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STATEMENT OF
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BEFORE THE
SUBCOMMITTEE ON POSTSECONDARY EDUCATION
HOUSE COMMITTEE ON EDUCATION AND LABOR
ON
GUARANTEE AGENCY FUNDING, OPERATIONS, AND
RESERVES UNDER THE GUARANTEED STUDENT LOAN PROGRAM

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss our review of guarantee agencies under the Guaranteed Student Loan Program (GSLP). The GSLP is the largest of six student aid programs administered by the Department of Education under title IV of the Higher Education Act of 1965.

We are currently working on three reviews of GSL guarantee agency operations. The first of these--which we will discuss today--concerns the basic structure and operation of the guarantee agency, with emphasis on how agencies are financed and how they accumulate, maintain, and use reserve funds. Our other reviews are assessing (1) the extent to which guarantee agencies ensure that lenders perform due diligence on loans submitted for claims and (2) the adequacy of guarantee agencies' collection efforts on defaulted loans which they hold.

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SUMMARY OF GAO TESTIMONY OF WILLIAM J. GAINER BEFORE THE HOUSE SUBCOMMITTEE ON POSTSECONDARY EDUCATION REGARDING GUARANTEE AGENCIES UNDER THE GUARANTEED STUDENT LOAN PROGRAM

Under the Guaranteed Student Loan Program (GSLP), 58 state and private nonprofit guarantee agencies insure loans for the nation's postsecondary students, with reinsurance by the Department of Education (ED). These agencies, financed through a mixture of funds provided by state governments, the federal government, student borrowers, and the agencies' own operations, have insured more than $42 billion under the GSLP, with $7.9 billion in fiscal year 1984 alone.

GAO is conducting a series of reviews of the GSLP. In the first review, GAO studied the operations of guarantee agencies, particularly in the area of financing and reserves. In analyzing the complex financing structure and large reserve balances that currently exist, GAO concluded that improved federal criteria are needed to ensure that guarantee agencies have enough funds to cover their needs but are not allowed to build unnecessarily large reserves at the expense of student borrowers or the federal government.

The Department of Education, in conjunction with the guarantee agencies, should determine how much an agency needs in reserves and should set limits to control unnecessary increases in reserve levels. To do this, the Congress would have to give the Department authority to establish points at which (1) federal advances would be returned and (2) limits would be placed on certain sources of funds which go into the reserves.

BACKGROUND

In fiscal year 1984, the GSLP accounted for 3.4 million loans totaling $7.9 billion. The vast majority--94.8 percent--of these loans were made under the "regular" GSL program as administered by state and private nonprofit guarantee agencies. The Federally Insured Student Loan program, now being phased out, accounted for only 0.5 percent of total GSLP loan volume. The remaining loans were made under the Parent Loans to Undergraduate Students program, which provided 4.7 percent of total GSL volume.

A major objective of the GSL program has been reached now that every state, district, and territory has created or designated a guarantee agency. In total, 47 organizations serve as the guarantee agencies for 58 separate reporting units under the GSLP. The differences in the number of organizations and number of reporting units are because two large private nonprofit agencies--the Higher Education Assistance Foundation and the United Student Aid Funds--serve as the designated guarantor for more than one state.

The guarantee agency is the "middleman" of the GSLP, between the Department of Education and lenders. In this role, the guarantee agency insures loans lenders make to students and seeks to encourage student access to loans while assuring that lenders, students, and schools adhere to the requirements of the GSLP. Agencies have considerable flexibility in carrying out their responsibilities and may establish their own procedures and rules as long as they are consistent with federal requirements.

By the end of fiscal year 1984, guarantee agencies had insured a cumulative total of 22.1 million loans, totaling $42.8 billion, thus accounting for 85.3 percent of all loans made under the GSLP. Of this total, $34.7 billion in loans were outstanding at September 30, 1984.

SOURCES AND USES OF GUARANTEE AGENCY FUNDS

Guarantee agencies are funded through a variety of sources, with each source having its own set of requirements on how and for what it is to be used. In general, however, guarantee agency funds come from one of four sources:

--the state government,

--the federal government,

--the student borrower, and

--the agency's own investment income.

State appropriations are a minor source of funds. In fiscal year 1984, only 10 agencies reported receiving state appropriations. In that year, state appropriations accounted for only 1.5 percent of all guarantee agency funds.

