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MAR 0 3 2004

ED-OIG/A07-C0032

Elizabeth Wong, Executive Director
New Jersey Higher Education Student
Assistance Authority
4 Quakerbridge Plaza
Trenton, NJ 08625-0540

Dear Dr. Wong:

This ***Final Audit Report*** (Control Number ED-OIG/A07-C0032) presents the results of our Audit of the New Jersey Higher Education Student Assistance Authority's (HESAA) monitoring of law firms (special counsels) providing collection services to HESAA. Our objectives were to: (i) determine the adequacy of the procedures HESAA had implemented to monitor the activities of the special counsels, (ii) determine whether borrowers were only being assessed collection costs that were permitted and reasonable, and (iii) assess whether all collections were being remitted to HESAA on a timely basis.

BACKGROUND

HESAA is a state guaranty agency that provides nearly $1 billion in financial aid annually. Each year, HESAA programs assist more than 500,000 students with grants, scholarships, loans and information resources.

HESAA has written agreements with 10 special counsels[1] to provide collection services relating to borrowers who had defaulted on Federal Family Education Loan Program (FFELP) loans. At the beginning of our fieldwork, there were over 37,000 borrower accounts, worth $174 million, assigned to special counsels and active during our audit period. The special counsels' offices were located in the states of New Jersey, New York, Florida, and Pennsylvania. In addition, one special counsel, Hayt, Hayt, and Landau (HHL), New Jersey, had affiliates located in 48 states,

[1] Gordin and Berger; Hayt, Hayt, and Landau, New Jersey; Hayt, Hayt, and Landau, New York; Levin, Clancy, Foster & Arena; Scott Marcus and Associates; Marvel & Maloney; State of New Jersey, Division of Law; Rolfe & Lobello; Schachter Portnoy; and Waters, McPherson and McNeill

Puerto Rico, the Virgin Islands, and Washington, D.C. The borrower account portfolios were referred to special counsels after HESAA's internal collection staff had been unsuccessful in their efforts. As the defaulted loans were held by HESAA, it was responsible for monitoring the special counsels to ensure their compliance with federal laws and regulations, as well as applicable state law (in the majority of cases, the special counsel obtained judgments from the applicable state court to enable the attachment of assets).

Prejudgment collection costs and attorney fees were governed and determined by the appropriate state court, and were normally included in the final judgment amount. HESAA requested that the court include special counsel fees in the judgment at the rate provided for in the agreement between HESAA and the special counsel. Postjudgment collection costs and interest rates were determined by the court. Postjudgment attorney fees assessed to the borrower at a flat rate were not permitted. Postjudgment attorney fees for specific items were allowable if adequately supported. Postjudgment collection costs (except for the state of Florida) were to be assessed only after the outstanding balances of principal and interest were cleared.

AUDIT RESULTS

We found that (1) the guaranty agency did not adequately monitor the special counsels to ensure compliance with applicable laws and regulations and the formal, written agreement that the agency had with each special counsel, (2) reviews of the special counsels' activities were not being conducted as required, and (3) all collections were not being remitted to HESAA on a timely basis.

The agreements between the guaranty agency and its special counsels state,

> Under applicable federal and state law, a guaranty agency is responsible for its agent's compliance with all federal and state regulatory and statutory requirements. Accordingly, [HESAA] will conduct a review of your student loan collection and bankruptcy practices as they pertain to [Office of Student Assistance] accounts no less frequently than every three years.

Improper Application of Payments

The State of New Jersey, Division of Law, one of the special counsels, did not apply the borrowers' payments to judgment balances in the order prescribed by HESAA policy. It was applying the payments first to outstanding judgment principal, then to postjudgment interest. This practice is harmful to the federal interest. The guaranty agency informed us that it was aware of the problem and had requested a reamortization of the accounts in the portfolio.

In 21 of 25 borrower accounts we reviewed, another special counsel, Waters, McPherson, and McNeill, added collection costs to the outstanding judgment balance at various times after the final judgment had been entered, and computed interest on the combined balance. The special counsel considered these costs as part of the docketing process prior to final judgment. In most cases, however, special counsels considered collection costs as postjudgment costs (since the judgment had been previously entered in the lower court) and applied payments to them after the outstanding balances of judgment principal and interest had been cleared. Applying payments to postjudgment collection costs in this manner is in accordance with HESAA policy and the special counsel agreement. However, Waters, McPherson, and McNeill did not follow the established policy. As a result of including collection costs in the outstanding postjudgment principal balance, we estimated that the total outstanding balances in the account portfolio of 5,699 accounts were overstated by $163,859.

In 4 of 20 closed accounts we reviewed from Waters, McPherson, and McNeill, the special counsel improperly applied payments to the outstanding judgment principal balance before clearing the outstanding postjudgment interest. This practice violates HESAA policy and the special counsel agreements, and is harmful to the federal interest. As a result of not applying payments to interest before principal, we estimated that the 1,296 closed accounts in the portfolio were erroneously reduced by $9,720.

Improper Computation of Interest

Gordin and Berger, another special counsel, improperly computed interest at intervals that did not always coincide with receipt of the borrower's payments. Because payments must be applied first to computed interest and then to principal, this methodology is incorrect because the special counsel failed to compute the amount of interest that had actually accrued on the outstanding principal balance on the date on which a payment was received and credited to the debt. Payments were therefore credited against the outstanding principal balance before all computed interest had been satisfied in full. For five of the six accounts reviewed, interest was erroneously reduced by an average of $98.48. As a result, the Federal Fund did not receive its share of the additional interest that would have accrued on principal mistakenly paid by amounts that should have been credited to computed interest. We estimated that computed interest was erroneously reduced by $15,461 for the 157 accounts in the portfolio.

Interest was overstated an average of $97.10 for six of seven accounts reviewed that were held by another special counsel, Scott Marcus and Associates (one of the seven accounts was erroneously reduced). We could not determine what caused the differences. Interest was

overstated (borrowers were assessed excessive amounts of interest) by an estimated $43,112 for the 516 accounts in the portfolio.

Improper Remittances

HHL, New Jersey, violated its agreement when it withheld its fees from remittances of borrower payments to the guaranty agency. In June 2001, HESAA discovered this violation and notified HHL that it must cease and desist this practice immediately. HHL informed HESAA that it would not comply until HESAA completed a detailed reconciliation. HESAA did not feel it was under any obligation to do so, but completed this reconciliation in November 2001. At that time, HHL began depositing 100 percent of the collections. As a result of HHL withholding its fees from remittances, the Federal Fund at HESAA, which is the property of the federal government, did not receive its share of interest income—$25,632—that would have been earned on the full remittance amounts had they been properly deposited into the holding account.

Untimely Deposits

The guaranty agency violated the 48-Hour Rule when it did not ensure that the federal government received its share of the interest that would have accrued on borrowers' payments timely deposited into an interest-bearing account. The special counsel agreements required that payments received from borrowers be deposited into a HESAA-controlled federal collections escrow (holding account) on a daily basis to comply with the 48-Hour Rule:

> [In accordance with] 34 CFR 682.419(b)(6) and Dear Guaranty Agency Director letter G-00-328... the United States Department of Education is requiring that we deposit funds received by our agent or us, whichever is earlier, within 48 hours of receipt of those funds... into a separate agency-controlled account or an agency-controlled escrow account.

