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ABSTRACT

Guidelines for determining the maximum amount of cash reserves needed by agencies guaranteeing loans under the Guaranteed Student Loan Program are offered to the U.S. House of Representatives by the U.S. General Accounting Office. The effect of the guidelines if implemented in fiscal year (FY) 1986 are estimated. The analysis was based on data on guaranty agencies' sources and uses of funds for FYs 1982-1985, as well as review of recent studies and meetings with Department of Education and guaranty agency officials. This information was used to develop a methodology for setting reserve levels and to analyze the potential effect of alternative reserve guidelines on agency reserves. It is suggested that guidelines should set separate reserve levels for each agency, taking into account the agency's potential to experience negative cash flow, which is largely determined by the value of its outstanding loan guarantee commitments and its single expense--claims paid to lenders. It is concluded that agency reserve limits could be set large enough to accommodate cash flow problems experienced in recent years, while not so large as to allow the accumulation of unnecessarily large reserves. Appendices include a list of guaranty agencies by state and information on the research methodology. (SW)

United States General Accounting Office

GAO

Briefing Report to the Chairman, Subcommittee on Postsecondary Education, Committee on Education and Labor, House of Representatives

August 1986

GUARANTEED STUDENT LOANS

Guidelines for Reducing Guaranty Agency Reserves

GAO/HRD-86-129BR

GAO
United States
General Accounting Office
Washington, D.C. 20548

Human Resources Division

B-223553

August 7, 1986

The Honorable William D. Ford
Chairman, Subcommittee on
Postsecondary Education
Committee on Education and Labor
House of Representatives

Dear Mr. Chairman:

This briefing report responds to an April 29, 1986, request by the Subcommittee that we provide guidelines for determining the maximum amount of cash reserves needed by agencies guaranteeing loans under the Guaranteed Student Loan Program. As requested, our analysis estimates the effect the guidelines would have had if implemented in fiscal year 1986. The Secretary of Education could use the proposed guidelines discussed in the report to begin recapturing federal advances (interest-free loans) in fiscal year 1987.

Guaranty agencies operate at the state level as the link between the Department of Education and lenders making education loans to students. They insure these lenders' loans against default, which are in turn reinsured by the Department. To encourage the establishment of these agencies and strengthen the cash reserves each agency holds to offset losses from defaults and other contingencies, the Department of Education has provided to these agencies almost $190 million in federal advances, of which about $156 million (82 percent) were still outstanding in April 1986.

To develop guidelines for determining reserve limits, we analyzed data on guaranty agencies' sources and uses of funds for fiscal years 1982-85, reviewed recent studies on related topics, and met with Department of Education and guaranty agency officials. We used this information to develop a methodology for setting reserve levels and analyzed the potential effect of alternative reserve guidelines on agency reserves by calculating (1) the level of reserves agencies would have been allowed to retain and (2) the portion of federal advances that could have been returned had the proposed guidelines been in effect in fiscal year 1986. For the most part, the calculations in this report are based on present law, but the guidelines developed allow for some uncertainty resulting from pending legislative changes.

BASIS FOR SETTING RESERVE REQUIREMENTS

Guaranty agencies' expenses are generally reimbursed by the federal government. Thus, the major financial risk that these agencies face is that reimbursements for defaulted loans and administrative costs necessarily lag behind expenses, such as insurance claims. In fact, 17 agencies did experience negative cash flows during either fiscal year 1984 or 1985 and were required to draw on their reserves to meet expenses. Even without reserves, however, 8 of the 17 agencies could have increased insurance premiums to offset their negative cash flows.

Our interviews with experts and our review of other studies showed that reserve funds held by financial institutions are often established as a percentage of outstanding loans (or insurance commitments), based upon past default (or claim) experience. Most guaranty agencies already have some sort of minimum reserve guidelines based on a percentage of outstanding guarantees, but this percentage is not necessarily related to either their expectations of negative cash flow or past claims experience.

We concluded that maximum reserves should be established individually for each agency and should, given the reimbursable nature of these agencies' expenses, be based upon the potential to experience negative cash flow. Because cash flow depends largely on each agency's loan guarantee volume and its single largest expense--insurance claims paid to lenders--we developed a methodology that would set maximum reserve levels as an amount equal to the largest of three factors:

--Guideline 1: a percentage of claims paid during the prior fiscal year.

--Guideline 2: a percentage of the amount of outstanding loans guaranteed by the agency at the end of the prior fiscal year.

--Guideline 3: a minimum dollar amount ($500,000) to provide for the smaller loan portfolios and claims activity of small agencies.

ESTIMATING THE GUIDELINES' POTENTIAL EFFECTS

Using these general rules, we developed a range of specific factors for each of the guidelines that would reduce reserves and recapture federal advances by larger or smaller amounts depending on which were selected. For each set of guidelines, we calculated the amount of (1) current reserves that agencies would have been allowed to retain in fiscal year 1986 had the guidelines been applied to cash reserves at the end of fiscal year 1985, (2) excess reserves, and (3) returnable federal advances, which represent that portion of agencies' advances that exceeded maximum reserve levels.

The following examples show how these guidelines would operate. The first two examples illustrate the effects of the low and high ends of what we believe is an acceptable range of possible reserve guidelines. The third illustrates the much higher reserves required by contractual agreements some agencies have with lenders.

Examples of the Effect of Applying Guidelines Limiting Reserves (Fiscal Year 1986)

Specific guidelines	Example 1	Example 2	Example 3
Guideline 1	40%	50%	50%
Guideline 2	0.3%	1.0%	1.7%
Guideline 3	$500,000	$500,000	$500,000
Reserves retained	$346,000,000	$440,000,000	$567,000,000
Excess reserves	$396,000,000	$301,000,000	$174,000,000
Returnable advances	$81,000,000	$64,000,000	$52,000,000

The guidelines in example 1 would have provided reserves in 1986 adequate to offset the largest negative cash flows experienced by any of the guaranty agencies in fiscal year 1984 or 1985. Assuming no proportionately larger expenses in the future, these guidelines should be adequate for agency operations. Had these guidelines been in effect in 1986, they would have allowed the return of more than the $75 million in federal advances that the Consolidated Omnibus Budget Reconciliation Act of 1985 requires to be recaptured during fiscal year 1988.

The guidelines in example 2 would decrease excess reserves by about $95 million over example 1 and would have resulted in the return of $64 million in advances. These guidelines would also allow for any significant cash flow changes that might result from amendments to the Higher Education Act or from provisions of the Budget Reconciliation Act. For example, the Senate's 1986 higher education reauthorization bill (S. 1965) could reduce federal reimbursement of agency default losses.

Example 3 reflects a rough estimate of the effect of minimum reserve requirements contained in many agencies' agreements with lenders. The only summary data available on this topic show that for those agencies that had such agreements in 1984, minimum reserve requirements averaged 1.7 percent of outstanding guarantees.

There are barriers that could greatly reduce or even eliminate any potential savings that would result from adopting the proposed guidelines. For example, existing state laws and contractual agreements between agencies and lenders, bondholders, and purchasers of loans require many guaranty agencies to maintain reserves in excess of those we believe are needed. While the Higher Education Act may preempt certain state laws and regulations, it is unclear whether the existing contractual agreements are binding and require the agencies to retain reserves in excess of those provided in our guidelines.

CONCLUSIONS

Agency reserve limits could be set within a broad range, but they should be large enough to accommodate the cash flow problems experienced by any of the agencies in recent years, while not so large as to allow the accumulation of unnecessarily large reserves.

The cost savings to be realized by the federal government in implementing these guidelines in fiscal year 1987 and beyond is unknown. Such savings would depend on the financial condition of each agency during the previous year and the extent to which the previously discussed barriers have been reduced or eliminated.

MATTERS FOR CONSIDERATION BY THE CONGRESS

The Congress should consider amending the Higher Education Act of 1965 to (1) establish maximum reserve limits using guidelines in the range of those analyzed above, (2) require the Secretary of Education to annually determine maximum reserves and require agencies to return advances in excess of the needed reserves, (3) require agencies to pay lenders for defaulted loans without reimbursement until they reach their reserve limits, and (4) give the Secretary of Education authority to consider and grant agencies' appeals of the reserve limits under certain circumstances.

AGENCY COMMENTS

We obtained written comments on this report from the Department of Education and the National Council of Higher Education Loan Programs. The Department of Education generally agreed with our methodology for establishing maximum reserve levels. The Council was concerned that the proposed guidelines are too rigid and fail to take into account the substantial differences between individual guaranty agencies. We are in fact proposing guidelines to determine agency reserve levels on an individual agency basis, with three separate guidelines applied to each agency and permitting the retention of reserves based on the guidelines allowing the highest amount. We addressed these comments in the report and made changes where appropriate.

As arranged with your office, we will distribute this report to other interested congressional committees and members, the Secretary of Education, and the guaranty agencies and will make copies available to others on request. If you have any questions regarding the report, please call William J. Gainer, Associate Director for Education and Employment, on (202) 275-5365.

Sincerely yours,

Edward A. Densmore

for Richard L. Fogel
Director

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ABBREVIATIONS

GAO General Accounting Office

GSLP Guaranteed Student Loan Program

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GUARANTEED STUDENT LOANS:

GUIDELINES FOR REDUCING

GUARANTY AGENCY RESERVES

BACKGROUND

The Guaranteed Student Loan Program (GSLP) is the largest federal program providing financial assistance to students seeking a postsecondary education. Authorized in 1965, it has expanded rapidly in recent years. Through the end of fiscal year 1985, the program had provided more than $59 billion in student loans, most of which were still outstanding. During fiscal year 1985, 3.8 million loans totaling $8.9 billion were made.

Under GSLP, a variety of lenders--such as commercial banks, savings and loan associations, credit unions, and state agencies--make low-interest loans subsidized by the federal government to students under the protection of guarantees issued by state or private nonprofit agencies. The guaranty agencies are then reinsured by the Department of Education. Currently, all new loans under the program are guaranteed by 58 reporting agencies. The guaranty agencies are listed in appendix I.

