae. This will ensure that the sale results in full privatization and not simply replacement of DOE or Sallie Mae by another Government-related entity.

In addition, we recommend that during some appropriate period following the sale of the Government's shares, Connie Lee be required to prominently display in any marketing materials distributed to potential customers or investors a statement that the company is not in any way connected to the Federal Government, and that the Federal Government does not stand behind the company's obligations. At a minimum, we believe that the language requiring clear disclosure of the fact that Sallie Mae is no longer supported by the Federal Government, which was inserted in H.R. 1617 at the recommendation of Representative Reed, should be applied to Connie Lee as well.

Let me conclude by briefly summarizing our subcommittee's position on the proposed privatization legislation.

We strongly support full privatization of Connie Lee.

We believe, however, that letting sale of the Government's shares lag the removal of Connie Lee's charter restrictions by as much as 1 year could jeopardize the efficient, timely transition of Connie Lee to a fully-privatized status, reduces the Treasury Department's bargaining position, and runs the risk of increasing the Federal Government's implicit liabilities precisely when Congress and the administration are seeking their reduction.

We therefore recommend that Senate 941 be revised to provide that Connie Lee's charter restrictions will be removed only when the sale of DOE's shares is completed.

We further recommend that the Senate's bill preclude the sale or issuance of Connie Lee shares to any Government agency or GSE, and that it require full and effective disclosure of the fact that Connie Lee is not in any way connected to the Federal Government.

On behalf of AFGI's Subcommittee on Government-Sponsored Enterprises, I would like once again to thank you for giving me the opportunity to speak today.

Senator JEFFORDS. Thank you, Ms. Corcoran.

[The prepared statement of Ms. Ann Stern follows:]

STATEMENT OF ANN C. STERN
CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER
FINANCIAL GUARANTY INSURANCE COMPANY

CHAIR, SUBCOMMITTEE ON GOVERNMENT-SPONSORED ENTERPRISES
OF THE FEDERAL LEGISLATIVE AFFAIRS COMMITTEE
ASSOCIATION OF FINANCIAL GUARANTY INSURORS

BEFORE THE SENATE COMMITTEE ON LABOR AND HUMAN RESOURCES
SUBCOMMITTEE ON EDUCATION, ARTS AND HUMANITIES

Senator Jeffords, members of the Subcommittee, ladies and gentlemen: I am Ann C. Stern, Chairman, President and Chief Executive Officer of Financial Guaranty Insurance Company -- one of the nation's leading insurers of bonds issued by state and local governments and agencies to finance investments in public facilities.

I will be speaking today on behalf of the Subcommittee on Government Sponsored Enterprises of the Federal Legislative Affairs Committee of the Association of Financial Guaranty Insurors, or AFGI. The Association's nine members are U.S.-based companies that insure or reinsure municipal bonds, as well as asset-backed and mortgage-backed securities. All of AFGI's members are state-chartered and regulated -- and all have claims-paying ability that is rated Triple-A by one or more of the major rating agencies.

On behalf of AFGI's members, I'd like to thank you for inviting me here today to discuss the proposed privatization of Sallie Mae and Connie Lee. My remarks will focus primarily on Connie Lee; but some of the issues I will be raising are relevant to Sallie Mae as well, and indeed to the privatization of any government-sponsored enterprise.

AFGI Supports Privatization of Connie Lee

Let me begin by stating clearly that the Association of Financial Guaranty Insurors strongly supports the concept of fully privatizing the College Construction Loan Insurance Association, or Connie Lee. We believe that the privatization proposal now before Congress implicitly recognizes the validity of a position to which AFGI has long adhered -- that the private market for bond insurance now works efficiently and effectively, to the benefit of both issuers and investors, and that there is no need for federal government involvement, either direct or indirect, in the provision of this service.

Since the early 1980's, private financial guaranty companies have insured a steadily growing share of outstanding municipal debt. But even as the size of the insured bond market has increased -- and as the challenges facing municipal issuers have become far more complex -- the real cost of bond insurance, expressed as a percentage of the value of the bonds insured, has declined dramatically.

At the same time, the protection offered to investors has proven to be ironclad. In the twenty-year history of our industry, no investor has ever failed to receive timely payment on a bond insured by an AFGI member.