On a bimonthly basis, HESAA remitted to the Federal Fund its share of borrower payments (including interest income from the holding account). Payments received from defaulted borrowers were not always deposited into the federal interest-bearing escrow account within 48 hours. Half of the special counsels had at least one late deposit. As a result of untimely deposits, we estimated that the Federal Fund lost interest amounting to $4,584. HESAA did not ensure that the special counsels established uniform procedures for receiving and recording payments.

The guaranty agency did not effectively implement management controls (formal review procedures) that were in place over the processing and recording of student loan payments received from defaulted borrowers by the special counsels. HESAA did not conduct reviews of

special counsels as required by its agreements with them. As of the date of our field exit conference, HESAA had conducted four on-site reviews during the period the account portfolios were held by the special counsels. Our analyses of two of the four reviews found that they focused on remitting and reporting collections to HESAA, rather than review of the special counsels' individual systems for applying payments to borrowers' accounts. Informal routine monitoring of special counsels also focused on attorney fees assessed and collection remittances to HESAA.

HESAA officials informed us that their agency had decided to shift resources to areas other than the monitoring of special counsel activities, i.e., required reviews of lenders and schools. They stated that subsequent to our audit period HESAA had hired new personnel and scheduled reviews to satisfy their policy on special counsel oversight.

Recommendations

We recommend that the Chief Operating Officer (COO) for Federal Student Aid (FSA) require that HESAA

1. Conduct reviews of all the special counsels as required by the agreements between HESAA and the special counsels.
2. Ensure that adequate management controls are established and/or implemented over the special counsels' systems for accounting for borrower collections.
3. Require that the Division of Law reamortize the applicable accounts in its portfolio to properly apply the payments to interest before principal and notify borrowers as appropriate.[2]
4. Remit to the Federal Fund the federal share of collections for Division of Law accounts that were closed prior to the reamortization.[3]
5. Require that Waters, McPherson, and McNeill reamortize all active accounts to properly exclude postjudgment collection costs from the outstanding principal balances, and to apply payments to the outstanding balances of interest, principal, and collection costs in the correct order; and notify borrowers as appropriate.
6. Require that Gordin and Berger reamortize all active accounts to correct the methodology used to compute interest and ensure that interest is calculated at the time payment is received, and notify borrowers as appropriate.[4]

[2] HESAA indicated that reamortization of accounts and borrower notification was in process.
[3] HESAA indicated that the Division of Law planned to ask the court to reopen closed accounts.

7. Require that Scott Marcus and Associates reamortize all active accounts to ensure that interest is computed correctly, and notify borrowers as appropriate.
8. Remit to the Federal Fund $25,632 in imputed interest lost as a result of fees withheld by HHL, New Jersey.[5]
9. Require that the special counsels establish uniform procedures for recording the date the borrower's payment is received.
10. Ensure that all payments are deposited into a federal interest-bearing account within 48 hours of receipt from the borrower.

HESAA's Comments and OIG Response

HESAA agreed with a majority of our conclusions and recommendations. Its comments (full text enclosed) specifically addressed the recommendations. The following is a summary of HESAA's comments and our response to the comments.

Conduct Reviews of All the Special Counsels as Required by the Agreements Between HESAA and the Special Counsel

HESAA stated that it concurred with this recommendation and, prior to our review, had taken significant steps to address this issue. HESAA had conducted initial reviews of all ten counsel that provided a basis for identifying compliance issues and prioritizing full compliance reviews. HESAA noted that, to date, one review had been completed.

OIG Response

We recognize that some steps may have been taken both prior to and after the start of our review to address the deficiencies noted during our review. HESAA officials informed us that the Audits and Quality Assurance Unit had not completed an on-site review in over three years. HESAA's policy required that this unit conduct biennial reviews focusing on compliance with collection and bankruptcy practices. In addition, during these reviews, the accounting records were to be reviewed to verify the correct outstanding balances of accounts.

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[4] On August 28, 2003, HESAA informed us that corrective action had been taken—all active accounts had been reamortized.

[5] HESAA remitted $14,573 to the Federal Fund on March 17, 2003. HESAA used the New Jersey Cash Management Fund rate to calculate the amount of imputed interest. We used the U.S. Treasury Current Value of Funds rate, which is specified by the Debt Collection Act of 1982 (31 U.S.C. 3717) as the minimal rate of interest for debts owed the federal government.

Ensure That Adequate Management Controls Are Established and/or Implemented Over the Special Counsels' Systems for Accounting for Borrower Collections

HESAA stated that it did not concur with this recommendation because it implies that adequate controls were not in place during the audit period. HESAA has in place several effective management controls that include annual attorney meetings, annual site visits, quarterly monitoring of attorney collections and core sample review. Core sample review involved testing sample accounts to ensure the attorney system is accurately recording credits and applying payments to principal and interest, as well as verifying the accuracy of interest accruals. Noncompliance is immediately communicated to the special counsel to remedy.

OIG Response

We recognize that HESAA had some controls in place prior to and during our review. As stated above, no major compliance reviews had been conducted in over three years and noncompliance issues were not adequately addressed for the period reviewed.

Require That the Division of Law Reamortize the Applicable Accounts in Its Portfolio To Properly Apply the Payments To Interest Before Principal and Notify Borrowers As Appropriate. Remit To the Federal Fund the Federal Share of Collections for Division of Law Accounts That Were Closed Prior To the Reamortization

HESAA stated that it concurred with these recommendations and had previously directed the Division of Law to reamortize their portfolio which is scheduled for completion by June 2004. Borrowers have been and will continue to be notified accordingly. For those accounts closed subsequent to January 1, 1998, HESAA will determine the amount of the Federal share of collections that must be remitted to the Federal Fund.

Require That Waters, McPherson, and McNeill Reamortize All Active Accounts To Properly Exclude Postjudgment Collection Costs From the Outstanding Principal Balances, and to Apply Payments To the Outstanding Balances of Interest, Principal, and Collection Costs in the Correct Order; and Notify Borrowers as Appropriate

HESAA stated that it did not concur with the finding or the recommendation as to the special counsel's treatment of "postjudgment collection costs", as referenced by the Inspector General. As described in the Revised Background Section of HESAA's comments, the costs were part of the judgment amount entered by the Special Civil Part and then docketed with the Clerk of the Superior Court. The capitalization of the costs awarded at judgment, and accrual of interest on those costs is acceptable and routine pursuant to N.J.Ct.R. 4:42-11. The costs were posted to

borrowers' accounts subsequent to the final judgment date as a result of an accounting system conversion. Waters, McPherson, and McNeill did follow established policy when, at HESAA's request, they converted their accounting system September 25, 1996, to include the costs awarded by the special Civil Part into the judgment balance. This counsel did not overstate the total outstanding balances in the account portfolio by including these previously awarded fees and costs in the judgment amount (principal balance).

With respect to the proper application of payment [applying payments to principal before interest] by Waters, McPherson and McNeill, HESAA stated that it concurred with the finding but disagreed with the recommendation. In October 2001, the attorney completed reamortization of active accounts to correct this problem. The remaining small number of closed accounts had negligible average balances, which fall within the small balance write-off guidelines issued by USDE. As a result, the finding should note that the active accounts have already been reamortized and borrowers notified.

