



UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF THE INSPECTOR GENERAL

September 14, 2004

INSPECTION MEMORANDUM

TO: Theresa S. Shaw
Chief Operating Officer
Federal Student Aid

Sally Stroup
Assistant Secretary
Office of Postsecondary Education

FROM: Cathy H. Lewis
Assistant Inspector General
Evaluation, Inspection and Management Services

SUBJECT: Monitoring the Federal Fund Reserve Level at Guaranty Agencies Needs Improvement (ED/OIG I13E0017)

This memorandum provides the results of our inspection of the monitoring of Federal Fund Reserve levels at guaranty agencies by Federal Student Aid's (FSA) Financial Partners Service. Our inspection objectives were to determine (1) if the Federal Funds at guaranty agencies are approaching the minimum reserve level and (2) the extent to which Financial Partners is monitoring the Federal Fund levels.

Executive Summary

The Higher Education Act of 1965 (HEA), as amended in 1998, provided guaranty agencies with a new financial model consisting of a Federal Fund and an Operating Fund.¹ The purpose of the Federal Fund includes paying a default aversion fee to the Operating Fund and to paying lenders for defaulted Federal Family Education Loan claims.² If a guaranty agency's Federal Fund reserve level falls below the required minimum in any two consecutive years,³ any guaranty agency's Federal reimbursement payments are reduced to 85 percent. In the alternative, if the Secretary determines that the administrative or financial condition of a guaranty agency jeopardizes the agency's ability to perform its responsibilities under its guaranty agreement, then the Secretary shall require the guaranty agency to submit and implement a management plan acceptable

¹ The Operating Fund is to be used for traditional operating expenses and other student financial aid related activities as selected by the guaranty agency.

² Additional uses of the Federal Fund are included in the implementing regulation at 34 CFR 682.419(c).

³ The minimum Federal Fund level is defined in 34 CFR 682.419(f).

to the Secretary within 45 working days of any such event. To meet the Secretary's obligation under the statute, Financial Partners is responsible for monitoring compliance with these requirements and reporting annually to Congress on the fiscal soundness of the guaranty agency system.

Guaranty agencies submit the annual Guaranty Agency Financial Report (GAFR) to Financial Partners. The GAFR data provides information on each agency's financial activities, including the Federal Fund and the Operating Fund. Data from the GAFR are used to produce Reserve Level Reports. As a result of our inspection, we determined that GAFRs may contain incomplete or inaccurate information when submitted. The instructions for three data elements in the Federal Fund section of the GAFR are not clear, resulting in a lack of consistency. Moreover, GAFR information is not always corrected. We also determined that accurate and complete information for the GAFRs is not always provided in a timely manner, resulting in a delay in producing the Reserve Level Report.

Generally, Financial Partner's monitoring of the Federal Fund reserve levels needs improvement. Enforcement action where a guaranty agency has failed to maintain the required reserve level, including the development of a management plan, has been delayed because of a lack of written policies and procedures.

Finally, Financial Partners has not, as required by the HEA, been informing Congress on an annual basis of the condition of the guaranty agencies. These reports would be based on information collected by Financial Partners. Financial Partners staff was unaware of this requirement and has not issued any reports. This may be a reflection of the frequent managerial turnover in this division over the last six years. Since the 1998 Amendments to the HEA, Financial Partners has had six different managers. In January 2004, the Chief Financial Officer (CFO) for FSA was assigned the additional responsibility of Acting General Manager for Financial Partners in order to improve the group's performance and is making improvements in the documentation of policies and procedures used by the Financial Partners' staff.

Recommendations

We recommend that Financial Partners:

1. Enforce the requirement that guaranty agencies submit an accurate and complete GAFR within 60 days after the end of the fiscal year, and withhold monthly payments to guaranty agencies not meeting the requirement.
2. Issue clear and concise instructions for the GAFR and provide training to the guaranty agencies to ensure consistent reporting.
3. Develop written policies and procedures to use as guidance in the development and evaluation of management plans.

4. Report to Congress on the fiscal soundness of the guaranty agency system as required by the HEA.

Background

Section 422A mandated the establishment of a Federal Fund at each guaranty agency. Currently, required deposits into the Federal Fund include: 1) reinsurance payments by the Department for defaulted FFEL loans; 2) a percentage of the defaulted borrower's payment, typically five percent; 3) earnings from the Federal Fund invested in low risk securities such as U.S. bonds, and 4) the total amount of insurance premiums collected of not more than one percent of the loan amount, which the guaranty agency may collect from the borrower.