Indeed, my colleague (and fellow AFGI member) Oliver Sockwell, President and Chief Executive Officer of Connie Lee, recently testified that as a fully-privatized company Connie Lee will be able to respond much more quickly and effectively to the rapidly-evolving needs of municipal issuers. And, I would add, as a private company Connie Lee will be able to serve its customers more effectively, even as the implicit taxpayer liability created by its relationship with the federal government is eliminated.

Since a fully-privatized Connie Lee will be free to compete with other AFGI members over a much wider range of markets than it does now, some might wonder why we are so firmly in favor of privatization. The answer is that we have never been afraid to compete. Vigorous competition is one of the great strengths of our industry. It has forced all of us to stay lean, to be responsive to our customers' needs, and to find new ways to serve them better. So we have no hesitation about inviting Connie Lee to compete with us over a wider range of business.

At the same time, the highly competitive nature of our industry as well as current market conditions must be taken into account in structuring Connie Lee's transition to a fully-privatized company. The bill's provisions relating to the sale of the Department of Education's shares of Connie Lee's stock must be flexible enough to permit the federal government to maximize its return while at the same time specific enough to assure that the privatization can be accomplished.

Connie Lee's Charter Restrictions Should Be Lifted Only When the Sale of the Government's Stock is Completed

While our Subcommittee strongly supports privatization of Connie Lee, we have some concerns about the timing and transition requirements as set forth in Senate 941. We are particularly concerned that while the bill would give the Administration one year from the date of enactment to complete the sale of the Department of Education's shares, it would eliminate immediately the restrictions Congress had previously imposed on Connie Lee's business operations. Our Subcommittee urges that the language contained in the Senate bill be revised to provide that these restrictions be removed only upon completion of the sale of the Department's shares.

From our viewpoint, there are both reasons of principle and pragmatic reasons for requiring that these two changes occur simultaneously. First, as presently structured, there is a real risk that the full privatization of Connie Lee might not be accomplished. In lifting the restrictions previously imposed on the lines of business in which Connie Lee can engage, Congress will be allowing it to compete fully in a market whose historically high barriers to entry have only grown higher, record low premiums and struggles to maintaining profitability have become dominant features of our business.

It is in the face of these market realities that the Treasury Department would have up to one year in which to dispose of the Department of Education's shares. But what absolute assurances can be given that the sale can be accomplished in that time period? By having already allowed the charter restrictions to be lifted prior to having structured the terms of the sale, the Treasury Department will have given away, up front, a major bargaining point with the likely ultimate purchaser of the shares: Connie Lee itself.

Second, it simply does not make sense to begin the process of federal disengagement by expanding the range of transactions in which Connie Lee is authorized to engage, and for which the federal government is implicitly liable. By letting the sale of

DOE's shares lag the removal of Connie Lee's charter restrictions by as much as a year, Congress would in effect be opening a one-year window in which the taxpayers' implicit liabilities could be increased -- an outcome that seems precisely the opposite of what Congress and the Administration are seeking to achieve. Ironically, any new business written as a consequence will increase the federal government's involvement with Connie Lee because the market will continue to see the federal government's implied backing of Connie Lee issues.

Finally, since this legislation will be seen as a precedent for how to privatize other GSEs, we believe it is essential that the guiding principles be unequivocally clear and consistent; charter restrictions should not be lifted until ties to the federal government have been completely severed.

The proposed transition might be of less consequence if there were compelling practical reasons for lifting Connie Lee's charter restrictions immediately, or for letting as much as a year lapse before the government's shares are sold. But there are not. Even under the most optimistic scenario, Connie Lee will need several months to gear up for entry into new market segments; and it should be possible to complete the sale of the Department's shares in less than a year. We strongly urge, therefore, that the bill be revised so that the restrictions on Connie Lee's activities remain in place until its ties to the federal government are completely severed.

AFGI Subcommittee Recommends Additional Changes in Senate 941

Our Subcommittee believes that Senate 941 can be improved in other ways as well.

We recommend that the language of Senate 941 be revised to preclude the sale or issuance to any other government agency or government-sponsored enterprise of any Connie Lee shares, including those now held by the Department of Education and Sallie

Mae. This will ensure that the sale results in full privatization, and not simply replacement of DOE or Sallie Mae by another government-related entity.