OIG Response

We agree that the costs were incurred prior to final judgment. In most cases, however, other special counsels followed the policy provided to us by HESAA for postjudgment costs, and consistently applied them to borrowers' accounts after the outstanding balances of principal and interest had been cleared. Our review found that the costs were posted to borrowers accounts held by Waters, McPherson, and McNeill inconsistently at various times. For example, a judgment was awarded on December 26, 1996, for one borrower; however, the costs included on the statement for docketing were not added to the account until August 6, 1999, and the account was paid-in-full on January 25, 2002.

With respect to the application of payments to principal before interest, according to HESAA, the special counsel has taken corrective action as of October 2001. We recommend that the Chief Operating Officer for Federal Student Aid determine if further action is necessary.

Require That Gordin and Berger Reamortize All Active Accounts to Correct the Methodology Used to Compute Interest and Ensure That Interest Is Calculated at the Time Payment Is Received, and Notify Borrowers as Appropriate

HESAA stated that it concurred with the finding, but disagreed with the number of accounts included in the erroneous reduction of interest calculation. The special counsel returned the portfolio and HESAA completed the reamortization of the active accounts. Borrowers were notified appropriately. As a result, HESAA requested that the erroneous reduction of interest calculation be limited to 79 closed accounts of the total 157 accounts in the portfolio. Therefore,

HESAA requested that the recommendation be removed, since all active accounts had already been reamortized.

OIG Response

The erroneous reduction of interest calculation included in the recommendation was based on total accounts affected at the time of our review, including both active and closed accounts. As stated in the *Objective, Scope, and Methodology* section of this report, the estimates presented assumed that the average error rates found in the samples would be representative of the entire population of borrower accounts related to a particular sample. However, given the sizes of our samples, we have no assurance that the samples are representative.

Require That Scott Marcus and Associates Reamortize All Active Accounts to Ensure That Interest is Computed Correctly, and Notify Borrowers as Appropriate

HESAA stated that it concurred with the recommendation that Scott Marcus reamortize all active accounts and notify borrowers as appropriate. HESAA has also taken additional steps to prevent borrowers from being assessed incorrect amounts in the future.

Remit To the Federal Fund $25,632 in Imputed Interest Lost As a Result of Fees Withheld by HHL, New Jersey

[As stated in our finding, HHL, New Jersey, violated its agreement when it withheld its fees from remittances of borrower payments to the guaranty agency. As a result of HHL withholding its fees from remittances, the Federal Fund at HESAA, which is the property of the federal government, did not receive its share of interest income.] HESAA stated that it had remitted $14,573 in imputed interest. HESAA felt that the calculation should be based on the rate of the New Jersey Cash Management Fund as opposed to the Federal Debt Collection rate and, therefore, did not feel that it should remit the additional $11,059 to the Federal Fund.

OIG Response

Our review of HESAA's comments did not change our position. The Treasury Current Value of Funds rate is specified by the Debt Collection Act of 1982, 31 U.S.C. 3717, as the minimal rate of interest for debts owed the Government.

Require That the Special Counsels Establish Uniform Procedures for Recording the Date the Borrower's Payment is Received

HESAA stated that it concurred with this recommendation and has taken corrective action.

Ensure That All Payments Are Deposited Into a Federal Interest-Bearing Account Within 48 Hours of Receipt From the Borrower

HESAA stated that it concurred with this recommendation and has taken corrective action.

Response To Inspector General's Statement of Management Controls

HESAA disagreed with the statement that the assessment disclosed significant management control weaknesses. Prior to notification of this audit by the Inspector General, HESAA had already identified most of the specific problems with the collections portfolios, and had begun necessary improvements to more effectively administer the portfolios.

OIG Response

At the time of our review, no major compliance reviews had been conducted in over three years. Borrowers were not always assessed costs that were permitted and reasonable. In addition, amounts collected from borrowers by the special counsels were not always remitted to HESAA in a timely manner.

OBJECTIVES, SCOPE, AND METHODOLOGY

The objectives of our audit were to (i) determine the adequacy of the procedures the guaranty agency had implemented to monitor the activities of the special counsels, (ii) determine whether borrowers were only being assessed collection costs that are permitted and reasonable, and (iii) assess whether all collections were being remitted to the guaranty agency in a timely manner. Our audit of timely deposits covered the period July 1, 2001, through June 30, 2002. Our audit of collection costs assessed to borrowers extended from the time of referral to a special counsel or from the date of judgment (in effect, a new loan is established at the time of judgment) through July 7, 2003. To accomplish our objectives, we

- Reviewed applicable federal laws and regulations.
- Reviewed state law applicable to judgments against defaulted borrowers obtained from state courts.

- Interviewed guaranty agency staff.
- Interviewed one special counsel's staff.
- Reviewed a program review of HESAA conducted from December 5 through December 7, 2000.
- Reviewed Retainer Agreements and modifications for the 10 special counsels.
- Reviewed two internal review reports prepared by HESAA staff.
- Reviewed quarterly variance reports prepared by HESAA staff.
- Reviewed the Comprehensive Annual Financial Report of the State of New Jersey, prepared by the State Auditor, for the fiscal year ended June 30, 2001.
- Reviewed the State of New Jersey Single Audit Report, prepared by the State Auditor, for the fiscal year ended June 30, 2001.

In addition, we randomly selected 50 transactions from a universe of 86,493 transactions and traced them to bank deposits and remittance reports to determine if they were deposited into a federal interest-bearing account in accordance with the 48-Hour Rule. From the 50 borrower accounts associated with this sample of transactions, we requested confirmations from borrowers of account information.

From these 50 borrower accounts, we judgmentally selected a preliminary sample of 40 accounts, and randomly selected an additional 85 borrower accounts from a universe of 7,209 borrower accounts, to verify the accuracy and allowability of costs assessed to borrowers. As the special counsels' records did not provide outstanding balances of principal, interest, and collection costs at the time of each payment, it was necessary to recalculate 78 of these accounts.

For the 78 accounts, we reviewed court, HESAA, and special counsel records to verify the correct outstanding balance at the time of judgment. We prepared a spreadsheet that automatically calculated the outstanding balances at the time of each payment. We compared the ending balances from the special counsels' systems to the ending balance from our spreadsheet. We traced amounts contained in the special counsels' systems to amounts reported in HESAA's system. Throughout the course of our fieldwork, we provided HESAA officials with spreadsheet data on 19 of 78 accounts to obtain additional information and/or their comments. The estimates presented in the *Audit Results* section of this report assumed that the average error rates found in the samples would be representative of the entire population of borrower accounts related to a particular sample. However, given the sizes of our samples, we have no assurance that the samples are representative.

To achieve our objectives, we relied on data from HESAA's and the special counsels' electronic collections systems. To assess the reliability of this data, we relied, to the extent possible, on work performed by HESAA's staff, and conducted additional tests of the data. We tested the accuracy, authenticity, and completeness of the data by comparing the data to source records. We concluded that the data contained in these systems were sufficiently reliable to be used in meeting the audit's objectives.

We performed on-site fieldwork at HESAA's offices from October 17 through October 25, 2002 and March 31 through April 4, 2003, and at the New Jersey Division of Law's offices on April 1, 2003. A field exit conference was held on April 4, 2003. We conducted additional analyses on borrower accounts in our Kansas City office from April 4 through August 5, 2003, and a final exit conference was held on August 28, 2003. We conducted the audit in accordance with generally accepted government auditing standards appropriate to the scope of the audit described above.