Role of program participants

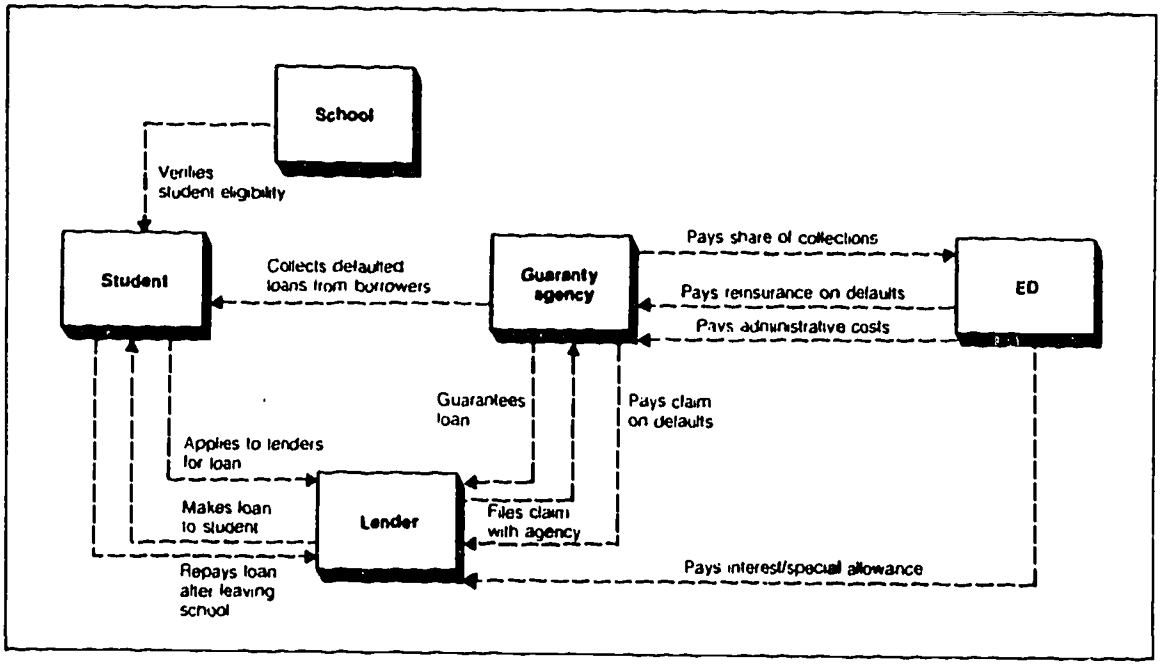
GSLP involves five separate parties, each having specific duties and responsibilities. The parties are the lender, the student borrower, the school, the guaranty agency, and the Department of Education. Figure 1 shows the basic relationships among these entities.

The guaranty agency is the program's "middleman," serving as the link between the Department and the lender. In this role, the guaranty agency insures loans made by lenders to students and seeks to encourage student access to loans while assuring that lenders, students, and schools adhere to program requirements.

The guaranty agency also helps lenders trying to collect on loans about to go into default. When a borrower fails to repay the loan, the guaranty agency reimburses the lender for the loan principal and any lost interest. The agency attempts to collect on the defaulted loans directly from the borrowers. When successful, the agencies are required to pay at least 70 percent of the fully insured amount collected on defaulted loans to the Department and are allowed to retain up to 30 percent to offset collection costs. These agencies may charge lenders an insurance fee, which is passed on to the student.

Figure 1

Roles of Program Participants



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The Department of Education establishes program rules; approves the participation of lenders, guaranty agencies, and schools; and oversees the operations of guaranty agencies and lenders. The Department pays all interest, including an interest subsidy to lenders while the student is in school. When the student begins repaying the loan, the payment includes interest and principal; however, the Department continues to pay the interest subsidy. The Department also reimburses guaranty agencies for most of their claims payments to lenders and for a portion of their administrative costs.

Guaranty agency reserves

To maintain an adequate level of working capital and to cover costs that are not reimbursed by the Department of Education, guaranty agencies maintain reserves. After interviewing experts and reviewing literature on the subject of reserves, it became clear that reserves for most lenders or insurers are established as a percentage of outstanding loans or insurance commitments based upon past default or claim experience. In fact, most agencies already have some minimum reserve guidelines that are based on a percentage of outstanding guarantees, but do not necessarily relate to either cash flow or claims experience.

In essence, reserves consist of the funds accumulated by an agency when its sources exceed its uses of funds. At the end of fiscal year 1985, the 58 agencies held $741 million in cash reserves,[1] a 1-year increase of 8.4 percent and a 2-year increase of 24.7 percent.

Although these reserves, which can be used to cover contingencies (generally cash flow problems), are an element of the program, neither the authorizing legislation nor the program regulations provide guidance on the level of reserves that should be maintained. Some states, guaranty agencies, and agency agreements with lenders or purchasers of agency tax-exempt bonds have set standards that specify minimum, but not maximum, desired reserve levels.

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[1]Throughout this report, we refer to cash reserves, rather than total or accrued reserves, since only cash reserves are available for use in case of a financial emergency. Accrued reserves include certain amounts receivable and payable by guaranty agencies. The amounts due, primarily from the Department of Education, are consistently larger than the amounts the agencies owe. At the end of fiscal year 1985, accrued reserves for all the agencies were $986 million, or $245 million more than their cash reserves.

However, there is no consistency among these requirements. So with the lack of federal guidance and the mix of other existing reserve requirements, each agency to some extent determines for itself what reserves are needed. Without federal guidance or maximum reserve levels, agencies have incurred a steady buildup of reserves so that aggregate reserves for all agencies seem disproportionately high in relation to their risks.[2] Figure 2 illustrates the growth of these reserves in recent years.

Federal advances

An issue closely related to the size of guaranty agencies' reserves is their retention of federal advances. Advances are interest-free loans the Department of Education makes to agencies. These advances make up a significant portion of many agencies' reserves. Two types of federal advances are authorized by law. The first type, authorized in 1965 and 1968 under section 422(a) of the Higher Education Act, was to help establish guaranty agencies and strengthen their reserves against claims for defaulted loans. Amendments to the act in 1976 authorized a second type of advances, under section 422(c), to be used only to pay lender claims.

The Department of Education can recall section 422(a) advances whenever it determines they are no longer needed to maintain adequate reserve funds, but has never done so although some agencies have repaid their advances. Section 422(c) advances are to be returned to the Department when they exceed 20 percent of the outstanding loans the agency has guaranteed, an amount which is on average over 50 times the amount of these agencies' section 422(c) advances.

Consequently, most advances have not been repaid. As of April 1986, $17.2 million of the $23.9 million advanced under section 422(a) and $138.7 million of the $165.8 million advanced under section 422(c) were outstanding. Thus, $155.9 million (82.2 percent) in total federal advances were outstanding at that time.

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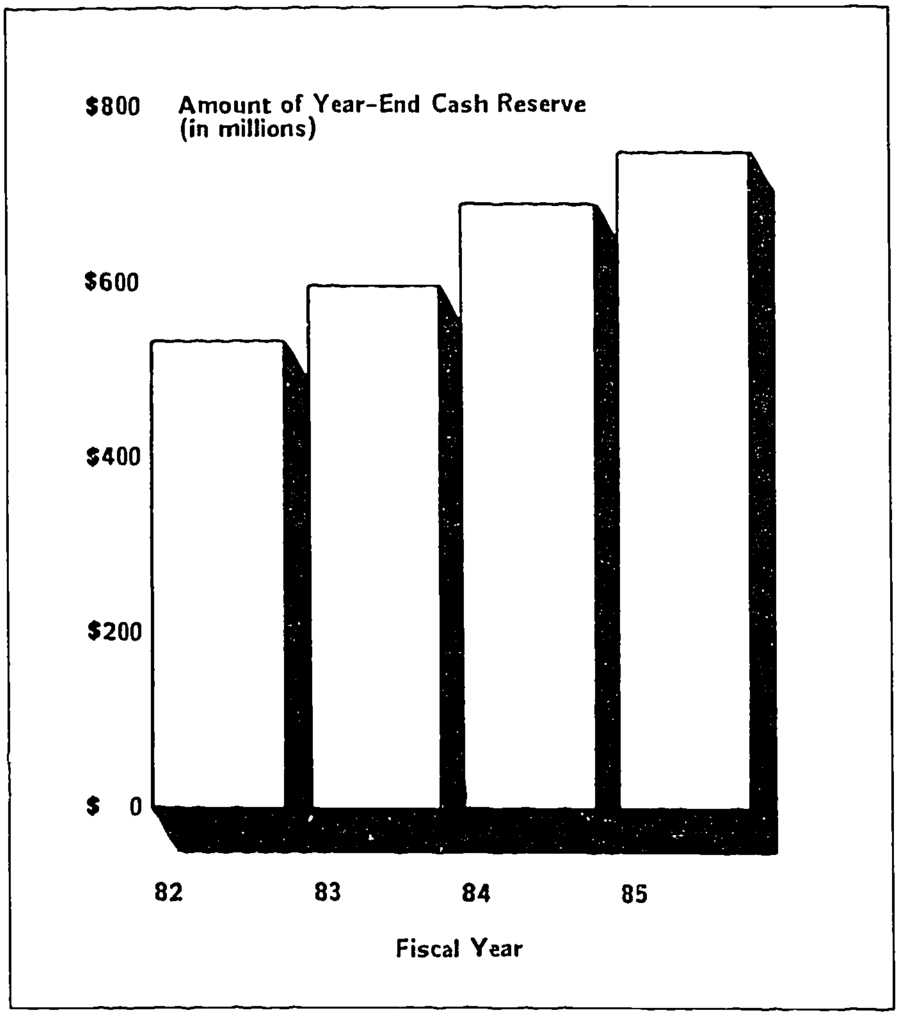
[2]We testified on this matter before the Subcommittee on Postsecondary Education, House Committee on Education and Labor, on June 20, 1985.

Figure 2

Growing Size of Guaranty Agency Reserves



Review objectives and scope

This briefing report responds to an April 29, 1986, request by the Subcommittee that we provide guidelines for determining the maximum amount of cash reserves needed by agencies guaranteeing loans under GSLP. It provides preliminary analysis from our work in compliance with the Consolidated Omnibus Budget Reconciliation Act of 1985. The act requires the Comptroller General to assess the solvency and maturity of each guaranty agency and provide the results to the Secretary of Education, who is required to recover $75 million of federal advances held by these guaranty agencies during fiscal year 1988.

The report also elaborates on our recent recommendation to the Congress to enact legislation to reduce guaranty agency reserves that was contained in our report entitled Guaranteed Student Loans: Better Criteria Needed for Financing Guarantee Agencies (GAO/HRD-86-57, July 2, 1986). It describes an approach for annually determining maximum reserve limits and suggests that agency reserves in excess of these limits be used by the agencies to first repay their federal advances and then to pay lenders' insurance claims without normal reimbursement from the Department of Education until the excess reserves are exhausted. As requested, our analysis illustrates how the proposed guidelines would have affected each guaranty agency had they been implemented at the beginning of fiscal year 1986.

To develop the guidelines for determining reserve limits, we analyzed data on guaranty agencies' sources and uses of funds for fiscal years 1982-85, analyzed basic agreements between the Department of Education and guaranty agencies participating in the program, reviewed recent studies on related topics, and met with officials of the Department and individual guaranty agencies. We used the information to develop alternative guidelines for setting reserve levels. We analyzed the effect of these guidelines on all agencies by calculating (1) the level of reserves that each agency would be allowed under each guideline, and (2) the portion of an agency's advances that could be returned under these reserve requirements. We also analyzed recently enacted and proposed legislative actions affecting administrative cost allowances, reinsurance rates, insurance premiums, and default claim filing periods to ensure that our suggested range of guidelines for determining maximum reserve levels would allow for any significant cash flow changes resulting from these changes.