In addition, we recommend that during some appropriate period following the sale of the government's shares, Connie Lee be required to prominently display in any marketing materials distributed to potential customers or investors a statement that the company is not in any way connected to the federal government, and that the federal government does not stand behind the company's obligations. At a minimum, we believe that the language requiring clear disclosure of the fact that Sallie Mae is no longer supported by the federal government -- which was inserted in H.R. 1617 at the recommendation of Representative Reed -- should be applied to Connie Lee as well.

Conclusion

Let me conclude by briefly summarizing our Subcommittee's position on the proposed legislation:

- We strongly support full privatization of Connie Lee.
- We believe, however, that letting sale of the government's share lag the removal of Connie Lee's charter restrictions by as much as a year could jeopardize the efficient, timely transition of Connie Lee to a fully-privatized status, reduces the Treasury Department's bargaining position and runs the risk of increasing the federal government's implicit liabilities precisely when Congress and the Administration are seeking to reduce those liabilities.

- We further believe that such an increase in potential liabilities is not needed to effect the transition to a fully-privatized Connie Lee, and would set the wrong precedent for how to go about privatizing other GSEs.
- We therefore recommend that Senate 941 be revised to provide that Connie Lee's charter restrictions will be removed only when the sale of DOE shares is completed.
- We further recommend that the Senate's bill preclude the sale or issuance of Connie Lee shares to any government agency or GSE; and that it require full and effective disclosure of the fact that Connie Lee is not in any way connected to the federal government.

On behalf of AFGI's Subcommittee on Government-Sponsored Enterprises, I would like once again to thank you for giving me the opportunity to speak with you today.

Senator JEFFORDS. Dr. Mulford.

Mr. MULFORD. Good morning, Mr. Chairman. My name is David C. Mulford, and I am vice chairman of CS First Boston, as well as a member of the company's executive board. Credit Suisse First Boston is specifically recognized as the leading advisor to governments around the world for privatization transactions and also on securitization of assets.

I personally have been in the investment banking business for 30 years. Prior to joining CS First Boston in 1992, I served for 9 years in the Treasury Department, most recently as undersecretary for international affairs. It is a pleasure, Mr. Chairman, to appear once again today before the Senate.

i have been asked by the subcommittee to speak about the privatization of the Student Loan Marketing Association, Sallie Mae, and my remarks will be confined to that topic; and I will make a brief summary of the testimony already submitted, which is more lengthy.

There are two critical questions before the subcommittee today: Is Sallie Mae's contribution to the legitimate and important public policy objectives in education finance contingent on its status as a GSE? Our belief is no. Are there market-based solutions to effect the transition to a privatized status and prudently manage the business as an ongoing concern? Our judgment today is yes.

To support these views, let us examine briefly the distinctive features of GSE status as it pertains to Sallie Mae and assess the impact of the potential surrender on such status.

The primary feature of Sallie Mae's agency status is the pricing of and demand for its debt securities which fund its assets. Unlike the mortgage agencies, Sallie Mae's agency status has no identifiable impact on its assets. There is little doubt that Sallie Mae could raise the debt securities it needs to run its business without agency status.

In the mid-1980's, CS First Boston introduced a new form of financing for issuers with consumer loans on their balance sheet. Receivables held by lending institutions for credit cards, auto loans, home equity loans, boat loans and others, including Federally-guaranteed student loans, can now be financed in a form of financing called securitization.

What does this mean for Sallie Mae? Today, Sallie Mae and other student loan-holders can finance their assets and asset purchases by means of a very significant market which did not exist several years ago. Put another way, given the existence of these markets, were Congress today creating founding legislation for a GSE to support education, it is possible that you would conclude that you do not need to create one.

Since its creation in 1972, Sallie Mae has evolved numerous times in response to market changes. Rechartering or privatization would represent another logical step in that evolution. In this regard, it is worth noting that Sallie Mae has been generally conducting itself as a "privatized" company for many years. This allows one to feel confident that the prospects of prudently managing the company post rechartering are quite high based on the track record of the company and its management.

significant experience in capital raising and investment banking assignments for the various Government-Sponsored Enterprises ("GSEs ") and Federal Agencies. I have been in the investment banking business for 30 years. However, prior to joining CS First Boston, I served for nine years (1984-1992) in the Treasury Department, most recently as Under Secretary for International Affairs. It is a pleasure to appear again before the Senate.

