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MAR 18 2003

Mr. Richard Boyle
President and CEO
Educational Credit Management Corporation
101 East 5th Street, Suite 2400
St. Paul, Minnesota 55101

Dear Mr. Boyle:

Enclosed is our final report (Control Number ED-OIG/A05-C0014) entitled, *Educational Credit Management Corporation's Administration of the Federal Family Education Loan Program Federal and Operating Funds*. The report incorporates the comments you provided in response to the draft audit report. 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 Education Department 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, D.C. 20202-5132

Office of Management and Budget Circular A-50 directs Federal agencies 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 the general public to the extent information contained therein is not subject to exemptions in the Act.

Sincerely,

Richard L. Dowd
Regional Inspector General for Audit

Attachment

Educational Credit Management Corporation's Administration of the Federal Family Education Loan Program Federal and Operating Funds

FINAL AUDIT REPORT

ED-OIG/A05-C0014

March 2003

Our mission is to promote the efficiency, effectiveness, and integrity of the Department's programs and operations

U.S. Department of Education
Office of Inspector General
Chicago, Illinois

NOTICE

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

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

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Educational Credit Management Corporation's Administration of the Federal Family Education Loan Program Federal and Operating Funds

Control Number ED-OIG/A05-C0014

EXECUTIVE SUMMARY

Except for the findings discussed in this report, Educational Credit Management Corporation (ECMC) generally complied with the Higher Education Act of 1965 (HEA), as amended, while establishing and maintaining its Guarantor Federal and Operating Funds during the period April 1, 2000 through March 31, 2001. We identified three findings:

- ECMC transferred $14.6 million in federal funds to the Guarantor Operating Fund. These funds represented a portion of interest earned on bankruptcy loans assigned to its Federal Services Bureau Federal Reserve Fund. ECMC's agreement with the U.S. Department of Education (Department) does not provide for such transfers.

- ECMC used the Federal Services Bureau Federal Reserve Fund, a special purpose reserve fund created by an agreement with the Department, to subsidize expenses that benefited other lines of business such as the Guarantor Operating Fund and ECMC's for-profit affiliates. ECMC also did not always charge personnel expenses using the employee distributions that are the basis for its cost allocation plan. Based on our testing in selective periods, we determined that ECMC used $65,832 from the Federal Services Bureau Federal Reserve Fund to pay expenses that benefited other lines of business.

- ECMC deposited $390,324 in supplemental preclaims assistance (SPA) payments into the Guarantor Operating Fund. The Higher Education Amendments of 1998 required supplemental preclaims assistance payments received after October 1, 1998 to be deposited into the Guarantor Federal Fund.

We also noted an issue that warrants Federal Student Aid's (FSA) attention. ECMC pays usage fees for federal assets, but its calculation of the fee ceases after an asset's value is less than $5,000 and is not consistently applied to all federal assets.

We recommend the Chief Operating Officer (COO) for FSA require ECMC to return approximately $15 million plus imputed interest to its federal funds and reimburse the Federal Services Bureau Federal Reserve Fund for any misallocated costs.

We provided ECMC a draft report. ECMC disagreed with Finding 1 and generally disagreed with Finding 2. For Finding 2, ECMC agreed to reallocate only $1,189 in expenses it overcharged to the FSB. ECMC agreed to implement the recommendations for Finding 3 and planned to return $390,324, plus imputed interest, to the Federal Fund no later than December 31, 2002. Based on ECMC's comments and additional work, we eliminated the subheading, *NSLDS Needs Timely Updates*, from the Other Matters section of the report. We summarized ECMC's comments after each finding and also included them in their entirety as an Attachment.

AUDIT RESULTS

During the period April 1, 2000 through March 31, 2001, except for the findings discussed below, ECMC complied with the HEA, as amended, while establishing and maintaining its Guarantor Federal and Operating Funds. ECMC, at the instruction of FSA, delayed the establishment of the Guarantor Federal and Operating Funds until April 1, 2000, and established the funds retroactively effective October 1, 1998. ECMC appropriately divided nonliquid assets purchased as of September 30, 1998, between its two newly created federally owned funds, the Federal Services Bureau (FSB) Federal Reserve Fund and the Guarantor Federal Fund. ECMC carried out the establishment process set forth in its restructuring proposal and subsequent correspondence with the Department. ECMC elected not to transfer funds from the Guarantor Federal Fund to the Guarantor Operating Fund under § 422A (f), as added by the Higher Education Amendments of 1998; therefore, ECMC was not required to adhere to the prohibited uses of assets regulations.

Finding 1 – The Guarantor Operating Fund Received Unauthorized Sources of Income

ECMC transferred $14.6 million in federal funds to the Guarantor Operating Fund. These funds represented a portion of interest earned on bankruptcy loans assigned to its FSB Federal Reserve Fund. ECMC's agreement with the Department does not explicitly authorize such transfers. Therefore, the Guarantor Operating Fund contains federal funds that belong to the FSB. The Department and ECMC agreed to modify ECMC's financial structure to comply with the Higher Education Amendments of 1998. ECMC updated its agreement with the Department (Agreement) on December 21, 2000, and the Department signed it on January 3, 2001. Under the revised Agreement, ECMC continued processing bankruptcy claims assigned to ECMC by the Department and guaranty agencies. All revenues and expenses associated with bankruptcy processing are recorded separately under accounts assigned to the FSB.