Guaranty agencies that waived the insurance fee did so for a variety of reasons, including, to compete with the William D. Ford Federal Direct Loan Program, and to compete with each other and to provide schools with borrower benefits. The President's 2005 budget proposes to require guaranty agencies to collect the one percent insurance fee on all loans guaranteed or disbursed after October 1, 2004.

This report covered the period ending 12/30/03. According to FSA they have since taken action to address the management and oversight of this area. After the review was concluded and the initial draft report issued, FSA provided copies of revised draft procedures for reviewing annual GAFRs and monitoring the minimum Reserve levels/management plan development, as well as new systems documentation.

Inspection Results

Objective 1: Are the Federal Funds at guaranty agencies approaching the minimum reserve level?

According to GAFR data submitted to the Department, the Federal Funds at five guaranty agencies were below the minimum reserve level for FY 2002.⁴ However, due to imprecise instructions and errors in completing the GAFR, the GAFR's may not provide a reliable measure of the reserve level at each guaranty agency. For one of the five agencies, Financial Partners reviewers found during an on-site review that the agency had misunderstood the directions and incorrectly completed line AR-25, "Other Expenses". The reviewers recalculated the reserve level, and found that the agency's Federal Fund exceeded the minimum reserve level. Our review of data elements suggests other possible inconsistent reporting.

Guaranty agencies are required by regulation (34 C.F.R. §682.414(b)(1)) to submit an accurate and complete report concerning the status of their Federal Fund and operation of the agency's loan guarantee program. Regulations also specify that guaranty agencies not be paid any funds, the amount of which are determined by reference to data in the

⁴ An additional two agencies were below the minimum level; however, these agencies had voluntary flexible agreements with the Department that waived the minimum reserve level.

report, until a complete and accurate report is received. FSA reported that they monitor the monthly reports provided by the agencies and do withhold payments on those reports until errors are resolved by the agencies.

We found that the instructions for the Federal Fund section of the GAFR were imprecise and not sufficiently detailed to ensure consistent, accurate reporting. For example, the instruction for line AR-25 states: "Report other expenses, which are not reported elsewhere in the Federal Fund section." The term "other expenses," however, is not defined in the instructions, nor does that term appear in § 422A(d) of the HEA or 34 C.F.R. § 682.419(c), which define the exclusive, legally permitted uses of the Federal Fund. The instructions do not specify what an authorized "other expense" would be.

In a separate notice to the guaranty agencies, which provided guidance for the September 30, 2002 GAFR, Financial Partners instructed agencies to use line AR-25 for the agency's required share of the mandatory reserve fund recall. This instruction, however, is confusing when trying to comply with the instruction for line AR-22, "Recall of Federal Funds to the Restricted Account," that stated an agency should "Report the Agency's required share of the reserve fund recall recognized [sic] fiscal year."

The instruction for line AR-19, "Insurance Premiums" is similarly imprecise: "Report insurance premiums (guarantee fees) recognized. Add or subtract, as appropriate, insurance premiums transferred at the time loan guarantees were transferred to/from guaranty agencies as well as premium refunds." Our review of guaranty agency reporting for this line suggests that the agencies have inconsistently interpreted this instruction. One guaranty agency that waived all insurance premiums during the reporting period reported a deferred credit for insurance fees collected prior to the 1998 Amendments on GAFR line AR-56 and recorded the associated revenue on line AR-19. Another guaranty agency that also waived all insurance premiums reported a zero on AR-19. In 2002, nineteen guaranty agencies reported a zero on line AR-19. This inconsistency in reporting on a revenue source could have a material impact on the minimum reserve level.

Additionally, in a March 17, 2004 e-mail, Financial Partners staff reported that GAFR reports had been received which were incomplete, with agencies failing to report reinsurance received from the Department and claims paid to lenders.⁵

The data for FY 2001 and 2002 reserve levels for several agencies are known by Financial Partners staff to be inaccurate but had not been corrected at the time of our inspection. Currently, the Reserve Level Report for FY 2002 indicates seven agencies did not meet the minimum reserve level in FY 2002, however, as noted above, this report still reflects the uncorrected data for one of the guaranty agencies and provides data on

⁵ The Acting General Manager met with guaranty agency chief financial officers in March, and continues in follow-up calls, to discuss the monthly and annual financial reports due to the Department. The intention of these meetings is to discuss specifics of reporting, the ambiguity in the instructions, and consistency between monthly and annual reporting.

two guaranty agencies that were exempt from the reserve level requirement (and therefore should not have been included in the report).

