UNITED STATES DEPARTMENT OF EDUCATION
OFFICE OF INSPECTOR GENERAL

AUDIT SERVICES

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James W. Runcie
Chief Operating Officer
Federal Student Aid
U.S. Department of Education
Washington, D.C. 20202

Dear Mr. Runcie:

This final audit report, entitled *Oversight of Guaranty Agencies During the Phase-Out of the Federal Family Education Loan Program,* presents the results of our audit. The audit objectives were to evaluate Federal Student Aid's (FSA) (1) process for ensuring the continued protection of Federal funds at Guaranty Agencies (GA); (2) oversight of GAs' ability to perform their duties; and (3) actions for the GAs' successful participation during the phase-out of the Federal Family Education Loan Program (FFELP) loans. The SAFRA Act (SAFRA), part of the Health Care and Education Reconciliation Act of 2010 (Pub. L. 111-152), mandated that no new loans be made or insured under FFELP after June 30, 2010. The audit evaluated FSA's policies and procedures for its oversight of GAs during the phase-out of FFELP from July 1, 2009, through June 30, 2011, and we performed additional audit work related to updates to FSA's actions for the GAs' FFELP participation through May 1, 2014.

We determined that FSA does not have an adequate process to protect Federal funds because the methodology FSA uses to calculate a GA's current reserve ratio is not in compliance with the requirement that the Federal fund balance used in the reserve ratio is calculated using an accrual basis of accounting. FSA's method overstates the financial position of the GAs.

We found that FSA performed monitoring of the GAs' ability to perform their duties. However, FSA did not establish criteria for GAs to use to develop the financial projections that FSA required GAs to report on the Guaranty Agency Financial Report Annual Form 2000 (Annual Form 2000). We also found that FSA did not document the procedures for actions it should have taken on information GAs reported on the Guaranty Agency Financial Report Monthly Annual Form 2000 (Monthly Annual Form 2000) that identified GAs under possible financial stress.

FSA developed a methodology, named the Transition Evaluation Process, to select a successor GA for a GA that requested to end its participation in FFELP in fiscal year (FY) 2011. FSA subsequently modified that methodology for another GA that also wanted to end its participation in FFELP in FY 2012. We determined that both the initial and modified methodologies

contained deficiencies. During a follow up interview, FSA officials stated that they planned to use the second Transition Evaluation Process for GAs that want to transition out of FFELP. FSA took actions for the GAs' successful participation during the phase-out of FFELP by attempting to implement Voluntary Flexible Agreements (VFA).[1] FSA issued two Federal Register notices (on May 31, 2011 and August 14, 2013) to invite GAs to submit proposals to enter into VFAs. The VFAs would have permitted a more flexible agreement between the Secretary of Education (Secretary) and the GAs than the standard agreements and would have permitted GAs to develop, use, and evaluate alternative models for ensuring that they carried out their responsibilities in a more cost effective and efficient manner. The purpose of the May 2011 VFA solicitation was to establish new GA structures and financing mechanisms to protect the Federal fiscal interest in light of the diminishing outstanding FFELP portfolio. However, FSA did not enter into any VFAs because the GAs did not submit proposals that met FSA's requirements in the Federal Register notice. The purpose of the August 2013 VFA solicitation was to establish VFAs with a small number of GAs, each of which would assume responsibility of some or all of a terminating GA's defaulted and non-defaulted loans. FSA received 13 letters of request and completed an analysis of the letters. However, FSA put the August 2013 VFA on hold because of changes to GA compensation made in the Bipartisan Budget Act of 2013 (Public Law 113-67)(Act).[2] According to FSA, the Act changed the payment schedule for the GAs and FSA's Director of Policy Liaison and Implementation stated that FSA did not think it could select GAs based on the requirements it had identified for the August 2013 VFA. When we contacted FSA on May 1, 2014, to update our information regarding plans for GA FFELP participation, the Director of Policy Liaison and Implementation stated that FSA has had minimal discussions regarding the August 2013 VFA and is unsure about how to go forward with the VFA. FSA officials stated that if several moderately sized GAs chose to transition out of FFELP, FSA could easily use larger GAs as successors. As a result, there has been no change in the relationships between FSA and the GAs participating in FFELP because of SAFRA.

In its response to the draft of this report, FSA concurred with the findings and agreed to take action that is responsive to the recommendations in the report. We made changes to the report in response to FSA's comments. Specifically, we changed the Finding 2 caption, removed the discussion in the draft report under Finding 3 about the GA recovery rate, and changed the Finding 3 draft report conclusion to identify that the reordering of the Transition Evaluation Process steps would result in a more logical process. The comments are summarized at the end of each finding along with the OIG's response. The full text of FSA's comments to the draft report is included as Attachment 5 to the report.

BACKGROUND

According to Section 141(a)(1) of the Higher Education Act of 1965, as amended (HEA), FSA is responsible for managing the administrative and oversight functions supporting the Title IV

[1] Section 428A of the HEA authorizes the Secretary to enter into VFAs with GAs in lieu of the standard agreements between the Secretary and the GAs.
[2] The Act reduced the maximum fee GAs could charge borrowers when GAs sold their rehabilitated FFELP loans and required GAs that sold rehabilitated loans to repay all (rather than a portion) of the default insurance payments on such loans beginning on July 1, 2014.

student financial assistance programs. As such, FSA is responsible for monitoring GAs' program compliance with the HEA. FSA's responsibilities include ensuring that GAs (1) maintain adequate service levels to perform default aversion activities, (2) report on loan default collections, and (3) protect Federal funds.

A GA is a State or private nonprofit agency that has agreements with the Secretary to administer certain aspects of the FFELP loans, including insuring private lenders against losses due to a borrower's default. FFELP is a federally guaranteed loan program in which private lenders provided loans, GAs insure those loans, and the U.S. Department of Education (Department) reinsures the loans. One GA stated that it is also responsible for informing schools, students, lenders, secondary markets, and servicers of FFELP requirements. Although there are no new FFELP loan originations, GAs continue to insure FFELP loans already disbursed, perform default aversion activities, oversee lenders, collect defaulted FFELP loans, pay lender default claims, and report on loan statuses. In addition to performing their responsibilities under their agreements with the Department, GAs' other lines of business can include managing State grants, managing non-Federal student loan programs, and developing financial literacy training programs.