Lenders are required to repurchase certain loans based on subsequent events in bankruptcy proceedings. When a lender repurchases bankruptcy loans assigned to ECMC's FSB line of business, ECMC deposits the principal and capitalized interest, accrued up to the claim date, into the FSB Federal Reserve Fund. ECMC then transfers any additional interest accrued from the time of the bankruptcy claim to the repurchase date to its Guarantor Operating Fund. The Guarantor Operating Fund, by statute, is considered the property of ECMC and is normally not subject to regulation by the Department. As a result, federal funds have been converted, and used by ECMC for its own purposes.[1] As of December 2001, ECMC transferred $14.6 million to

[1] After transferring the funds to the Guarantor Operating Fund, ECMC then loans those funds to Educational Credit Services Company, a related for-profit corporation that provides private label educational loans.

the Guarantor Operating Fund. These transfers have benefited ECMC to the detriment of the Department, which owns the FSB Federal Reserve Fund.

Transferring a portion of bankruptcy repurchases from the FSB to the Guarantor Operating Fund conflicts with the proposal that led to the Agreement and the language of the Agreement:

- The proposal, "Redefining the Financial Structure of THE EDUCATIONAL CREDIT MANAGEMENT CORPORATION", dated February 22, 2000, stated that one of the problems that needed to be addressed was the incorrect appearance that ECMC has subsidized its Virginia "guarantor" operations with earnings derived from its bankruptcy servicing operations.

- The Agreement, paragraphs 4., 5.a., and 5.b., states that the revenues of ECMC/the Guarantor and ECMC/the Federal Services Bureau shall be recorded separately.

- Paragraph 6 of the Agreement states that the FSB will be responsible for all aspects of servicing loans on which the borrower has filed a petition for relief under Chapter 13 of the U.S. Bankruptcy Code. This responsibility includes arranging for lenders to repurchase loans on which the borrower is completing the repayment plan. In this situation, the FSB shall retain the amount that would otherwise be due to the Department and a new guarantee shall be issued by ECMC/the Guarantor.

- Paragraph 8.a. of the Agreement, Bankruptcy Processing, states, in part, ECMC shall deposit any and all payments it receives on such loans from any source into its FSB Federal Reserve Account.

ECMC officials stated that the Agreement supports ECMC's repurchase procedures. Specifically, ECMC officials said that paragraph 6 of the Agreement discusses ECMC's responsibility to arrange for lenders to repurchase bankruptcy loans and states, in part, "ECMC/the Federal Services Bureau shall retain the amount that would otherwise be due the Department under the Department's regulations." ECMC officials interpreted this to mean it could transfer the interest accrued after a claim is paid on accounts that are subsequently repurchased to the Guarantor Operating Fund. ECMC provided correspondence it sent to the Department's Office of the General Counsel on January 4, 2001, after the Agreement was executed. ECMC explained how it planned to deposit repurchase interest into the Guarantor Operating Fund because the Agreement mentioned that only the federal share would be deposited into the FSB. Based on this correspondence, ECMC officials stated that they clearly communicated ECMC's course of action and the Department accepted the terms of the financial restructuring by signing the Agreement. ECMC officials stated that they never received a response from the Department.

Although ECMC stated its intended course of action, the Agreement itself was never amended. The Agreement does not have a provision for any funds to be transferred to the Guarantor

Operating Fund. Paragraph 6 states that the FSB will retain the amount that would otherwise be due to the Department. Although paragraph 6 is silent as to how the remaining share is handled, paragraph 8 states that any payments received for bankruptcy servicing will be deposited into the FSB.

Recommendations

We recommend that the COO for FSA require ECMC to

1.1 Return $14.6 million plus imputed interest to the FSB.

1.2 Return to the FSB any additional repurchase interest transfers made after December 2001 until this finding is resolved plus imputed interest.

ECMC Comments – ECMC disagreed with Finding 1. ECMC said its actions are consistent with Department regulations, its Agreement with the Department, as well as long established practices by all guaranty agencies. ECMC said the Agreement clearly discusses how ECMC will handle bankruptcy repurchases and the parties to the Agreement have agreed on its interpretation. Therefore, the audit team misinterpreted the Agreement and they should inquire what the actual parties to the Agreement have interpreted it to mean. Additionally, ECMC explained that in accordance with established industry practice, any additional interest that has accrued from the time the original lender claim was paid to the lender's repurchase date is retained by a guaranty agency as Operating Fund revenue. In the absence of any legal or regulatory prohibitions to the contrary, ECMC, acting as Guarantor, should be authorized to follow a clear industry practice on the treatment of these funds. ECMC sought clarification from the Department on this issue on several occasions and said there is no need to formally amend a contract where the parties have reached a clear understanding of what they meant by a particular provision. Also, loan repurchases are federal property, no actual "transfer" of funds occurs at ECMC or any other guarantor, and the issue is one of how to allocate the repurchase amount received. No transfer authority is necessary in the Agreement as ECMC allocates repurchase monies in the same way as all other guarantors.

OIG Response – ECMC's comments did not change our position. In operating the FSB, ECMC is not serving as a guarantor but as a separate service provider to the Department. Therefore, ECMC's statements that it is following the regulations and industry practice are inapposite.

Unlike other guaranty agencies, the Agreement requires ECMC to segregate all revenues and expenses of the Guarantor and the FSB. ECMC's response ignores Paragraph 8.a of the Agreement, Bankruptcy Processing, that states, in part, "ECMC shall deposit any and all payments it receives on such loans from any source into its [FSB] Federal Reserve Account."

The Agreement does not authorize the transfer of any such payments out of the FSB Federal Reserve Fund.

Although ECMC sought clarification from the Department on this matter, it did not provide evidence that the Department responded in writing to any correspondence provided after signing the Agreement. Authorization to transfer federal property out of the FSB Federal Reserve Fund should be clear to third parties regardless of any verbal understandings between the contract parties. By transferring a portion of the repurchase proceeds from the FSB to the Guarantor Operating Fund, the Guarantor Operating Fund contains federal funds that belong to the FSB.