I have been asked by the subcommittee to speak about the privatization of the Student Loan Marketing Association ("Sallie Mae "), and my remarks today will be confined to that topic.

We support the rechartering of Sallie Mae for the following reasons:

- Agency status is no longer required for Sallie Mae to access funds or liquidity.
- It is natural, and good public policy, to allow GSEs to evolve in form and status as they mature financially, and as other market mechanisms develop.
- By virtually all measures, Sallie Mae has operated as a "privatized" company for years.

The rationale for the creation of a GSE is to create a vehicle to access capital to support the primary or secondary markets for important public policy objectives such as education, housing, or agricultural finance. Financial markets have changed dramatically since the founding of Sallie Mae in 1972 and particularly since its initial stock offering to the public in 1983. The fundamentally distinctive nature of a shareholder-owned GSE is much better understood, and appreciated, by the markets today than in the 1970s or 1980s. Equity and debt investors, whose capital investments are the key to the success of these enterprises, are better able to reconcile the sometimes conflicting purposes of GSEs, namely the pursuit of public policy goals and the maximization of shareholder value. One of the principal reasons that the various shareholder-owned GSEs have been able to raise attractively priced capital to support the missions of housing and education is that investors are confident that their interests will be fairly considered in any legislative debate with regard to these enterprises.

The critical questions today are: Is Sallie Mae's contribution to the legitimate and important public policy objectives in education finance contingent on its status as a GSE? Our belief is no. Are there market-based solutions to effect the transition to a privatized status and prudently manage the business as an ongoing concern? The answer today is yes. To support these views, let us examine the distinctive features of GSE status as it pertains to Sallie Mae and measure the impact of the potential surrender of such status.

The primary feature of Sallie Mae's agency status is the pricing of and demand for its debt securities which fund its assets. Unlike the mortgage agencies, Sallie Mae's agency status has no identifiable impact on its assets. Sallie Mae's recent balance sheet reported approximately $50 billion of debt securities against $52 billion of assets. In 1994, issuers borrowed almost $750 billion of debt securities of term beyond one year in the global public markets. Only approximately $150 billion of this worldwide total, or 20 percent, were for the U.S. agencies. Last year alone, therefore, approximately $600 billion of term debt capital was raised by non-agencies (*i.e.*, private companies). Given these figures, there is little doubt that Sallie Mae could raise the debt securities it needs to run its business without agency status.

In the mid-1980s, CS First Boston introduced a new form of financing for issuers with consumer loans on their balance sheet. Receivables held by lending institutions for credit cards, auto loans, home equity loans, boat loans and others, including federally guaranteed student loans, can now be financed in a form of financing called securitization. CS First Boston is recognized as the pioneer and continued leader in the securitization market. Since the mid-1980s we have acted as lead manager for over $100 billion in securitizations in an overall securitization market of approximately $350 billion. In recent years, we have applied that market technology to student loan transactions, including a $1 billion single issue. What does this mean? Sallie Mae (and other student loan holders) can finance their assets and asset purchases by means of a very significant market which did not exist several years ago. Put another way, given the existence of these markets, were Congress today creating founding legislation for a GSE to support education, it is possible that you would conclude that you did not need to create one.

Since its creation in 1972, Sallie Mae has evolved numerous times in response to market changes. Rechartering represents yet another logical step in that evolution. In its early years, Sallie Mae relied strictly upon the Federal Financing Bank ("FFB ") for its funds. In the early 1980s, in response to market opportunities as well as its growing maturity, Sallie Mae "graduated" from the FFB and began borrowing debt directly in the capital markets. Since that time it has borrowed many billions and has become one of the most sophisticated and responsible borrowers in the world.

