TICAS

BRIEFING PAPER

THE INSTITUTE FOR COLLEGE ACCESS AND SUCCESS, INC. WWW.TICAS.ORG MAY 26, 2005

HOW NON-PROFIT STUDENT LOAN OFFICIALS GET RICH

Will Californians get shorted on an inside deal?

In California's state capital, there's a tug-of-war going on over a non-profit organization called EDFUND. Created by the California Student Aid Commission (CSAC), EDFUND's 670 employees administer the federal guarantee on student loans made at some California colleges and universities. The federal government pays the agency through fees that are set by Congress. If CSAC does its job more efficiently, it gets to keep some of the federal money. State budget officials like getting that income, and they would like to get more of it.

In April, a performance review of EDFUND revealed a lack of adequate oversight of government assets, poor financial controls, consistent over-budgeting, potential conflicts of interest, and the possible abuse of contracting authority. In reaction, 17 state legislators requested a more detailed audit of EDFUND. [i] CSAC—whose members are appointed by the governor and by legislative leaders—attempted to rein in EDFUND by reconstituting the board. A few weeks later, some legislators sought language in budget legislation that would have made it clear that CSAC is responsible for protecting the public's interest in EDFUND.

Increased public scrutiny and clearer lines of accountability seem appropriate. But two influential lawmakers have asked for a delay of the new audit, and have encouraged CSAC to not make further changes to the board of directors. The legislators expressed concern that organizational changes "could compromise the enterprise value of EDFUND" and disturb "continuing discussions on business diversification which could include one or more partners."[ii]

What does that mean? The term "enterprise value" strongly suggests that someone, somewhere is going to "buy" EDFUND. A sale of EDFUND could work much like the sale of a public building: the state gets the money from the sale, and then pays rent to the new owner. In the case of EDFUND, the state would pay the new owner to perform the state's duties in the federal guaranteed student loan program. If the new owner can run the operation more cheaply, the state can keep more of the money it gets from the federal government for its role in the guarantee process.

Who Benefits from Inside Deals when Non-Profits Convert?

Here are two simplified scenarios of conversions of a hypothetical non-profit entity with a market value of $100 million.

INSIDE DEAL:

- Corporate buyer pays $60 million for public assets worth $100 million.
    - o Buyer pays the facilitator of the deal (e.g., an official at the non-profit) $10 million (not disclosed as part of the deal).
- $50 million (the publicly-declared purchase price) is dedicated to charity (typically by endowing a new foundation).

COMPETITIVE BIDDING:

- Buyer pays $100 million for public assets worth $100 million.
- $100 million is dedicated to charity.

But there is danger in the actual conversion of EDFUND's operations to a for-profit entity. The history of these types of deals does not favor the public. This briefing paper provides some of that history, and makes recommendations for California and for the federal government.

How Non-Profits Convert to For-Profit

Charities do not have shareholders. No one invests in a non-profit organization with the expectation—or even the hope—of a windfall profit. By declaring that they are dedicated to a public purpose, non-profit groups gain valuable tax benefits and other preferential treatment. Individuals, foundations, and government entities give money to the charity, or do business with the organization, with the knowledge that any extra funds—after reasonable salaries and expenses are paid—are dedicated to a public purpose, such as education, health care for the needy, or the performing arts. When donations and operations are exempt from taxation, it means that the government is, indirectly, helping to finance the charity.

It is illegal for executives of nonprofit organizations to take "profits." Any income and assets—including the value of the charity's networks and reputation—are legally dedicated to the public benefit for which the charity was formed.

But sometimes it may make sense to convert a non-profit organization into a for-profit entity. When that happens—such as when health insurance companies like Blue Cross convert to for-profit—the public has to be compensated. Generally, an outside entity buys the non-profit group's assets, and the purchase price goes to a new or existing charity with a similar purpose. Often, the result is a new charitable foundation, like the endowments that came out of the health care conversions, and education foundations that have been created through conversions of non-profit student loan companies.