Finding 2 – ECMC Overcharged the FSB When Allocating Shared Expenses

ECMC used the FSB Federal Reserve Fund to subsidize expenses that benefited other lines of business such as the Guarantor Operating Fund and ECMC's for-profit affiliates. The Agreement instructs ECMC to charge the FSB for any expenses related to maintaining facilities for standby capacity in the event the Department assigns ECMC additional guarantor services. ECMC established the Infrastructure line of business within FSB to accumulate these expenses. ECMC charged the personnel expenses for selected positions and other related expenses to the Infrastructure. According to ECMC's cost allocation process and interviews with ECMC employees, a significant portion of these expenses benefited other lines of business. ECMC also did not always charge personnel expenses using the employee time distributions that are the basis for its cost allocation plan. As a result, ECMC used the FSB Federal Reserve Fund to pay expenses that benefited other lines of business.

The Agreement covers ECMC's bankruptcy processing and guaranty agency responsibilities. It requires ECMC to segregate operations and financial data between the FSB, the Guarantor (having both a Federal and Operating Fund), and its other affiliates. The Agreement states,

13. The Department acknowledges that it had been informed that ECMC is reorganizing its corporate structure and that the new structure may include for-profit entities. ECMC shall ensure that the reorganization will be consistent with ECMC's fiduciary obligations to the Department and will ensure that Federal funds are not used to support activities not authorized by the Original Agreements or this Agreement.

14. ECMC shall ensure a proper allocation of costs between ECMC/the Guarantor, ECMC/the Federal Services Bureau and any other affiliated entities.

The Agreement also allows ECMC to charge the FSB for the costs of maintaining standby capacity for guarantor services and the infrastructure required to support ECMC activities and operations.

We reviewed ECMC's procedures to meet these provisions. ECMC allocates expenses using the prior month's employee time spent in each line of business. Each month supervisors review the time distribution reports and adjust the allocations to reflect the prior month's actual activity for themselves and their staff. The current month's expenses that are directly linked to a specific employee are allocated based on that employee's time distribution taken from the previous month. Expenses that are not directly linked to a specific employee are allocated based on the cumulative employee time distribution in the benefiting line of business, location, or entire group of companies. Indirect time, such as time spent in ECMC's for-profit affiliates ECMC Management Services Corporation (MSC) and ECMC Technology Services Corporation (TSC), is allocated further to their customers, or lines of business such as, the FSB, Guarantor Operating Fund, and Educational Credit Services Company (ECSC).

To test ECMC's compliance with the Agreement, we reviewed a sample of salary expenses incurred during February 2001. ECMC did not allocate salary expenses according to its own policy. Salary expenses that ECMC charged to the various lines of business for 17 out of a sample of 35 employees (49 percent) did not match the allocations reported on the time distribution reports. For the sample, ECMC undercharged its for-profit affiliate, ECSC, by $11,281 and overcharged the Guarantor Operating Fund by $10,092 and the FSB by $1,189. For example, the FSB paid the entire salary expense for two employees whose time in the previous month was spent either on ECSC (75 percent) or Guarantor (50 percent) activities, respectively.

For the same month, ECMC reported that 19 employees spent either all (12) or most (7) of their time on Infrastructure activities, charged to the FSB. According to officials, ECMC groups the expenses of core management/technical expertise in the Infrastructure line of business. These employees are typically executive management who work on activities such as guarantor services, finance, and information systems. As executive management, they work on activities that benefit the Guarantor, its for-profit affiliates, or the entire group of companies. In fiscal year (FY) 2001, the FSB paid $3.1 million in Infrastructure expenses.[2]

In response to our initial test results, ECMC officials assured us that they allocated expenses properly and did not use FSB funds to pay for employee time spent on non-ECMC related activities. To test updated procedures, we reviewed ECMC's November 2001 personnel expense allocations for employees with reported time spent on ECSC and Infrastructure activities. ECMC allocated the expenses according to employee time spent in each line of business during October. However, executive management later adjusted expense allocations for 15 employees, of which 10 had most of their personnel expenses transferred to the Infrastructure and resulted in the FSB paying an additional $64,643 originally charged to lines of business such as the Guarantor, MSC and TSC. We interviewed employees who confirmed their responsibilities included Guarantor and for-profit affiliate activities. The employees also stated that once assigned to the Infrastructure, they do not distinguish between time spent on Guarantor or FSB-

[2] ECMC's policy is to charge to the Guarantor Operating Fund any Infrastructure personnel expenses that exceed 118.05 percent of total salary paid under the Department's Level I Executive pay schedule.

related activities. Thus, expenses for these employees did not agree with employee time spent in each line of business per the cost allocation system or with employee job descriptions. ECMC made additional entries to adjust salary and benefits for these same employees during the 9-month period ended December 31, 2001, and charged an additional $360,279 to the FSB.

We also identified three employees who reported time spent on ECSC activity, but ECMC assigned their personnel expenses to the Infrastructure. Management acknowledged the error, and made an adjusting journal entry to reimburse the FSB for $13,998. However, ECMC's adjustment did not reimburse the FSB for the employees' time spent in other lines of business such as the Guarantor, TSC, or MSC.

ECMC made errors in implementing its cost allocation plan and charged expenses to the Infrastructure line of business that did not represent standby capacity for additional guarantor services. A significant portion of the expenses charged to the Infrastructure benefited other lines of business such as the Guarantor and ECMC's for-profit affiliates. The Agreement only allows the cost of standby capacity to be charged to the FSB.

ECMC officials stated that they explained their procedures when they provided the Department with a capacity plan, listing ECMC's mission, organizational structure, and annual operating expenses per line of business.[3] The capacity plan explains that Infrastructure costs represent the basic infrastructure available to be expanded as necessary and that none of the costs displayed result directly from the processing of existing volumes. The capacity plan defines ECMC's infrastructure as consisting of basic personnel, facilities, and equipment that create the foundation of the corporation and are required for the core personnel to function. Personnel are categorized into executive, operations, guarantor relations and services, finance, and information systems divisions.

