DOCUMENT RESUME

ED 353 881		HE 026 136
TITLE	Guaranty Agency Solvency: Can the Government Recover HEAF's First-Year Liquidation Cost of $212 Million? Briefing Report to the Chairman, Committee on Labor and Human Resources, U.S. Senate.	
INSTITUTION	General Accounting Office, Washington, D.C. Div. of Human Resources.	
REPORT NO	GAO/HRD-93-12BR	
PUB DATE	13 Nov 92	
NOTE	31p.	
AVAILABLE FROM	U.S. General Accounting Office, P.O. Box 6015, Gaithersburg, MD 20877 (first copy free, additional copies $2).	
PUB TYPE	Reports - Evaluative/Feasibility (142)	
EDRS PRICE	MF01/PC02 Plus Postage.	
DESCRIPTORS	Cost Effectiveness; Cost Estimates; Costs; Educational Finance; *Federal Government; Federal Programs; Higher Education; *Loan Default; Loan Repayment; *Student Loan Programs	
IDENTIFIERS	*Higher Education Assistance Foundation	

ABSTRACT

This study examined the federal cost incurred from the Higher Education Assistance Foundation's (HEAF) planned liquidation for fiscal year 1991 and whether the government can recover those costs. The study reviewed agreements between the Department of Education and guarantor agencies, examined HEAF's financial data for fiscal year 1991, and analyzed the Department's reinsurance payments for defaulted HEAF loans for fiscal year 1991. Also, officials from these entities were interviewed for additional information about the liquidation agreement and its costs. The study estimated that of the HEAF liquidation costs of $212.4 million during fiscal year 1991, the largest portion, $138.8 million, was due to the Department's agreeing to pay 100 percent reinsurance for all of HEAF's defaulted loans during the year, rather than reimbursing at the 90 and 80 percent rates for those claims submitted over the threshold. The remaining $73.6 million was primarily due to HEAF retaining default collections that normally would be forwarded to the Department. In addition, Department and other officials believe that net federal cost for the liquidation will be lower in fiscal years 1992 and 1993, and that loan collections after the Department receives all of HEAF's defaulted loan portfolio will eventually exceed the government's cost for liquidating HEAF. (JB)

United States General Accounting Office

GAO

Briefing Report to the Chairman, Committee on Labor and Human Resources, U.S. Senate

November 1992

GUARANTY AGENCY SOLVENCY

Can the Government Recover HEAF's First-Year Liquidation Cost of $212 Million?

GAO/HRD-93-12BR

HE

GAO

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

Human Resources Division

B-249252

November 13, 1992

The Honorable Edward M. Kennedy
Chairman, Committee on Labor
and Human Resources
United States Senate

Dear Mr. Chairman:

This report responds to your request for information concerning the Department of Education's agreement to liquidate the Higher Education Assistance Foundation (HEAF), a national guarantor of student loans under the Stafford Student Loan Program.[1] HEAF was experiencing serious financial difficulty, and in June 1990 announced that it was at risk of being unable to timely pay all of its lenders' student loan default claims—one of the primary responsibilities of a guaranty agency. Specifically, you asked that we determine what federal costs were incurred in fiscal year 1991 due to the Department's agreeing to this liquidation.[2]

HEAF, like other guaranty agencies, reimburses lenders for 100 percent of all defaulted loans if lenders follow prescribed loan-servicing requirements. In turn, the guaranty agencies normally receive 100-percent reinsurance from the Department of Education for their payments to lenders. However, if an agency's default claims exceed certain legislative thresholds, it is reimbursed at a 90- or 80-percent level for those claims submitted over the threshold during the remainder of that particular fiscal year.

On June 24, 1992, we briefed your staff on the results of our work. (See app. I.) This letter summarizes and expands on the information discussed at that meeting.

Results in Brief

Before the Higher Education Amendments of 1992, the Department had no direct legal obligation to pay lenders' default claims if a guaranty agency such as HEAF became insolvent or otherwise failed to meet its obligations. These amendments also specify certain actions that the Department can take if it determines an agency is not financially viable, including providing federal advances to any agency having immediate cash needs to assure

[1] The program has been renamed the "Federal Family Education Loan Program" by the Higher Education Amendments of 1992 (P.L. 102-325).