When all goes well, those foundations continue the charitable causes to which their predecessor organizations were dedicated.

One of the most important issues in a conversion is the question of whether the public is getting a fair deal — whether the selling price reflects the true value of taxpayers' investment in the nonprofit. The who and how of determining that price—the right amount to compensate the public—can be manipulated. If you're an officer of a highly valued non-profit, it's not hard to figure out how to game the system. You may even feel, after putting your own sweat into the enterprise, that you deserve some of the spoils, even if the organization promised that it was dedicated to charity.

"In some cases, insiders (officers, directors, and executives) walked away with millions of community dollars." —*Consumers Union*

Here's what you do to get rich from a non-profit: you work out a deal with a for-profit buyer. You avoid a competitive bidding process, so the state Attorney General, who is responsible for reviewing the transaction, is unable to tell for sure if the price represents the fair market value. After the purchase, you take a position with the for-profit company at a healthy salary increase and with generous stock options. The company's value increases quickly, because it turns out that the market value of the non-profit was actually much higher than the purchase price. After a short time, you leave the company and live off your stock options.

Assessing the value of a nonprofit's assets is best done by the market through competitive bidding.

This raiding of charitable funds happens all too frequently. According to Consumers Union, the publisher of *Consumer Reports* magazine:

> There are many examples of the undervaluation of a non-profit corporation's assets. . . In each of these cases, the nonprofit corporation did not preserve the full fair market value of its assets for nonprofit purposes, but instead used some of the assets to benefit private individuals and investors or support the new for-profit's endeavors. In some cases, insiders (officers, directors, and executives) walked away with millions of community dollars. [iii]

Assessing the value of a nonprofit's assets is best done by the market through open, competitive bidding. An open process, with full public scrutiny, protects the value of assets that belong to the community, and prevents back-room deals that inappropriately enrich employees and board members of organizations that are supposed to be committed to charity.

Conversion of Student Loan Secondary Markets

In banking, a "secondary market" is an entity that purchases loans from banks so that the banks can make new loans. A secondary market can be for-profit (like Sallie Mae) or non-profit (like Nellie Mae prior to its conversion). Non-profits, which are sometimes state government agencies, theoretically offer somewhat lower costs to borrowers, and their earnings are dedicated to a charitable purpose, such as providing opportunity to disadvantaged youth.

Before 1996, it was difficult for non-profit secondary markets to convert to for-profit, because some of their assets and debt instruments could not legally be held by a for-profit entity. Then, late one night in Washington, D.C., at the urging of executives of non-profit student loan charities, a Senator quietly inserted an amendment into a tax bill, opening the door to conversion. According to Consumers Union:

> [L]eaders of the non-profit student loan secondary markets saw conversion to for-profit status as a way to broaden the scope of their business and focus on products and markets that would generate large profits. They would also be able to reap huge windfalls for themselves by taking an ownership interest in the new for-profit business. [iv]

The Attorney General found that charitable assets were being used to benefit the for-profit corporation.

Consumers Union analyzed several conversions of student loan secondary markets and concluded that the public's interest had not been adequately protected in the transactions. For example:

- When Boston-based nonprofit Nellie Mae was purchased by the for-profit Sallie Mae, it generated a "huge windfall" for executives of the former nonprofit. "The windfall came about as a result of generous compensation packages, including stock options that these executives had negotiated for themselves when they became employees of the new for-profit Nellie Mae Corporation. A small handful of executives received $5.7 million in stock options upon the sale to Sallie Mae."

- In Nebraska, a foundation that was created as a result of a conversion was closely affiliated with the resulting for-profit (now known as Nelnet). Prompted by an exposé in the *Omaha World-Herald*, the state Attorney General investigated and found that "charitable assets were being used for the benefit of the for-profit corporation."

Consumers Union found that while some conversions in the health care industry have been fair and honest, "the picture has not been as bright in the student loan industry conversions."