STATEMENT ON MANAGEMENT CONTROLS

As part of our review, we assessed the system of management controls, policies, procedures, and practices applicable to HESAA's monitoring of the special counsels' collections of defaulted loans. Our assessment was performed to determine the level of control risk for determining the nature, extent, and timing of our substantive tests to accomplish the audit objectives.

For the purpose of this report, we assessed and classified the significant controls into the following categories:

- Receipt and recording of borrower payments.
- Remitting and reporting collections.
- HESAA's on-site monitoring of special counsels.

Because of inherent limitations, a study and evaluation made for the limited purpose described above would not necessarily disclose all material weaknesses in the management controls. However, our assessment disclosed significant management control weaknesses that allowed for improper application of payments, improper accrual of interest, improper remittances, and untimely deposits of collections. These weaknesses and their effects are fully discussed in the *Audit Results* section of this report.

ADMINISTRATIVE MATTERS

If you have any additional comments or information that you believe may have a bearing on the resolution of this audit, you should send them directly to the following Department of Education official, who will consider them before taking final Departmental action on the audit.

Theresa S. Shaw
Chief Operating Officer
Federal Student Aid
U.S. Department of Education
Union Center Plaza, Room 112G1
830 First Street, NE
Washington, DC 20202

It is the policy of the U.S. Department of Education to expedite the resolution of audits by initiating timely action on the findings and recommendations contained therein. Therefore, receipt of your comments within 30 days would be greatly appreciated.

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

If you have any questions, or if you wish to discuss the contents of this report, please contact William Allen at (816) 268-0509. Please refer to the control number in all correspondence related to the report.

Sincerely,

William Allen
Regional Inspector General
for Audit

Enclosure

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JAMES E. MCGREEVEY
Governor

ELIZABETH WONG
Executive Director

January 26, 2004

William Allen
Regional Inspector General for Audit
U.S. Department of Education
Office of Inspector General
8930 Ward Parkway, Suite 2401
Kansas City, MO 64114-3302

Dear Mr. Allen:

On behalf of New Jersey's Higher Education Student Assistance Authority (HESAA), I am responding to the Draft Audit Report (Control Number ED-OIG/A07-C0032).

If you have any questions, or if you wish to discuss HESAA's response, please contact Francine Andrea at (609) 588-7702 or Gene Hutchins at (609) 588-4584.

Sincerely,

Elizabeth Wong
Executive Director

EW:jac
Enclosure

c: Francine Andrea
Gene Hutchins

This New Jersey Higher Education Student Assistance Authority ("HESAA") Response to your December 15, 2003 Draft Audit Report (Control #ED-OIG/A07-C0032) ("Draft") presents our comments and response to the findings and recommendations in the Draft. Our goal is to assist you in carrying out the objectives of the audit, and to ensure that you fully understand the HESAA policies and procedures already in place, or soon to be implemented, for monitoring law firms (special counsel) providing collection services. We appreciate your staff's diligent field work, open communication, constructive criticism, and thoughtful analysis during the audit process over the past year, and greatly appreciate this opportunity to commend on your Draft before it is finalized.

We begin with brief comments on the Background section of the Draft, with particular reference to special counsel collection activities which are governed by the New Jersey Court Rules. We then provide you with specific numbered responses to the numbered recommendations in the Draft and some comments on the Statement of Management Controls.

HESAA Comments on Draft – "Background"

In our view, some of the special counsel's procedures characterized as "improper" in the Audit Results Section of the Draft, result from special counsels' methods for accounting for collection costs based on upon procedures peculiar to the New Jersey courts. Therefore, we ask that the final paragraph of the "Background" Section of the Report be revised as follows:

Prejudgment costs and attorney fees are governed and determined by the appropriate State court, and are normally included in the final judgment amount. In New Jersey, the judgment process in many cases is a two-tiered system. The first tier involves obtaining a judgment in the Special Civil Part, which is New Jersey's court where disputes under $15,000 are adjudicated. The dollar threshold for adjudicating claims in this court has been increased over the years. Since the promissory notes provide for a defaulted borrower to pay HESAA's attorney fees and collections costs, at the Special Civil Part tier, HESAA requests that the court include special counsel fees-in the judgment at the same rate provided for in the agreement between HESAA and the special counsel (N.J.Ct.R. 4:49-9[2.11]). Collections costs including attorneys' fees (if adequately supported) are determined by the Special Civil Part in accordance with New Jersey Court Rules ("N.J.Ct.R. 6:5-1; N.J.Ct.R. 4:42-8, -9) and are stated on the transcript of the judgment. Attorney

fees assessed to the borrower at a flat rate are not permitted.

After this judgment is awarded by the Special Civil Part, the attorney may then take this judgment to the second tier of the system by "docketing" the Special Civil Part judgment with the Clerk of New Jersey's Superior Court. Docketing serves to further protect the Secretary's interest by creating a statewide lien against any real estate owned by the borrower. This lien enhances collectability and helps to facilitate satisfaction of the debt. Once the judgment is docketed, the docketed judgment amount will include the principal, interest, costs and attorney fees already awarded at the Special Civil Part level, as well as any credits to the borrower. Under State law, interest accrues on this docketed judgment amount at the post-judgment interest rate (which is adjusted annually based on the State of New Jersey Cash Management Fund average rate of return) as established in the court rules (N.J.Ct.R 4:42-11).

As a separate matter, certain collection costs incurred subsequent to the entry of the final judgment in the Special Civil Part (Post-judgment costs) are allowable under the court rules for this tier, if adequately supported (N.J.Ct.R. 4:42-8). Collection costs are to be satisfied only after the outstanding balance of principal and interest are paid. Again, the docketed judgment balance may include principal, pre-judgment interest, costs, and attorney fees. Interest accrues on this docketed judgment balance. Additional costs subsequent to docketing do not accrue interest. Subsequent collections costs are to be satisfied only after the outstanding docketed judgment balance and post-judgment interest are paid.

Response to Recommendations

1. **Conduct reviews of all the special counsels as required by the agreements between HESAA and the special counsels.**

HESAA Response #1:

HESAA concurs with this recommendation and in the spring of 2002, prior to the Inspector General's visit, had taken significant steps to address this issue. HESAA reorganized its Audits & Quality Assurance Unit by hiring a new director and additional staff to conduct reviews of all special counsel by the end of calendar year 2004. Initially, the Audits & Quality Assurance

Unit conducted a survey (Core Sample Review) of all ten special counsel. This survey provided a basis for identifying compliance issues and prioritizing full compliance reviews of all special counsel during the current biennium.

To date, the Audits & Quality Assurance Unit has completed the review of one special counsel (Hayt, Hayt & Landau - NJ) and is in process of completing reviews on three other special counsels (Waters, McPherson and McNeill; Rolfe & Lobello; and Grodin and Berger). Reviews of the remaining six special counsels will be conducted in calendar year 2004 and are included in HESAA's 2004 Audit Plan as approved by Higher Education Student Assistance Authority Board. All reviews will be completed by December 31, 2004.

HESAA's Audits & Quality Assurance Unit will continue to conduct biennial reviews of all special counsel as provided for in the Special Counsel Retainer Agreements executed between HESAA and its special counsels.