[2] The Student Loan Marketing Association (Sallie Mae) and the Minnesota Guarantor Servicing, Inc. (MGSI), a Sallie Mae subsidiary, were also involved in the liquidation.

uninterrupted payment of lenders' claims. Also, the Secretary of Education has broad legal powers under the Stafford program that may be used to help preserve lenders' participation in and student access to the Stafford program. In response to HEAF's financial problem, the Department, Sallie Mae, and MGSI agreed in October 1990 on a liquidation agreement for HEAF. The Department estimated the federal cost for the liquidation at $30 million.

We estimate that the HEAF liquidation cost the government $212.4 million during fiscal year 1991. The largest portion—$138.8 million—was due to the Department's agreeing to pay 100-percent reinsurance for all of HEAF's defaulted loans during the year, rather than reimbursing it at the 90- and 80-percent rates for those defaults over the threshold. The remaining $73.6 million was primarily due to HEAF retaining default collections that normally would be forwarded to the Department.

Department and Sallie Mae officials believe that: (1) net federal cost for the liquidation will be much lower in fiscal years 1992 and 1993, and (2) loan collections after the Department receives all of HEAF's defaulted loan portfolio (due by December 31, 1993) will eventually exceed the government's cost for liquidating HEAF. However, we are unable to determine the extent to which federal costs may be offset.

Background

The Stafford program helps students obtain financial assistance to finance their postsecondary education. The loans are made by entities such as commercial lenders and savings and loan institutions. Each state establishes a guaranty agency or designates another entity to perform a guaranty agency's functions on behalf of the state. These include, among other things, guaranteeing student loans against default or other statutory reasons for nonrepayment for the participating lenders. As such, HEAF was the designated guarantor in the District of Columbia, Kansas, Minnesota, Nebraska, West Virginia, and Wyoming. In addition, HEAF was one of two national or multistate guarantors, and was allowed to guarantee loans in other jurisdictions.

After the Department of Education reinsures a guaranty agency for a default claim, the agency retains the defaulted loan and continues to try to collect it from the defaulting student-borrower. The amount of reinsurance an agency receives depends on its default claims during each fiscal year. When an agency's default claims exceed 5 percent but not more than 9 percent of the principal amount of loans that it guaranteed that were in repayment at the end of the previous fiscal year, the agency is reimbursed at 90 percent. Further, if an agency's defaults exceed 9 percent of guaranteed loans, it is reinsured at 80 percent. At the beginning of each fiscal year, Department reimbursements for defaults return to 100 percent and remain so until an agency's default claims exceed the 5-percent trigger.

The proceeds that a guaranty agency subsequently collects from a defaulting borrower are distributed as follows. If an agency received less than 100 percent when the Department paid reinsurance, the agency retains the portion of its default collections for which the Department did not reimburse it. The agency also retains 30 percent of total collections to help offset collection costs, and forwards the remaining amount to the Department. For example, assume that the Department reimbursed an agency for a $100 defaulted loan at the 80-percent rate and the agency subsequently collected $100 from the borrower. First the agency retains the $20 for which it was not reimbursed. Then the agency retains $30 (30 percent of $100) to offset collection costs and forwards the remaining $50 to the Department.

The Higher Education Amendments of 1992 (Public Law 102-325) made several significant changes in the responsibilities of guaranty agencies and the Department. For example, beginning in fiscal year 1993, each guaranty agency must maintain specified minimum reserve levels, which increase in each of the 3 succeeding years. The Department is required to collect information annually on each guaranty agency's reserves, cash disbursements, and accounts receivable to evaluate the financial solvency of each agency. The Department is also required to report to the Congress annually on the fiscal soundness of the guaranty agency system, together with recommendations for legislative changes, if necessary, for the maintenance of a strong guaranty agency system.

The amendments allow the Department to terminate its agreement with any agency if, for instance, it is in danger of financial collapse. In such cases, if the guaranty agency is not backed by the full faith and credit of the state for which it is the primary guarantor, the amendments (1) require the Department to assume responsibility for all functions of the guaranty agency pertaining to the loan insurance program and (2) authorize it to take a wide range of actions to ensure the continued availability of student loans to the residents of the state or states in which the guaranty agency did business.