In 1983, in response to market developments and reflecting its own maturity, Sallie Mae liberalized its share holdings and accessed the broader markets for equity capital. In the 1980s, it accessed for the first time the preferred stock, convertible debt, and equity warrants markets, all of which furthered its mission of supporting education finance. Rechartering, or privatization, would represent another logical step in this evolution. The various markets which would provide necessary capital to fund or provide liquidity for the ongoing operations of Sallie Mae are certainly able to do so today.

It is also worth noting that Sallie Mae has been generally conducting itself as a "privatized" company for many years. This allows one to feel confident that the prospects of prudently managing the company post-rechartering are quite high, based on the track record of the Company and its management.

The Congress has been very successful in creating GSEs to achieve market-based solutions to public policy objectives. The financial community is carefully watching developments at Sallie Mae, and does not believe that the status quo is an acceptable alternative. Confidence in the marketplace is critical to ensure the orderly and consistent flow of funds to issuers. Lack of confidence, as seen most recently in the emerging markets crisis of 1995, can lead to a withdrawal of investor support. If the legitimate interests of investors in Sallie Mae are not reflected in the legislative process, the market will rightfully lessen its confidence in the Federal Government's support for the GSE concept. Such lack of confidence will adversely affect the creation of new GSEs. Investors are watching this process carefully. For example, any proposal to sunset the GSE without shareholder approval would undermine the privatization process and chili the government's future ability to access private capital for public purposes.

In closing, I would like to emphasize a few important caveats which should be kept in mind as you consider legislation to privatize Sallie Mae:

- Clear and consistent statements of policy are necessary to ensure that investors who purchased debt securities which carried agency status are protected in the privatization process; in other words, outstanding GSE debt must be "grandfathered" as Sallie Mae transitions to a fully private company. This is based on the principles of equity and fairness, as well as the practical need for Congress to maintain the confidence of investors in all of its GSEs. The total securities outstanding of the various agencies (FNMA, FHLMC, FFCB, SLMA, TVA, and FHLB) total over $1 trillion, of which there is approximately $48 billion of Sallie Mae debt. We believe anything short of a full and complete "grandfathering" of the debt instruments of Sallie Mae, were Congress to privatize it, would be very damaging.
- Equity holders have suffered a staggering financial burden since early 1993. From January 1993 to today, the Dow Jones Industrial Average ("DJIA") has gone from 3,250 to 4,500, a gain of 38 percent. The equity market value of Sallie Mae was approximately $6.5 billion then, and is now $3.4 billion. Had that original value performed as the DJIA did, it would be worth nearly $9.3 billion. Sallie Mae shareholders could be viewed as having suffered an opportunity loss of over $6 billion since 1993. Any further "costs" in the way of exit or offset fees to be borne by shareholders would be unfair.
- Markets do not like uncertainty and eagerly await definitive resolution of the rechartering of Sallie Mae.

I would like to thank the subcommittee for this opportunity to share my views on this important issue, and would welcome any questions which you might have.

Senator JEFFORDS. Thank you very much, Dr. Mulford. All of the testimony has been very helpful.

Barbara, do you think some kind of Sallie Mae exit fee is justified based on your analysis of the artificially high returns from Sallie Mae's GSE status, especially in response to Dr. Mulford's comments?

Ms. MILES. I am inclined to say no, had we thought about it in advance. This is a problem with a lot of GSE policies; it tends to be made on an ad hoc basis, and this is the first time we have been in this place.

When you see artificially high returns to equity, that is the time to start thinking about a user fee, not only to take away the returns, but also to lift that market so that private competition can respond to those high returns.

In the absence of that, what you end up with is the potential for a kind of monopoly operating in the field, and I would like to indicate that a monopoly is itself a form of market failure. To an economist, that simply means that the marginal conditions are not met—and I could throw out a few other mind-boggling phrases like "predo-optimality," but I will not.

The difficulty is that if you have a GSE that settles in as a monopoly, it can be very difficult to blast them back out, and ultimately, we should hope for a GSE as a transitional kind of organization. We do not really have a made market until we have a competitive market. That is why I made that distinction in my testimony. Once the market problem is overcome by the GSE, you have to recognize that not only has the market been made, but you are very likely now also providing a subsidy to that market. At least some of that subsidy will show up as high profits. That is the point at which something needs to be done about making the market competitive. But after the fact, especially after those profits have been paid out in terms of dividends, after they have been cashed in in stock sales, that money is simply not there to get; it is gone.