As of September 30, 2013, the guaranteed loan portfolio consisted of about $264 billion in outstanding FFELP loans held by private lenders. FSA held $59.7 billion in defaulted FFELP loans, which included both loans that GAs were responsible for collecting and loans that were assigned to FSA to collect.

Significant statutory changes affecting FFELP included the Ensuring Continued Access to Student Loan Act (ECASLA) of 2008 (Pub. L. 110–227), which authorized the Secretary to create programs to allow FFELP loan holders to sell certain FFELP loans to the Secretary. The Secretary concluded that as a result of ECASLA "the outstanding portfolio of [FFELP] loans under guarantee has declined by more than $100 billion, reducing both the short-term and long-term revenues of [GAs]." In addition, SAFRA mandated that no new loans be made or insured under FFELP after June 30, 2010. According to the Federal Register, as a result of SAFRA, GAs would not have an "estimated $75 billion of annual new loan volume that otherwise would have been added to their portfolios, resulting in further reductions to [GA] revenues." The total dollar amount of FFELP loans held or insured by GAs has diminished and will continue to diminish, resulting in less revenue available to these agencies and jeopardizing their ability to meet their FFELP responsibilities.

Voluntary Flexible Agreements

The purpose of a VFA is to permit a more flexible agreement than the standard agreements between the Secretary and the GAs. Under Sections 428(b) and (c) of the HEA, GAs perform certain roles in FFELP pursuant to agreements with the Secretary. Section 428A of the HEA authorizes the Secretary to enter into VFAs with GAs in lieu of the agreements entered into under Sections 428(b) and (c) of the HEA. This authority allows the Secretary to work with GAs to develop, use, and evaluate alternate ways of ensuring that the responsibilities of the GAs are fulfilled in the most cost-effective and efficient manner possible.

FSA Selection of Successor GAs for GAs Ending Participation in FFELP

FSA may decide to terminate its agreement with a GA. A GA can choose to continue performing the activities under its FFELP agreement with FSA or request to end participation in

FFELP. When a GA's participation in FFELP ends, its FFELP loan portfolio is transitioned to another GA.

FSA Monitoring of GAs

Federal Fund and Operating Fund
GAs are responsible for managing two separate funds: the Federal fund and the operating fund. The Federal fund is the property of the Federal Government. The operating fund is the property of the GA. The HEA requires a GA to deposit revenue from specified sources into the Federal fund and limits the use of Federal fund assets. GAs must use assets from the Federal fund to pay lender claims and to pay default aversion fees they earn into their operating fund. Default aversion fees are paid to a GA for performing default aversion activities. These activities are directly related to providing collection assistance to the lender on a delinquent loan before the loan is placed in a default status. The HEA also specifies deposits into the operating fund and the general uses of operating fund assets. Except for funds transferred from the Federal fund, the GA owns the operating fund and uses it to pay its daily operating expenses. GAs use money in the operating fund for repayment status management, default aversion activities, default collection activities, financial aid awareness and related outreach activities, and compliance monitoring.

Guaranty Agency Financial Report Annual Form 2000
GAs report their annual financial information on the Annual Form 2000. The Annual Form 2000 is used for billing and information purposes and contains data for the GAs' operating fund, Federal fund, balance sheet, and financial information used to calculate the reserve ratio. The reserve ratio is a financial indicator calculated by FSA to determine a GA's ability to pay claims on defaulted student loans. FSA also uses the information on the Annual Form 2000 to monitor the GAs' financial activities, including activities relating to the operating and Federal funds. In addition, information in the balance sheet is used by FSA to conduct annual reconciliations. The annual reconciliation is the process by which FSA compares the information each GA reported on its Annual Form 2000 to the information it reported on its Monthly Annual Forms 2000 to determine whether inconsistencies or data anomalies exist. If FSA finds inconsistencies or anomalies, it contacts the applicable GA for corrections and updates as necessary. The Annual Form 2000 is also used by GAs to request payments from and make payments to the Department.

Guaranty Agency Financial Report Monthly Annual Form 2000
GAs report their financial information on the Monthly Annual Form 2000. GAs submit their monthly financial data to FSA by the 20th day of the month following the month the financial activity occurred. The Monthly Annual Form 2000 includes the same line items as the Annual Form 2000; however, all of the individual line items in the Monthly Annual Form 2000 are estimates. According to FSA, the line items are estimates because the information is due on a monthly basis from the GAs and subject to change when finalized numbers are reported on the Annual Form 2000.

FSA prepares three reports using the information on the Monthly Annual Form 2000: the Monthly Variance Report, the Monthly Annual Data Report, and the Quarterly Trend Analysis. The Monthly Variance Report displays the dollar and percentage changes from month to month.

The Monthly Annual Data Report displays the financial data for beginning and ending balances; the reinsurance amounts compared to the claims expensed to the lenders that hold the loans

guaranteed by the GAs; the Secretary's and GAs' share of collections, if applicable; default aversion fees; and other expenses for each agency. The report also includes monthly amounts of each GA's Federal and operating funds and balance sheet calculations.

The Quarterly Trend Analysis report contains information regarding the GAs' financial solvency and ability to pay claims based on changes in the Federal fund and operating fund balances and the trigger rate. The trigger rate is calculated by dividing the total reinsurance claims the Department paid to a GA during the current fiscal year by the amount of loans in repayment insured by that GA at the end of the preceding fiscal year. The trigger rate determines the percentage rate at which the Department will reimburse a GA for losses on default claims paid to lenders.

AUDIT RESULTS

The objectives of our audit were to evaluate FSA's (1) process for ensuring the continued protection of Federal funds at GAs; (2) oversight of GAs' ability to perform their duties; and (3) actions for the GAs' successful participation during the phase-out of FFELP loans.

We determined that FSA does not have an adequate process to ensure the continued protection of Federal funds because the methodology FSA uses to calculate a GA's current reserve ratio is not in compliance with the requirement that the Federal fund balance used in the reserve ratio be calculated using an accrual basis of accounting. The current reserve ratio calculation overstates GAs' Federal fund and results in an inflated reserve ratio and understates the level of financial stress a GA may be under.