2. **Ensure that adequate management controls are established and/or implemented over the special counsels' systems for accounting for borrower collections.**

HESAA Response #2:

HESAA respectfully does not concur with this recommendation, which implies that adequate controls were not in place during the audit period. However, HESAA continues to implement additional management controls to improve processes where applicable. HESAA has in place several effective management controls that include annual attorney meetings, annual site visits, quarterly attorney account reconciliations, monthly review of attorney status reports, quarterly monitoring of attorney collections, and core sample review. This last control involves testing sample accounts to ensure the attorney system is accurately recording credits and applying payments to principal and interest, as well as verifying the accuracy of interest accruals. Additionally, irregularities or issues of non-compliance are immediately communicated to the special counsel to remedy. Continued instances of non-compliance are directed to the Contract Administrator and Director of Audits & Quality Assurance for further action. All of the above controls represent a good faith effort on behalf of HESAA to monitor its portfolio in the absence of regulatory guidance.

HESAA is working to enhance additional electronic exchanges of information with special counsels concerning matters placed with them to reduce manual errors and to improve timeliness.

3. **Require that the Division of Law re-amortize the applicable accounts in its portfolio to properly apply the payments to interest before principal and notify borrowers as appropriate.**

4. **Remit to the Federal Fund the federal share of collections for Division of Law accounts that were closed prior to the re-amortization.**

HESAA Response #3 and #4:

HESAA concurs with these recommendations and has previously directed the Division of Law to re-amortize their portfolio. To date, the Division of Law has completed several phases of the re-amortization process. The final phase of the re-amortization process for active accounts will be completed by April 2004. Borrowers have been and will continue to be notified accordingly.

The Division of Law is currently in the process of re-amortizing the portfolio of accounts closed subsequent to January 1, 1998. This task will be completed by June 2004. Based on the balance variances, HESAA will determine the amount of the Federal share of collections that must be remitted to the Federal Fund.

The Division of Law was advised to return HESAA's defaulted loan portfolio. Upon receipt of the portfolio, HESAA will conduct file reviews and reassign the active judgment accounts.

5. **Require that Waters, McPherson, and McNeill re-amortize all active accounts to properly exclude post judgment collection costs from the outstanding principal balances, and to apply payments to the outstanding balances of interest, principal, and collection costs in the correct order; and notify borrowers as appropriate.**

HESAA Response #5:

HESAA respectfully does not concur with the finding or the recommendation as to the special counsel's treatment of "post judgment collection costs", as referenced by the Inspector General.

The special counsel's payment history reflected permissible costs including attorney fees originally awarded by the Special Civil Part, which were posted to the borrower's account subsequent to the final judgment date as a result of an accounting system conversion by Waters, McPherson and McNeill (see Attachment I). As described in the Revised Background paragraph above, these costs were part of the judgment amount entered by the Special Civil Part and then docketed with the Clerk of the Superior Court. (See, Attachment I – Judgment amount was $3,377.24 plus Fees and Costs awarded in the amount of $86.54 for a total docketed judgment of $3,463.78 as of 8/06/96). However, it was not until September 25, 1996 (after the judgment was docketed with the Clerk of the Superior Court), that this special counsel's accounting system was updated to include the $86.54 in costs in the principal balance upon which post-judgment interest accrues. The capitalization of the attorney fees and costs awarded at judgment, and accrual of post-judgment interest on those costs is acceptable and routine pursuant to N.J.Ct.R. 4:42-11. We disagree with the finding on page 3 of the draft, which states "Waters, McPherson and McNeill did not follow established policy". Special counsel Waters, McPherson, and McNeill did follow established HESAA policy when, at our request, they converted their accounting system during 1996 to include the costs awarded by the special Civil Part into the judgment balance. This counsel did not overstate the total outstanding balances in the account portfolio by including these previously awarded fees and costs in the judgment amount (principal balance).

With respect to the proper application of payment by Waters, McPherson and McNeill, HESAA concurs with the finding but disagrees with the recommendation. In October 2001, the attorney completed a re-amortization of active accounts to correct this problem. The remaining small number of closed accounts had negligible average balances, which fall within the small balance write-off guidelines issued by USDE. As a result, the findings should note that the active accounts have already been re-amortized and borrowers notified. Therefore, HESAA respectfully requests that this recommendation #5 be removed.

6. **Require that Gordin and Berger re-amortize all active accounts to correct the methodology used to accrue interest and ensure that interest is calculated at the time payment is received, and notify borrowers as appropriate.**

HESAA Response #6:

HESAA concurs with the finding, but disagrees with the number of accounts included in the understatement of interest calculation. The special counsel returned the portfolio and HESAA completed the re-amortization of the active accounts. Borrowers were notified appropriately. As a result, we request that the understatement of interest calculation in the finding be limited to seventy-nine (79) closed accounts of the total one hundred fifty-seven (157) accounts in the portfolio. Therefore, HESAA respectfully requests the removal of this recommendation, since all active accounts have already been re-amortized.

7. **Require that Scott Marcus and Associates re-amortize all active accounts to ensure that interest is accrued correctly, and notify borrowers as appropriate.**

HESAA Response to #7:

HESAA concurs with the recommendation that Scott Marcus and Associates re-amortize all active accounts. HESAA has taken the following corrective actions:

- Annual special counsel meeting – reiterated proper payment allocation method and accrual methodology
- Reviewed sample cases with special counsel to evaluate balance calculations.
- June 2003, HESAA staff conducted an annual site visit at the special counsel's office to review the system records and system calculations of accrued interest. HESAA had continued to monitor the system's calculation and has provided additional assistance to the special counsel.

Borrowers are being advised of their correct balance subsequent to re-amortizations and provided with a statement displaying the balance.

8. **Remit to the Federal Fund $25,632 in imputed interest lost as a result of fees withheld by HHL, New Jersey.**

HESAA Response to #8:

HESAA does not concur with this recommendation and respectfully requests its removal from

the report. The Federal debt collection interest rate under 31 U.S.C.A. Sec. 3717 should not apply to monies owed to HESAA's Federal Student Loan Reserve Fund (FSLRF) pursuant to Title IV of the Higher Education Act of 1965, specifically 20 U.S.C.A. 1072(h)(4)(A), as well as regulations issued thereunder, specifically 34 CFR part 682.419. HESAA, as a Federal Guaranty Agency is authorized to place monies in a restricted account "established by the Agency with the approval of the Secretary." HESAA has a long-standing policy of depositing these funds in the New Jersey Cash Management Fund. DCL 99-G-316 (Attachment II) expressly permits guaranty agencies "that have invested the Federal reserve funds in 'pooled investments' as part of a State investment program" to continue to utilize that investment vehicle for the FSLRF without requesting specific approval from the Secretary. The Notice of Proposed Rulemaking for the FFELP program, dated August 3, 1999 uses the same language when creating rules for the FSLRF. While these funds and investment earnings are undisputedly owned by the Federal government, they are under HESAA's fiduciary care, have been invested by HESAA in the New Jersey Cash Management Fund, and have historically accrued interest at the rate earned by that fund. Accordingly, any amounts collected by HESAA for the FSLRF would have been placed in this account and accrued interest at that rate. Therefore, the rate of the New Jersey Cash Management Fund should be the appropriate rate used to determine the interest due to the FSLRF on any FFELP student loan collection remitted by HESAA as opposed to the Federal Debt Collection rate. Based on this rate of return, HESAA reimbursed to the FSLRF $14,573, the actual amount of interest that the FSLRF would have earned had the special counsel deposited these collections in compliance with the 48-hour rule.