At that point, what you have to talk about is the continuing legacy of the Government introduction that was made from setting up the GSE, and I do believe that the smoothest way to bring that kind of thing about is to use some form of stock warrants, which as I said, we have used before. If you try to take a chunk of capital out of the company as a condition of exit, you may be setting up a barrier or hurdle that simply cannot be gotten over, and that would be the concern I would have; it would run counter to what it is you are actually trying to do.

But trying to get in on future profitability, I have no qualms about. We do need to recognize that we are taking a risk any time we do that. That is just the economic theory of it.

Senator JEFFORDS. Explain for me, and perhaps for some of my colleagues who are not here, how a stock warrant works, and how it may be advantageous or disadvantageous.

Ms. MILES. A stock warrant or a stock option is simply a piece of paper that gives the Government, in this case, the right to exercise it to purchase shares of stock in the corporation at some future date, usually within a fairly—well, I was going to say a narrow band, but I believe in the case of Chrysler, the band was 10 years. Whatever the stock is trading for today, normally, the price at which the option would be exercised would be something just above that. A rule-of-thumb that I have heard—and I should leave this to the market-makers to talk about—is something between 5 and 10 percent above that.

At some point, if the company is in fact wildly successful, it should show up in a dramatic increase in their share value; at that point, the Government still has the right to go back and exercise these stock warrants and buy stock in the company at the price that was listed in the warrant. You can then immediately turn around and sell the shares of stock and have an instant profit.

The alternative, of course, is simply to sell the warrants themselves. In the case of Chrysler, Chrysler Corporation, in order to avoid a major dilution of their share value, did in fact buy them back themselves, and the Government did very well. I would assume that that sort of thing is how it would work out here.

Senator JEFFORDS. In the Chrysler case, they bought them back at a profit above the market rate?

Ms. MILES. Yes. In the Chrysler case, the warrants had tremendous value—I do not remember exactly what it was—but the share price at which they could have purchased was well below what the share price was in the market. They simply said, Here are some stock warrants for sale for anybody who wants the right to by Chrysler shares, at I think $7 per share at the time. And in fact Chrysler got out there and bought them quick, so they did not actually have to issue the shares.

Senator JEFFORDS. Any comment?

Mr. MULFORD. No.

Senator JEFFORDS. I am concerned about the privatization of Connie Lee. Janet, I would like to ask you this. If an association such as Connie Lee is no longer needed, doesn't that mean that there is full coverage of the high-risk requests out there in the postsecondary construction loan market?

Ms. CORCORAN. I think our industry certainly feels there is room for additional competition, and that certainly improves the level of service that is available to State and local governments in terms of the diversity of the portfolios which the insurers can have, that overall, Connie Lee's presence in the market I think would be a positive occurrence.

Senator JEFFORDS. Well, do you object to Connie Lee expanding into other markets if there was some protection regarding willingness to accept high-risk loans?

Ms. CORCORAN. No, we do not object. We would, though, point out to the subcommittee that, like its other competitors, the nature of those high-risk sectors that Connie Lee will be able to enter—I think there was an earlier reference to the high-risk transportation-type issues—is all going to be subject to what the rating agency's requirements are, so that market discipline will be present.

Senator JEFFORDS. Does anyone else have any comments they would like to make before I close?

Mr. Mulford.

Mr. MULFORD. I would like to summarize one or two points, Mr. Chairman, after having listened to the discussion this morning, throughout the proceedings.

On the question of the exit fee, I think it is important to bear in mind that the offset fee which is present and which has already been negotiated, as I understand it, in order to solve the budget scoring problem, is something that I think is quite unusual, and I think the Members of Congress and the administration should regard that as unusual and take that as a very positive result for themselves and not go beyond that and seek still more in the way of fees, an exit fee, for example, because I do not think it is justified. The warrants are not a bad idea; if you feel you have to make that kind of a deal, the warrants offer a solution. So if that is the way that comes out, I am sure the markets would accept that.

But I think that to move heavily with some bigger ideas on exit fees would be damaging to market confidence.