The capacity plan does not support ECMC's cost allocation procedures. It says the Infrastructure assumes no processing functions. While the new capacity plan, revised September 2000, discusses ECMC's structural changes, it does not disclose that executive management's functions have changed or expanded. Employees assigned to Infrastructure now perform activities necessary to process current loan volumes and conduct day-to-day responsibilities for bankruptcy processing, the Guarantor, and its for-profit affiliates. The employees provide more than just standby capacity to take over other guaranty agencies. For example, TSC and MSC management oversee operations that provide financial and information systems services to the FSB, the Guarantor, its for-profit private label loan company, as well as a potential for additional customers. By charging Infrastructure expenses to the FSB, the Guarantor and the other affiliates benefit from these services at no cost.

When ECMC assigns executive management to Infrastructure, it affects more than just personnel expenses. ECMC allocates expenses associated with those employees to Infrastructure. In FY

[3] The initial capacity plan was developed in 1994.

2001, some expenses benefited more than the Infrastructure line of business. For example, ECMC charged the Infrastructure consulting fees for attending board of directors meetings, revising the employee manual, searching for a new Vice President of Human Resources, and analyzing executive salaries ($33,400). In addition, the FSB pays for the board of directors' expenses, which totaled approximately $330,000 in FY 2001. The Guarantor and the other affiliates benefited from services paid by the FSB.

Recommendations

We recommend that the COO for FSA require ECMC to

2.1 Return $65,832 to the FSB using funds from the benefiting lines of business.

2.2 Review all shared expenses allocated since ECMC segregated its operations, make appropriate adjustments if expenses were not paid according to the employee time spent in each line of business, and have its independent public accountant certify the results.

2.3 Allocate future expenses to all benefiting lines of business.

2.4 Assign future expenses to the Infrastructure only when the expenses relate to standby capacity maintained for takeovers/other requests by the Department.

2.5 Follow its cost allocation plan when determining the expenses that are allocable to the FSB.

2.6 Submit cost allocation plans for future periods to the Department for prior approval.

ECMC Comments – ECMC disagreed with Finding 2. ECMC said its maintenance of a core infrastructure provides the Department with a valuable resource to assume guarantor responsibilities at short notice, in any state. ECMC demonstrated this capability when called upon to resolve a failed guarantor situation in Virginia in 1996. ECMC explained that this concept is explicitly reflected in Paragraph 8.b. of the Agreement which defines standby capacity as immediate availability of a guarantee system capable of reading data from other systems, assuming responsibility for processing the data on short notice, and converting it to ECMC's system without disruption of any payment stream. ECMC further explained its logic by stating that its Infrastructure consists of key individuals and costs that if no other uses were found for them, ECMC would still need to retain them to maintain its standby capacity, which is considered an FSB expense. Therefore, based on its definition of infrastructure, ECMC does not agree that it improperly allocated $64,643 in costs.

ECMC also stated that any time spent by individuals assigned to the Infrastructure line of business that does not ultimately benefit ECMC is charged to the appropriate affiliated entity.

ECMC said its cost allocation policies do not improperly use federal funds to subsidize for-profit entities, evidenced by extensive reviews by its external auditors who certified that the March 31, 2001 and December 31, 2001 financial statements present fairly, in all material respects, the financial position of ECMC. For FY 2001, ECMC restated 18 months of financial data to retroactively comply with the Higher Education Amendments of 1998. ECMC re-sorted over one million transactions into over 500 possible lines of business/entity/cost center account matrices. ECMC agreed that it inadvertently overcharged $1,189 to the FSB during its complex period of change and plans to refund the FSB from the appropriate affiliated company.

OIG Response – ECMC's comments did not change our position. ECMC's Agreement with the Department does not clearly define the expenses that should be assigned to Infrastructure. Based on ECMC's records and interviews with ECMC staff, we determined that expenses, which benefited the Guarantor and for-profit affiliates, were charged to the FSB. Therefore, ECMC allocated more expenses to the FSB than those directly related to maintaining standby capacity for the Department.

The Agreement requires a proper allocation of costs between the FSB, Guarantor, and its affiliates. A proper allocation of costs generally implies that expenses are charged to the benefiting lines of business. ECMC inappropriately charged expenses to the FSB that benefited the Guarantor and ECMC's for-profit affiliates. As discussed in the finding above, ECMC allocates expenses based on employee time distribution reports. However, we found that ECMC assigned the expenses related to selected employees who had responsibilities for managing ECMC's other lines of business to Infrastructure. As a result, the FSB pays these expenses regardless of whether they are related to maintaining standby capacity or the day-to-day operations of the FSB, Guarantor, or for-profit affiliates.

ECMC stated that its Infrastructure consists of key individuals and costs that if no other uses were found for them, ECMC would still need to retain them to maintain its standby capacity. ECMC did find other uses for these employees, such as managing its Guarantor and for-profit affiliates. Interviews with key individuals assigned to Infrastructure and time distribution reports confirmed that other lines of business benefited from these expenses but were not allocated a share of the expenses.

ECMC's response did not address Recommendation 2.2. Since ECMC agrees that our tests identified inappropriate allocations of salary expenses attributable to its for-profit affiliates, FSA should require ECMC to review the remaining periods to identify additional similar expenses. Based on the rebuttals above, FSA should also require ECMC to review the remaining periods for all expenses inappropriately allocated to the FSB.

Finding 3 – ECMC Deposited SPA Payments Intended for the Guarantor Federal Fund into the Guarantor Operating Fund

ECMC received approximately $390,324 in supplemental preclaims assistance (SPA) payments from the Department after October 1, 1998. When ECMC established its Guarantor Federal and Operating Funds in April 2000, it transferred the SPA payments to the Guarantor Operating Fund. According to § 422A (c) (4), as added by the Higher Education Amendments of 1998, a guaranty agency shall deposit all payments received for supplemental preclaims activity performed prior to October 1, 1998, into the Guarantor Federal Fund. Therefore, the Guarantor Operating Fund contains funds that belong to the Guarantor Federal Fund.