We also found that FSA performed monitoring of the GAs' ability to perform their duties. However, FSA did not establish criteria for GAs to use to develop financial projections that FSA required GAs to report on the Annual Form 2000. We also found that FSA did not document the procedures for actions it should have taken on information GAs reported on the Monthly Annual Form 2000 that identified GAs under possible financial stress.

We also determined that FSA's initial methodology used to select successor GAs for GAs ending participation in FFELP was deficient. FSA modified the initial methodology but the modified methodology also contained deficiencies. FSA officials stated that they planned to use the second Transition Evaluation Process for GAs that want to transition out of FFELP. FSA has used the modified process to transition two GAs out of FFELP and transfer their portfolios to other GAs.

In addition, FSA took actions for the GAs' successful participation during the phase-out of the FFELP program by attempting to implement VFAs. The VFAs would have permitted a more flexible agreement between the Secretary and the GAs than the standard agreements and would have permitted GAs to develop, use, and evaluate alternative models for ensuring that they carried out their responsibilities in a more cost effective and efficient manner. However, FSA did not enter into any VFAs. The GAs did not submit proposals that were responsive to FSA's requirements in the May 2011 Federal Register notice and FSA placed the August 2013 VFA

process on hold to consider the impact of the Act on the revenues available to GAs. As a result, there has been no change in the relationships between FSA and the GAs participating in FFELP because of SAFRA.

In its response to the draft of this report, FSA concurred with the findings and agreed to take action that is responsive to the recommendations in the report. We made changes to the report in response to FSA's comments regarding the suggestion for a revised Finding 2 caption, the use of the gross GA recovery rate as a performance indicator and that the reordering of the Transition Evaluation Process steps for identifying the future successor GAs would make the process more logical. Specifically, we changed the Finding 2 caption, removed the discussion in the draft report under Finding 3 about the GA recovery rate, and changed the Finding 3 draft report conclusion to identify that the reordering of the Transition Evaluation Process steps would result in a more logical process. The comments are summarized at the end of each finding along with the OIG's response. The full text of FSA's comments to the draft report is included as Attachment 5 to the report.

FINDING NO. 1 – FSA's Methodology for Calculating a GA's Federal Fund Reserve Ratio Overstates the GA's Financial Health

We determined that the methodology FSA uses to calculate a GA's Federal fund reserve ratio is not in compliance with the requirement at 34 C.F.R. § 682.419(f)(1) that the Federal fund balance used in the calculation be based on accrual accounting, which resulted in the overstatement of GA financial health.

Accrual accounting matches revenues to expenses when the transaction occurs rather than when payment is made or received. FSA's current methodology for calculating a GA's reserve ratio overstates the GA's reserve ratio, which FSA uses to assess the financial solvency of the GA.

Section 428(c)(9)(A) of the HEA requires GAs to meet a minimum reserve ratio of at least 0.25 percent. This means that a GA's Federal fund balance must equal at least 0.25 percent of the outstanding loans it guaranteed. Under Section 428(c)(9)(C) of the HEA, if the GA does not meet the reserve ratio for 2 consecutive years, or if the Secretary determines that the GA's administrative or financial condition jeopardizes the agency's continued ability to perform its responsibilities under its guaranty agreement, the Secretary will require the GA to submit and implement a management plan that is acceptable to the Secretary within 45 days of any such event. Under Section 428(c)(9)(D) of the HEA, the management plan must include the means by which the GA will improve its financial and administrative condition to the required level within 18 months.

FSA uses data from the Annual Form 2000 Balance Sheet Section (Federal fund) to calculate the reserve ratio. The Annual Form 2000 reporting instructions for this section state, "The balances reported in this section should reconcile to amounts reported on the Guarantor's audited financial statements Balance Sheet as of the end of the Federal fiscal year." The reporting instructions further state that "[a]ll reporting [on the form] should be on an accrual basis and in accordance with Generally Accepted Accounting Principles." In addition, the instructions for the Federal fund balance line item state "this amount should represent the equity on the audited balance sheet section of the Federal Fund." The Federal fund balance line item is reported on an accrual basis. FSA's methodology for calculating the reserve ratio adds allowances and other non-cash charges

from the Annual Form 2000 to the accrual accounting Federal fund balance, resulting in an inflated reserve ratio calculation as shown below.

$$\frac{\text{Federal Fund Balance + Allowances and Other Non-Cash Charges}}{\text{Original Principal Outstanding}}$$

Because the Annual Form 2000 already requires accrual accounting, no adjustments to the Federal fund balance line item are needed to meet the accrual accounting requirement for the Federal fund balance used in the reserve ratio calculation. That is, the allowances and other non-cash charges have already been properly deducted from the Federal fund balance reported in the Annual Form 2000 and should not be added back to the Federal fund balance line item.

In our April 2009 audit report, "Federal Student Aid's Oversight and Monitoring of Guaranty Agencies, Lenders, and Servicers Needs Improvement" (ED-OIG/A20I0001), we identified that FSA's reserve ratio calculation improperly overstated the financial condition of GAs.

We recalculated the reserve ratio using the accrual basis of accounting for all 32 GAs for FY 2010. We used only the accrual accounting Federal fund balance from the FY 2010 Annual Form 2000 in the numerator without adding allowances and other non-cash charges, as required by the regulations. We determined that using FSA's current methodology made GAs appear to have a stronger financial position. As shown in Table 1, three GAs would not have met the minimum reserve ratio using the accrual accounting Federal fund balance, but met the minimum reserve ratio requirement using FSA's current methodology. Overall, FSA's current methodology inflated GA reserve ratios by an average of 27 percent above the reserve ratios calculated using accrual accounting.