Federal funds, consisting of advances, administrative cost allowance (ACA) reimbursements, and reinsurance (reimbursements for claims paid), provided more than two-thirds of all guarantee agency revenues in fiscal year 1984. Federal advances are essentially noninterest-bearing loans. Under some circumstances they are subject to return at the discretion of the Secretary of Education, while in other cases they are recallable based upon a statutory formula. Of the $147.4 million advanced since the beginning of the GSL program, $120.4 million, or 81.7 percent, were outstanding at April 30, 1985.

Education pays the guarantee agencies an administrative cost allowance to cover a portion of the agencies' operating costs. The yearly allowance is limited to actual costs up to 1 percent of the principal amount of loans guaranteed by each agency.

The guarantee agencies' largest source of financing is the reimbursement of claims paid on defaulted loans from the Department of Education, known as reinsurance. Reinsurance accounted for 62 percent of guarantee agency income during fiscal year 1984. In most cases, guarantee agencies receive 100 percent reimbursement on all claims paid, although the reinsurance rate can be reduced (to 90 percent or 80 percent) for all those claims paid during a fiscal year after the agency's claims rate reaches a statutory limit.

Funds obtained from student borrowers include collections on defaulted loans and the so-called "insurance premium." By statute, guarantee agencies are entitled to retain (1) up to 30 percent of all collections on defaulted loans to cover collection-related costs and (2) an additional portion on loans which were not fully reinsured. Their remaining collections are remitted to the Department of Education. In fiscal year 1984, collections accounted for 11.5 percent of guarantee agency funds.

The other source of student-provided funds is the insurance premium. This is essentially a user fee that the guarantee agency charges lenders. Since lenders may discount the insurance premium from the loan proceeds, the actual cost is passed on to students. Agencies vary in the premium they charge from nothing at all to 1 percent a year over the life of the loan. In total, insurance premiums accounted for 11.6 percent of agency income during fiscal year 1984.

The final source of agency funding is income earned by investing surplus funds. In fiscal year 1984, investment income accounted for 5.6 percent of guarantee agency revenues.

Guarantee agency funds are used for one of four purposes:

--claims paid,

--remittance of collections to the Department,

--operating costs, and

--other expenses such as fees to lenders.

The largest expenditures are to pay lender claims for borrowers' defaults. As noted earlier, these claims generally are reimbursed fully by the Department. In fiscal year 1984, claims accounted for 74 percent of all agency expenditures.

Education's share of collections are those remitted after the guarantee agency has deducted its collection-related expenses under a statutory formula. These payments accounted for 9 percent of all agency expenditures.

Operating costs include such costs as salaries, equipment, service contracts and rent. Many of these are reimbursed through either the agency's share of collections retained or ACA reimbursement. Operating costs comprised 14.9 percent of all agency expenditures during fiscal year 1984.

Other guarantee agency uses of funds include such items as lender fees, repayment of federal advances, and repayment of state loans. In total, these were just over 2 percent of all expenditures by agencies in fiscal year 1984.

Since most expenditures are fully reimbursed and the agencies have some discretion in charging an insurance premium and earning interest income, the agencies typically enjoy a surplus. In fiscal year 1984, for example, 52 of the agencies reported an operating surplus for the year. In total, the 58 agencies' sources of funds were $1.063 billion while their expenditures were $897 million, creating a one year surplus of $166 million. (A summary of sources, uses, and surplus is included in attachment I.)

GUARANTEE AGENCY RESERVES

In recent years, considerable attention has been focused on guarantee agency reserves which are growing as a result of operating surpluses. The term "reserves" refers to the cumulative surplus of funds which have been generated by the agencies since they started in the program and which are held for contingencies. The Administration has expressed concern over the rapid growth of reserves and has recommended reductions in agency income feeding these reserves. According to Education's statistics, the agencies reported reserves of $841.9 million at the end of fiscal year 1984. This was an increase of 30.8 percent above reserves held at the end of fiscal year 1983 and an increase of 55.3 percent as compared to fiscal year 1982. (A table showing each guarantee agency's reserves in relation to outstanding loan obligations is included in attachment II.)

Are the reserves too large?

Unfortunately, there is no simple answer as to whether the reserves are too large because neither the Department nor the guarantee agencies have clear criteria for determining the size of reserves. Nor do the Higher Education Act or Education's regulations provide any guidance. The regulations do provide that the federal advances to strengthen reserves may be recalled when the Secretary of Education determines they are no longer needed, but provide no effective guidance on how need is to be measured. The Secretary has not exercised this discretion. (A summary of each agency's federal advances in relation to reserves is included in attachment III.)