Additionally, all amounts due and owing to the USDE as part of the Secretary's equitable share of total collections are reported on the Monthly Form 2000 and were paid on a timely basis or used as an offset against student loan reinsurance amounts due to HESAA from the USDE, as appropriate.

9. **Require that the special counsels establish uniform procedures for recording the date the borrower's payment is received.**

HESAA Response to #9

HESAA concurs with this recommendation and has already instructed the special counsels to stamp all checks with the date of receipt. Although this is not defined in any federal regulation, we agree this is a good business practice.

10. Ensure that all payments are deposited into a federal interest-bearing account within 48 hours of receipt from the borrower.

HESAA Response to #10

HESAA concurs with this recommendation and has already taken the following actions to further ensure compliance with the federal regulation requiring deposit of student loan payments into an interest bearing federal account within 48 hours. These include:

- HESAA deposit procedures are communicated to the special counsels on a periodic basis.
- HESAA requires special counsel to fax the daily deposit ticket and a listing of items being deposited. As previously stated above, checks are required to be stamped with the date of receipt, and the list of items being deposited must contain borrower information. This provides for a reconciliation between the daily deposit and the remittance report.
- HESAA monitors daily deposit activity of special counsel.
- HESAA Finance Division sends an e-mail notification to any attorney for any business day when no deposits and no faxes were received indicating there were no deposits, and makes the initial phone contact to special counsel personnel if necessary.
- HESAA Finance Division reports any instances of non-compliance to the program administrator and Office of Audits and Quality Assurance for appropriate action.

Response to Inspector General's Statement On Management Controls:

HESAA disagrees with the statement that the assessment "disclosed significant management control weaknesses". Prior to notification of this audit by the Inspector General, HESAA had already identified most of the specific problems with the collections portfolio, which are described in the Audit Results section of the Draft, and had begun necessary improvements to

more effectively administer the special counsels' portfolios. To address these concerns, HESAA has over the past two years, implemented a series of additional management controls to improve and strengthen our special counsels' compliance with program requirements. HESAA has taken the following actions:

- In 2002, HESAA reorganized its Audits & Quality Assurance unit by hiring a new Director. Subsequently, additional staff was hired to facilitate the review of all special counsel.
- Conducted a survey (Core Sample Review) of all ten special counsel.
- Conducted and will continue to conduct annual attorney meetings with all special counsel to keep special counsel informed of new initiatives, address control weaknesses identified, and reiterate federal compliance requirements.
- Continued site visits to all special counsel by HESAA's Servicing and Collections Unit at least once a year to discuss systems and servicing issues identified by HESAA that pertain to counsel.
- HESAA's Audits & Quality Assurance unit is conducting biennial compliance reviews of all special counsel. These reviews are included in HESAA's Annual Audit Plans approved by the Higher Education Student Assistance Authority Board.
- HESAA revised the Special Counsel Retainer Agreement in August 2003. The new retainer agreement strengthens HESAA's management controls, standardizes special counsel receipt and application of borrower payments, the remittance and reporting of collections, and monitoring processes.
- HESAA continuously reviews and revises its policies and procedures on an ongoing basis to ensure accuracy and compliance with federal and state rules and regulations.
- Continuous monitoring of all special counsels by Servicing and Collections staff and HESAA's finance staff. This includes:
    - On-site testing of special counsel system computations
    - Sampling of borrower accounts
    - Reconciliation of cash receipts to remittance reports

- Reconciliation of the attorney portfolio
- Monitoring changes in attorney collection performance
- Follow-up on instances of non-compliance.

We ask that the statement of Management Controls be revised to delete the phrase "significant management control weaknesses" and, instead, to state that "our assessment disclosed that HESAA has recently improved its management control systems with respect to special counsel to better prevent improper application of payments, improper accrual of interest, improper remittances and untimely deposits of collections. Such problems as were identified during the audit period are fully discussed in the "Audit Results" section of this report."

Conclusion

In sum, HESAA appreciates the opportunity to review and comment upon the Draft prior to it being finalized, and accepts a majority of the findings and recommendations. We ask that the Background, Recommendations numbers 2, 5, 6, & 8, and the Statement of Management Controls (as noted above) be revised to more accurately described your findings and recommendations concerning the management and collections procedures of HESAA and its special counsels. Thank you for your cooperation and consideration during the entire audit process, which has been a valuable learning experience for all concerned.

ATTACHMENT 1 (Control #ED-OIG/A07-C0032)

NEW JERSEY HIGHER EDUCATION ASSISTANCE AUTHORITY

PLAINTIFF

VS

[redacted]

DEFENDANT

SUPERIOR COURT OF NEW JERSEY
LAW DIVISION SPECIAL CIVIL PART
BERGEN COUNTY

ON (X) CONTRACT ( ) TORT
DOCKET NO. DC-007023-96

STATEMENT FOR DOCKETING
Plaintiff's Attorney:

WATERS, MCPHERSON, MCNEILL
300 LIGHTING WAY
SECAUCUS, N J 07096

Judgment in the above entitled cause was entered in the Bergen County Special Civil Part in favor of the Plaintiff(s) and against the defendant(s).

An Execution was issued on_____ Judgment date 08/06/96

and was returned on_____ Judgment amount $3377.24

Monies received by Officer $_____ Costs & Atty fees $ 86.54

Total credits..... $_____ ADD'L costs $_____

An Execution was issued on_____ TOTAL $3463.78

and was returned on_____ CREDITS, if any $_____

Monies received by Officer $_____ TOTAL..... $3463.78

Total credits.....$_____

I HEREBY CERTIFY THAT the foregoing reflects the judgment and costs of record in the Court, as of this time.

DATED: AUGUST 29,1996
PM

ANGELO J. CATALDO
Clerk of the Court

I, the undersigned (Attorney for the above named Plaintiff) certify that at the present time there is due upon the above mentioned judgment, which is about to be docketed in the SUPERIOR COURT of New Jersey, (TRENTON)

Total judgment due	$ 3463.78
Total credits	$ -0-
Subtotal	$ 3463.78
Interest	$ 24.77
Total due this date (being a sum not less than Ten Dollars)	$ 3488.55

I hereby certify that the foregoing is a true copy of the original on file in my office.

Clerk

I certify that the foregoing statements made by me are true. I am aware that if any of the foregoing statements made by me are willfully false, I am subject to punishment.

DATED September 24, 1996

ATTACHMENT 1 (Control #ED-OIG/A07-C0032)

[redacted]

WATERS,MCPHERSON,MCNEILL
INDIVIDUAL ACCOUNT STATEMENT

FILE #12165

Date	Credit	Interest	Charge	Principal Bal.	Interest Bal.
06/06/95	$0.00	$0.00	$0.00	$3,377.24	$0.00
09/25/98	$0.00	$25.44	$88.54	$3,463.78	$25.44
			JUDGEMENT COST		
06/16/98	$20.00	$328.30	$0.00	$3,463.78	$333.74
	TAX CREDIT				
06/16/98	$38.00	$0.00	$0.00	$3,463.78	$295.74
	TAX CREDIT				
12/31/99	$0.00	$293.85	$0.00	$3,463.78	$589.59
12/31/00	$0.00	$173.66	$0.00	$3,463.78	$763.25
05/30/01	$112.00	$78.29	$0.00	$3,463.78	$729.54
	TAX CREDIT				
08/21/01	$300.00	$43.32	$0.00	$3,463.78	$472.86
	TAX CREDIT				
09/25/01	$50.00	$18.27	$0.00	$3,463.78	$441.13
	TAX CREDIT				
12/31/01	$0.00	$50.63	$0.00	$3,463.78	$491.76
05/29/02	$224.00	$84.84	$0.00	$3,463.78	$352.60
	TAX CREDIT				
06/04/02	$3,819.80	$3.42	$0.00	$0.00	+ $0.00 =
	* TAX CREDIT				

END OF RECORDS--PRINTED 11/6/02

BALANCE $0.00

Tax credit actually $430.00

remainder applied to 'B' File

DCLPublicationDate: 1/1/99
DCLID: 99-G-316
AwardYear:
Summary: Provisions of the Higher Education Amendments of 1998 (Pub. L. 105-244) that relate to the Federal Fund and Operating Fund used by guaranty agencies in the Federal Family Education Loan Program.