Conversion of Guaranty Agency Operations

In addition to secondary markets, the federal government's guaranteed student loan program recognizes a separate type of nonprofit or government entity known as the "guaranty agency" (see sidebar). These agencies are not lenders—they do not make or purchase student loans in their role as guarantors. Instead, they serve a regulatory function, putting the U.S. Department of Education's seal of approval on a student loan made by a bank, and then policing that guarantee to make sure it is not abused.

The Higher Education Act, which created and governs the guaranty agency role, requires that the entities be nonprofit organizations or state agencies. So completely converting to a for-profit entity is not possible. However, substantial portions of the operation can be converted to for-profit status. The remaining non-profit entity can then contract with its for-profit spinoffs to do its work. Depending on the terms of the conversion and the contracts, the result can be more efficient use of public dollars or a significant loss of public benefits.

In the 1990s, the largest federal guaranty agency, a nonprofit organization called USA Funds (USAF) requested permission from the IRS to create a new nonprofit organization, USA Group. While USA Group was purportedly designed to "support" USAF, creating "operating efficiencies" that would allow USAF managers "to concentrate their energies toward their exempt purposes," the new organization quickly became the umbrella for several nonprofit and at least seven for-profit subsidiaries. Over time, in addition to serving as a guaranty agency, the organization also became the loan collector for bank clients.

"Guaranty Agency"—a Misnomer

When the federal guarantee system was created 40 years ago, the idea was that state agencies and public charities would serve as co-guarantors, shouldering a portion of the default costs, and taking on the front-line responsibility for program oversight. Risk-sharing soon failed, however, when not enough states and nonprofits were willing to take on the risk. That should have taken the entities out of the equation. Instead, Congress kept sweetening the deal.

Eventually, the federal government assumed all of the program costs—but the local agencies remained in place. The agencies now operate like contractors—essentially, they are extensions of the U.S. Department of Education—except there is less accountability. The agencies are not hired or paid through a competitive process, but through a set of complicated formulas set by Congress.

The system is like a roommate who you thought was going to split the rent, but who you end up paying to live with you. Instead of reducing the federal costs as originally intended, guaranty agencies turned out to add yet another layer of subsidies and complexity to the system.

(Since the guaranty agency is responsible for policing the guarantee for federal taxpayers, this creates a conflict of interest. See box).[v]

On December 31, 1999, USA Group—still a nonprofit organization under the law—entered into a "strategic alliance" with Bank One, one of the largest originators of federal student loans. Six months later, USA Group executives agreed to sell the charity's assets—including the Bank One arrangement—for $800 million in cash and stock to Sallie Mae.[vi] The sale was portrayed as a merger, and the Chief Executive Officer of USA Group was offered the position of Chief Operating Officer at the acquiring company, which gave him:

- $4,051,203 in compensation in the first year of a three-year contract;
- Stock options valued at $21,000,000;
- A pension at age 62 of $530,000 a year;

Many predicted that the USA Group executive would not stay at Sallie Mae for long. According to the *Chronicle of Higher Education:*

> Critics of Sallie Mae, including many bankers, scoffed, saying that the loan giant has a history of buying up companies, giving the companies' leaders top executive positions, and then letting them go a year or so later with lucrative compensation packages.

The *Chronicle* pointed to the former Nellie Mae CEO who left Sallie Mae with a "cushy package" less than a year after Sallie gobbled up that nonprofit. Sure enough, the USA Group executive left Sallie Mae after nine months. And it turns out that in addition to the compensation and valuable stock options noted above, his contract also included a promised payment of $5,000,000 if he and the company parted ways during the first year of his employment. [vii]

Did USA Group's executives short the public on the sale of the company? Was the short-term job at Sallie Mae, paying upwards of $3 million a month, a payoff? How much more would have been committed to charitable purposes if the sale had been conducted through an open bidding process? It's impossible to know for sure. But USA Group already had a history of shorting the public. And even though Sallie Mae owned USA Group for only five months in 2000, the company reported that after-tax fee income increased the company's net income by $128 million *primarily because of the USA Group acquisition.* That is quite a hefty short-term return on an investment of $800 million.