ECMC officials transferred SPA payments to the Guarantor Operating Fund because they considered those payments related to SPA activity performed on eligible loans after October 1, 1998. When notified of our finding, ECMC officials changed their position and calculated a pro-rated portion of the SPA payments related to activity performed after October 1, 1998. ECMC used the dates lenders requested assistance to estimate the percentage of related work performed after October 1, 1998, but ECMC did not provide documentation to support its estimates. Using ECMC's calculations, the Guarantor Operating Fund was entitled to $165,424 of the $390,324.

Neither the HEA nor the regulations discuss a prorated allocation between the Guarantor Federal and Operating Funds for SPA payments received after October 1, 1998. Using the 5 percent U.S. Department of the Treasury Current Value of Funds Rate, we estimated that the SPA payments earned about $40,000 in interest through August 31, 2002.

Recommendations

We recommend that the COO for FSA require ECMC to

3.1 Return $430,324 to the Guarantor Federal Fund. This amount includes:

(a) $390,324 in SPA payments transferred to the Guarantor Operating Fund, and

(b) Imputed interest of $40,000.

3.2 Return to the Guarantor Federal Fund imputed interest earned on the $390,324 after August 31, 2002 through the date this issue is resolved.

ECMC Comments – ECMC stated it acted in good faith in interpreting available information and Department directives at the time this transaction was recorded, and while officials do not fully agree with our interpretation of the relevant regulation, ECMC will comply with the recommendation. No later than December 31, 2002, ECMC planned to transfer $430,324, plus another $6,500 in imputed interest earned through December 31, 2002, from its Guarantor Operating Fund to its Guarantor Federal Fund.

OTHER MATTERS

We noted an additional issue that warrants FSA's attention. ECMC pays usage fees for federal assets, but its calculation of the fee ceases after an asset's value is less than $5,000; this practice is not consistently applied to all federal assets. We did not fully develop the issue into a finding, as we could not establish a material effect.

ECMC's Guarantor Operating Fund pays both the FSB and Guarantor Federal Fund usage fees for assets purchased prior to October 1, 1998. In FY 2001, the Guarantor Operating Fund paid the FSB $54,715 in usage fees and $8,474 to the Guarantor Federal Fund for assets purchased prior to October 1, 1998. The usage fee was calculated based on a percentage of an asset's monthly depreciation expense. The percentage is determined based on the time spent per activity in the line of business that purchased the asset. No fees are paid for assets with a value of less than $5,000 or once they are fully depreciated. We found errors in ECMC's FY 2001 calculations. We notified ECMC officials of the errors and they also discovered usage fees for these assets had not been paid since November 2000. To correct the errors, ECMC transferred $155,640 to the FSB and $91,911 to the Guarantor Federal Fund. The Department has not issued guidance on usage fees and should evaluate ECMC's procedures for calculating usage fees once guidance is issued.

The Guarantor Operating Fund also pays the FSB a $35,000 monthly fee for the use of the GSII guarantee computer system. ECMC officials stated the fee was set in October 1998 based on incremental costs. However, ECMC did not maintain documentation showing how the fee was calculated. To date, the fee has not been modified. This fee arrangement violates the Agreement that states assets may be shared provided usage fees are appropriate and fully documented. The Department should also evaluate ECMC's procedures for this fee.

ECMC Comments – ECMC responded that its procedures for calculating usage fees are consistent with the Agreement and generally accepted accounting practices. In the event the Department issues new guidance on usage fees, it will fully comply with new procedures.

OIG Response – ECMC's usage fee calculations for use of the GSII guarantee computer system are not consistent with the Agreement. As previously stated, the Agreement requires usage fees that are well documented. The monthly usage fee is outdated. It has not been revised since October 1998 and ECMC could not provide supporting documentation for its calculation.

BACKGROUND

The Higher Education Amendments of 1998, enacted on October 7, 1998, required each guaranty agency to establish a Federal Fund and an Operating Fund within 60 days. The final date for establishing these funds was December 6, 1998. Unless otherwise specified, the Higher Education Amendments of 1998 were effective October 1, 1998. FSA issued interim guidance in January and November 1999, and published regulations relating to the Federal and Operating Funds on October 29, 1999.

All funds, securities and other liquid assets of the guaranty agency's Federal Family Education Loan (FFEL) program reserve fund were to be transferred to the Federal Fund, which is the property of the Federal Government. The HEA required a guaranty agency to deposit revenue from specified sources into the Federal Fund and also specified the uses of Federal Fund assets. The HEA also specified deposits into the Operating Fund and the general uses of Operating Fund assets. Except for funds transferred from the Federal Fund, the Operating Fund is the property of the guaranty agency. If the Operating Fund contains transferred funds owed to the Federal Fund, it may be used only as permitted by the regulations, which prohibit certain uses of reserve funds.

ECMC is a nonprofit corporation operating as a guaranty agency designated by the U.S. Department of Education. During the year ended March 31, 2000, ECMC worked with the Department to develop a financial reporting methodology that would more accurately reflect its functions and allow ECMC to more fully comply with the funding structure required under the Higher Education Amendments of 1998. As a result, ECMC established two reporting entities: ECMC – The Guarantor and ECMC – The Federal Services Bureau. ECMC – The Guarantor is the designated guarantor for the State of Virginia. ECMC – The Federal Services Bureau collects and monitors payments from borrowers making payments on bankruptcy loans transferred from the Department and other guaranty agencies. It also performs specialty student loan services for the Department.