Table 1. Comparison of Reserve Ratio Calculation for FY 2010

Guaranty Agency	FSA's Reserve Ratio Calculation	Accrual Accounting Reserve Ratio Recalculation
American Student Assistance (Massachusetts)	0.30	0.22
Kentucky Higher Education Assistance Authority	0.36	0.24
College Assist (Colorado)	0.26	0.19

We performed the same recalculation described above for the 32 GAs using the FY 2011 Annual Form 2000 information. As shown in Table 2, four GAs would not have met the minimum reserve ratio using the accrual accounting Federal fund balance, but met the minimum requirement using FSA's current methodology. American Student Assistance did not meet the minimum reserve ratio using either calculation. FSA's current methodology inflated GA reserve ratios by an average of 30 percent above the reserve ratios calculated using accrual accounting and presented each GA in a stronger financial position in FY 2011.

Table 2. Comparison of Reserve Ratio Calculation for FY 2011

Guaranty Agency	FSA's Reserve Ratio Calculation	Accrual Accounting Reserve Ratio Recalculation
American Student Assistance (Massachusetts)	0.24	0.16
Kentucky Higher Education Assistance Authority	0.31	0.19
College Assist (Colorado)	0.25	0.18
Student Loan Guarantee Foundation of Arkansas	0.33	0.20
New York State Higher Education Services Corporation	0.28	0.19

We performed the same recalculation described above for the all GAs using the FY 2012 Annual Form 2000 information. As shown in Table 3, seven GAs would not have met the minimum reserve ratio using the accrual accounting Federal fund balance, but met the minimum requirement using FSA's current methodology. FSA's current methodology inflated GA reserve ratios by an average of 43 percent above the reserve ratios calculated using accrual accounting and presented each GA in a stronger financial position in FY 2012.

Table 3. Comparison of Reserve Ratio Calculation for FY 2012

Guaranty Agency	FSA's Reserve Ratio Calculation	Accrual Accounting Reserve Ratio Recalculation
American Student Assistance (Massachusetts)	0.25	0.18
Kentucky Higher Education Assistance Authority	0.29	0.16
College Assist (Colorado)	0.26	0.19
Student Loan Guarantee Foundation of Arkansas	0.27	0.15
New York State Higher Education Services Corporation	0.28	0.20
Michigan Guaranty Agency	0.35	0.24
Higher Education Student Assistance (New Jersey)	0.84	0.14

FSA's erroneous calculation identified that all GAs met the minimum reserve ratio in FY 2010, all but one GA (Massachusetts) met the minimum reserve ratio in FY 2011, and all GAs met the minimum reserve ratio in 2012 (see attachments 2, 3 and 4 for all GAs reserve ratio recalculations). Based on the correct calculation, College Assist, Kentucky Higher Education Assistance Authority, Student Loan Guarantee Foundation of Arkansas (Arkansas), American Student Assistance, and New York State Higher Education Services Corporation fell below the minimum ratio for two consecutive years and should have been placed on management plans.

Recommendations

We recommend that the Chief Operating Officer of Federal Student Aid—

1.1 Cease adding allowances and other non-cash charges to the accrual accounting Federal fund balance when calculating the reserve ratio.

1.2 Recalculate the reserve ratio for all GAs for the two most recently completed fiscal years using the accrual basis of accounting Federal fund balance to determine whether any of the GAs would have failed to meet the ratio and should be required to submit a management plan.

FSA's Comments

FSA concurred with Finding No. 1 and stated it would take the actions described in the recommendations.

OIG Response

FSA's planned corrective actions, if properly implemented, are responsive to the finding and recommendations.

FINDING NO. 2 – FSA Did Not Document the Procedures for Actions it Should Have Taken on Information That Identified Guaranty Agencies Under Possible Financial Stress

FSA did not establish criteria for GAs to use in developing the financial projections that FSA required GAs to report on the Annual Form 2000 and FSA did not document the procedures for actions it should have taken on the information GAs reported on the Monthly Annual Form 2000 that identified GAs under possible financial stress. FSA required GAs to project revenues and expenses for 5 years in both the Federal and operating funds accounts on the Annual Form 2000. In the absence of criteria for developing projections, each GA used its own methodology, which made it impossible for FSA to meaningfully compare GAs. Also, FSA did not require GAs to submit support for the projections, so FSA could not be confident that the projections were reasonable estimates.

In addition, GAs must submit a Monthly Annual Form 2000 that contains financial information for both the Federal and operating fund accounts. We found that FSA's procedures state that FSA staff should use the Monthly Variance Report, the Monthly Annual Data Report, and the Quarterly Trend Analysis to identify inconsistencies or data anomalies and for the annual reconciliation process. The procedures do not state that staff should act on information in the

three reports that identifies GAs under possible financial stress, and we did not find evidence that staff used the three reports for that purpose. For example, the Quarterly Trend Analysis report contains information regarding the GAs' financial solvency and ability to pay claims. For the first quarter of FY 2011, the Quarterly Trend Analysis report identified four GAs with a high risk of becoming insolvent and 14 GAs as not having the ability to pay claims. There was no indication that FSA increased its monitoring of the GAs identified with a high risk of insolvency or the inability to pay claims based on the information reported in the Quarterly Trend Analysis.

Based on our work discussed in Finding 1, six GAs we identified as failing to meet the reserve ratio were also identified in the Quarterly Trend Analysis report as not having the ability to pay claims. Two of the six GAs were also identified as having a high risk of becoming financially insolvent. On March 19, 2014, Arkansas submitted a formal request to FSA to transition out of FFELP and have its portfolio transferred to a GA better suited to pay claims. Arkansas requested that FSA complete the process by September 30, 2014. As reported in Finding 1, Arkansas failed to meet the reserve ratio requirement for FY 2011 and FY 2012 as recalculated by the Office of Inspector General (OIG) and should have been placed on a management plan. Arkansas was one of the GAs identified in the FY 2011 Quarterly Trend Analysis report as not having the ability to pay claims and as having a medium risk for financial insolvency.

According to Section 428(c)(9) of the HEA the Secretary is required to evaluate the financial and administrative condition of GAs. The statute also allows the Secretary to terminate GA agreements if the GA is not meeting the requirements of the program.

According to the Director of Business Operations, FSA recognizes that the projections are not calculated consistently between each GA and, as such, FSA places little importance on the accuracy of the GA projections on the Annual Form 2000. Although FSA uses the Monthly Annual Form 2000 to identify anomalies and discrepancies, FSA did not use the reported data to determine whether a GA is under financial stress and did not take action based on that information.

