South Dakota Legislative Research Council

Issue Memorandum 96-23

FEDERAL STUDENT LOAN PROGRAM: THE RELATIONSHIP BETWEEN THE STATE AND SOUTH DAKOTA LOAN FINANCE CORPORATION

Background

Congress passed the Higher Education Act in 1965 encouraging states to initiate and administer a student loan program. This act allowed states as well as private lenders to provide students loans. However, defaults and inferior services provided by private lenders led Congress to amend the Act in 1976 to mandate that each state establish a program.

Legislation was adopted in 1966 in South Dakota providing for a higher education loan guarantee program. The Board of Regents was designated as the agency with the oversight functions as outlined in SDCL 13-56, and in 1978 these oversight functions were transferred to the Department of Education and Cultural Affairs (DECA) by Senate Bill 177. This bill also granted the Governor the authority to designate an organization to create and administer a student loan program.

The Kneip administration had determined to pass the responsibility of the program to a nonprofit private corporation and established a selection process. Governor Kneip, after reviewing the recommendations of the Guaranteed Student Loan Committee and the Education and Cultural Affairs Planning Commission, notified the U.S. Office of Education of his decision that the South Dakota Education Assistance Corporation (EAC) be granted the right to administer the guaranteed student loan program for South Dakota. The U.S. Office of Education was requested to work with EAC to complete the necessary arrangements and contracts to facilitate Governor Kneip's request. Another major organization known as the United Student Aid Funds of Indianapolis and New York City was also interviewed during this selection process.

On December 13, 1978, Governor Wollman requested the EAC to make the necessary arrangements to provide for a statewide student loan acquisition program through a nonprofit corporation. The EAC immediately established the Student Loan Assistance Corporation, currently known as the Student Loan Finance Corporation (SLFC), as the nonprofit private agency to provide lenders with a secondary market for the student loan program for South Dakota. The Student Loan Finance Corporation was organized under the South Dakota Nonprofit Corporation Act. The corporation was designated pursuant to the provision granting the Governor this authority, and each Governor since then has outlined some minimum parameters for the corporation to follow. Since the designation process was used, there is no record of any contracts between the SLFC corporation and the Board or Regents or the Department of

Education and Cultural Affairs as provided in SDCL 13-56-1.

Governor Janklow ratified the action taken by Governor Wollman and made additional stipulations to the designation granting the authority to the SLFC to administer the student loan guaranty program. The action that could be taken by the state in the event of a default by the SLFC was stipulated in a letter dated June 25, 1979. The SLFC was required to provide copies of its annual audit, itemization of expenses, and a copy of its annual budget to the Governor's Office. The SLFC also agreed to obtain the approval of the Governor when adding or replacing members of the Board of Directors and that the board consists of a minimum of seven directors. However, the stipulation concerning the minimum number of directors was never met.

On May 11, 1987, Governor Mickelson ratified the action taken on December 13, 1978, by Governor Wollman granting the authority to SLFC to act as an eligible lender for the Federally Guaranteed Student Loan Program. This letter stipulated again the action that could be taken by the state in the event of a default by the SLFC. It also required the SLFC to provide copies of its annual audit, itemization of expenses, and a copy of its annual budget to the Governor's Office. It also recognized that the Board of Directors consisted of five individuals and that any replacement or additional members be approved by the Governor.

Relationship of the SLFC and EAC

It is important to understand the SLFC's relationship with the Education Assistance Corporation (EAC) which acts as one of the guarantors of the SLFC bonds. The two corporations perform different functions but share a common purpose of making education loans accessible to South Dakotan students. The SLFC and EAC are private nonprofit corporations organized under South Dakota law. Each corporation has specific goals. One of the SLFC's goals is to generate sufficient revenue under its bonding authority to purchase the loans originated by other private financial institutions. The ability of the SLFC to purchase these loans rests on its bonding capability. One factor that affects the SLFC's bonds is the assurance that the bond holders will be repaid and the purpose of the EAC is to act as the guarantor of the bonds, ensuring that those bond holders will be repaid. While SLFC and EAC may share some common goals and their respective boards consist primarily of the same directors, they are unable to function under one corporation charter because of federal restrictions. Specifically, under the Internal Revenue Code, a corporation cannot be the holder of the notes and also act as the guarantee agency.

The SLFC is considered a tax-exempt organization under Section 501(c)(3) of the Internal Revenue Code. The corporation is organized for the purpose of acquiring student loan notes and provides procedures for the servicing of such loans as acquired for the continued participation in the Federally Insured Guaranteed Student Loan Program under the Higher Education Act of 1965. Any income received may only be used for: (1) the payment of expenses and debt service on bonds or notes, (2) acquisition of student loan notes, and (3) payment to the United States.

Board of Directors

The Board of Directors for SLFC is V. G. Stoia, Chair: A. Norgrin Sanderson, President and Treasurer; Harvey C. Jewett, Secretary; and Manley B. Feinstein. At one time James G. A. Bishop was a member of the Board of Directors. Mr. Stoia has held this position since the formation of the corporation, along with Mr. Sanderson who has served as the Executive Director. The original charter of the Corporation provided that the board of directors consists of three members, Mr. Stoia, Mr. Bishop, and Mr. Feinstein, with a provision that the board could be expanded to seven members.

In 1987 the charter was amended to provide that the board of directors would consist of not fewer than four members, nor more than seven members. The bylaws of the corporation provided that the members of the board may be removed and successors appointed by the Governor in the event that a default occurs under the terms of the corporation's student loan bond issues, otherwise this issue is addressed in the letters from Governors Janklow and Mickelson.