During the year ended March 31, 2001, ECMC reorganized its operations. Seven related-party entities were incorporated and commenced operations on January 1, 2001: ECMC Group, Inc.; ECMC Group Holdings Foundation; ECMC Holdings Corporation; ECMC Technology Services Corporation; ECMC Management Services Corporation; Educational Credit Services Company; and ECMC Receivables Management Corporation. The latter five are for-profit entities. ECMC is not the parent, and the financial results of these entities are not included in the financial statements of ECMC. ECMC is subject to the control of ECMC Group, Inc. ECMC changed its year-end to December 31 to coordinate with the year-ends of the related entities.

AUDIT OBJECTIVE, SCOPE, AND METHODOLOGY

The purpose of our audit was to determine whether ECMC complied with the HEA and regulations governing the establishment and operation of the Guarantor Federal and Operating

Funds, during the period April 1, 2000 through March 31, 2001. Specifically, we evaluated the areas of (1) initial establishment of the two funds, (2) continued operations of the two funds, (3) the Guarantor Operating Fund's compliance with prohibited uses of assets regulations, (4) ownership of nonliquid assets and usage fees paid, and (5) reasonableness of the cost allocation plan. We later expanded the scope to include a limited review of ECMC's accounting of federal funds in its FSB, including repurchase interest and personnel expenses incurred during ECMC's next reporting period, the nine-months ended December 31, 2001.

To accomplish our objectives, we judgmentally selected and reviewed (1) FY 1999, 2000, and 2001 records relevant to the establishment of the FSB and Guarantor Federal and Operating Funds, (2) nine accounting transactions in FY 2001 related to the transfer of funds from the Guarantor Federal Fund to the Guarantor Operating Fund, and (3) supporting documentation for ECMC's shared operating expenses in FY 2001. Specifically, we judgmentally selected February 2001 salary allocations for 15 cost centers, 11 transactions for consulting services, and outside services incurred for the quarter ended March 31, 2001. We conducted additional testing of ECMC's November 2001 personnel expense allocations for those employees who spent time on Infrastructure and ECSC. We also reviewed accounting adjustments made for personnel expenses posted during the period ended December 31, 2001.

We judgmentally selected June and December 2000 to review all transactions for the distribution of post-default collections. We assessed the reasonableness of FY 2001 obligations paid from the Guarantor Federal and Operating Funds, and ECMC's calculation and accounting of usage fees paid for assets purchased prior to October 1, 1998. We examined the Department's analysis of NSLDS data for the period January through March 2002, and ECMC's accounting of FY 2001 loan processing and issuance fees. We reviewed ECMC's accounting for (1) federal FY 2000 4th quarter account maintenance fees payments, (2) SPA received from December 1998 through May 1999, and (3) default aversion fees received for 10 loans in the month of January 2001 and rebated default aversion fees for 21 loans that defaulted in January 2001. We reviewed ECMC's financial and Office of Management and Budget Circular A-133 reports for the years ended March 31, 1999, 2000, and 2001, to determine whether the independent public accountant (IPA) identified significant findings related to our audit. We reviewed the FY 2000 and 2001 supporting working papers of the IPA who performed those audits. We also interviewed various ECMC personnel and FSA officials.

To achieve our audit objectives, we relied on computer-processed data contained in ECMC's automated general ledger system, Solomon IV for Windows®. To assess the reliability of these data, we relied on the work completed by the IPA and we completed additional tests by comparing computerized data to source documents. In assessing general and application controls, the IPA reported a material weakness related to inadequate access controls that could have allowed unauthorized access and system misuse to ECMC's hardware and software applications. We concluded that the data were sufficiently reliable to be used in meeting our objectives.

We conducted our field work from February 25, 2002 through August 31, 2002. We performed the majority of our field work at ECMC's location in St. Paul, Minnesota and additional analysis at our office. We discussed the results of our audit with ECMC officials on December 18, 2002. We performed our audit in accordance with generally accepted government auditing standards appropriate to the scope of review described above.

STATEMENT ON MANAGEMENT CONTROLS

As part of our audit, we made an assessment of ECMC's management control structure, policies, procedures, and practices applicable to ECMC's administration of the FFEL program. We performed the control risk assessment to assist us in determining the nature, extent, and timing of the substantive tests needed to accomplish our audit objectives.

To make our assessment, we identified significant controls and classified them into the following categories:

- Establishment of the FSB and Guarantor Federal and Operating Funds
- Maintenance of the FSB and Guarantor Federal and Operating Funds
- Ownership of fixed assets used to administer the FFEL program
- Transfers of assets from the Federal Fund to the Operating Fund
- Transactions involving the Federal Reserve Fund prior to the establishment of the Federal and Operating Funds, which significantly impacted the opening balances of those funds

Due to inherent limitations, a study and evaluation made for the limited purpose described above would not necessarily disclose all material weaknesses in the control structure. However, we identified weaknesses in ECMC's controls over the maintenance of its FSB and Guarantor Federal and Operating Funds. We describe the weaknesses in Findings 1 and 2. We are not recommending corrective action regarding control weaknesses in Finding 3 because SPA no longer exists.

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December 18, 2002

Mr. Richard J. Dowd
Regional Inspector General for Audit
U.S. Department of Education
Region V
111 North Canal, Suite 940
Chicago, IL 60606

Dear Mr. Dowd:

This letter is in response to your November 19, 2002 transmittal of a Draft Audit Report (ED-OIG/A05-C0014). ECMC appreciates the Regional Inspector General for Audit's overall comment that "ECMC generally complied with the Higher Education Act of 1965 (HEA), as amended, while establishing and maintaining its Guarantor Federal and Operating Funds during the period of April 1, 2000 through March 31, 2001."

However, before turning to our response to the specific findings and recommendations within the draft report, let me first note that we believe that the findings therein, as currently drafted, do not appropriately give effect to the unique nature of Educational Credit Management Corporation (ECMC) and its differentiated role in the FFELP, as that role has evolved in close collaboration with the U.S. Department of Education (Department) in order to meet the Department's needs. The financial structure and practices of ECMC are designed to not only fully comply with the provisions of law and regulation which apply to all guaranty agencies, but to also provide for the special "standby" services ECMC was founded to maintain, as required by the Department.