January 27, 1999

99-G-316

SUBJECT: Provisions of the Higher Education Amendments of 1998 (Pub. L. 105-244) that relate to the Federal Fund and Operating Fund used by guaranty agencies in the Federal Family Education Loan Program.

Dear Guaranty Agency Director:

This letter provides the Secretary's initial guidance concerning the two new funds each guaranty agency is required to establish under the Higher Education Amendments of 1998 – the "Federal Fund" and the "Operating Fund." The Secretary has asked that I share this guidance with you. A separate letter is being prepared about the other provisions of the 1998 Amendments that primarily affect guaranty agencies and lenders, for example, voluntary flexible agreements, prohibited inducements, and blanket certificates of guaranty. The Secretary invites your views on those other provisions, which will be helpful as the next letter is prepared.

We welcome your comments concerning this initial guidance about the Federal and Operating Funds. If you have questions about this new legislation, or the guidance in this letter, please call my staff at (202) 708-8242.

Sincerely,

Greg Woods
Chief Operating Officer
Office of Student Financial Assistance Programs

THE FEDERAL FUND

Establishing the Federal Fund

Under §422A of the Higher Education Act of 1965, as amended (the "HEA") each guaranty agency is required to establish a Federal Student Loan Reserve Fund (the "Federal Fund"), within 60 days of enactment of Pub. L. 105-244. The date of enactment of Pub. L. 105-244 was October 7, 1998, the date it was signed by the President. Guaranty agencies were informed during subsequent discussions that the two new funds must be established by December 6, 1998.

The Secretary has decided that all of the funds, securities, and other liquid assets in the agency's

reserve fund as of September 30, 1998, as described in 34 CFR 682.410(a), must be deposited into the Federal Fund when it is established. The new legislation specifies that the Federal Fund shall be located in a type of account selected by the agency, with the approval of the Secretary. The new Federal Fund must be a separate account that contains only funds belonging to the Federal Fund. A guaranty agency may use its existing Federal reserve fund account established pursuant to 34 CFR 682.410(a) that satisfies the above requirement as the new Federal Fund simply by notifying the Secretary in writing. If a different account is desired, the agency must provide a description of the proposed account and promptly request the Secretary's approval.

Ownership of the Federal Fund

The statute stipulates that the Federal Fund, and nonliquid assets (such as buildings or equipment) developed or purchased by an agency in whole or in part with Federal reserve funds, regardless of who holds or controls the Federal reserve funds or assets, are the property of the United States. The ownership of assets will be prorated based on the percentage of the asset developed or purchased with Federal reserve funds.

Section 422A(d) of the HEA allows the Federal Fund to be used only to pay lender claims and to pay default aversion fees into the agency's Operating Fund. Under the statute, these same restrictions apply to nonliquid assets. The statute also authorizes the Secretary to restrict or regulate the use of such assets to the extent necessary to reasonably protect the Secretary's prorated share of the value of such assets. A strict application of this restriction would prohibit an agency from using nonliquid assets developed or purchased with Federal Funds for any other purpose and would unnecessarily burden the agency's performance of its other responsibilities in the Federal Family Education Loan Program. The Secretary recognizes that Federal regulations in effect prior to the amendments authorized guaranty agencies to use the Federal portion of nonliquid assets for other allowable purposes and wishes to continue that policy. Accordingly, the Secretary hereby authorizes guaranty agencies to use the Federal portion of nonliquid assets for activities necessary and appropriate to fulfill the agencies' guaranty responsibilities as provided in 34 CFR 682.410. In addition, the Federal portion of nonliquid assets may also be used for activities other than those described in 34 CFR 682.410, subject to the conditions described in 34 CFR 682.410(a)(6)(i).

Deposits into the Federal Fund

The statute requires an agency to deposit into the Federal Fund:

1. Default reinsurance payments received from the Secretary, and payments made to the agency by the Secretary on death, disability, bankruptcy and loan cancellation and discharge claims;

2. A percentage of collections equal to the complement of the reinsurance percentage paid on a defaulted loan, and 100 percent of payments obtained with respect to a loan that the Secretary has repaid or discharged under §437 of the HEA;

3. Insurance premiums collected from borrowers pursuant to §428(b)(1)(H) and §428H(h) of the HEA;

4. All amounts received from the Secretary as payment for supplemental preclaims activity performed on or before September 30, 1998;

5. 70 percent of amounts received on or after October 1, 1998, as payment for administrative cost allowances for loans upon which insurance was issued on or before September 30, 1998; and

6. Other receipts as specified in the Department's regulations.

Investments of the Federal Fund

The Federal Fund (and amounts in the Operating Fund that are borrowed from the Federal Fund) shall be invested in securities issued or guaranteed by the United States or a State, or with the approval of the Secretary, in other similarly low-risk securities selected by the guaranty agency. Guaranty agencies that have invested the Federal reserve funds in "pooled" investments as part of a state investment program may continue using that investment vehicle for the new Federal Fund without requesting specific approval from the Secretary. Earnings on the investment of the Federal Fund are the sole property of the Federal Government. Guaranty agencies shall exercise the level of care

required of a fiduciary charged with the duty of investing the money of others. Accordingly, a guaranty agency may not prepay obligations of the Federal Fund unless it demonstrates, to the satisfaction of the Secretary, that the prepayment is in the best interests of the United States.

THE OPERATING FUND

Establishing the Operating Fund

Each guaranty agency must establish a fund designated as the "Operating Fund" by December 6, 1998 (within 60 days after the enactment of Pub. L. 105-244.) The Operating Fund must be in an account that is separate from the Federal Fund. The statute requires an agency to deposit into the Operating Fund:

1. Loan processing and issuance fees;

[**Note:** Under §428(f) of the HEA, each guaranty agency will be paid a processing and issuance fee equal to 0.65 percent of the total principal amount of loans originated during fiscal years 1999 through 2003 on which such agency issued insurance (beginning with fiscal year 2004, the fee drops to 0.40 percent of the principal amount of the loans). No payment may be made for loans for which the disbursement checks have not been cashed or for which electronic funds transfers have not been completed. The fee will be paid quarterly. The Secretary has decided to calculate the amount of the fee based on aggregates of each guaranty agency's data reported to the National Student Loan Data System.]

2. 30 percent of administrative cost allowances received after October 1, 1998, for loans upon which insurance was issued before October 1, 1998;

3. Account maintenance fees;

[**Note:** Under §458 of the HEA, each guaranty agency will receive an account maintenance fee in an amount equal to 0.12 percent of the original principal balance of guaranteed loans outstanding during fiscal years 1999 and 2000. During fiscal years 2001 through 2003 the fee shall be 0.10 percent of the original principal balance of guaranteed loans outstanding during the year. The fee will be paid quarterly.