Second, I think the discussion that we heard this morning where the administration is proposing that in the event that the package that is finally legislated is voted on by the shareholders, and the shareholders decide, for example, not to accept that package, the idea that there should be a liquidation provision there, presented this morning by the administration, struck me as really rather cavalier, in market terms, because what they seem to be saying is that no matter what is in that package, they think there should be a liquidation provisions. That is like holding a gun to the heads of the shareholders. The shareholders, after all, own the company, and that is a rather important principle in the United States.

So that although one can see that there might be a desire to wind up the company if the shareholders say no, the more traditional approach would be for the shareholders if they say no to sit down and figure out what they do want to do. And among those options might be liquidation, because they might not have a franchise anymore that was worth developing a company around. But I do think it is very important that that rest with the shareholders in our system of economy and markets. So I just wanted to make those points.

Senator JEFFORDS. I appreciate it. I think that is an important discussion, and I am a little confused about it. We, of course, got ourselves into an unusual situation through the budget process by trying to figure out how we could milk a little more money out of Sallie Mae in order to help the budget process, which created an anomaly in the normal process with the GSEs. And now, how do we get out of it without creating reverse problems in the budget?

Mr. MULFORD. Well, I sympathize. I have had a lot of experience with those budget-scoring problems, and they make you do some funny things sometimes. But as I understand it, that is resolved in principle, at least, and the solution has been found with two different proposals in the legislation.

Senator JEFFORDS. Well, I am worried about precedent-setting here, too——

Mr. MULFORD. Yes, I think so, because that could come home to haunt you.

Senator Jeffords. [continuing]. And I think we should declare it as an anomaly rather than leave it sitting there as a precedent, suggesting to other GSE's that they may get tagged if they try to get out of this deal.

Mr. MULFORD. Yes. It makes a strong disincentive. And after all, the original charter of a GSE is that something needs to be done; the Government takes a step in that direction, the private sector takes a step; the mission is accomplished successfully, which in this case, one can certainly say it has been. And it has been, as I said, an evolutionary process. The company has adapted well to the different developments in the market. And I think it might be a good idea to say job well-done and privatize. But I recognize the reality of the budget-scoring problem, and that is a very tough problem to get around.

Senator JEFFORDS. Can you give me an analysis or explain why the price of the stock went down from $6 billion? What happened to create that fall?

Mr. MULFORD. Well, I think it is a combination of things, but I would think it has a lot to do with the fact that the Government decided to enter directly into the student loan business and declared its interest in entirely taking over that business, therefore in effect undermining the franchise of Sallie Mae.

This is a company which has one main business, and if you look at the performance of stock prices for companies that are one-product companies, if something happens where there is a doubt that their product is going to be around anymore, their stock price plunges. So I would say that that decision, and then the uncertainty in the process that has been operating with regard to possible privatization, what the future of the company should be and so on, has not been particularly helpful. And the kinds of discussions that are held this morning, which are very important to get the right legislation, do have some fallout because you get ideas coming out like, if the shareholders say no, we should put a gun to their heads and liquidate their company. That does not do anybody any good in market terms.

So it is the combination of those uncertainties and, I think, the Government's aggressive stance on student loans that has had that effect on the market. And of course, if your money had been elsewhere, I am not saying you would have made the Dow, but you might have done very substantially better.

Senator JEFFORDS. Following up on that, since a substantial secondary market had evolved for guaranteed student loans, that would indicate that guaranteed student loans were very profitable. When direct lending entered as a competing entity, that competition reduced the advantages of the GSEs, and therefore the stocks went down. Is that a fair ananlysis?

Mr. MULFORD. Well, it took a company which had a single-product franchise and presumably, a pretty well-understood margin of profitability and an industry in fact in that area, and if you take it to the logical conclusion, that the Government is going to entirely take over that business franchise in the future, then you are looking at a product and an area of enterprise which is going to shrink, and the margins will be substantially reduced, and uncertainties become paramount—and that affects stock prices.

Senator JEFFORDS. Well, thank you all very much. I appreciate your testimony, and I hope you will be amenable to some additional questions as we go forward on this, especially Barbara, and those others of you whom I know I can get my hands on here in Washington.

Thank you all very much for a very excellent hearing.

[Whereupon, at 12:02, the subcommittee was adjourned.]

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