We used data from fiscal year 1985 to project these effects because it was the most recent year for which guaranty agency data were available. Our methodology is described in greater detail in appendix II.

CASH RESERVES NEEDED BY GUARANTY AGENCIES

As noted, a guaranty agency needs cash reserves so it can continue to meet its financial obligations in the event that a negative cash flow is experienced (i.e., its cash expenses exceed its cash income). Negative cash flow may result, for example, when the agency's payments for claims and operating expenses exceed its reimbursements for these expenses by an amount greater than its income from other sources. It may also result from a delay in receiving reimbursements for claims paid or administrative costs from the Department of Education.

Because the agencies' annual outstanding loans guaranteed and claims paid vary greatly, their cash flow and level of reserves needed to offset potential negative cash flows could be expected to be related to these factors. There were 17 guaranty agencies that experienced a negative cash flow in either fiscal year 1984 or 1985. No agency had negative cash flow in both years. Our analysis of these 17 agencies showed that the negative cash flows averaged 21 percent of annual claims paid and 0.39 percent of the original amount of outstanding loans. (See fig. 3.) In every instance, these agencies had cash reserves that exceeded the amount of their negative cash flow for the year in question. In fact, the 17 agencies had a 2-year aggregate positive cash flow of over $15 million. (See fig. 4.) In short, negative cash flow did not threaten the solvency of any of these 17 agencies.

Figure 3

Extent of Cash Flow Problems

Agencies with negative cash flow	Cash flow	Amount as percentage of claims paid in prior year	Amount as percentage of outstanding loans in prior year
Fiscal Year 1984:			
Alaska	$ (28,047)	45%	0.17%
Connecticut	(805,651)	5	0.07
Florida	(1,557,921)	55	0.30
Oklahoma	(946,205)	27	0.67
Rhode Island	(666,813)	22	0.32
Fiscal Year 1985:			
Arizona	$ (496,954)	4%	0.19%
California[a]	(27,750,583)	40	1.12
Idaho	(253,210)	18	0.33
Illinois	(3,681,600)	12	0.18
Louisiana	(704,025)	18	0.25
Maryland	(2,909,726)	23	0.53
Massachusetts	(904,200)	3	0.05
Nevada	(175,442)	16	0.31
New Mexico	(316,305)	28	0.34
Trust Territories	(16,515)	9	0.41
United Student Aid Fund	(987,586)	8	0.15
Washington	(114,562)	2	0.03
Total	$ (42,315,345)		
Average		21%	0.39%

[a] California's 1985 cash flow was negative because about $41 million of advances disbursed from the Department of Education late in the fiscal year was not received until fiscal year 1986. If these advances had been received in fiscal year 1985, the cash flow would have been positive.

Figure 4

Extent of Cash Flow Problems Over 2-Year Period

Agencies with negative cash flow	Cash flow in fiscal year 1984	Cash flow in fiscal year 1985	Cash flow over the 2-year period
Alaska	$ (28,047)	$ 88,358	$ 60,311
Connecticut	(805,651)	1,037,652	232,001
Florida	(1,557,921)	4,479,393	2,921,472
Oklahoma	(946,205)	2,561,331	1,615,126
Rhode Island	(666,813)	926,635	259,822
Arizona	276,055	(496,954)	(220,899)
California	34,672,676	(27,750,583)	6,922,093
Idaho	736,590	(253,210)	483,380
Illinois	5,461,799	(3,681,600)	1,780,199
Louisiana	1,481,750	(704,025)	777,725
Maryland	1,847,026	(2,909,726)	(1,062,700)
Massachusetts	495,575	(904,200)	(408,625)
Nevada	456,380	(175,442)	280,938
New Mexico	478,806	(316,305)	162,501
Trust Territories	2,617	(16,515)	(13,898)
United Student Aid Fund	776,242	(987,586)	(211,344)
Washington	2,056,668	(114,562)	1,942,106
Total	$44,737,547	($29,217,339)	$15,520,208

Even before considering reserves, 13 of the 17 guaranty agencies had the opportunity to reduce or eliminate any negative cash flow they experienced by increasing the insurance premium they charged students. A 1984 survey of guaranty agencies by New York State's guaranty agency showed that 44 agencies charged less than the maximum practical insurance premium for the loans they guaranteed.[3] We estimate that 13 of the 17 agencies that experienced a negative cash flow in either fiscal year 1984 or 1985 could have reduced or eliminated their negative cash flows by charging the maximum practical insurance premium. In the aggregate, these agencies could have generated over $20 million by increasing their insurance rates during the 2-year period. (See fig. 5.) This would have reduced the aggregate total negative cash flow of these agencies in fiscal years 1984 and 1985 by about 48 percent and eliminated the negative cash flow of 8 of the 17 agencies.

GUIDELINES FOR SETTING RESERVE LEVELS

There are no legislative or departmental guidelines that specify what maximum guaranty agency reserve levels should be. After interviewing experts and reviewing the literature on the subject, we concluded that any guidelines adopted should set separate reserve levels for each agency. Such guidelines should take into account the agency's potential to experience negative cash flow, which is largely determined by the value of its outstanding loan guarantee commitments and its single largest

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[3]Guaranty agencies may charge an annual insurance premium of 1 percent of the unpaid balance of the loan, over its life. If the premium charge covers more than the anticipated in-school period, plus 1 year (what we term the maximum practical charge), agencies must refund portions of premiums paid by students who leave school earlier than anticipated or repay their loans early. To save the administrative cost of refunding premiums, all agencies charge premiums less than or equal to this maximum practical amount. Thus, if a student expects to go to school for 2-1/2 years after receiving a loan, the guaranty agency may practically charge an insurance premium of 3.5 percent (3-1/2 years x 1 percent) of the loan amount. The student pays this one-time insurance premium when the loan is disbursed.

Figure 5

Offsetting Negative Cash Flow by Raising Premiums

Agency	Amount of cash flow	Estimated additional premium income if maximum practical amount charged	Estimated cash flow if maximum practical amount charged
Fiscal year 1984			
Alaska	$ (28,047)	$ 51,102	$ 23,055
Connecticut	(805,651)	2,276,745	1,471,094
Florida	(1,557,921)	1,111,399	(466,522)
Oklahoma	(946,205)	189,565	(756,640)
Rhode Island	(666,813)	459,125	(207,688)
Total--fiscal year 1984	($4,004,637)	$4,087,935 [a]	$83,299
Fiscal Year 1985			
Arizona	$ (496,954)	$ 1,184,266	$ 687,312
California	(27,750,583)	0	(27,750,583)
Idaho	(253,210)	0	(253,210)
Illinois	(3,681,600)	4,789,610	1,108,010
Louisiana	(704,025)	0	(704,025)
Maryland	(2,909,726)	561,022	(2,348,704)
Massachusetts	(904,200)	6,405,199	5,500,999
Nevada	(175,442)	90,768	(84,674)
New Mexico	(316,305)	0	(316,305)
Trust Territories	(16,515)	28,100	11,585
United Student Aid Fund	(987,586)	2,573,520	1,585,934
Washington	(114,562)	419,088	304,526
Total--fiscal year 1985	($38,310,708)	$16,051,573	($22,259,135)
Total--both fiscal years	($42,315,345)	$20,139,509	($22,175,836)

Notes:

Our estimates assume that all insurance premium receipts come from regular Guaranteed Student Loan Program loans, but about 6 percent of national loan volume consists of Parent Loans to Undergraduate Student (PLUS) loans. Different rates apply to PLUS loans, and data is insufficient to estimate the impact of potential increases in these rates.

[a] Total does not add because of rounding.

expense--claims paid to lenders. The methodology we developed would establish reserve levels as an amount equal to the largest of three factors:

--Guideline 1: a percentage of claims paid during the preceding fiscal year.

--Guideline 2: a percentage of the amount of outstanding loans guaranteed by the agency at the end of the prior fiscal year.

--Guideline 3: a minimal dollar amount ($500,000) to protect smaller agencies.

Such guidelines could be applied at the end of the first quarter of each fiscal year to each guarantee agency's claims and guarantees outstanding from the prior fiscal year. We then tested this methodology using data from fiscal years 1984 and 1985 and a wide variety of values for guidelines 1 and 2 ranging from 20 percent to 70 percent of claims, and 0.1 percent to 1.7 percent of outstanding loan guarantees, respectively.

Illustrative examples

To illustrate the effect of such guidelines, had they been in place in fiscal year 1986, we applied them to each agency's reserves as of September 30, 1985.

The first two examples illustrate the effects on reserves and advances of the low and high ends of what we believe is a narrower range of acceptable possibilities for reserve guidelines. The third example illustrates the much higher reserves required by contractual agreements many agencies have entered into with lenders and others. Guideline 3 remains the same ($500,000) in each example.

Example 1. Applying the guidelines at the end of fiscal year 1985 where guideline 1 was set at 40 percent of claims and guideline 2 at 0.3 percent of outstanding loan guarantees would have allowed reserves just adequate to offset the negative cash flows that 17 agencies experienced during either fiscal year 1984 or 1985. As shown in figure 3, only two agencies had a negative cash flow that exceeded 40 percent of claims paid in the prior year. The negative cash flows as a percentage of outstanding loans guaranteed in the prior years for those two agencies were 0.17 percent and 0.30 percent. Thus, no agency had a negative cash flow in either fiscal year 1984 or 1985 that exceeded both 40 percent of claims paid and 0.3 percent of outstanding guarantees in the prior year. Applying these limits provides an estimate of excess agency reserves in fiscal year 1986 of $396 million and $81 million in returnable advances.

Example 2. Applying a more conservative set of guidelines using 50 percent of claims paid for guideline 1 and 1 percent of outstanding loan guarantees for guideline 2 showed that 41 agencies would have held excess reserves totaling $301 million, of which $64 million would have been in returnable advances. This is a decrease of $95 million in reserves compared to the guidelines in example 1. (See fig. 6.) Conversely, these guidelines would have allowed agencies to retain $440 million of the reserves they had at the end of fiscal year 1985, which is a substantially greater amount than needed to cover any negative cash flows in fiscal years 1984 or 1985. But some portion of these retained reserves could be needed to cover possible increased agency costs resulting from unexpected contingencies or program changes included in the Budget Reconciliation Act or potential changes resulting from the reauthorization of the Higher Education Act.