The Secretary has decided to calculate the amount of the fee by using the guaranty agency's data reported to the National Student Loan Data System. In order to pay promptly following the end of each quarter, the amounts of the first three quarterly payments for each fiscal year will be 0.12 percent of the original principal balance of loans outstanding at the beginning of the fiscal year, divided by four. The fourth quarter payment will be calculated by obtaining the sum of the original principal balance of loans outstanding at the beginning and end of the fiscal year, dividing by two, multiplying the result by 0.12 percent, and subtracting the amounts of the first three quarterly payments.]

4. Default aversion fees;

[**Note:** Pub. L. 105-244 added a new default aversion fee in §428(l) of the HEA to replace the supplemental preclaims assistance payment made under prior law. Upon receipt of a completed request for assistance from a lender not earlier than the 60th day of delinquency, a guaranty agency must engage in default aversion activities designed to prevent a default by the borrower. For any loan on which a default claim is not paid by the guaranty agency as a result of the loan being brought into current repayment status by the guaranty agency on or before the 360th day of delinquency, the guaranty agency shall be paid a default aversion fee. For the purpose of earning the default aversion fee, the term "current repayment status" means that the borrower is no longer delinquent as a result of paying all principal and interest on the loan for which a payment due date has passed. The fee shall be equal to 1 percent of the total unpaid principal and accrued interest on the loan at the time the request for assistance is submitted by the lender.

The default aversion fees earned may be transferred by the guaranty agency to its Operating Fund from the Federal Fund no more frequently than monthly. The statute stipulates that the fee may not be paid more than once on any loan, unless (1) at least 18 months have elapsed between the date the borrower entered current repayment status and the date the lender filed a subsequent default aversion assistance request; and (2) the borrower was not more than 30 days past due on any payment of

principal and interest during such period.]

5. Amounts remaining from collections of defaulted loans after payment of the Secretary's equitable share and depositing the complement of the reinsurance percentage into the Federal Fund;

[**Note:** The statute authorizes guaranty agencies to deposit an amount equal to 24 percent of the payments made by or on behalf of a defaulted borrower into its Operating Fund. Beginning October 1, 2003, the amount of collections an agency may deposit into its Operating Fund is reduced to 23 percent.]

6. Amounts borrowed from the Federal Fund; and

7. Other receipts as specified in the Department's regulations.

Borrowing from the Federal Fund

Under §422A(f) of the HEA, in addition to using the Federal Fund for the purposes described earlier, a guaranty agency may borrow a limited amount of funds from the Federal Fund to establish the Operating Fund. Upon receiving the Secretary's approval, an agency may borrow from the Federal Fund an amount up to the equivalent of 180 days of cash expenses (not including claim payments) for normal operating expenses for deposit into the agency's Operating Fund. The amount borrowed and outstanding during the first 3 years after establishing the Operating Fund may not at any time exceed the lesser of 180 days cash expenses (not including claim payments), or 45 percent of the balance in the Federal reserve fund as of September 30, 1998.

The statute requires a guaranty agency that wishes to borrow principal or interest from the Federal Fund to provide the Secretary with a repayment schedule and evidence that it can meet the schedule. Therefore, prior to borrowing from the Federal Fund, a guaranty agency shall provide the Secretary with the following:

1. A request for the loan that identifies the desired amount and the desired terms of repayment;

2. A projected revenue and expense statement (that must be updated annually during the repayment period), that demonstrates that the agency will be able to repay the loan within the repayment period requested;

3. A certification that sufficient funds will remain in the Federal Fund to pay lender claims within the required time periods, to meet the reserve recall requirements of §422 of the HEA, and to satisfy the statutory minimum reserve level of 0.25 percent, as mandated by §428(c)(9) of the HEA; and

4. A certification that there are no legal prohibitions to the agency obtaining or repaying the loan.

Borrowing of Interest

Section 422A(f)(2) authorizes the Secretary to permit a limited number of agencies to borrow an amount greater than 180 days of operating expenses (not including claim payments) in certain limited cases. Specifically, an agency may be authorized to exceed the 180-day limit by the amount of interest income earned on the Federal Fund during the 3-year period following the date of enactment. To be allowed to borrow the interest income, in addition to items 1-4 above, the agency must demonstrate to the Secretary that the cash flow in the Operating Fund will be negative without the transfer of such interest, and the transfer will substantially improve the financial circumstances of the guaranty agency.

The Secretary will respond to a guaranty agency's request to borrow from the Federal Fund within two weeks after receiving the items described above. All correspondence should be addressed to: Mr. Larry Oxendine, Director, Guarantor and Lender Oversight Service, U.S. Department of Education, Washington, DC 20202. Guaranty agencies may call Mr. Oxendine's staff at (202) 401-2280 for information concerning their requests.

Ownership and control of the Operating Fund

Except for funds an agency borrows from the Federal Fund under §422A(f) of the HEA, the Operating Fund shall be considered the property of the guaranty agency. The statute authorizes the Secretary to regulate the uses or expenditure of the Operating Fund during any period in which funds are owed to the Federal Fund as a result of borrowing under §422A(f) of the HEA. Accordingly, the Secretary has decided that, during any period in which the guaranty agency has an outstanding balance owed to the Federal Fund, 34 CFR 682.410(a)(2) and 682.418 shall apply to the use of money in the Operating

Fund.

General usage rule
The statute specifies that the Operating Fund shall be used by the guaranty agency to fulfill its responsibilities under the HEA. In addition to repaying money borrowed from the Federal Fund, permissible uses include application processing, loan disbursement, enrollment and repayment status management, default aversion, collection activities, school and lender training, financial aid awareness and outreach activities, compliance monitoring, and other student financial aid related activities, as selected by the guaranty agency.

Repayment of loans borrowed from the Federal Fund
Except as specified in the special rule discussed below for repaying interest borrowed from the Federal Fund, the statute requires an agency to begin repayment of money borrowed from the Federal Fund not later than the start of the 4th year after the establishment of the Operating Fund. All amounts borrowed shall be repaid not later than 5 years after the date the Operating Fund is established.
Repayment of interest
The statute authorizes the Secretary to extend the period for repayment of interest borrowed under §422A(f)(2) of the HEA, from 2 years to 5 years if the Secretary determines that the cash flow of the Operating Fund will be negative if the borrowed interest had to be repaid earlier, or the repayment of the interest would substantially diminish the financial circumstances of the agency. To receive an extension, the agency must demonstrate that it will be able to repay all borrowed funds by the end of the 8th year following the date of establishment of the Operating Fund, and that the agency will be financially sound upon the completion of repayment. Repayment of amounts borrowed from the Federal Fund pursuant to §422A(f)(2) of the HEA that are repaid during the 6th, 7th, and 8th years following the establishment of the Operating Fund shall include the amount borrowed, plus any income earned after the 5th year from the investment of the borrowed amount. In determining the amount of income earned on the borrowed amount, the Secretary will use the average investment income earned on all the agency's investments.
If an agency fails to make a scheduled repayment to the Federal Fund, the agency may not receive any other federal funds until the agency becomes current in making all scheduled payments, unless the Secretary waives this restriction.

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