We believe that guarantee agency needs for reserves should be related to the risks they are asked to assume.

Reserves should be related to agency risk

The Higher Education Act and Education's regulations do not address the overall financing of guarantee agencies as a unified process. Instead, they attempt to control the use of each particular source of funds. The result can be confusing because reimbursement of certain costs may be prohibited from one source of funds but payable from another. Yet every agency expense must be paid from some source of funds and the funds left over generally go into the agencies' reserve funds.

Most guarantee agency funds result from reimbursement for specific categories of expenses. Thus, the payments from the

Education department referred to as reinsurance are reimbursements for claims paid on defaulted loans, and the portion of collections retained are a reimbursement for the cost of making these collections. Federal advances, which are made available to agencies to strengthen their reserves or to pay insurance claims prior to the receipt of reinsurance, are actually federal loans and must be repaid at some point. State appropriations to guarantee agencies may or may not be restricted to specific uses by the various states. Insurance premiums and investment earnings on reserves are not reimbursements but are used to cover those costs not specifically reimbursed by state or federal funds and to assist in building the reserves.

Reserve funds are needed to cover the contingency that, at some point in the future, reimbursements may be inadequate to cover expenses or that such reimbursements will lag behind the actual incurring of costs, which will cause a cash flow problem. More specifically, agencies face three possible risks:

1. Net losses on insurance claims could occur.
2. Administrative cost allowances and other income might not cover all operating expenses.
3. Slow reimbursements from Education could result in short term negative cash flow.

The first risk is that reinsurance will not be paid at 100 percent, since by statute the reimbursement rate for claims paid by an agency can go as low as 80 percent of those claims exceeding the statutory limitation. The risk is moderated somewhat because (1) the rate cannot fall below 80 percent and (2) the claims rate which determines the point at which reinsurance is reduced is calculated anew at the beginning of each fiscal year. Thus, an agency risks losing a portion of full reinsurance for only the remainder of the fiscal year after it exceeds the reimbursement rate threshold. During fiscal year 1984, 15 of the 58 agencies were reduced to 90 percent reinsurance at some point during the year, with the earliest occurring in April 1984. Two of these were subsequently reduced to the 80 percent reinsurance limit, both in August 1984.

The second risk faced by guarantee agencies is that not all operating costs will be offset by either the portion of collections retained or the agency's administrative cost allowance (ACA). This could occur if (1) collection costs are greater than the fee of 30 percent of the amount collected which agencies retain, (2) other operating costs exceed the yearly ACA limit of 1 percent of the amounts guaranteed, or (3) other costs are incurred which cannot be paid for with the ACA.

The third risk involves agency cash flow. At a given time, an agency may owe Education a share of its collections on defaulted loans. At the same time, however, an agency may be awaiting reinsurance payment or its administrative cost allowance from Education for costs already incurred. When the amount Education owes the agency is in excess of what the agency owes Education (which is typical), the agency must use its reserves to cover the shortfall. In essence, such a shortage may always exist, although the amount could fluctuate significantly.

With total agency reserves standing at $841.9 million at the end of fiscal year 1984, Education owed the agencies $160.1 million net of agency funds owed Education.

We did not attempt to determine the exact amount a given guarantee agency might require in reserve, since this would require detailed projections of future agency cash flows. However, the total sources and uses of funds for all agencies as reported for fiscal year 1984 would appear to indicate the reserves were much larger than needed. Looking at the three risks faced by the agencies, we identified a total of $86.6 million in possible losses in 1984.

--Claims paid for the year were $663.5 million while reinsurance was $659 million, for a loss of $4.5 million during the year.

--The agencies also lost $48.8 million on their operating and other costs. These costs were $152.5 million for the year while their net collections (after deducting payments to Education) and ACA reimbursement were $103.7 million.

--And while not actually a loss, the net amount Education owed these agencies increased by $33.3 million during fiscal year 1984, which necessitates that agencies fund this amount for some period.

But as an offset to these "losses" the agencies had other sources of funds. For example, insurance premiums for fiscal year 1984 were $123.5 million and investment earnings were $59.4 million. This total of $182.9 million from these sources far exceeded the losses due to the three forms of risk.