Recommendations
We recommend that the Chief Operating Officer of Federal Student Aid—

2.1 Develop criteria for fund projections that GAs are required to report on the Annual Form 2000.

2.2 Develop action plans when available information indicates that a GA is under possible financial stress.

FSA's Comments

FSA concurred with Finding No. 2 and stated it would take the actions described in the recommendations. However, FSA stated that the finding caption was not accurate.

OIG Response

Based on FSA's response, we changed the finding caption. FSA's planned corrective actions, if properly implemented, are responsive to the finding and recommendations.

FINDING NO. 3 – FSA's Transition Evaluation Process for Selecting Successor GAs Has Deficiencies

We identified deficiencies in the methodology FSA developed to transition two GAs out of FFELP. Specifically, the analysis FSA used to select these potential successors GAs contained deficiencies related to projected fund balances, used subjective factors, and did not provide a rationale for why the variables FSA selected to predict GA financial solvency were the most relevant variables.

<u>FSA Initial Methodology for Identifying Successor GAs</u>
For GAs that no longer want to participate in FFELP, FSA developed a methodology to select successor GAs. In response to a GA's request to exit FFELP in March 2011, FSA developed a process it called the "Transition Evaluation Process" to evaluate successor GA capacity.

The Transition Evaluation Process involved FSA officials reviewing eight variables and using their personal knowledge about individual GAs to identify acceptable successors. The eight variables were Financial Health, trigger rate, recovery rate, 2010 Federal fund, 2010 operating fund, financial bandwidth, data and asset security, and cohort default rate FY 2009. We identified deficiencies with this process. Specifically, as part of its analysis, FSA used the reported operating and Federal fund projections through 2015, which GAs submitted on their Annual Forms 2000. As discussed in Finding 2, since each GA used its own methodology for these projections, FSA cannot make meaningful comparisons among them.

In addition, FSA officials used their personal knowledge of the GAs to add or remove GAs from consideration as successor GAs. FSA officials did not have documentation of or explanations for the criteria they used to make these decisions. The personal knowledge criteria varied and were based on FSA officials' experience working with the GAs.

FSA used this process to identify three acceptable successors GAs for the GA that requested to exit FFELP in March 2011. As of October 2013, the requesting GA was still participating in FFELP.

<u>FSA's Modified Methodology for Identifying Successor GAs</u>
In November 2011, a second GA requested to end its participation in FFELP. FSA modified the initial Transition Evaluation Process by using seven instead of eight variables—it eliminated the use of the operating and Federal fund projections variable. FSA also did not rely on FSA officials' personal knowledge about individual GAs to make successor selections. Nonetheless, this modified process also contained deficiencies.

The modified methodology was a two-step process. First, FSA ranked the 32 GAs according to the seven variables. Second, FSA selected the 10 highest ranked GAs for further evaluation based on GA capacity and size. In the first step of the process for ranking GAs, FSA gave a higher score to GAs with lower 2-year cohort default rates and lower trigger rates.

In the second step of the process, FSA evaluated the GAs ranked in the top 10 from step one. FSA then eliminated six GAs that it determined did not have the capacity to serve as a successor GA. FSA's criteria for determining whether a GA had the capacity to serve as a successor GA was whether the GA had both defaulted and non-defaulted loan portfolios at least two-thirds the

size of the transitioning GA. FSA should have eliminated GAs that did not meet the capacity threshold from consideration before establishing relative rankings based on the seven variables so that the GAs that ultimately were ranked among the top 10 would all have been viable candidates for selection. This would have resulted in a more logical process.

This modified process resulted in FSA selecting four GAs as potential successor GAs. FSA allowed the transitioning GA to select which of the four potential successors the GA preferred to work with. The transitioning GA selected a successor, which the Secretary then approved. FSA terminated the exiting GA's participation in FFELP and transitioned the GA's portfolio to the successor GA.

Recommendation

We recommend that the Chief Operating Officer of Federal Student Aid—

3.1 Correct the deficiencies in the Transition Evaluation Process, if circumstances require this process to be used in future selections of successor GAs, and consider these deficiencies in developing a process to evaluate GAs in the future.

FSA's Comments

FSA concurred with Finding No. 3 and stated it would take the actions described in the recommendation. In its response, FSA stated that it considers the GA recovery rate to be a performance indicator, not an indicator of financial health. FSA also agreed to reconsider the steps for selecting successor GAs in the Transition Evaluation Process to make the process more logical.

OIG Response

Based on FSA's comments we removed the discussion in the draft report about the GA recovery rate. Additionally, we changed the draft Finding 3 conclusion that a ranking process that first eliminated from consideration any GAs that did not meet the capacity threshold would have been more efficient than the existing process. We now conclude that such a process would be more logical rather than more efficient. FSA's planned corrective actions, if properly implemented, are responsive to the finding and recommendation.

OBJECTIVES, SCOPE, AND METHODOLOGY

The audit objectives were to evaluate FSA's (1) process for ensuring the continued protection of Federal funds at GAs; (2) oversight of GAs' ability to perform their duties; and (3) actions for the GAs' successful participation during the phase-out of FFELP loans.

We revised the second objective which originally included a review of FSA's oversight of GAs' compliance with program requirements. While FSA had policies and procedures for oversight of GAs, we did not develop sufficient, appropriate evidence to answer the second objective as originally written. For the program reviews conducted prior to SAFRA, we did not believe the

reviews were relevant to our audit because we decided to focus only on the oversight of financial solvency of GAs. During the audit period, FSA's oversight included developing and implementing annual risk matrices, annual work plans, and conducting various program reviews focused on the risk identified. We identified risk areas within FSA's annual risk matrices that were related to the audit objectives, such as GAs transitioning out of FFELP and the financial solvency of GAs. FSA also developed and implemented work plans aligned to the risk areas identified. After SAFRA, FSA completed five program reviews during FY 2012. We evaluated the reports for the programs reviews conducted and determined that the reviews did not focus on the financial solvency of the GAs.