The persons who constitute the Board of Directors for the SLFC also serve as the Board of Directors for the EAC and the Educational Assistance Service Company, Inc. (EASCI), a wholly-owned subsidiary of the EAC. The primary purpose of the EASCI is to provide loan origination, processing, monitoring, and related services for the student loans. The SLFC also leases telephone equipment through Tel Serv in which some of the directors are partners.

U.S. Secretary of Education

The Higher Education Act established a program allowing state agencies or private nonprofit corporations to administer student loan insurance programs. The Secretary of Education has certain oversight powers pertaining to the operations of the SLFC and the guarantee agencies which include the EAC. The Secretary monitors the ability of the guarantee agencies to meet obligations and maintain the guarantee funds at certain levels, as well as satisfying certain standards for its administrative and financial condition. The Secretary of Education has filed letters with the EAC seeking to terminate the agreements with the Secretary of Education and establish preapproval restrictions of the EAC's expenditures. The EAC has appealed these proposed actions and no settlement has been announced. This action against the EAC has not hindered the ability of the SLFC to finance student loans through the proceeds from various bond issues.

Operations of the Corporation

Governor Wollman asked that the EAC pursue the secondary market in December 1978. The first loan was guaranteed on January 17, 1979. The investment banker selected was Smith Barney, Harris Upham & Company with no startup money from the government sources. The first series of bonds was issued in August 1979. The SLFC purchased student loans from various lenders with the proceeds of those bonds. The initial lenders do not like to hold these loans.

Economies of scale that can be realized in servicing and financing these loans favor accumulation by a secondary lender.

The SLFC acquires student loans from the proceeds of its commercial paper note issues and other borrowings. The proceeds are also used to acquire student loans for which the borrower is neither a resident of the state nor attending an eligible school located within the state. The SLFC has operated this secondary market since 1988. However, the majority of its operations are related to South Dakota students.

There are four types of loans available to students through the federal program: Stafford Loans, Unsubsidized Stafford Loans, Plus Loans, and Consolidation Loans. The SLFC has entered into agreements with the U.S. Department of Education providing federal loan insurance and authorization needed to make these programs accessible to South Dakota students and lenders.

The corporation also acts as the servicer of student loans it acquires. SLFC has owned and was servicing student loans to approximately 90,000 borrowers representing approximately $474,000,000 outstanding principal amount of student loans as of October 31, 1995. The corporation has purchased these loans from more than two hundred initial lenders.

Dissolution of the Corporation

If the corporation is dissolved, no individual is entitled to any distribution or division of its property or proceeds and the balance of money and other property after payments of all debts and obligations will be distributed to the United States as required under federal guidelines. Any money or other property not otherwise required to be turned over to the federal government shall be distributed to the State of South Dakota for public purposes according to the Articles of Incorporation. This clause may hold a limited benefit for the state, assuming there is in fact a failure, because there may not be any remaining funds to distribute.

Other Bond Authorities

The other state-authorized bonding authorities have a more direct relationship with the state. The SLFC may not be able to function, however, without the Governor's designation and ability to issue tax-exempt bonds which are subject to the tax-exempt bond cap for the State of South Dakota. Most bond authorities as required in their legislative statutory authority are overseen by the Governor or a board appointed by the Governor. The SLFC is primarily monitored by the U.S. Department of Education and is essentially a quasi-federal institution.

The SLFC during a special Bonding Review Committee meeting at Aberdeen in 1982 stated that they submitted reports to the Governor and would continue to report to the Legislature on a volunteer basis, and that the EAC submitted reports to DECA on an annual basis. However, the Department does not have any current reports or documents from the EAC in their files. The SLFC has continued to attend and report to the Legislative Bonding Committee but has maintained that this is a courtesy, not a requirement.

Conclusion

SDCL 13-56 when amended in 1978 provided that an organization may be designated by the Governor to implement the provision of the federally insured student loan program. No records are found that the other provisions of SDCL 13-56 which outline the potential role of the Department of Education and Cultural Affairs have ever been utilized. After the Legislature granted the authority to the Governor to designate an organization to create this program, it did not outline other potential reporting requirements or compel that agreements be made in the same manner for which the Department may have been required pursuant to SDCL 13-56-1 and 13-56-6. The power given to the Governor is important to the operation of the student loan guaranty program as well as participating in the state's tax-exempt bond cap.

The authority provided by Senate Bill 177 is referred to in Governor Kneip's letter, while the Articles of Incorporation of SLFC and EAC do not make any reference to SDCL 13-56 as it was adopted to encourage the creation of student loan authority. This chapter is referred to in the letters from Governors Kniep, Wollman, and Janklow designating the SLFC as the nonprofit private agency to provide initial lenders with a secondary market for the student loan program for South Dakota.

Attorney General Mark Meierhenry in Memorandum Opinion No. 82-05 stated that the SLFC is not an agency, department, or subdivision of the state. However, SDCL 13-56 was referenced in Opinion No. 82-05 in response to a question concerning the responsibilities of the SLFC's authority to issue bonds and reporting requirements. The opinion also referred to the statement in SDCL 13-56-5 providing that action of any organization established under this chapter shall never encumber or obligate the state of South Dakota.

The product and services delivered to South Dakota students have been satisfactory. The program has never demonstrated financial weaknesses. Much of the success of the program is due to the responsibility of the South Dakota students who access these loans and their commitment to repaying these loans. The SLFC has enjoyed one of the lowest default rates in the nation.

The primary concern the U.S. Department of Education has with the SLFC and EAC is that the Board of Directors of each corporation consists of the same individuals and the respective relationships of those individuals with ancillary businesses and contracts.

However, the audits of each corporation have not identified any findings of a nature that require immediate action, nor have the services to students from South Dakota and the region been diminished.

This issue memorandum was written by Fred Baatz, Senior Research Analyst for the Legislative Research Council. It is designed to supply background information on the subject and is not a policy statement made by the Legislative Research Council.