The January 3, 2001 Agreement between the United States Department of Education and Educational Credit Management Corporation (the Agreement) and subsequent clarifications and interpretations of the Agreement reflect practices that evolved since ECMC's founding in April 1994. All of those practices fully comply with applicable law and Department regulations. All are designed to ensure that the operations of ECMC provide taxpayers with a cost-effective resource to address any major access issues that may arise as a result of guarantor insolvency, operational failure or other contingency. While we admit that ECMC's configuration as both a Guarantor and a Federal Services Bureau (FSB) (ECMC's bankruptcy servicing operation) is differentiated from other guarantors, we believe that this difference yields a significant benefit to the Department, as well as taxpayers.

Response to Finding #1

Finding #1 concludes that ECMC improperly transferred $14.6 million in federal funds to its Guarantor Operating Fund. ECMC respectfully disagrees with this finding for the following reasons.

1. ECMC's practice of retaining as Operating Fund revenue post-claim payment interest accrued on loans subsequently repurchased by lenders is completely consistent with the Department regulations, as well as long established practice by all guaranty agencies. In fact, Finding #1 is not based on alleged violation of any specific provision of law or regulation but on an incorrect interpretation by the Office of Inspector General (OIG) of the Agreement.

2. The finding states that ECMC's practice with regard to repurchase interest is improper, inconsistent with the Agreement and not explicitly authorized by the Agreement. The finding quotes portions of five separate paragraphs of the Agreement in an attempt to support this finding.

   This attempt fails due to both the express language of the Agreement, as well as how the parties to the Agreement have agreed to interpret it. Paragraph #6 of the Agreement is quite clear in stating:

   > "As provided in prior agreements with the Department, ECMC shall remain responsible for collecting and administering loans on which the borrower has filed a petition for relief under Chapter 13 of the U.S. Bankruptcy Code. ECMC/the Federal Services Bureau shall be responsible for all aspects of servicing these loans. This responsibility includes, but is not limited to, arranging for a lender to repurchase a loan on which the borrower is completing the repayment plan and the loan is subject to repurchase. In this situation, ECMC/the Federal Service Bureau shall retain the amount that would otherwise be due the Department under the Department's regulations. A new guarantee shall be issued by ECMC/the Guarantor."

   It is clear that "the amount that would otherwise be due the Department under the Department's regulations" refers to the principal and capitalized interest accrued as of the claim paid date (i.e., the claim amount reinsured at that time by the Department). That is the amount explicitly determined in properly filing ED Form 2000 pertaining to what a guaranty agency must return to the Department upon repurchase of a loan. In accordance with established industry practice, any additional interest that has accrued from the time the original lender claim was paid to the lender's repurchase date is retained by a guaranty agency as Operating Fund revenue. The Department has not issued any specific regulations prohibiting this industry practice, nor has the 1998 Reauthorization Act (Reauthorization) prohibited such practice. We believe that, in the absence of any legal or regulatory prohibitions to the contrary, ECMC, acting as the Guarantor, should be authorized to follow a clear industry practice on the treatment of these funds

3. Finding #1 appears to be based on the OIG's interpretation of the intent of the Agreement. We believe that the most effective manner to determine the intent of the parties in this case is to inquire what the actual parties to that contract have agreed the contract means.

   One of the pillars of ECMC's working relationship with the Department has been a concerted effort to avoid unnecessary misunderstandings by sharing information and confirming the Department's views relative to any issues not explicitly covered by law or regulation. In that spirit ECMC sought the Department's concurrence that Paragraph (6) of the Agreement could be applied as follows.

"When repurchase amounts are received, the amounts that would otherwise be due the Department are deposited into the Federal Services Bureau Reserve Fund and, as we discussed, the remaining amounts are deposited into a segregated account within the Guarantor and will be used to issue private label loans, a use of funds as allowed under 34 CFR part 682.423(c)(2)."

This paragraph is an excerpt from a letter dated January 4, 2001 to Mr. Brian Siegel, Office of the General Counsel of the Department (Mr. Siegel was the primary representative of the Department in fashioning the Agreement). Later in 2001, ECMC's external auditors verbally confirmed with Mr. Siegel that his office had received the above letter and concurred with its contents.

4. Finding #1 attempts to dismiss all of the above considerations by stating that:

> "Although ECMC stated its intended course of action, the Agreement itself was never amended. The Agreement does not have a provision for any funds to be transferred to the Guarantor Operating Fund."

We have two objections to the final conclusion.

- First, there is simply no need to formally amend a contract where the parties have reached a clear understanding of what they meant by a particular provision. After seeking clarification from the Department on this issue on several occasions, which were confirmed in written correspondence to the Department, ECMC saw no need for further clarification through a formal amendment of the Agreement. We believed, and still believe, in good faith that the Department agrees with how we are interpreting the proper handling and accounting of these funds. In addition to our discussions and clarifying correspondence with the Department, we believe if we were also to have requested an amendment to the Agreement this would have been both unnecessary and arguably "overkill".

- The finding generally refers to a "transfer" of funds. In fact, in transactions of the type in question (loan repurchases) no actual "transfer" of funds occurs at ECMC or any other guarantor. It is clear that any loan on which reinsurance has been paid is federal property and thus when such a loan is repurchased by a lender while the loan is assigned to a guarantor, the issue is one of how to allocate the repurchase amount received. The provisions of properly filing ED Form 2000 provide a clear basis of such allocation and no "transfer" authority is required. Thus, the finding's concern that no explicit "transfer" authority exists in the Agreement is irrelevant--no guarantor has such "transfer' authority, yet all other guarantors allocate repurchase monies in the same way as ECMC.