If a guaranty agency experiences financial difficulty, the 1992 amendments specify that the Department can take certain actions if it terminates a guaranty agency's agreement, including providing federal advances to any guaranty agency having immediate cash needs to assure uninterrupted payment of lenders' claims.

Agreements to Ensure HEAF's Default Claims Are Paid

In June 1990, HEAF—which at the time was the largest guarantor—notified the Department of its serious financial problems and its anticipated inability to pay lenders' claims. Because of its high default rate, HEAF was eligible for only 80-percent reimbursement on many of its loans while paying lenders 100 percent for their losses. On October 31, 1990, an agreement (Definitive Agreement) was reached on how to resolve HEAF's financial difficulties. This agreement was among the Department, Sallie Mae, and MGSI. A second agreement (Guarantor Servicer Agreement) was reached on November 13, 1990, between HEAF and MGSI.

The Definitive Agreement provides for the Department to reimburse HEAF 100 percent of all defaulted loan claims submitted to the Department regardless of whether defaults exceed the 5- and 9-percent triggers. The Department also agreed to allow HEAF to retain all collections on its defaulted loan portfolio until December 31, 1993, or such date as the Department and Sallie Mae agree that HEAF has sufficient assets available to meet expected expenditures and to establish a contingent liability reserve. As agreed, HEAF does not have to submit the Department's share of collections within 60 days of receipt, as normally required by the Department's regulations. In addition, the agreement allows HEAF to retain for its operations funds that were already payable to the Department, primarily related to collections on previously defaulted loans in fiscal year 1990. On December 31, 1993, HEAF's net assets, including its portfolio of defaulted loans, are to be turned over to the Department.

The Guarantor Servicer Agreement requires MGSI to manage HEAF until December 31, 1993, and for HEAF to pay MGSI up to $20 million for its services. These services will account for $9.5 million in management fees and up to $10.5 million in contingency fees depending on how well MGSI performs such tasks as transferring HEAF loan guarantees to other guaranty agencies. The Department estimated the HEAF liquidation would cost $30 million, including the payments to MGSI. In this report, these two agreements are simply referred to as the liquidation agreement.

Scope and Methodology

We reviewed the agreements between the Department, Sallie Mae, MGSI, and HEAF. For fiscal year 1991, we analyzed selected HEAF financial data and the Department's payment records for defaulted loans guaranteed by HEAF. We interviewed officials from these entities to obtain additional information concerning the liquidation agreement and its costs.

Our work was conducted between September 1991 and June 1992 in accordance with generally accepted government auditing standards.

Principal Findings

Department Had No Direct Legal Obligation to Lenders

Before enactment of the Higher Education Amendments of 1992, we had determined that the Department had no direct or explicit legal obligation to lenders if a guaranty agency, such as HEAF, became insolvent or otherwise failed to meet its obligations.[3] The contracts that the Department entered with guaranty agencies did not extend to lenders.

Although the Department had no legal responsibility to the lenders, Department officials believed that HEAF's problems had to be resolved to maintain lender confidence in and student access to the Stafford program. They were concerned that if HEAF became insolvent, lenders would begin denying loans to eligible students, thereby reducing student access to Stafford program loans and, potentially, to a postsecondary education.

Full Reinsurance and Retention of Loan Collections Increases Federal Costs

The Department paid $1.1 billion for HEAF default claims in fiscal year 1991. Department financial statements show that this amount is about $138.8 million more than what the Department would have paid HEAF if there was no liquidation agreement. This increase was caused by paying 100-percent reinsurance for all HEAF default claims rather than limiting payments to 90- and 80-percent because of the high volume of HEAF's default claims.

HEAF collected and retained $124.1 million of defaulted loans in fiscal year 1991. We estimate that the Department's agreement with Sallie Mae and MGSI allowed HEAF to retain $78.2 million of these collections that would normally have been paid to the Department. Thus, Department revenues

[3]Financial Problems in the Stafford Student Loan Program (GAO/T-HRD-90-52, July 27, 1990). Testimony of Franklin Frazier, Director, Education and Employment Issues, U.S. General Accounting Office, before the Senate Committee on Banking, Housing, and Urban Affairs.

declined by $78.2 million in fiscal year 1991 as a result of the agreement. In addition, the agreement allowed HEAF to retain $35.4 million of funds payable to the Department primarily related to collections it received in fiscal year 1990 on previously defaulted loans.