Example 3. Many guaranty agencies have agreements with lenders requiring them to retain reserves at a percentage rate tied to their outstanding loan guarantees. We determined what effect these agreements would have on reserve levels when we applied the guidelines for fiscal year 1986. Since we did not have the time to survey agencies to determine their reserve requirements in individual lender agreements, we relied on the findings in a New York State guaranty agency report on this topic. It reported that for agencies that had such contractual agreements with their lenders in 1984, the reserve requirements in their agreements ranged from 1 percent to 2.2 percent of outstanding loan guarantees, or an average rate of about 1.7 percent. We therefore determined the level of reserves agencies would be required to retain in fiscal year 1986 assuming that all agencies had agreements requiring a retention of 1.7 percent of outstanding loan guarantees in reserve. We applied the guidelines to each agency's reserves on September 30, 1985, assuming the levels of reserves to be the greater of 1.7 percent of outstanding loans guaranteed, 50 percent of claims paid, or $500,000. We determined that the agencies would have been allowed to retain $567 million of their existing reserves during fiscal year 1986. Under these guidelines, the agencies would have had to return $52 million in advances and reduce their reserves by $122 million.

Figure 6

Guaranty Agencies That Would Have Been Affected if Guidelines Using 50 Percent of Claims and 1 Percent of Outstanding Loan Amounts Had Been Implemented in Fiscal Year 1986

Agency	Cash reserves on September 30, 1985	Maximum amount under guidelines	Amount over guideline on September 30, 1985
Alabama	$ 3,017,177	$ 2,367,500	$ 649,677
Arkansas	7,062,508	1,578,061	5,484,447
Colorado	13,438,520	4,763,078	8,675,442
Delaware	3,992,080	1,165,131	2,826,949
District of Columbia	9,956,439	5,968,753	3,987,687
Georgia	14,124,966	3,716,587	10,408,379
Hawaii	2,548,016	1,070,865	1,477,152
Indiana	12,867,705	7,148,018	5,719,687
Iowa	20,176,470	5,966,634	14,209,836
Kansas	13,400,164	10,095,623	3,304,541
Kentucky	10,990,606	3,496,256	7,494,350
Maine	6,513,150	2,569,011	3,944,139
Maryland	17,058,173	6,836,956	10,221,217
Massachusetts	33,277,340	21,157,940	12,119,401
Michigan	33,385,474	19,519,836	13,865,639
Minnesota	40,552,198	20,788,964	19,763,235
Mississippi	1,962,844	1,441,028	521,816
Missouri	20,308,975	6,025,530	14,283,446
Montana	2,793,845	1,064,717	1,729,128
Nebraska	10,370,844	5,378,740	4,992,104
Nevada	1,458,789	833,458	625,331
New Hampshire	4,506,030	2,152,073	2,353,957
New Mexico	2,109,551	1,149,934	959,617
North Carolina	15,726,576	2,789,068	12,937,508
North Dakota	4,666,823	1,101,747	3,565,076
Ohio	49,699,992	16,429,238	33,270,754
Oklahoma	6,585,729	2,655,577	3,930,153
Oregon	8,105,348	3,663,255	4,442,093
Pennsylvania	71,537,263	44,250,067	27,287,197
Puerto Rico	2,906,112	1,671,282	1,234,830
Rhode Island	8,539,338	2,747,839	5,791,499
South Carolina	3,041,652	845,736	2,195,917
South Dakota	8,488,908	2,709,345	5,779,563
Tennessee	9,615,562	4,408,518	5,207,044
Texas	14,172,604	8,174,313	5,998,291
Utah	7,846,217	2,622,123	5,224,095
Vermont	1,917,764	1,457,710	460,054
Virginia	30,577,643	7,339,819	23,237,824
West Virginia	4,779,681	4,000,341	779,341
Wisconsin	24,355,848	14,340,461	10,015,388
Wyoming	1,015,643	526,743	488,900
Total	$559,450,567	$257,987,868	$301,462,699

Notes:

Guaranty agencies with reserve balance below maximum allowed by guideline: Alaska, American Samoa, Arizona, California, Connecticut, Florida, Guam, Idaho, Illinois, Louisiana, New Jersey, New York, Northern Marianas, Trust Territories, United Student Aid Fund, and Washington.

Columns and rows may not add and subtract because of rounding.

Figure 7 shows the aggregate amount of excess cash reserves that guaranty agencies held at the end of fiscal year 1985 based on these three examples and many other combinations of percentages for guidelines 1 and 2.

Secretarial discretion to relax guidelines may be needed

Once the guidelines were applied, each agency should be given the option of appealing to the Secretary of Education to retain reserves exceeding the guideline limit, if any of the following conditions existed.

1. An agency's financial position deteriorated after the end of the prior fiscal year. This might result from a sudden increase in claims or an unusual delay in payments due from the Department of Education.

2. An agency's agreements with lenders or bondholders required it to keep reserves that exceed those set by the guidelines. For example, the Texas Guaranteed Student Loan Corporation has agreements with certain lenders requiring it to maintain reserves equal to at least 1.5 percent of the unpaid principal amount of outstanding loan guarantees, rather than 1 percent of the original principal amount in our suggested guidelines.[4]

3. Significant changes in the economic environment or programmatic changes render the guidelines inadequate for individual agencies.

After the guidelines have been used to determine the maximum reserve level needed by each guaranty agency, agencies with excess reserves would be required by the Secretary of Education to (1) repay their federal advance and (2) pay for certain program expenses without receiving their normal reimbursement from the Department. Agencies with reserve levels below the levels set by the guidelines could retain their advances and reserves.

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[4]Some of these agreements may be altered by any change in federal law. Department officials believe this to be the case based upon current program regulations applying to agreements entered into by guaranty agencies. If this occurs, the number of such appeals would likely be substantially reduced.

Impact of Alternative Guidelines

If the guidelines had been applied in fiscal year 1986, guarantee agencies' aggregate cash reserves would have exceeded guideline levels by amounts shown for each combination of values for guidelines 1 and 2.

If guideline 2 for percent of original amount of loan guaranty outstanding had been:	If guideline 1 for percent of claims paid in prior year had been: 20%	30%	40%	50%	60%	70%
	(Dollar amounts in millions)					
0.1%	$552	$471	$396	$329	$284	$240
0.2%	551	471	396	329	284	240
0.3%	548	469	$\boxed{396}$	329	284	240
0.4%	542	466	394	328	284	240
0.5%	525	462	391	326	282	239
0.6%	497	454	386	323	280	237
0.7%	463	441	381	319	277	235
0.8%	427	419	374	314	273	232
0.9%	391	391	361	308	269	229
1.0%	357	357	343	$\boxed{301}$	263	224
1.1%	326	326	321	290	257	220
1.2%	295	295	293	275	250	213
1.3%	265	265	264	256	239	207
1.4%	239	239	239	236	225	200
1.5%	217	217	217	215	208	190
1.6%	195	195	195	193	188	176
1.7%	174	174	174	174	171	163

Note:
This table shows the impact of alternative values for guideline 1, percent of claims paid in the prior year, and guideline 2, percent of the original amount of loan guaranty outstanding. In computing the figures for the table, we assumed that guideline 3, $500,000, would remain in effect. The impacts of guidelines we recommend (50 percent of claims and 1 percent of the outstanding loans) and guidelines needed to provide enough reserves to offset the worst negative cash flow of any agency in fiscal years 1984 and 1985 (40 percent of claims and 0.3 percent of outstanding loans) are boxed.

RETURN OF UNNEEDED ADVANCES

The first step in reducing excess agency reserves would be to require the agencies with excess reserves to return any federal advances held in excess of needed reserves. The Reconciliation Act requires that the Secretary of Education recover \$75 million of guaranty agency advances during fiscal year 1988. We estimated the amount of federal advances that could have been returned had the guidelines been applied to each agency in fiscal year 1986. For our purposes, it was unnecessary to distinguish between section 422(a) and 422(c) advances because they are both interest-free loans and are subject to repayment to the Department of Education. For example, using the guidelines with 1 percent of outstanding loan guarantees and 50 percent of claims paid, 41 agencies had reserves exceeding the limits, of which 32 had advances. Twenty-nine of these agencies would have had to return all of their outstanding advances, and 3 would have had to return a portion. These 32 agencies would have had to return \$64 million in advances if the guidelines had been put into effect in fiscal year 1986. (See fig. 8.)

ADDITIONAL REDUCTION IN RESERVES POSSIBLE

Under example 2, after returning \$64 million of advances, 38 agencies would still have had more than an additional \$237 million in reserves that exceeded the guidelines based upon 50 percent of claims and 1 percent of outstanding guarantees.

Further reductions in such reserves could be accomplished by reducing the guaranty agency's income by any of several methods. For example, Department of Education reimbursements for agency administrative costs or agency payments for claims could be reduced by an amount equal to the agency's remaining excess reserves. Or agencies could reduce the insurance premiums they charge borrowers. But the only reimbursable agency expense that is large enough to absorb most agencies' excess reserves in one year is the payment of claims to lenders for defaulted loans. Thus, if the Congress wished to have agencies "spend down" most of their excess reserves in a single year, it could require agencies to pay lenders for defaulted loans without reimbursement from the Department until they had paid claims equal to the amount of the excess reserves remaining after the repayment of advances. This "spend down" requirement could be applied 90 days after the end of each fiscal year in which excess reserves were accumulated. If this requirement had been implemented at the beginning of fiscal year 1986, 38 guaranty agencies would have been required to pay claims of up to \$237 million without reimbursement during fiscal year 1986. (See fig. 9.)

Figure 8

Guaranty Agencies That Would Have Returned Outstanding Advances if Guidelines Using 50 Percent of Claims and 1 Percent of Outstanding Loan Amounts Had Been Implemented in Fiscal Year 1986

Agency	Advances to be returned
Alabama	$ 649,677
Arkansas	279,151
Colorado	5,600,807
Delaware	331,624
District of Columbia	49,818
Georgia	2,148,227
Hawaii	968,802
Indiana	2,129,115
Iowa	1,310,382
Kentucky	1,384,046
Maine	61[illegible]783
Maryland	1,0[illegible]4,207
Michigan	4,[illegible],899
Mississippi	[illegible],857
Missouri	[illegible]88
Montana	[illegible]3
Nevada	[illegible]
New Hampshire	397,1[illegible]3
New Mexico	250,000
North Carolina	1,015,850
North Dakota	150,000
Ohio	2,964,256
Oklahoma	677,181
Pennsylvania	13,934,372
Puerto Rico	405,760
South Carolina	455,000
South Dakota	2,336,600
Tennessee	1,349,014
Texas	5,998,291
Utah	1,344,518
Vermont	460,054
Wisconsin	4,208,064
Total	$63,796,778 [a]

Notes:

Our estimates assume that all outstanding advances for each jurisdiction were held by the designated agency except in cases where advances are held by the United Student Aid Fund. In some cases, agencies that previously operated in a jurisdiction may hold advances that they did not transfer to the presently designated agency. However, we did not make this determination in our review.

[a]Total does not add because of rounding.