The inaccuracies in reporting by the guaranty agencies are resulting in delays in developing the annual Reserve Level Report. As of March 18, 2004, Financial Partners could not provide a Reserve Level Report for the fiscal year ending September 30, 2003. While Financial Partners stated that they had received all annual GAFRs on time or had granted extensions, they were continuing to work with ten guaranty agencies to resolve incomplete or inaccurate data.

Inspection Objective 2: To what extent is Financial Partners monitoring the Federal Funds?

Financial Partner's monitoring of the guaranty agencies' compliance needs improvement. There has been delay and inconsistency in handling the situation where a guaranty agency has failed to meet the minimum reserve levels for two consecutive years because Financial Partners has not developed written policies or procedures on how to address this issue. In addition, Financial Partners was unaware of the requirement to report annually to Congress on the financial condition of the guaranty agencies.

The GAFR data provided by the guaranty agencies is designed to provide the Department with a basis for: 1) financial reviews; 2) evaluating the current and projected financial status of guaranty agencies; 3) projecting the impact in changes in revenue; and 4) managing Federal Funds held by the guaranty agency. The data used in creation of the reports is one of the items generally examined during program reviews.

Financial Partners conducted 17 guaranty agency reviews during FY 2003. During the course of last year's reviews, Financial Partners determined that based on projected data provided by the guarantors, two agencies will be below the minimum reserve level in 2003, two will be below the minimum level in 2004, one in 2005, two in 2006 and one in 2007. If all GAFR data is corrected for FY 2001, 2002 and 2003, it may disclose additional guaranty agencies that did not meet the required minimum reserve level for two consecutive years. Even though errors were detected and documented during the reviews, no corrections were made to the FY 2001 and FY 2002 Reserve Level Reports.

Section 428 (c)(9)(C) of the HEA states, "If (i) any guaranty agency falls below the required minimum reserve level in any two consecutive years, (ii) any guaranty agency's Federal reimbursement payments are reduced to 85 percent pursuant to paragraph (1)(B)(i), or (iii) the Secretary determines that the administrative or financial condition of a guaranty agency jeopardizes such agency's continued ability to perform its responsibilities under its guaranty agreement, then the Secretary shall require the guaranty agency to submit and implement a management plan acceptable to the Secretary within 45 days of any such event." Section 428 (c)(9)(D)(1) states that the management plan must improve the guaranty agency's financial and administrative condition to the required level within 18 months.

Financial Partners has not developed written policies and procedures that document the necessary components of an acceptable management plan. In February 2003, an on-site review by Financial Partners found a guaranty agency would be unable to meet the minimum reserve level for two consecutive years, FY 2002 and 2003. As required by statute, the guaranty agency submitted a management plan. The plan was delivered to a Financial Partners regional office in November 2003. While this did meet the 45-day deadline for submission, it did not address the simultaneous requirement that the plan be *implemented and accepted by the Secretary* during that timeframe. As of August 2, 2004, the plan was in final review awaiting comments from the CFO, Office of Postsecondary Education (OPE) and the Office of the General Counsel (OGC).

Section 428(c)(9)(K) of the HEA, requires the Department, within three months of the end of each fiscal year, to submit a report specifying the Department's assessment of the fiscal soundness of the guaranty agency system to the House Committee on Education and the Workforce and the Senate Committee on Labor and Human Resources. Based upon our interviews with Financial Partners senior staff in February 2004, we determined that no reports have been filed to date and that they were unaware of the requirement to file them. This may be a result of the consistent managerial turnover. Since the 1998 Amendments, Financial Partners has had six different managers.

Conclusion

Financial Partners did not produce an accurate and complete guaranty agency Reserve Level Report for the years 2001, 2002 and 2003. This failure can be attributed to several factors. There was a lack of clear GAFR instructions for certain data elements, which resulted in inaccurate, inconsistent and incomplete data. Financial Partners has not corrected the data even when it discovered errors during program reviews. In addition, there were no written policies or procedures for staff to follow in reviewing the management plans required for guaranty agencies that fall below required minimum reserve levels for two consecutive years (it is not possible to accurately determine how many guaranty agencies failed the minimum reserve level in FY 2001, 2002 or 2003 by examining GAFR data). Finally, senior leadership was apparently unfamiliar with the reporting requirements of the Federal Fund minimum reserve level legislation.

Inspection Scope and Methodology

We began the inspection on February 13, 2004 and continued to collect and analyze additional data for the period October 1, 1998 through September 30, 2003. We completed our analysis on March 18, 2004.