Receiving HEAF's Assets Will Reduce Federal Costs

HEAF had net assets of $40 million at the end of fiscal year 1991. HEAF's agreement provides that its net cash assets and remaining defaulted loans held for collections be turned over to the Department on December 31, 1993. Thus, we deducted the $40 million from our estimate of the Department's total HEAF cost of $252.4 million in fiscal year 1991 to calculate the Department's net costs of $212.4 million. (See table 1.)

Table 1: Federal Cost for HEAF Liquidation in Fiscal Year 1991

Dollars in millions

	Amount
Additional reinsurance paid by the Department	$138.8
Retention of 1991 loan collections	78.2
Retention of 1990 loan collections and other monies due the Department	35.4
Total costs	252.4
Less HEAF net assets	40.0
Net federal cost	$212.4

Department and Sallie Mae officials said that the net federal costs of the HEAF liquidation will be much lower in fiscal years 1992 and 1993, resulting primarily from a sharp decline in the volume of HEAF loans that would normally be reinsured at the 80- and 90-percent levels.[4] These officials also said that after receiving HEAF's default portfolio by December 31, 1993, the Department's total loan collections will eventually exceed the government's cost of liquidating HEAF.

While this may be the case for total collections, it is less certain for the incremental revenue the Department will receive from its collections of HEAF loans and collection costs assessed borrowers for HEAF loans received under the liquidation agreement. The incremental revenue represents the difference between (1) the Department's total collections (loan debt plus assessed collection costs), less its collection costs; and (2) HEAF's total collections (loan debt), less the 30-percent share of collections

[4]An HEAF official stated that one-time events in the first quarter of fiscal year 1992 (primarily former affiliates forgiveness of $46.5 million of demand notes due them) increased HEAF's net worth by $37.2 million. As a result, HEAF may have net income in fiscal year 1992, thereby reducing the cumulative liquidation costs.

the guaranty agency may keep to offset collection expenses and less collections of any unreinsured loan amounts. For example, if the Department collected $1,000 from a HEAF guaranteed defaulted loan plus $293 of collection costs charged to the borrower, and had collections costs of 26 percent, its net collections would be $957.[5] If HEAF had continued to operate as a guaranty agency, the Department would have received about 63 percent of its collections of defaulted loans in fiscal year 1991.[6] Table 2 compares the Department's estimates of its net collections of defaulted loans to be acquired from HEAF under the liquidation agreement to the portion of collections the Department would normally have received from HEAF in fiscal year 1991 if HEAF had continued to operate as a guaranty agency.

Table 2: Comparison of Department Net Collection Receipts

Factor	Receipts from Department collections of HEAF loans	Receipts normally received from HEAF loan collections
Loan collections	$1,000	$1,000
Collection charges collected	293	•
Minus agency's 30-percent share of collections and 100 percent of unreinsured loans (avg. 37 percent) for HEAF)	•	370
Minus Department's collection cost (26 percent)	336	•
Net collection receipts	$957	$630

Using the example illustrated in table 2, the incremental revenue the Department would receive under the liquidation agreements is $327 ($957 minus $630), or 32.7 percent of the loan amount collected. Therefore, the Department would subsequently need to collect about $650 million from HEAF's default portfolio to offset the $212.4 million in liquidation costs. This estimate ($650 million) assumes that the Department would receive average collection costs equal to 29.3 percent of defaulters' balances, which may be an optimistic assumption.

[5]The Department estimates that it receives $293 in collection cost assessments per $1,000 of defaulted loan collections and that its collection costs are 26 percent of total collections.

[6]An HEAF official estimated that about 63 percent of HEAF's total collections would normally have been paid to the Department in fiscal year 1991. This is a weighted estimate. Portions of individual collections normally due to the Department ranged from 70 percent of collections of defaulted loan amounts, for which the Department had fully reimbursed HEAF, to 50 percent of collections, for which the Department provided 80-percent reimbursement.