Figure 9

Guaranty Agencies That Would Have Received Less Reinsurance if Guidelines Using 50 Percent of Claims and 1 Percent of Outstanding Loan Amounts Had Been Implemented in Fiscal Year 1986

Agency	Reduction in Reinsurance Reimbursements
Arkansas	$ 5,205,296
Colorado	3,074,635
Delaware	2,495,325
District of Columbia	3,937,869
Georgia	8,260,152
Hawaii	508,350
Indiana	3,590,572
Iowa	12,899,454
Kansas	3,304,541
Kentucky	6,110,304
Maine	3,325,356
Maryland	9,187,010
Massachusetts	12,119,401
Michigan	9,785,740
Minnesota	19,763,235
Mississippi	203,959
Missouri	8,269,658
Montana	994,955
Nebraska	4,992,104
Nevada	425,061
New Hampshire	1,956,765
New Mexico	709,617
North Carolina	11,921,659
North Dakota	3,415,076
Ohio	30,306,497
Oklahoma	3,252,971
Oregon	4,442,093
Pennsylvania	13,352,824
Puerto Rico	829,070
Rhode Island	5,791,499
South Carolina	1,740,917
South Dakota	3,442,963
Tennessee	3,858,030
Utah	3,879,577
Virginia	23,237,824
West Virginia	779,341
Wisconsin	5,807,324
Wyoming	488,900
Total	$237,665,921[a]

[a] Total does not add because of rounding.

BARRIERS TO REALIZING GUIDELINE SAVINGS

There are several barriers to reducing reserves, recapturing advances, or realizing savings for the federal government if the proposed guidelines are adopted. Unless the following barriers are removed, such savings could be greatly reduced or even eliminated.

1. Some guaranty agencies have chosen to use their excess reserves for nonprogram purposes, and may continue to do so rather than allow the federal government to realize any cost savings. Our July 1986 report, Guaranteed Student Loans: Better Criteria Needed for Financing Guarantee Agencies (GAO/HRD-86-57), described instances in which guaranty agencies used their reserve funds for other purposes and recommended that the practice be stopped. According to the Department, its current regulations allow a guaranty agency that has repaid its federal advances to use its reserves for nonprogram purposes. The Department has recognized this as a problem--namely an agency can generate surplus income from the program and spend it elsewhere. In its September 4, 1985, Notice of Proposed Rulemaking, the Department proposed the elimination of this possibility. As of July 15, 1986, these rules had not been issued in final form, and the passage of legislation to reduce reserves could encourage agencies to continue to divert reserves to nonprogram uses.

2. Guaranty agencies can also choose to reduce or eliminate the insurance premiums they currently charge borrowers. (The one exception is Alaska, which does not charge a premium.) This would reduce agency income and consequently cash reserves and in turn would reduce the savings attainable by the federal government. Although it would have the beneficial effect of ultimately reducing student costs, these premiums are paid in the form of a loan discount that students actually pay for after graduation. If all agencies had eliminated their insurance premium charges in fiscal year 1985, their income (and the buildup in their reserves) would have been reduced by $145 million. Department officials said that a mandatory insurance premium might be needed if reserves were capped by legislation to preclude agencies from reducing the premiums and thus increasing yearly subsidy costs above those necessary if the premiums are retained.

3. Many agencies have agreements with lenders, bondholders, and the purchasers of loans guaranteed by the agency to maintain reserves at levels in excess of those suggested in this report. Also, some states have laws and regulations that require agencies to retain a certain level of reserves, usually a percentage of their outstanding loan guarantees. For example, lenders' agreements often require agencies to maintain reserves ranging from 1.0 percent to 2.2 percent of outstanding guarantee obligations. It is not clear whether these requirements to

maintain reserves are to be applied to total (accrued) reserves or cash reserves. Although we are analyzing cash reserves in this report, it is possible that the reserve requirements may be applied to total reserves, which include an additional $245 million in accruals.

The Higher Education Act may preempt certain state laws and regulations. However, it is not clear what effect it has on guaranty agency agreements with lenders, bondholders, and the purchasers of loans. Therefore, the Secretary of Education should ensure that implementing the proposed guidelines would not violate existing laws, regulations or agreements.

CONCLUSIONS

For guaranty agencies to meet their financial obligations, they must maintain sufficient reserves to carry them through periods when their cash flow is negative. Our comparison of the cash reserves of each guaranty agency with those needed to meet its financial obligations in a worst case situation showed substantial excess reserves, which include advances loaned to the agencies by the Department of Education. However, neither the Congress nor the Department has defined adequate reserves or effectively limited agencies' accumulation of reserves.

We believe that specific criteria are needed to limit agencies' maximum reserve levels and provide a guide to their repayment of federal advances. These criteria could be set at a variety of levels as percentages of guarantee obligations and insurance claims. The reserve limits should be large enough to accommodate the types of cash flow problems experienced in recent years, but not so large as to allow the accumulation of unnecessarily large reserves.

Based on our analysis, setting reserve limits at the larger of 0.3 percent of outstanding loan guarantees and 40 percent of prior year claims would have provided adequate cash reserves to accommodate agency cash needs in 1984 and 1985 and would be an appropriate lower range for the guidelines. An upper limit on reserves at the largest of 1 percent of outstanding loan guarantees, 50 percent of prior year claims, or $500,000 would allow for unforeseen circumstances, such as unusually large insurance claims in some future year, and potential increased agency costs resulting from recently enacted or pending program changes. This level of reserves would accommodate significantly greater negative cash flows than experienced in the past, allowing for uncertainty, while still reducing reserves significantly from their current levels.

Regardless of where reserves are set, we believe a process for appealing the limits to the Secretary of Education should be provided to allow higher reserve levels for individual agencies on an exception basis.

MATTERS FOR CONSIDERATION BY THE CONGRESS

The Congress should consider amending the Higher Education Act of 1965 to:

--Require that guaranty agency reserves be limited during each fiscal year to the largest of (1) a percentage in the range of 40 to 50 percent of claims paid during the preceding year, (2) a percentage in the range of 0.3 to 1 percent of the original amount of outstanding loans guaranteed by the agency at the end of the preceding year, or (3) a minimum dollar amount of $500,000 to protect smaller agencies.

--Require the Secretary of Education to (1) annually determine--at the end of the first quarter of each fiscal year--the cash reserve applicable to each agency during the current fiscal year and (2) where actual cash reserves at the end of the prior fiscal year exceed the limits, require that such excess reserves be used first to return federal advances and then to pay default claims without reimbursement.

--Provide for appeal by the guaranty agencies to the Secretary of Education of the maximum reserve levels permitted at the end of each fiscal year on the basis that (1) an agency's financial position had deteriorated significantly after the end of the fiscal year, (2) an agency has agreements that require the agency to maintain reserves that exceed the maximum limits, or (3) significant changes in the economic environment or the program render the guidelines inadequate for individual agencies.

AGENCY COMMENTS AND OUR EVALUATION

In commenting on a draft of our report, the Department of Education agreed with our proposed methodology for establishing maximum annual reserve levels for guaranty agencies. The Department suggested that the specific percentages used to establish reserves be at the lower end of the range we suggested--namely reserves would be limited to the larger of 0.3 percent of outstanding loans guaranteed or 40 percent of claims paid during the prior year. It cited our finding that no agency's negative cash flow exceeded both these levels during fiscal years 1984 and 1985. While we did not recommend a specific set of percentages, we believe that some leeway for larger reserves may be needed to accommodate unforeseen circumstances or because changes pending in the Higher Education Act or passed in the

Budget Reconciliation Act could increase agency costs. For this reason, our proposed alternatives include a range from 0.3 to 1.0 percent of outstanding loans guaranteed and from 40 to 50 percent of claims paid during the prior year, and we are suggesting that the Congress consider giving the Secretary of Education the authority to grant appeals to guaranty agencies for exceptions to the guidelines that are adopted to accommodate any unusual financial circumstances not predictable on the basis of past experience.

The Department also proposed that the Congress pass legislation that would address potential barriers to reducing reserves and realizing savings for the federal government if reserve guidelines are established by (1) prohibiting the use of agency reserve funds for nonprogram purposes and (2) requiring agencies to charge minimum insurance premiums of 1 percent per year until the borrower graduates and begins repaying the loan. (This would be approximately equal to the maximum practical charge we discussed on p. 16.) In addition, the Department pointed out that it remained committed to the return of all advances by fiscal year 1988.

The National Council on Higher Education Loan Programs also provided written comments on a draft of this report. The Council said that we were successful in beginning to set out limits that might be considered in determining when a guaranty agency has excessive reserves. However, it said that our guidelines are too rigid and fail to take into account substantial differences between individual agencies.

We are proposing guidelines to determine agency reserve levels on an individual agency basis, with three separate guidelines applied to each agency and allowing retention of reserves based on the guidelines allowing the highest amount. In every case, when the suggested guidelines are applied, they allow for reserves in excess of the past cash needs of the agencies.

The Council also expressed concerns about our cash flow analysis, the application of the guidelines, the effect of recent and proposed changes to GSLP, and the effect of state laws and agreements guaranty agencies have with lenders, bondholders, and purchasers of loans. The Council's principal comments and our evaluation of them follow.

1. The Council said that our cash flow analysis was based on the assumption that GSLP would be operated in the future as in the past. It said that the program has changed much during the last few years as it has been amended annually since 1980.

In this report we recognized that there are uncertainties in the program's future, that program changes have already been made through the Budget Reconciliation Act, and that more changes have been proposed in amendments to the Higher Education Act. Our suggested guidelines provide for such changes by allowing reserve limits to be set well above the past cash flow needs of the agencies to allow for such uncertainties.

2. The Council felt that the proposal providing for agencies to appeal reserve limits to the Secretary of Education was unacceptable. The Council said that neither the Secretary nor the administration was sensitive to guaranty agency problems and that the administration had repeatedly proposed to reduce funding and reimbursements to the agencies.

Although the Council does not agree with the administration's views toward GSLP, the Secretary of Education is responsible for operating the program and, thus, has the responsibility and authority to operate it in the most efficient and effective manner. Although the guidelines we have provided could be expected to be adequate for all agencies based on recent experiences, we believe some appeal mechanism is needed and that the Secretary is the appropriate official to consider such appeals.

3. The Council also said that our guidelines ignore the costs related to the other functions performed by the guaranty agencies, such as encouraging lenders to participate in the program, monitoring lenders' and schools' compliance with program requirements, and helping lenders bring delinquent loans into repayment.

Our analysis did not get into the question of specific guaranty agency operations and assumes that the agencies will continue to perform these functions as they have in the past, and with similar financial consequences.

4. The Council said that our guidelines did not adequately consider (1) these agencies' functions as insurers for lenders or (2) the fact that agencies' reserves provide confidence that they have sufficient funds to meet their commitment of a 100-percent guarantee to lenders even though their reinsurance from the Department of Education may be for less than 100 percent of claims.

The cash flow analysis we conducted and the resulting guidelines were based on the agencies' recent default claims, and the reserve levels were developed to provide adequate reserves for agencies with the largest negative cash flows. With the continued availability of federal advances for qualifying agencies, the provision for agencies to appeal their reserve levels to the Secretary, and their ability to borrow against accrued reserves, the agencies would have adequate protection against unusual default losses.