To accomplish the objectives we relied on data from Financial Partners concerning the Federal Fund Balance and reserve level for each guaranty agency. This data is submitted by guaranty agencies in the annual GAFR. Although we did not assess the reliability of the data on-site at the guaranty agencies, we noted inconsistencies in the data used to prepare the Reserve Level Report obtained from the annual GAFR and discussed them with Financial Partners. We read 17 guaranty agency reviews performed by Financial

Partners. We also submitted questions and interviewed members of Financial Partners to obtain information regarding compliance with the requirements of the 1998 Amendments specific to the Federal Fund minimum reserve levels.

At the exit conference on June 2, 2004, the Acting General Manager for Financial Partners requested that our inspection report reflect corrective actions taken and proposed to effect change. Although we are including them in a footnote on page 4, we did not evaluate these actions because they took place subsequent to our review.

After a subsequent meeting to discuss with OIG their response to the draft of this report, FSA did produce additional draft documentation of new procedures and the system for reviewing and evaluating the report data in the future.

Departmental Response

We provided FSA with a draft report. FSA's comments and our response are presented below. FSA's response is included in its entirety as an attachment.

Recommendation One: Enforce the requirement that guaranty agencies submit an accurate and complete GAFR within 60 days after the end of the fiscal year, and withhold monthly payments to guaranty agencies not meeting the requirement.

Department Comments

FSA does not concur with the recommendation but states in its response, "When an Annual GAFR is not received within the required time frame (60 days from Sept. 30), or if it is rejected due to a hard-edit failure, FSA will withhold monthly payments to the guaranty agency. However, if a guaranty agency submits its Annual Form within the required timeframe in 'good faith' and fails due to a soft-edit then they should be entitled to their monthly payments while the error(s) are corrected. FSA has incorporated hard- and soft-edit policies into detailed systems documentation to differentiate between those submissions, which cannot be accepted, versus those that can be easily corrected. NOTE: The Annual GAFR is not used to pay guaranty agencies. The monthly portion of the GAFR (formerly ED Form 1189) is used to make payments to guaranty agencies.

OIG Response

Although FSA does not concur with the recommendation, FSA states in its response, "When and Annual GAFR is not received within the required time frame (60 days from Sept. 30), or if it is rejected due to a hard-edit failure, FSA will withhold monthly payments to the guaranty agency. We have modified the recommendation accordingly.

Recommendation Two: Issue clear and concise instructions for the GAFR and provide training to the guaranty agencies to ensure consistent reporting.

Department Comments

FSA concurs with the recommendation.

OIG Response

No change has been made to the recommendation.

Recommendation Three: Develop written policies and procedures to use as guidance in the evaluation of management plans.

Department Comments

FSA concurs with the recommendation.

OIG Response

No change has been made to the recommendation.

Recommendation Four: Report to Congress on the fiscal soundness of the guaranty agency system as required by the HEA.

Department Comments

FSA concurs with the recommendation.

OIG Response

No change has been made to the recommendation.

Other Issues

FSA raised some general issues they requested that OIG address in the final report. First, they felt that the report did not adequately address the efforts the organization has been making to improve the management and oversight in this area. As a result of these comments, the report has been modified to include reference to materials provided by FSA after the submission of the draft to FSA for review.

Secondly, FSA believes that the citing only the statutory language with respect to the uses for the Federal Fund was misleading without including language from the implementing regulation. We have included a reference to the implementing regulations.

Additionally, FSA noted that the background section of the reported stated that guaranty agency may collect an insurance fee of one percent, when the current insurance premium is “up to one percent.” The report has been modified to reflect this change.

FSA did not agree that the instructions for lines AR-22 and AR-25 for reserve recall reporting were “contradictory”. The OIG has modified the sentence to describe the language as “confusing.”

FSA believed that the OIG misquoted the Higher Education Act in describing when a management plan must be submitted. The OIG draft report summarized the statutory language. To avoid confusion, the final report now quotes the statutory language in question.

FSA noted that they found the timeline originally detailed on pages 5-6 for the submission of a specific guaranty agency’s management plan to be inaccurate and they provided more detail with respect to the review process. We added additional information on the status of the plan, however, we have not modified our finding. Changes have been made to clarify this section of the report to more clearly reflect the status of this plan.

Administrative Matters:

This inspection was performed in accordance with the President’s Council on Integrity and Efficiency (PCIE) Quality Standards for Inspections (1993).

We appreciate the cooperation given to us during the inspection. If you have any questions or wish to discuss the contents of this report, please call me at 202-245-7029 or Deb Schweikert, Director, Evaluations and Inspections Division at 202-245-7026. Please refer to the control number in all correspondence relating to this report.