Total collections of this magnitude would be about 19 percent of HEAF's $3.5 billion defaulted loan portfolio as of March 31, 1992. This would total over five times the amount of HEAF's default collections of $124.1 million in fiscal year 1991. However, Department collections that will be needed to offset HEAF liquidation costs will depend on the cumulative liquidation costs as of December 31, 1993. These costs may be higher or lower than the $212.4 million cost at the end of fiscal year 1991, depending on HEAF's financial performance after fiscal year 1991.

We are unable at this time to determine the (1) future federal costs or accrued income from the HEAF liquidation, (2) size of the HEAF default portfolio the Department will receive, (3) potential federal collections on this portfolio, or (4) degree to which the Department's incremental revenue will offset the cumulative net federal cost of the HEAF liquidation.

As agreed with your office, we did not obtain written comments on this briefing report from the Department of Education or other interested parties. We did, however, discuss its contents with Department program officials and HEAF officials. We incorporated their comments where appropriate.

We are sending copies of this briefing report to other congressional committees, the Secretary of Education, and other interested parties. Should you wish to discuss its contents, please call me on (202) 512-7014. Other major contributors to this briefing report are listed in appendix II.

Sincerely yours,

Linda G. Morra

Linda G. Morra
Director, Education and
Employment Issues

Contents

Abbreviations

GAO	General Accounting Office
HEAF	Higher Education Assistance Foundation
MGSI	Minnesota Guarantor Servicing, Inc.

What Were the Federal Costs for the HEAF Liquidation in Fiscal Year 1991?

Figure I.1

GAO Guaranty Agency Solvency

Can the Government Recover HEAF's First-Year Liquidation Cost of $212 Million?

12

Figure I.2

GAO Objective

Determine the federal cost incurred from the Higher Education Assistance Foundation's (HEAF) liquidation for fiscal year 1991

Figure I.3

GAO Background

Guaranty agencies insure lenders' claims in case of borrowers' death, default, disability, or bankruptcy

- Agencies receive 100% federal reinsurance for most of their default claims

If agencies' default volume exceeds certain thresholds—their reinsurance drops to 90% and then 80%

14

Figure I.4

GAO Background (continued)

Guaranty agencies are also responsible for collecting defaulted loans

- They retain at least 30% of defaulted loan collections and forward the remaining portion to the Department of Education
- Collection submissions to the Department must be sent within 60 days of receipt by the guaranty agency

Figure I.5

GAO Background (continued)

HEAF was the designated guarantor for 5 states and the District of Columbia; and was 1 of 2 national guarantors

HEAF's financial difficulties occurred when it held many defaulted loans that were only eligible for reimbursement at the 90% and 80% levels

Figure I.6

GAO **Background (continued)**

To resolve HEAF's financial difficulties an agreement was reached on 10/31/90 between

- Department of Education
- Student Loan Marketing Association (Sallie Mae)
- Minnesota Guarantor Servicing, Inc. (MGSI)—a Sallie Mae subsidiary

A second agreement was also reached on 11/13/90 between HEAF and MGSI

Figure I.7

GAO **Key Elements of the Agreements**

Until 12/31/93 HEAF will:

- Receive 100% reinsurance for all default claims
- Retain all default collections
- Be managed by MGSI which can be paid up to $20 million in HEAF funds

HEAF can use collections, reinsurance, and other income to pay its expenses

Figure I.8

GAO **Key Elements of the Agreements (continued)**

HEAF will turn over its assets to the Department on 12/31/93

These assets include

- Net cash assets
- Defaulted loans held for collection
- Software used for servicing loan guarantees

HEAF will set up reserve fund to cover contingent liabilities

Figure I.9

GAO **Scope and Methodology**

Reviewed agreements between the Department, Sallie Mae, MGSI, and HEAF

Examined HEAF's financial data for fiscal year 1991

Analyzed Department's reinsurance payments for defaulted HEAF loans for fiscal year 1991

2

Figure I.10

GAO **Results in Brief**

Department entered into a liquidation agreement

Estimated federal cost for liquidation is $212.4 million as of September 30, 1991

Costs affected by HEAF's
- Receiving full reinsurance
- Retaining loan collections and other monies
- Returning its net assets