5. The Council also reiterated the requirements of guaranty agencies to maintain certain levels of reserves in accordance with state laws and regulations and in agreements they have with lenders, bondholders, and purchasers of their loans.

In this report, we have recognized that most agencies have contractual agreements with lenders and bondholders, which along with certain state laws and regulations, may not allow the Department to obtain the maximum cost savings from the proposed guidelines. As noted, the Higher Education Act may preempt certain state laws and regulations. As for the agreements, it is not clear that they are not already regulated by federal program rules. In addition, these agreements can probably be renegotiated in some circumstances and in future contracts.

6. The Council expressed concern that we did not adequately consider the impact of recently enacted and proposed legislative actions affecting administrative cost allowances, reinsurance rates, insurance premiums, and claims filing periods in developing the proposed guidelines for determining maximum reserve levels.

While the lower limits suggested for reserve guidelines (40 percent of prior year claims or 0.3 percent of outstanding guarantees) are based on the program as it operated in fiscal years 1984 and 1985, the upper limits of 50 percent of claims or 1.0 percent of outstanding guarantees would allow for significant cash flow changes resulting from the legislative actions. In addition, we have suggested that an appeal process be established enabling guaranty agencies to request exemptions from the reserve limits under certain circumstances. We have revised our report to include a discussion of each of these four factors (see app. II).

LISTING OF GUARANTY AGENCIES

State	Guaranty agency
Alabama	Alabama Commission on Higher Education
Alaska	Alaska Commission on Postsecondary Education
American Samoa[a]	Pacific Islands Education Loan Program
Arizona[a]	Arizona Educational Loan Program
Arkansas	Student Loan Guarantee Foundation of Arkansas
California	California Student Aid Commission
Colorado	Colorado Guaranteed Student Loan Program
Connecticut	Connecticut Student Loan Foundation
Delaware	Delaware Guaranteed Student Loan Program
District of Columbia[b]	Higher Education Assistance Foundation[c]
Florida	Florida Student Financial Assistance
Georgia	Georgia Higher Education Assistance Corporation
Guam[a]	Pacific Islands Education Loan Program
Hawaii[a]	Hawaii Educational Loan Program
Idaho	Student Loan Fund of Idaho, Inc.
Illinois	Illinois State Scholarship Commission
Indiana	State Student Assistance Commission of Indiana
Iowa	Iowa College Aid Commission
Kansas[b]	Higher Education Assistance Foundation
Kentucky	Kentucky Higher Education Assistance Authority
Louisiana	Governor's Special Commission on Educational Service
Maine	Maine Guaranteed Student Loan Program
Maryland	Maryland Higher Education Loan Corporation
Massachusetts	Massachusetts Higher Education Assistance Corporation
Michigan	Michigan Department of Education; Michigan Higher Education Assistance Authority
Minnesota[b]	Higher Education Assistance Foundation
Mississippi	Mississippi Guarantee Student Loan Agency - Board Trustees of State Institutions of Higher Learning
Missouri	Missouri Department of Higher Education
Montana	Montana Guaranteed Student Loan Program
Nebraska[b]	Higher Education Assistance Foundation
Nevada	Nevada Guaranteed Student Loan Program
New Hampshire	New Hampshire Higher Education Assistance Foundation
New Jersey	New Jersey Higher Education Assistance Authority
New Mexico	New Mexico Student Loan Guarantee Corporation
New York	New York State Higher Education Services Corporation

State	Guaranty agency
North Carolina	North Carolina State Education Assistance Authority
North Dakota	North Dakota Guaranteed Student Loan Program
Northern Marianas[a]	Pacific Islands Education Loan Program
Ohio	Ohio Student Loan Commission
Oklahoma	Oklahoma State Regents for Higher Education
Oregon	Oregon State Scholarship Commission
Pennsylvania	Pennsylvania Higher Education Assistance Agency
Puerto Rico	Puerto Rico Higher Education Assistance Corporation
Rhode Island	Rhode Island Higher Education Assistance Authority
South Carolina	South Carolina State Education Assistance Authority
South Dakota	South Dakota Education Assistance Corporation
Tennessee	Tennessee Student Assistance Corporation
Texas	Texas Guaranteed Student Loan Corporation
Trust Territories[a]	Pacific Islands Education Loan Program
Utah	Utah Higher Education Assistance Authority
Vermont	Vermont Student Assistance Corporation
Virginia	Virginia State Education Assistance Authority
Virgin Islands	Virgin Islands Guaranteed Student Loan Program
Washington	Washington Student Loan Guaranty Association
West Virginia[b]	Higher Education Assistance Foundation
Wisconsin	Wisconsin Higher Education Corporation
Wyoming[b]	Higher Education Assistance Foundation

[a]The United Student Aid Fund, a private nonprofit organization, is the designated guaranty agency. It also guarantees loans for lenders in states where it is not the designated guarantor and reports these activities separately to the Department of Education.

[b]The Higher Education Assistance Foundation, a private nonprofit organization, is the designated guaranty agency. The Foundation does not separately report to the Department of Education.

[c]In addition to the Foundation, an older guaranty agency also operates in the District of Columbia. Although the older agency does not guarantee any more new loans, it continues to service all its outstanding loans.

SCOPE AND METHODOLOGY

In developing guidelines for setting agency reserve levels, we analyzed Department of Education data on the sources and uses of funds for all 58 guaranty agencies for fiscal years 1982-85. Data were not available for the Virgin Island guaranty agency in fiscal years 1984 and 1985.

To provide background and to help us plan our analysis, we reviewed the literature from Congressional Research Service and the Congressional Budget Office.

We reviewed the GSLP legislation and regulations regarding basic agreements between the Department of Education and guaranty agencies participating in the program.

We analyzed other studies that proposed guidelines for setting agency reserves. These included studies by the College Board, the New York Higher Education Service Corporation, the Wharton Center for Applied Research, and the National Commission on Student Financial Assistance. We discussed with a knowledgeable representative of the accounting firm of Touche Ross and Company the study of guaranty agency finances the firm made for the Department of Education.

We obtained most of the agency financial data for our analysis from Department of Education computer tapes that store data submitted by guaranty agencies on Department Form 1130, the Guarantee Agency Quarterly Report. We did not independently verify the accuracy of the data on the forms. Department officials told us that these were the best available data for our purposes. In verifying the accuracy of the calculations shown on the Department's computer tapes, we found three cases in which a guaranty agency's total income or expenses were incorrectly totaled. We computed the correct totals and used those figures in our analysis. We also obtained a report from the Department on the status of outstanding advances held by guaranty agencies as of the end of fiscal year 1985. We also obtained data on guaranty agency insurance premium rates from the New York Higher Education Services Corporation for our estimates of the amount of additional insurance premium income that guaranty agencies could have earned by raising their premiums.

To clarify the meaning of key data items on the Guarantee Agency Quarterly Reports, we held numerous discussions with Department of Education officials familiar with the report's format. We then visited the Washington state guaranty agency and verified that officials there interpreted the key data items in the same way as described by Department officials.

We assessed the solvency of each guaranty agency. We evaluated the financial risks that all agencies face to develop two short-term solvency measures: (1) cash reserves as a percentage of claims paid in the prior year and (2) cash reserves as a percentage of outstanding loan guarantees.

We correlated each of these solvency measures with the agency's age (maturity). We did this to determine if the more financially stable agencies were also the more mature. We found, however, that this was not the case because both solvency measures had low negative correlations with agency maturity. This indicates that there is almost no relationship between agency age and solvency. Because the agency's age made very little difference in its solvency, we did not further consider the maturity of agencies in developing guidelines for setting reserve levels. At any rate, the Department already has special rules for new agencies that provide them with 100-percent reinsurance during the first several years of operation as compared to insurance rates for established agencies based on their default rate.

We analyzed the 17 agencies that had negative cash flows in fiscal years 1984 and 1985 to determine if the negative cash flows were adequately covered by their reserves. In addition, we interviewed guaranty agency officials and Department of Education officials to learn why some had negative cash flows.

We used this information and other data on the financial diversity of agencies to develop guidelines for setting reserve levels. We analyzed the impact of these guidelines on all agencies by calculating the level of reserves that each agency would be allowed under each guideline. We also varied the threshold values of the reserve requirements in the guidelines to determine the resultant impact on agencies. We calculated the return of advances as that portion of an agency's advances that exceeded the guideline's reserve requirement.

We also analyzed recently enacted and proposed legislative amendments that would affect guaranty agencies' cash flows to ensure that our suggested range of criteria for determining maximum reserves would cover any increased costs likely to be experienced by the agencies. Our analyses are summarized below.

--Administrative cost allowance: The Consolidated Budget Reconciliation Act of 1985 requires the Department of Education to pay the guaranty agencies administrative cost allowances in future years and retroactively for fiscal year 1985. The Department did not make such payments in fiscal year 1985 or in 1986 as of July 29, 1986. While our guidelines are based in part on fiscal year 1985 cash flows, which did not include the cost allowance payments, our suggested lower range is based on the worst cash flows experienced by the agencies in fiscal years 1984 and 1985. To the extent these cash flows occurred in 1985 and were reduced by the Department's nonpayment of the cost allowance, the proposed guidelines will overstate the maximum reserves required--to the agencies' benefit.

--Reinsurance rates: The Senate bill to reauthorize the Higher Education Act (S. 1965) would reduce federal reinsurance rates to guaranty agencies for defaults. The higher range of our suggested guidelines is designed to allow for such a condition. In fact, we estimate that if the proposed rate reductions had been implemented in fiscal year 1985, guaranty agencies would have received $20.5 million less in reinsurance--well within the estimated $94 million increase in allowable reserves that would occur within the higher range of our guidelines.

--Insurance premiums: The Senate bill to reauthorize the Higher Education Act would limit insurance premiums charged to borrowers by the guaranty agencies to a total of 3 percent of the loan. We used the 3-1/2 percent maximum practical amount in our analysis (see p. 16). Because we did not know the specific insurance premium charged by each agency, we could not determine whether a change to 3 percent would increase or decrease individual agency premiums. An analysis in the aggregate showed that agencies' income could be reduced up to $26 million annually. As of July 31, 1986, the proposed amendment had not been enacted.

We do not believe that implementation of our guidelines should be precluded or delayed because the impact of this proposed change could not be determined. Rather, our proposed guidelines recognize the need for flexibility to adjust to changing circumstances by providing (1) a range of criteria within which adjustments can be made to reflect recent guaranty agency cash flow experience and (2) an appeal process whereby agencies can request exemptions from the reserve limits in certain situations.