To complete our audit work, as discussed below, we limited our review to FSA's policies and procedures for its oversight of GAs during the phase-out of FFELP. The audit evaluated FSA's policies and procedures for its oversight of GAs during the phase-out of FFELP from July 1, 2009, through June 30, 2011, and we performed additional audit work related to FSA's actions for the GAs FFELP participation through May 1, 2014. During the follow up discussions, we learned that FSA planned to use the second Transition Evaluation Process for GAs that wanted to end their participation in FFELP and that two GAs had successfully transitioned out of FFELP and transferred their portfolios to other GAs within the last two years. We interviewed officials from FSA's Business Operations, Financial Institution Oversight Service, and Funds Control and Operations Branch at the FSA headquarters in Washington, D.C. We also performed audit work at three GAs: College Assist, Texas Guaranty, and United Student Aid Funds. We selected 3 of the 32 GAs to review based on the following criteria: one GA with a small FFELP portfolio that applied for a VFA (May 2011), one GA with a large FFELP portfolio that applied for a VFA (May 2011), and one GA with a large FFELP portfolio that did not apply for a VFA.

To accomplish our objectives, we performed the following procedures.

- Reviewed FSA's organizational charts.
- Reviewed prior reports issued by OIG related to FSA's oversight, FFELP, and GAs and a Government Accountability Office report related to a prior VFA process.
- Interviewed FSA officials from the office of the Chief Operating Officer, the Business Operations Group, the Financial Institution Oversight Service, the Funds Control and Accounting Branch, and GA management and staff.
- Reviewed and verified Monthly Annual Form 2000 and Annual Form 2000 information at the three GAs visited. We also reviewed the Annual Form 2000 for all GAs, used by FSA to calculate the reserve ratios.
- Reviewed the initial VFA proposals submitted in reference to the Federal Register issued on May 13, 2011, and the resubmitted proposals to determine whether the initial and revised proposals met the requirements of the Federal Register.
- Reviewed the Federal Register issued on August 14, 2013, to evaluate the VFA requirements for GAs submitting proposals.
- Evaluated FSA's risk matrices for FY 2009 through FY 2012 to determine whether FSA included risk elements associated with the decline in loan balances at GAs after the passage of the SAFRA Act. The risk matrices identified critical and high-risk areas.
- Evaluated the program review guides to determine that the methodologies used by FSA would address the risk identified and were reviewed in FY 2009 through FY 2012. We identified the following program reviews: Analysis of Managerial Controls, Verification

of Claims, Post Default Due Diligence, Payment Application, Conflict of Interest Review, GA Profitability Program Review, and Financial Reviews.
- Reviewed FSA's work plans for FY 2009 through FY 2012[3] to determine the number and type of reviews that were conducted by FSA with regards to the risk areas associated with GAs. The work plans included reviews that were pertinent to our objectives; specifically, 12 profitability reviews; 2 reviews of merging GAs, 4 GA transition reviews, and 15 GA program reviews.
- Evaluated the review guides and reports for the five financial reviews conducted after SAFRA in FY 2012.
- Reviewed policy and procedures of the Business Operations Group, as it relates to monitoring the GAs and reports submitted by GAs; and the Financial Institution Oversight Service, as it relates to program reviews.
- Reviewed two Transition Evaluation Processes.
- Recalculated reserve ratios of all 32 GAs for FY 2010, FY 2011, and FY 2012 using the accrual calculation and compared to FSA's current reserve ratio methodology.

To achieve our audit objective related to evaluating FSA's ability to protect Federal funds, we relied, in part, on computer-processed data. To recalculate the reserve ratio, we obtained the Annual Form 2000 data for FY 2010 and FY 2011 from FSA's Financial Management System. To verify data completeness, we obtained a copy of the Annual Form 2000 information from FSA. We then reviewed the Annual Form 2000 information to ensure that all appropriate data fields were completed for each of the 32 GAs. We verified the reliability of the data by reviewing 3 months of Monthly Annual Form 2000 at the three GAs visited and compared all the fields in the Monthly Annual Form 2000 to source documents. We noted that the information in the GAs source documents agreed with the information reported on the Annual Form 2000. Based on our testing, we concluded that the data were complete and sufficiently reliable for the purposes of our audit. For FY 2012, we obtained Annual Form 2000 information from FSA's Financial Partners Publications website.

We conducted site visits at FSA during the weeks of July 11, 2011, and January 30, 2012. We also completed audit work at College Assist during the week of September 19, 2011, Texas Guaranty during the week of October 11, 2011, and United Student Aid Funds during the week of November 14, 2011. We held an exit conference with FSA on May 30, 2013, to discuss the results of the audit. We also held a subsequent meeting with FSA in September 2013 and another meeting in May 2014 to gain an understanding of the status of the VFA solicitation issued on August 14, 2013.

Internal Controls

We gained an understanding of the internal controls concerning oversight of GAs at FSA. We determined the control activities standard of internal control was significant to our audit objectives. We tested the control activities through inquiries of FSA and GA personnel, review of written policies and procedures, and inspection of documents and records. We identified weaknesses in the auditee's control activities, which are fully discussed in the audit findings. We determined FSA did not have adequate control activities to ensure the continued protection of Federal funds at GAs.

[3] The work plan and program reviews for FY 2012 were completed after the SAFRA Act.

We conducted this performance audit in accordance with generally accepted government auditing standards, except for obtaining sufficient, appropriate evidence to address our second objective. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

ADMINISTRATIVE MATTERS

Corrective actions proposed (resolution phase) and implemented (closure phase) by your office will be monitored and tracked through the Department's Audit Accountability and Resolution Tracking System (AARTS). ED policy requires that you develop a final corrective action plan (CAP) for our review in the automated system within 30 days of the issuance of this report. The CAP should set forth the specific action items, and targeted completion dates, necessary to implement final corrective actions on the findings and recommendations contained in this final audit report. An electronic copy of this report has been provided to your Audit Liaison Officer(s).

In accordance with the Inspector General Act of 1978, as amended, the Office of Inspector General is required to report to Congress twice a year on the audits that remain unresolved after six months from the date of issuance.

Statements that managerial practices need improvements, as well as other conclusions and recommendations in this report, represent the opinions of the Office of Inspector General. Determination of corrective action to be taken will be made by the appropriate Department of Education officials.