Unlike the conversion of the secondary markets, USAF continues to exist as a nonprofit organization, because only nonprofits and state agencies can serve the guaranty agency role. At the same time as the acquisition of USA Group, USAF granted Sallie Mae a five-year renewable contract to carry out the guarantee servicing activities for the nonprofit.[viii] As such, Sallie Mae serves as the federal regulator overseeing most of its government-guaranteed loans.

Guarantors as Loan Collectors:
A Fundamental Conflict of Interest

Guaranty agencies serve a regulatory function, responsible for protecting the interests of federal taxpayers. They police the banks, ensuring that lenders are diligent in collecting loan payments before asking the government to reimburse them for a defaulted loan. Several guaranty agencies have started side businesses working for the banks they are supposed to regulate. Other guaranty agencies contract with lenders like Sallie Mae to perform the agencies' oversight functions. These relationships create a fundamental conflict of interest.

According to the U.S. Government Accountability Office:

> Guaranty agencies have legally extended their activities beyond insuring loans and monitoring lenders to include servicing and purchasing loans. These activities create inherent conflicts of interest because, **by assuming ownership and servicing roles, guaranty agencies are, in effect, responsible for regulating their own rather than lender activity**...[S]uch activities eliminate the independent oversight for which guaranty agencies are responsible and paid. [ix]

According to the U.S. Department of Education's Inspector General:

> **There is an obvious conflict of interest when a guaranty agency reviews the due diligence practices of its affiliated secondary market or loan servicer.** In such cases, the guaranty agency's findings affect its own financial position. The close relationships between the FFELP service providers pose a significant risk that due diligence irregularities could occur and go unreported. [x]

Protecting the California Public

Perhaps the most disturbing finding in the recent performance review of EdFund is the extent to which EdFund officials view the organization—or "the company," as they call it—as belonging to them, rather than to the public. The independent reviewers report EdFund officials treat the organization "as though it were independent and autonomous in its own right." The reviewers say they faced antagonism and intransigence in their efforts to seek even basic information from EdFund's management, and they point out that whatever its managers may believe:

> The reality is that EdFund is not an independent company, but a non-profit auxiliary of a State public sector agency, funded through revenues derived predominantly from its interaction as a State agency with the federal government.

Even in a private company, shareholders have substantial oversight and are provided with detailed financial information. This oversight and transparency is particularly important when a merger or acquisition is under consideration. EdFund's shareholders are California's taxpayers: the public. But EdFund's management "seems resistant" to the idea of public oversight, according to the performance review. [xi]

There are rumored to be at least two corporate suitors ready to make a deal to partner in some way with EdFund. State officials need to realize that any prospective buyer with a chance of striking a deal will prefer that the deal be done behind closed doors. That way, the buyer can try to convince the state that it is getting the best price for the public's asset, even if it is not. The buyer may even promise or hint at rewards that will go to those who are cooperative in making a deal possible.

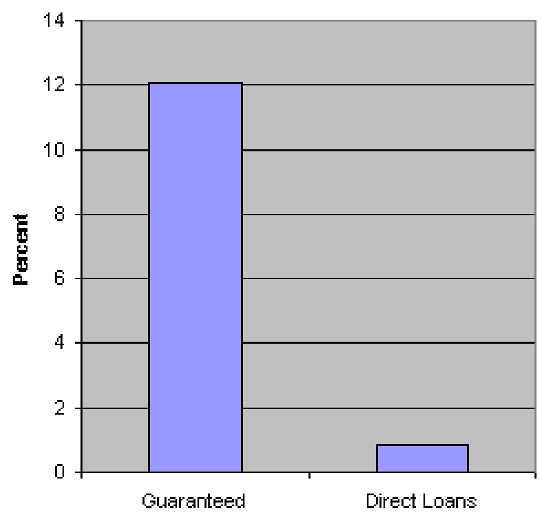
But history suggests that public and non-profit officials do not generally serve the public's best interest when they make these types of decisions behind closed doors. The only way to know for sure if the public gets a fair price for EdFund is through an open, competitive bid process. Any other analysis is just guesswork, and highly vulnerable to manipulation.