--Default claim filing periods: The Budget Reconciliation Act extends by 60 days the period a guaranty agency must hold a defaulted loan before filing for reimbursement from the Department of Education, thereby resulting in a one-time stretch-out of reinsurance payments that will reduce revenues in fiscal year 1987. We did not estimate the monetary effect of the stretch-out requirement. As discussed in connection with the proposed insurance premium change, the suggested guidelines provide the flexibility--through a range of criteria based on cash flow experience and an appeal process--to recognize and adjust for changing circumstances to provide the guaranty agencies adequate reserve levels.

We made the assumption that GSLP would continue to operate under present law in doing our analysis and basing our cash flow calculations on past years' claims activity, but in suggesting alternatives we:

--provided alternatives that would allow for (1) significant increases in expenses for most agencies without depleting reserves ($100 million in the aggregate) and (2) significant changes in law, such as reinsurance triggers;

--based guidelines for each year on prior year claims so that an increase in claims automatically increases future allowable reserves; and

--based guidelines on a percentage of outstanding loans guaranteed, which will automatically allow reserves to grow unless the program shrinks overall, in which lower reserves might be appropriate.

In calculating guaranty agency excess reserves and advances, we assumed that any federal law and/or regulation that was enacted to set reserve levels would preempt any federal or state law or regulation and any other standards regarding reserve requirements for guaranty agencies. We also assumed that the Department of Education would issue in final form its proposed regulations that would prevent guaranty agencies from using their funds for nonprogram uses. Finally, we assumed that the guidelines for the return of advances would be applied to all agencies regardless of their age.

Finally, the Department of Education and an education finance expert with the American Enterprise Institute who is knowledgeable about GSLP reviewed and critiqued our analysis. We also obtained comments on this report from the National Council of Higher Education Loan Programs.

ADVANCE COMMENTS FROM THE DEPARTMENT OF EDUCATION

MEMORANDUM

UNITED STATES DEPARTMENT OF EDUCATION
WASHINGTON, D.C. 20202

DATE: JUN 19 1986

TO : William J. Gainer, Associate Director
Human Resources Division
U.S. General Accounting Office

FROM : Assistant Secretary for
Postsecondary Education

Subject: Briefing Document on Guaranteed Student Loan Program Guarantee Agency Reserves

Thank you for providing a copy of the above referenced report to us for review. Several offices within the Department of Education have reviewed the report, including the Office of Planning, Budget and Evaluation, the Office of Postsecondary Education and the Office of Legislation. The Department commends the GAO for developing a high quality report in a short period of time. We believe the general thrust of GAO's analysis and recommendations will be helpful to the Department and the Congress, especially during this period of reauthorization of the Higher Education Act.

We believe it is important at the outset to clarify the general intent of the GAO in its analysis of the reserve fund needs of the guarantee agencies. In our view, GAO's task was to determine appropriate maximum reserve levels in relationship to the probable requirements encountered by the guarantee agencies for the use of such reserve funds (e.g., to cover the costs associated with the time delay between an agency's making claims payments to lenders and receiving reinsurance payments for such claims from the Department of Education). This task, therefore, would not encompass a broad measure of an agency's "solvency," per se, since solvency is based on numerous other factors (e.g., alternative sources of funding, potential maximum liabilities, etc.) many of which are not related to the practical level of reserves needed to assure a smooth flow of agency operations. Thus, the Department views the guidelines proposed by GAO as approximate measures of reserves required to cover probable agency needs for such funds--not as measures of reserves required to ensure solvency under potential liabilities.

This Administration has sought to address the problem of more appropriate levels of agency reserves through several means, notably in our reauthorization proposal to require return of all Federal advances. Other proposals, such as reduced reinsurance rates, would address this problem, as well as encourage improvements in default prevention and collection and in administrative cost efficiency. We continue to urge the Congress to enact these legislative changes to improve the long-term operation of the GSL program.

However, we are supportive of the GAO's proposed criteria for establishing maximum guarantee agency reserve levels on the basis of: (1) a percentage of default claims paid during the prior fiscal year; (2) a percentage of the original principal amount of outstanding loans, and (3) $500,000 as a minimum dollar amount for reserves.

We suggest that the first measure should be set at 40 percent of claims paid in the prior year and the second at 0.3 percent of outstanding loans. The GAO report indicates that no agency's negative cash flow exceeded both of these levels during Fiscal Years 1984 and 1985. The maximum reserve level established by these two criteria will increase on an annual basis as the amount of default claims paid and loan volume increase. Thus, reserve fund maximums pegged at either 40 percent of default claims paid or 0.3 percent of outstanding loans should provide sufficient reserves to meet any reasonable contingencies in subsequent years since the levels of liabilities and reserve funds should rise concurrently. Furthermore, we believe that an overly generous criterion with respect to default claims paid would marginally reduce incentives for guarantee agencies to take stronger measures to prevent and reduce defaults. In addition, the $500,000 minimum provides a reliable floor for very small agencies.

We are concerned that agencies not be permitted to manipulate their reserve fund balances and thus avoid repaying their advances or having their reinsurance payments withheld by using monies from their reserve funds for non-program purposes (see attachment citing abuse practices in this area). Although we have issued proposed regulations which would prohibit such practices, we feel strongly that the Congress should legislatively prohibit such inappropriate uses of agency reserve funds.

We are also concerned with possible agency manipulation of reserve fund levels to avoid repaying advances or having reinsurance payments withheld by reducing or eliminating the insurance premium charged to borrowers. The insurance premium is the agencies' largest source of income. In the past, the Department has favored allowing agencies discretion in setting the amount of their own insurance premiums. However, in the context of the GAO's recommended criteria, we are concerned about the potential for abuse which could prove costly to the taxpayers. Therefore, we recommend that the agencies be required to charge a minimum insurance premium of one percent per year of the unpaid balance of the loan during the in-school and grace periods--the "maximum practical amount" cited by the GAO. This is also the typical amount currently charged by the majority of agencies. In essence, we are proposing that Congress legislate the typical current practice as a minimum for all agencies.

The proposal for reducing excess reserves by withholding reinsurance payments is commendable. However, we would like to stress that this proposal should not be viewed as an alternative to pending proposed legislation, designed to improve an agency's default prevention and collection efforts by decreasing the reinsurance rates based upon the agency's default and collection experience. The withholding of reinsurance payments can be effective in reducing excess reserves over the next few years. However, once an agency's reserves have been limited to a reasonable level, no strong financial incentive will exist for the agency to reduce defaults and improve collections. Our proposals for reduced reinsurance rates, loan counseling and other program changes would effect long-term improvements in default prevention and collection.

While we fully support the proposal to require agencies to return Federal advances as determined under GAO's proposed criteria, we remain committed to the proposition that agencies no longer need Federal advances and that all such monies should be returned immediately. Therefore, we suggest a timetable for immediate implementation be incorporated into this proposal to ensure that the problem of excessive reserve funds be addressed and that advances are returned before Fiscal Year 1988 as currently mandated. We strongly suggest that the effective date should be established to assure that Fiscal Year 1986 will be the first baseline year used. In addition, we recommend that the GAO include in its report a recommendation for repeal of the authority for making additional Federal advances currently found in Section 422(c) of the Act.

We believe that, after these provisions have been in effect for one year, their effectiveness should be thoroughly evaluated to determine if the criteria for setting the maximum reserve levels are appropriate.

Again, thank you for allowing us to review and comment on the draft report. We appreciate the opportunity to work with the GAO in a cooperative effort to make more efficient use of Federal funds.

C. Ronald Kimberling

C. Ronald Kimberling

Attachment

Use of GSL Reserve Fund Monies for Non-GSL Purposes

The reserve fund established by a guarantee agency is intended to support the agency's loan guarantees. The Federal government advances funds to an agency on certain conditions. Included among those conditions is that the agency's reserve fund may be used only for specific purposes related to the GSL program. Once the Federal monies are returned to the Federal government the use of the reserve fund is no longer restricted by Federal regulations.

Several agencies that have repaid their Federal advances have immediately used their reserve funds for purposes which are completely unrelated to the GSL program. For example:

- o The New Jersey Higher Education Assistance Authority returned \$6.7 million in Federal advances earlier this year. Of the monies remaining in the reserve fund, \$15 million were transferred to a dedicated fund under the control of the State Board of Education, and up to \$10 million were transferred to an "Educational Loan Development Fund," to be used for unspecified purposes.

- o The Oregon State Scholarship Commission returned their Federal advances and subsequently transferred \$1.6 million of the monies remaining in the reserve fund to a State grant program.

ADVANCE COMMENTS FROM THE NATIONAL COUNCIL

OF HIGHER EDUCATION LOAN PROGRAMS, INC.

RESPONSE OF
THE NATIONAL COUNCIL OF HIGHER EDUCATION LOAN PROGRAMS, INC.

TO THE DRAFT REPORT
BY THE GENERAL ACCOUNTING OFFICE:

"GUARANTEED STUDENT LOANS:
Guidelines for Reducing Guarantee Agency Reserves"

The National Council of Higher Education Loan Programs, Inc. appreciates the generosity of the General Accounting Office in allowing the Council to comment on the draft report "Guaranteed Student Loans: Guidelines for Reducing Guarantee Agency Reserves." At the outset, the Council would like to commend GAO on its efforts to address an extremely difficult topic -- what are adequate reserve funds to support the activities of a guarantor?

The characteristics of guaranty agencies vary widely; some predate the enactment of the Guaranteed Student Loan Program in 1965, others have been in existence less than 5 years. Approximately half are part of their States' government; others are private nonprofit corporations created by their State legislatures, for which the States have no additional fiscal responsibility. State laws which do not conflict with federal statute may govern their day-to-day operations, reappropriate their Federal funds, or mandate their reserve requirements. In addition, contracts with lenders, bond authorities, and the Student Loan Marketing Association may require individual guarantors to maintain certain levels of reserves.

Due to the variations in age, organizational structure, and operation of the agencies, any analysis of guarantors' ability to return Federal advances, or to reduce the amount of reserves they maintain against risk of loss, must be done on an agency-by-agency basis. The Council was pleased to see a recognition of this fact by the General Accounting Office in its report, "Guaranteed Student Loans: Better Criteria Needed for Financing Guarantee Agencies," (see p. 24: "What is the optimum level [of reserves]? Such a determination would have to be made on an agency-by-agency basis, because reserve levels and the magnitude of individual risks vary widely among the agencies.")

Unfortunately, the draft report does not follow GAO's previous statement; this report recommends the establishment of a single standard for all guaranty agencies, within certain limits, with provision for an appeal to the Secretary of Education in exceptional or catastrophic situations. The Council believes that such a "straight-jacket" approach to agency finances, relying strictly on cash-flow analyses of FY 1984 and FY 1985 to make recommendations on acceptable levels of agency funding for the future, is insufficiently sensitive to individual agency situations to provide a basis for Congressional action.

In developing its tests for fiscal viability, GAO has made a number of assumptions concerning the financing of the Guaranteed Student Loan Program:

Administrative Cost Allowance: The report is based on actual cash flow, including ACA in the agencies' sources of funds for FY 1984 but not for FY 1985. The Administration refused to pay ACA for FY 1985.