In accordance with the Freedom of Information Act (5 U.S.C. §552), reports issued by the Office of Inspector General are available to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act.

We appreciate the cooperation given us during this review. If you have any questions, please call Daniel P. Schultz at (646) 428-3888.

Sincerely,

/s/

Patrick J. Howard
Assistant Inspector General for Audit

Attachment(s)

Attachment 1: Abbreviations, Acronyms, and Short Forms Used in This Report

Act	Bipartisan Budget Act of 2013
Annual Form 2000	Guaranty Agency Financial Report Annual Form 2000
Department	U.S. Department of Education
ECASLA	Ensuring Continued Access to Student Loan Act of 2008
FFELP	Federal Family Education Loan Program
FSA	Federal Student Aid
FY	Fiscal Year
GA	Guaranty Agencies
HEA	Higher Education Act of 1965, as amended
Monthly Annual Form 2000	Guaranty Agency Financial Report Monthly Annual Form 2000
OIG	The Office of Inspector General
SAFRA	The SAFRA Act
Secretary	Secretary of Education
VFA	Voluntary Flexible Agreement

Attachment 2: OIG's Recalculation of the Reserve Ratio for FY 2010 for All GAs

GA Short Name	FSA's Reserve Ratio Percentage	Accrual Reserve Ratio Percentage	Percentage Point Difference	Percentage Increase from Accrual to FSA
Arkansas	0.41	0.27	0.13	52%
Colorado	0.26	0.19	0.07	37%
Florida	0.92	0.73	0.19	26%
Georgia	0.73	0.57	0.16	28%
Illinois	0.76	0.67	0.09	13%
Iowa	0.79	0.71	0.08	11%
Kentucky	0.36	0.24	0.11	50%
Louisiana	0.64	0.48	0.15	33%
Maine	0.46	0.40	0.06	15%
Massachusetts	0.30	0.22	0.08	36%
Michigan	0.40	0.28	0.12	43%
Missouri	0.69	0.59	0.11	17%
Montana	0.47	0.44	0.03	7%
Nebraska	0.51	0.39	0.13	31%
New Hampshire	0.75	0.40	0.34	88%
New Jersey	0.74	0.34	0.40	118%
New Mexico	0.55	0.47	0.08	17%
New York	0.33	0.26	0.07	27%
North Carolina	0.62	0.57	0.04	9%
North Dakota	0.87	0.76	0.11	14%
Oklahoma	0.75	0.62	0.13	21%
Pennsylvania	0.39	0.33	0.06	18%
Rhode Island	0.85	0.60	0.25	42%
South Carolina	0.60	0.56	0.04	7%
Tennessee	0.55	0.45	0.09	22%
Texas	1.47	1.39	0.09	6%
Utah	2.09	1.82	0.26	15%
Vermont	0.80	0.76	0.04	5%
Washington	0.45	0.38	0.07	18%
Wisconsin	0.74	0.68	0.07	9%
United Student Aid Funds	0.40	0.33	0.07	21%
ECMC	1.22	1.05	0.16	16%
Average			0.12	27%

Note: All numbers rounded to the nearest percentage point.

Attachment 3: OIG's Recalculation of the Reserve Ratio for FY 2011 for All GAs

GA Short Name	FSA's Reserve Ratio Percentage	Accrual Reserve Ratio Percentage	Percentage Point Difference	Percentage Increase from Accrual to FSA
Arkansas	0.33	0.20	0.13	65%
Colorado	0.25	0.18	0.07	39%
Florida	0.99	0.80	0.19	24%
Georgia	0.66	0.55	0.11	20%
Illinois	0.76	0.67	0.09	13%
Iowa	0.88	0.81	0.06	9%
Kentucky	0.31	0.19	0.13	63%
Louisiana	0.65	0.52	0.13	25%
Maine	0.49	0.43	0.06	14%
Massachusetts	0.24	0.16	0.08	50%
Michigan	0.41	0.32	0.10	28%
Missouri	0.72	0.61	0.12	18%
Montana	0.44	0.40	0.04	10%
Nebraska	0.47	0.34	0.13	38%
New Hampshire	0.89	0.59	0.30	51%
New Jersey	0.81	0.26	0.55	212%
New Mexico	0.55	0.48	0.07	15%
New York	0.28	0.19	0.09	47%
North Carolina	0.60	0.57	0.03	5%
North Dakota	0.86	0.71	0.15	21%
Oklahoma	0.81	0.65	0.16	25%
Pennsylvania	0.40	0.34	0.06	18%
Rhode Island	0.89	0.62	0.27	44%
South Carolina	0.57	0.52	0.05	10%
Tennessee	0.44	0.33	0.11	33%
Texas	1.91	1.81	0.11	6%
Utah	2.32	2.12	0.19	9%
Vermont	0.81	0.77	0.04	5%
Washington	0.42	0.35	0.06	20%
Wisconsin	0.74	0.69	0.06	7%
United Student Aid Funds	0.39	0.33	0.07	18%
ECMC	1.70	1.55	0.15	10%
Average			0.12	30%

Note: All numbers rounded to the nearest percentage point.

Attachment 4: OIG's Recalculation of the Reserve Ratio for FY 2012 for All GAs

GA Short Name	FSA's Reserve Ratio Percentage	Accrual Reserve Ratio Percentage	Percentage Point Difference	Percentage Increase from Accrual to FSA
Arkansas	0.27	0.15	0.12	79%
Colorado	0.26	0.19	0.08	40%
Florida	1.02	0.84	0.18	22%
Georgia	0.62	0.51	0.11	23%
Illinois	0.80	0.72	0.08	11%
Iowa	1.01	0.93	0.07	8%
Kentucky	0.29	0.16	0.13	78%
Louisiana	0.61	0.50	0.11	22%
Maine	0.47	0.39	0.08	20%
Massachusetts	0.25	0.18	0.08	42%
Michigan	0.35	0.24	0.11	44%
Missouri	0.72	0.62	0.10	17%
Montana	0.43	0.39	0.03	9%
Nebraska	0.40	0.26	0.14	55%
New Hampshire	0.99	0.73	0.26	35%
New Jersey	0.84	0.14	0.70	490%
New Mexico	0.44	0.36	0.08	21%
New York	0.28	0.20	0.07	36%
North Carolina	0.56	0.50	0.06	12%
North Dakota	0.89	0.86	0.04	4%
Oklahoma	0.93	0.77	0.16	21%
Pennsylvania	0.35	0.28	0.08	28%
Rhode Island	0.95	0.42	0.53	125%
South Carolina	0.52	0.46	0.07	14%
Tennessee	0.47	0.37	0.10	29%
Texas	2.26	2.17	0.09	4%
Utah	2.58	2.42	0.17	7%
Vermont	0.84	0.79	0.05	7%
Washington	0.40	0.33	0.07	20%
Wisconsin	0.73	0.65	0.07	11%
United Student Aid Funds	0.35	0.28	0.07	24%
ECMC	0.92	0.77	0.14	18%
Average			0.13	43%