"[T]he Federal Government assumes almost all of the risk for the [student] loans, while Federal subsidies to intermediaries—lenders and guaranty agencies—are set high enough to allow the less efficient ones to generate a profit. These problems lead to unnecessary costs for taxpayers and prevent the program from achieving the efficiencies the market is designed to provide."
—President Bush's FY 2006 Budget

Federal Reforms Would Be Even Better for California Taxpayers

Regardless of what happens with EdFund, the conversion issue raises a much larger question. Why is the *State* of California involved in *Federal* student loans in the first place? Other Federal college aid reaches students without the state playing a role.

Taxpayer Subsidy Rates for Federal Student Loans, FY 2004 Actual



Source: Budget of the U.S. Government, FY 2006, Appendix p. 371

The fact is that the State of California—and guaranty agencies in general—are not needed in the federal student loan system. The State values its role *only* because it keeps a small profit off the operation, which it can use to subsidize other state operations. But to produce the state's earnings, it costs Californians as federal taxpayers 10 or 20 times as much. CSAC, EdFund, and the state legislature are not acting irrationally when they seek to expand their role; they are simply blind to the Federal costs.

CSAC expects to net perhaps $30 million on its federal loan operations this year. But California could get hundreds of millions more out of the federal student loan system if Congress *eliminated* the state role, streamlined the loan program, and passed along the federal budget savings. In fact, if all federal loans were financed through the cost-efficient Direct Loan Program, the federal government would have saved enough money on this year's new loans to provide California with $896,268,564.[xii] Compared to the CSAC/EDFUND approach, this alternative system would involve far fewer government employees and greater use of market forces, and would leave more money for states to develop and expand financial aid programs that serve low-income families in their own states.

The current controversy over EDFUND's spending practices and lack of accountability is important to resolve. The best solution is for the federal government to make it all moot. The system that caused it is broken, and taxpayers are paying the price.

i Letter from Assembly Member Wilma Chan, et. al., to the Honorable Nicole Parra, Joint Legislative Audit Committee, April 22, 2005.

ii Letter from Senator Jack Scott and Assemblywoman Carol Liu to the Members of the California Student Aid Commission, May 18, 2005.

iii Consumers Union of U.S., Inc., *Good as Gold: Preserving Community Resources in Nonprofit Conversions, June 2000.* http://www.consumersunion.org/pdf/Gold.pdf

iv ibid.

v Letter to the Commissioner of the Internal Revenue Service from Senator Paul Simon, July 18, 1996.

vi Securities and Exchange Commission, Form 10-K filed by USA Education, Inc. (aka Sallie Mae or SLM Holding Corporation), 2000. The funds were used to start the USA Group Foundation, now known as the Lumina Foundation for Education.

vii "Top Official Steps Down at Sallie Mae," Chronicle of Higher Education, May 25, 2001; "Notice of 2001 Annual Meeting and Proxy Statement," USA Education, Inc. (aka Sallie Mae).

viii Securities and Exchange Commission, Form 10-K filed by USA Education, Inc. (aka Sallie Mae or SLM Holding Corporation), 2000.

ix *Financial Audit: Guaranteed Student Loan Program's Internal Controls and Structure Need Improvement,* GAO, March 1993.

x *ED Should Prohibit Conflicts of Interest Between Guaranty Agencies and Affiliated Organizations,* U.S. Department of Education, Inspector General, Management Improvement Report 93-02, March 1993.

xi *Performance Review of EdFund: An Analysis for the California Student Aid Commission,* Public Works, February 2005.

xii "Corporate Welfare in Disguise," *National Crosstalk,* National Center on Public Policy and Higher Education, Winter 2005. http://www.highereducation.org/crosstalk/ct0105/voices0105-shireman.shtm