In addition, the agencies received $16.4 million in state appropriations, and were holding $103.3 million in federal advances. In total, reserves were $841.9 million at the end of fiscal year 1984. Even after deducting net amounts owed by ED, "cash" reserves would have been $680.9 million.

This discussion provides a general guide to the magnitude of risks agencies incur, and is useful only in the aggregate because the actual risks may vary from agency to agency. It is also important to note that some agencies are subject to state laws requiring minimum reserve levels. Finally, some agency officials are concerned about the increased need for funds that might result from any changes in the current financing structure of the program.

Summing up our reasoning on reserves, we believe the source and use of funds data which agencies report to Education support our contention that reserves appear high in relation to the risks. Most agency costs are reimbursed and those not reimbursed are generally covered by other income. Even if agencies were not running surpluses, the actual losses to which agencies have been exposed are much lower than the amounts held in reserve.

Some agencies have used GSLP funds for other purposes

During our review, we noted three instances in which guarantee agencies used funds for purposes not related to their loan insurance programs. One agency transferred funds from the

GSLP to other state administrative accounts. Another agency was allowing the state to retain a portion of investment earnings on GSLP reserves. Both of these agencies made corrections after we questioned these practices.

The third agency used GSLP funds to help finance a state grant program. The Department of Education's Office of the Inspector General questioned this action; however, the Department ruled that its regulations allow the use of certain GSLP funds for non-program purposes once an agency has repaid its federal advances, which was the case with this agency. Education officials said they intend to revise their regulations to prevent GSL funds from being used for non-program purposes, but have not yet done so.

What is needed?

We believe that guarantee agencies should have enough funds to carry out their responsibilities and that current program rules governing guarantee agency financing and reserves should be modified to provide that the agencies do not generate unnecessary income or reserves at the expense of either the student borrower or the federal government. Such changes are possible within the existing guarantee agency financing structure and could include the following.

--First, agencies could be required to use funds generated through their loan programs for program purposes only. Also, other than to establish amounts available under particular sources, no practical purpose is served by tying specific uses of funds to specific sources. In our opinion, a better approach would be to specify the permitted uses of funds regardless of the source.

--Second, limits could be placed on the amount of reserve funds, considering the risks the guarantee agencies are asked to assume. Such limits could be established for each agency based upon its specific circumstances and the risks it faces. We believe that Education, with assistance from the individual guarantee agencies, is in the best position to determine the reserves necessary to insure smooth agency operations.

--Third, once an agency's reserves have reached a predetermined level, the agency could be required to return its federal advances. After all advances were returned, an agency could begin to restrict the growth of its reserves by reductions in certain sources of funds.

The third measure would require congressional action. Currently, any advances to help an agency pay reinsurance claims are not recallable unless the agency reaches limits established by statute. The Secretary of Education would have to be given statutory authority to recall advances when reserves reach a predetermined level.

Also, the decision to reduce sources of funds once reserves reach satisfactory levels affects basic GSLP policy and would require changes to the Higher Education Act. If the Congress wants to reduce student borrower costs, it could limit an agency's ability to charge an insurance premium. If the Congress wants to reduce federal costs, it could reduce the level of claim reimbursement (reinsurance), reduce ACA reimbursement, or lower the portion of collections which can be retained by the agencies to offset collection costs.

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Mr. Chairman, this concludes my statement. We will be pleased to answer any questions.

SOURCES AND USES OF FUNDS FOR GUARANTEE AGENCIES - FISCAL YEAR 1984

	Amount (000)		Percent[a]
Sources:			
State appropriations	$ 16,412		1.5
Insurance premium	123,490		11.6
Federal advances	20,357		1.9
Reinsurance	658,960		62.0
Administrative cost allowance	61,898		5.8
Collections	122,336		11.5
Investment income	59,442		5.6
Total sources		$1,062,895	100.0
Uses:			
Claims	663,501		74.0
Operating costs	133,236		14.9
Collections to ED	80,541		9.0
Other	19,282		2.2
Total uses		896,560	100.0
Surplus		$ 166,335	-

[a]Individual items may not total 100 percent due to rounding.

Source: Department of Education's GSLP Data Book, Fiscal Year 1984.