Note: All numbers rounded to the nearest percentage point.

Attachment 5: FSA's Comments on the Draft Report

September 24, 2014

Mr. Daniel P. Schultz
Regional Inspector General for Audit
Office of Inspector General
32 Old Slip
26th Floor
New York, NY 10005

Dear Mr. Schultz:

SUBJECT: Response to Draft Audit Report, *Oversight of Guaranty Agencies During the Phase-Out of the Federal Family Education Loan Program*, (ED-OIG A06-L0003)

On August 1, 2014, the Office of Inspector General (OIG) issued a draft audit report entitled "Oversight of Guaranty Agencies During the Phase-Out of the Federal Family Education Loan Program" (Control Number ED-OIG A06-L0003). In the report, the OIG concluded that Federal Student Aid (FSA) does not have an adequate process to protect Federal funds and that FSA did not act on information that Guaranty Agencies (GAs) report to us. While we agree with many of the OIG's findings and recommendations, we do believe that we have an adequate process to protect Federal funds and that we do act on information that the GAs report to us. FSA closely monitors guaranty agency Operating and Federal fund balances to protect Federal assets, to ensure timely payment of lender claims, and to ensure that Federal Family Education Loan (FFEL) borrowers receive the service to which they are entitled. The success of our efforts to control for risks are evident in that there have been no losses of Federal fund assets, we are not aware of any lender claims being paid untimely; and we are not aware of any instance where an insufficient Operating fund level has caused a FFEL borrower to not receive the services to which the borrower is entitled.

FINDING NO. 1 – FSA's Methodology for Calculating a GA's Federal Fund Reserve Ratio Overstates the GA's Financial Health

FSA concurs with the finding that the methodology that FSA uses to calculate the guarantor's Federal fund reserve ratio is not in compliance with the regulatory requirements of 34 CFR 682.419(f)(1) and that it results in an understatement of the risk associated with the GA's ability to pay lender claims timely. The statement that it "overstates GA's financial health" specifically refers to the risk associated with the GA's ability to pay lender claims timely. To effectively mitigate this risk in the past, often GAs will transfer money from the Operating fund to the Federal fund after having discussions with us.

Starting with the fiscal year 2015 calculation, FSA will cease adding allowances and other non-cash charges to the accrual accounting Federal fund balance when calculating the official reserve ratio. Any GAs failing to meet the ratio calculated for fiscal year 2015 and the revised ratio calculated for fiscal year 2014 will be required to submit a management plan.

FINDING NO. 2 – Federal Student Aid Did Not Act on Information That Identified Guaranty Agencies Under Possible Financial Stress

FSA concurs with this finding, though we believe a more accurate description of the finding is that FSA did not document the process or actions we took on information that identifies GAs under possible financial stress.

Specifically, we concur that there is no standard methodology requirement for Annual Form 2000 projections. FSA will determine the feasibility and develop consistent criteria/standard methodology requirements (where applicable) for fund projections that GAs are required to report on the Annual Form 2000 and update the Guaranty Agency Financial Reporting Instruction accordingly. In addition, FSA will modify the labeling on the Quarterly Trend Analysis to more accurately reflect the actual risks that the projections highlight so that assumptions made on the data are accurate. For example, the OIG pointed out that this report identified four GAs with a high risk of becoming insolvent and 14 GAs as not having the ability to pay claims. This is an overstatement since in the three years since the draft report was first issued no GA became insolvent and we are unaware of any lender claim that went unpaid.

FSA performs an analysis of the projections provided by the GA's on the Annual Form 2000 to make meaningful assessments. The analysis of projections used in our Guaranty Agency Analysis Guide is used to determine the long term viability of the agency and a level of risk. These projections are also reviewed in conjunction with the Annual Form 2000 analysis for reasonableness. Although there is not a consistent methodology requirement for the projections, as part of our Forms 2000 review, FSA ensures that the projections are reasonable. Agencies are contacted as part of the review process to discuss the reconciliation of any discrepancies, to ensure that projections are reasonable, and when applicable, to discuss long-term plans that the projections may require. We will better document the procedures we follow when taking action with GAs to address risks associated with deteriorating operating fund or federal fund balances.

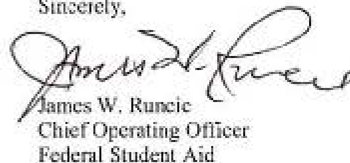
FINDING NO. 3 – FSA's Transition Evaluation Process for Selecting Successor GAs Has Deficiencies

FSA concurs with the OIG's finding that previous iterations of the process to identify a successor GA had deficiencies. As the OIG points out in their report, FSA improved upon the process in 2011, eliminating two of the deficiencies cited for the pre-2011 process.

The other two deficiencies cited by the OIG are the use of the GA recovery rate in the selection process and the order of the steps in the selection process. We do not believe that the use of the gross GA recovery rate is a deficiency. The GA recovery rate is meant as a performance indicator, not necessarily an indicator of the GA's financial health, therefore we would keep the gross recovery rate as part of the methodology. We will re-consider the order of the process steps when identifying future successor GAs and make the process more logical, as necessary.

Thank you for providing us with an opportunity to review and respond to the OIG's draft report.

Sincerely,



James W. Runcie
Chief Operating Officer
Federal Student Aid