Payment by the Department of FY 1985 ACA, pursuant to the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA), will occur in FY 1986. (The Congress in COBRA, as signed by the President, made the payment of ACA mandatory for all future years, and retroactive to FY 1985.) Under the GAO methodology, these funds will appear in agency cash flows for FY 1986, thereby artificially inflating the cash flow figures against which future fiscal years will be measured.

The Administration has not acknowledged that COBRA actually made payment of ACA mandatory, and is continuing to seek Congressional action, through authorizing or appropriations legislation, to repeal provisions concerning payment of ACA. Therefore, availability of this major source of agency funding is questionable at best when determining the construction of agency budgets. Use of a prior-year cash flow analysis of agency solvency, as a basis for determining agency reserves, seems to be an inadequate measure in light of continual uncertainty regarding ACA.

Reinsurance: The GAO report assumes that an agency's past experience with default will continue in the succeeding fiscal year. As part of that assumption, the GAO presumes that the existing reinsurance rates -- 100% reinsurance for the first 5% of defaults paid during the fiscal year, 90% on defaults amounting to between 5-9% of outstandings, and 80% on any defaults above 9% -- will continue.

This assumption may not be valid. The Senate version of S. 1965, the Higher Education reauthorization bill now pending in a House-Senate conference, reduces reinsurance levels to 100-80-70 percent annually, at the same trigger levels. Such a substantial change, or any modification of existing law, would have a significant effect on those 21 agencies which saw their reinsurance reduced by the default triggers in FY 1985. An additional four new agencies going into their sixth year of existence are no longer eligible for protection at 100% reinsurance, and have already tripped the reinsurance trigger. A fifth agency loses its protection in FY 1987 and can also be expected to receive reduced reinsurance early in that fiscal year.

Again, the methodology proposed by GAO fails to take into account prospective changes in the law which could substantially affect an agency's cash flow position in a subsequent fiscal year.

Guarantee Fee: The draft report points out that, according to a New York State survey in 1984, 44 guaranty agencies charged less than the "maximum practical insurance premium" for loans they insured. GAO defines "maximum practical insurance premium" as one percent of the anticipated in-school period plus one year. The report then comments that 13 agencies could have reduced or eliminated their negative cash flows by charging the full amount, and includes a chart showing the additional funds agencies failed to generate by increasing student charges. In its comments on the issue of the guarantee fee, the Department of Education also urges legislation to prevent agencies from charging student borrowers less than the "maximum practical" level.

In the "real world" of setting guarantee fees, guaranty agencies are under pressure to reduce student charges -- from the Congress, borrowers, competition between guarantors, and the existence of the 5% origination fee as an additional discount on the borrower's loan amount, among others.

However, the recommendation proposed by GAO would not be possible even in the absence of these counter-pressures. Changes which will occur in the reauthorization process would make charging a fee at the "maximum practical" level impossible; both the Senate and House versions of S. 1965 provide for a student charge of no more than 3% of the principal amount of the loan for any single year. Depending on the make-up of an agency's portfolio, this could potentially make more or less funds available from student sources. Prior year experience under the old law will no longer be relevant due to a new method of calculation.

Definition of "Default": Under the law at the time GAO analysed agency cash flows, lenders were permitted to turn over defaulted paper to guaranty agencies after 120 days of delinquency. Agencies were permitted to file for Federal reinsurance at any time after they received the default claim from the lender.

The default and claims procedure was extended by two sixty day periods under the provisions of COBRA. As a result, lenders may not submit delinquent paper for payment by the agency on its guarantee until 180 days after it becomes delinquent. Similarly, the agency holding period has been extended until the 270th day of delinquency before a reinsurance claim may be filed with the Department of Education.

This sixty-day stretch-out of the loan holding period at the agency level (after an extended lender holding period prior to default) will have a direct effect on an agency's cash flow. This would not, however, be factored into a decision on reserves under the test proposed by GAO; prior year cash-flow would be determinative. Any consideration of measures of agency ability to repay Federal advances must take the revised definition of "default" into account.

Status Quo: One of the hallmarks of the measure proposed by GAO is that prior-year experience with agency cash-flow is a sufficient predictor of agency cash needs for the coming fiscal year. This assumption would make sense if the Guaranteed Student Loan Program remained unchanged for a substantial period of time. This, however, is not the case.

The law has been amended annually since the Higher Education Amendments of 1980, either through the authorization, appropriation, budget process, or a combination of those processes. Some of these changes have been significant, such as the reimposition of an income cap plus needs test included in the 1981 reconciliation legislation. The net effect of this change, plus the attendant publicity given to other (rejected) proposals to reduce GSL borrowing, led to as much as a 30% drop in activity for some agencies. Such a drop affects agency finances in a single fiscal year in two ways -- lower-than-anticipated revenues from student fees and reduced ACA payments based on such reduced volume. Both the House and the Senate reauthorization bills contain across-the-board need analysis for GSL borrowers in the future. This change can be expected to have an as yet unquantifiable impact on GSL borrowing and, concomitantly, on agency financing.

Similarly, provisions of COBRA which are only now being implemented, such as credit bureau reporting of all loans, multiple disbursement (with agency escrow options), supplemental preclaims activities, and guaranty agency as lender-of-last-resort, all have cost implications for guarantors which would not be reflected in any look-back to last year's experience with agency cash flow. If other reauthorization changes are made, such as reduction in special allowance payments to lenders, lender reluctance to continue their current level of participation could substantially increase the responsibility of guaranty agencies to provide lender of last resort services to large numbers of borrowers, further increasing their costs.

Finally, it is not only changes in the law which affect agency costs from year to year. The Department of Education is currently preparing to issue final regulations implementing the Education Amendments of 1980. If the NPRM is any indicator of the direction the final regulations can be expected to take, substantial additional responsibilities for program administration, such as school and lender compliance reviews and increased due diligence requirements, will be shifted from the Federal level to that of the State. All of these additional responsibilities will take money -- money which may not have been budgeted for past fiscal years.

Appeal to the Secretary: The draft report seeks to take care of some of the above variables by providing for an appeal to the Secretary of Education for relief from an unreasonable reserve level in a given fiscal year. This appeal procedure is simply not acceptable.

In its legislative and budget proposals over the past several years, the Administration has shown itself to be insensitive to the problems confronting guaranty agencies. It has failed to pay, and sought repeal of, ACA. It has sought legislation to require the return of all advances, regardless of agency fiscal viability. It has sought not only to reduce reinsurance levels substantially, but also to make the trigger levels for reduced reinsurance cumulative, rather than annually calculated. The Department's response to questions concerning continued agency survival is that the States should appropriate funds to support guaranty agencies, without any indication of State willingness, ability, or legal responsibility to do so.

Implementation of any statutory ceiling on guaranty agency reserves is too critical to the issue of guaranty agency survival to leave to the discretion of the Secretary. The Council strongly urges GAO to suggest another alternative appeals mechanism as part of its proposal to Congress.

The proposal made by GAO assumes a stable and continuously growing GSL program. Given the light of program pressures and changes, which are still continuing and which can be expected to continue into the foreseeable future, this is not a safe assumption. The use of the prior fiscal year as a benchmark not only for projecting agency needs for cash but also as a basis for a required spend-down in reserve funds leaves guaranty agencies at the mercy of unexpected changes in the program.

For example, assume that an agency, based on prior-year experience, had "excess reserves" (based on any of the proposed GAO tests) at the beginning of a fiscal year. It would then set its student fee under the law and would be ineligible for reinsurance payments on defaults until it had spent down its reserves to the appropriate level.

What happens if loan volume drops substantially during the fiscal year, or if defaults increase more dramatically than predicted based on past experience? The bulk of the loans were made in the Fall, at the beginning of the fiscal year. Permission through an appeals process to increase the reserve level is a hollow gesture, since the sources of funds are not available. Even increasing the student fee mid-year will not replenish the reserve funds, due to fewer loans being made. Unless the spend-down proposal is accompanied by a new authorization for mandatory "advances" when circumstances necessitate, the GAO proposal could threaten the existence of guaranty agencies.

The GAO draft, by focusing on agency cash flow, ignores other functions performed by State guaranty agencies. The agencies also serve as insurers, because Federal reinsurance is less than 100%. Their reserve funds provide lenders with confidence that the State agency has sufficient funds to honor its commitment to a 100% guarantee, regardless of how high defaults in the program rise. Once a guaranty agency's default rate hits the reinsurance trigger, there is no statutory relief from continued, and increasing, agency exposure. Lenders must be assured that funds are available to pay their claims under any "worst case" scenario, or they will be reluctant to continue to make loans.

Lenders, secondary markets, and the Student Loan Marketing Association have contractual arrangements with State guaranty agencies which require maintenance of specific levels of reserves as "collateral" for their activities. The Council believes that the draft report deals much too lightly with these existing obligations, which are closely monitored by bond rating agencies and by the market place. Any reduction in reserves could be seen by these parties not only as a breach of their contractual agreement but also as a weakening of the agency. Whether this makes good public policy or not, it is a reality of the market place; the perceptions of lenders and rating agencies of the strength and stability of guaranty agency resources cannot be ignored.

In addition, many States have statutes which require a specific level of an agency's portfolio to be retained in a reserve fund. Again, the draft GAO report does not give sufficient attention to these State requirements.

Agencies have significant responsibilities for encouraging lender participation, monitoring lender and school practices to ensure that the law is being followed, and assisting lenders in preclaims activities. An agency also remains responsible for collection of defaulted paper on which it has paid lender claims. These activities can be kept to a bare minimum to reduce agency cash flow, or can be expanded and improved, ultimately reducing Federal costs for erroneous payments and defaults. Reducing guaranty agency functions to a cash-flow analysis minimizes the importance of these crucial activities.

In summary, NCHELP believes that the GAO has successfully begun setting forth elements which might be considered in determining whether an agency has excessive reserves. However, the Council believes that the test is too rigid, failing to take into account the substantial differences between individual State guaranty agencies. The Council urges GAO to continue its analysis on a State-by-State basis, as recommended in its published report, taking into account individual State laws, contractual agreements, age and size of agency, and relationship to the State government -- all factors basically ignored in the draft. In addition, the Council urges GAO to solicit lender viewpoints in determining what reserves are in "excess," as lenders have a significant stake in the stability of the Guaranteed Student Loan program and its guaranty agencies.

The Council will be happy to make any necessary information or documentation available to the General Accounting Office as it continues its analysis.

<u>Note</u>:

The Council is an organization of agencies and organizations involved in the making, servicing, and collection of Guaranteed Student Loans. Voting members include almost all of the State guaranty agencies and State secondary markets and direct lenders participating in the program. Affiliated members include commercial lenders, servicers, collection agencies, law firms which serve as counsel or bond counsel to members agencies, underwriters, bond rating services, and other organizations which are involved, or interested, in the success of the Guaranteed Student Loan Program.

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