21

Figure I.11

GAO Department Entered Into a Liquidation Agreement

Although the Department had no direct legal obligation to lenders, it supported the HEAF liquidation agreement in order to

- maintain lenders' confidence and participation in the Stafford program
- assure continued student access to loans

Figure I.12

GAO

Full Reinsurance Increases Federal Costs

Department paid $1.1 billion for HEAF default claims in 1991

We estimate that amount is $138.8 million more than HEAF would have received if reinsured at 90% and 80% due to its high default volume

Figure I.13

GAO **Retaining All Default Collections Increases Costs**

HEAF retained $124.1 million in default collections for 1991—which we estimate includes $78.2 million that would have normally been submitted to the Department

Department also allowed HEAF to retain an additional $35.4 million in collections and other monies due to the Department as of September 30, 1990

24

Figure I.14

GAO **Receiving HEAF's Assets Will Reduce Federal Costs**

HEAF's net assets were $40 million at the end of fiscal year 1991

Debt forgiveness of $46.5 million increased HEAF's net assets in the first quarter of 1992

Whatever net assets exist on 12/31/93 will reduce the federal costs by that amount

Figure I.15

GAO **Federal Costs May Be Reduced in Future Years**

Department and Sallie Mae believe:

Federal costs in 1992 and 1993 will be much less than what we found in 1991 due to fewer loan defaults

Department's loan collections after receiving HEAF's defaulted loan portfolio will exceed the liquidation costs

26

Figure I.16

GAO **Summary of First-Year HEAF Liquidation Costs**

Cost of full reinsurance for HEAF defaults—$138.8 million

Cost for retaining all loan collections and other monies—$113.6 million

Cash cost—$252.4 million

Minus net assets—$40 million

Net cost—$212.4 million

Major Contributors to This Briefing Report

Human Resources Division, Washington, D.C.

Joseph J. Eglin, Jr., Assistant Director, (202) 512-7012
Christopher C. Crissman, Advisor

Seattle Regional Office

Charles M. Novak, Evaluator-in-Charge

Related GAO Products

Parent and Supplemental Student Loans: Volume and Default Trends for Fiscal Years 1989 to 1991 (GAO/HRD-92-138FS, Sept. 22, 1992).

Student Loans: Charactristics of Defaulted Borrowers in the Stafford Student Loan Program (GAO/HRD-91-82BR, Apr. 26, 1991).

Student Loan Lenders: Information on the Activities of the First Independent Trust Company (GAO/HRD-90-183FS, Sept. 25, 1990).

Defaulted Student Loans: Analysis of Defaulted Borrowers at Schools Accredited by Seven Agencies (GAO/HRD-90-178FS, Sept. 12, 1990).

Supplemental Student Loans: Legislative Changes Have Sharply Reduced Loan Volume (GAO/HRD-90-149FS, Aug. 3, 1990).

Financial Problems in the Stafford Student Loan Program (GAO/T-HRD-90-52, July 27, 1990).

GAO Views on the Stafford Student Loan Program (GAO/T-HRD-90-13, Feb. 20, 1990).

Supplemental Student Loans: Who Borrows and Who Defaults (GAO/HRD-90-33FS, Oct. 17, 1989).

Guaranteed Student Loans: Comparisons of Single State and Multistate Guaranty Agencies (GAO/HRD-89-92, July 11, 1989).

Guaranteed Student Loans: Analysis of Student Default Rates at 7,800 Postsecondary Schools (GAO/HRD-89-63BR, July 5, 1989).

Defaulted Student Loans: Preliminary Analysis of Student Loan Borrowers and Defaulters (GAO/HRD-88-112BR, June 14, 1988).

GAO's Views on the Default Task Force's Recommendations for Reducing Default Costs in the Guaranteed Student Loan Program (GAO/T-HRD-88-7, Feb. 2, 1988).

Guaranteed Student Loans: Legislative and Regulatory Changes Needed to Reduce Default Costs (GAO/HRD-87-76, Sept. 30, 1987).

Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are $2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20877

Orders may also be placed by calling (202) 275-6241.

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

Official Business
Penalty for Private Use $300

First-Class Mail
Postage & Fees Paid
GAO
Permit No. G100