COMPARISON OF RESERVES WITH OUTSTANDING LOAN BALANCES FOR EACH GUARANTEE AGENCY AS THE END OF FISCAL YEAR 1984

Agency	Outstanding loansa (000)	Cash reserves (000)	Percent	Total reservesb (000)	Percent
Alabama	$ 154,003	$ 1,682	1.1	$ 2,293	1.5
Alaska	18,154	168	.9	225	1.2
American Samoa	280	105	37.5	106	37.8
Arizona	262,830	1,199	.5	4,367	1.7
Arkansas	131,483	6,512	5.0	6,187	4.7
California	2,471,754	46,140	1.9	57,644	2.3
Colorado	379,434	11,291	3.0	13,459	3.5
Connecticut	1,207,526	6,851	.6	12,015	1.0
Delaware	105,641	3,871	3.7	4,252	4.0
District of Columbia	258,554	7,152	2.8	8,735	3.4
Florida	724,285	4,970	.7	12,281	1.7
Georgia	332,002	11,329	3.4	13,450	4.1
Guam	1,181	121	10.3	127	10.7
Hawaii	75,743	1,786	2.4	2,202	2.9
Idaho	77,589	1,435	1.8	1,534	2.0
Illinois	2,079,414	24,108	1.2	28,450	1.4
Indiana	599,608	11,275	1.9	12,761	2.1
Iowa	501,288	17,522	3.5	19,206	3.8
Kansas	463,538	11,902	2.6	13,399	2.9
Kentucky	307,357	6,385	2.1	7,823	2.5
Louisiana	286,020	3,678	1.3	3,959	1.4
Maine	224,024	5,815	2.6	7,388	3.3
Maryland	543,998	21,818	4.0	29,159	5.4
Massachusetts	1,832,351	34,181	1.9	43,616	2.4
Michigan	1,184,065	34,887	2.9	38,538	3.3
Minnesota	1,349,350	32,704	2.4	37,747	2.8
Mississippi	88,306	1,410	1.6	2,010	2.3
Missouri	467,306	12,115	2.6	16,488	3.5
Montana	78,626	1,910	2.4	2,390	3.0
Nebraska	322,854	8,293	2.6	9,896	3.1
Nevada	56,878	1,634	2.9	1,885	3.3
New Hampshire	188,599	4,065	2.2	4,399	2.3
New Jersey	1,879,443	21,119	1.1	34,845	1.9
New Mexico	92,552	2,426	2.6	2,574	2.8
New York	5,644,046	73,054	1.3	100,093	1.8
North Carolina	234,446	12,878	5.5	13,428	5.7
North Dakota	79,790	3,938	4.9	4,456	5.6
Northern Marianas	224	104	46.5	105	47.0
Ohio	1,443,852	42,909	3.0	46,525	3.2
Oklahoma	170,986	4,024	2.4	5,583	3.3
Oregon	307,825	7,643	2.5	8,037	2.6
Pennsylvania	3,221,299	65,488	2.0	77,513	2.4
Puerto Rico	103,556	2,452	2.4	3,321	3.2
Rhode Island	239,800	7,613	3.2	8,940	3.7
South Carolina	61,556	2,381	3.9	2,470	4.0
South Dakota	230,159	7,774	3.4	8,526	3.7
Tennessee	376,580	9,063	2.4	9,137	2.4
Texas	585,264	10,909	1.9	13,050	2.2
Trust Territories	4,041	95	2.4	165	4.1
United Student Aid Fundsc	679,510	2,557	.4	5,196	.8
Utah	198,542	7,326	3.7	8,799	4.4
Vermont	126,870	1,711	1.3	1,994	1.6
Virgin Islandsd	-	-	-	-	-
Virginia	602,674	26,823	4.5	29,173	4.8
Washington	344,042	4,182	1.2	6,367	1.9
West Virginia	188,512	3,658	1.9	4,775	2.5
Wisconsin	1,068,100	21,587	2.0	27,959	2.6
Wyoming	40,488	875	2.2	955	2.4
Totals	$34,698,194	$680,910	2.0	$841,974	2.4

[a]Excludes loans repaid, loans cancelled, and loans for which claims have been paid.

[b]Cash reserves (cumulative surplus of funds) plus net amounts owed by the Department of Education.

[c]USAF reports on national activities not included in statistics for individual states where it is the guarantor.

[d]Statistics for Virgin Islands not available. At the end of fiscal year 1983, outstanding loans were $7,270,395, cash reserves were $305,641 (4.2 percent), and total reserves were $410,932 (5.7 percent).

Source: Guarantee agency quarterly reports for September 30, 1984.