We would be willing, if agreed to by the Department, to execute an amended Agreement with the Department that incorporates therein the terms of this matter, as we have described it above, as a means of bringing the current understanding of the parties within the formal agreement.

Given all of the foregoing, ECMC respectfully declines to implement the audit recommendations that stem from Finding #1 and requests that this Finding be removed from the final audit report.

Response to Finding #2

Finding #2 concludes that ECMC used the FSB Federal Reserve Fund to subsidize expenses that benefited other ECMC Group entities such as ECMC's Guarantor Operating Fund and ECMC's for-profit affiliates.

ECMC respectfully disagrees with this finding for the reasons explained below.

This finding involves three related issues:

- ECMC's maintenance of a core infrastructure (an expense of the FSB Federal Reserve Fund) designed to provide standby capacity to assume guarantor responsibilities at short notice, in any state, at the Department's request.
- The basis on which costs are to be allocated among ECMC Group entities--and how that allocation basis accommodates the above infrastructure concept.
- The accurate application of that allocation basis during a specific time interval.

Our response to this finding has three components.

1. We believe that ECMC maintenance of a core infrastructure provides the Department with a valuable resource that has demonstrated its worth when called upon to resolve a failed guarantor situation in Virginia in 1996. Moreover, that concept is explicitly contemplated by Section 8(b) of the Agreement.

2. The cost allocation policies established by ECMC have been intensively reviewed by ECMC's external auditors, with particular emphasis on ensuring that federal funds are not improperly used to subsidize for-profit entities.

3. Fiscal year 2001, April 1, 2000 – March 31, 2001, was a transition period for ECMC. During this period ECMC, in response to the Reauthorization, created the FSB and the Guarantor reporting entities. ECMC diligently restated 18 months of financial data (October 1998 – March 2000) in order to retroactively comply with Reauthorization. Over one million transactions were resorted for this period into over 500 possible line of business/entity/cost center account matrices. On January 1, 2001, the ECMC Group of affiliated companies began operations. 2001 was the initial year ECMC implemented its new multiple companies cost allocation policies. These transitions resulted in a period of adjustment for employees as they became accustomed to the revised time distribution reporting requirements. ECMC's auditors have certified that the financial statements for the twelve month period ended March 31, 2001 and the nine month period ended December 31, 2001 present fairly, in all material respects, the financial position of ECMC, including the Guarantor Federal Reserve Fund, Guarantor Operating Fund, and FSB Federal Reserve Fund, and the results of its activities and its cash flows for the respective periods in conformity with accounting principles generally accepted in the United States.

The core issue involved in this finding is the definition of the "infrastructure" ECMC is required to maintain on behalf of the Department. Section 8(b) of the Agreement reads as follows.

"Maintenance of Standby Capacity - ECMC is directed to maintain standby capacity sufficient to ensure that it can assume responsibility for maintaining access to FFEL program loans in any state where the current guarantor ceases to provide such access. Such standby capacity includes, but is not limited to:

(i) Immediate availability of a fully capable, industry standard compliant guarantee system;

(ii) the ability to convert the current guarantor's data base to ECMC's system in a timely and accurate manner;

(iii) the capacity to process large volumes of additional guarantor transactions on short notice;

(iv) the ability to absorb and maintain access to guarantor records in multiple media; and

(v) the capacity to assume responsibility for a guarantor's post-default collections portfolio without disruption of its payment stream."

In practical terms, the "capacity" to meet the above requirements is a function of two variables: systems and experienced key personnel capable of effectively utilizing those systems (as well as doing the other things necessary to effectively accomplish a complex transition).

ECMC has continually maintained the "capacity" to achieve these requirements via its "infrastructure" that has existed--and been reported to the Department and the OIG--throughout the years of ECMC's existence since 1994. The logic of the concept is quite straightforward:

- Key individuals and costs are designated as "infrastructure" and considered FSB expense, (i.e., if no other use was found for such individuals or costs, ECMC would still need to retain them to maintain its Standby Capacity, and would appropriately charge such infrastructure costs to the FSB).
- Time spent by infrastructure individuals that does not ultimately benefit ECMC is charged to the appropriate affiliated entity.

We believe that ECMC has consistently and correctly applied the infrastructure concept contemplated by Section 8(b) of the Agreement and we do not agree that the $64,643 noted in the Draft Audit Report represents an improper cost allocation. We do, however, agree that $1,189 was inadvertently overcharged to the FSB during this complex period of change and will transfer that amount to the FSB from the appropriate affiliated company.

Given all of the foregoing ECMC respectfully declines to implement the recommendations associated with Finding #2 except as follows:

- ECMC will reallocate $1,189 expenses inadvertently charged to the FSB to the appropriate affiliated company.
- ECMC will cooperate with the COO of FSA in reviewing the "infrastructure" concept and how it is to be applied in future years if the COO so desires.

Response to Finding #3

Finding #3 concludes that ECMC incorrectly deposited $390,324 in Supplemental Preclaims Assistance (SPA) payments received after October 7, 1998 into its Guarantor Operating Fund instead of its Guarantor Federal Reserve Fund.

While we believe that ECMC acted in good faith in interpreting available information and Department directives at the time this transaction was recorded, and while we still do not fully agree with the OIG's interpretation of the relevant Regulation, ECMC will comply with the recommendation that results from this finding. No later than December 31, 2002, ECMC will transfer $390,324, plus imputed interest through August 31, 2002 of $40,000, plus imputed interest from September 2002 through December 2002 of $6,500 from its Guarantor Operating Fund to its Guarantor Federal Reserve Fund.

In addition to the above findings the draft audit report notes two additional issues as "other matters" which warrant FSA's attention. We believe these issues also warrant ECMC comment.

1. ECMC's Procedures for Calculating Usage Fees

   ECMC believes that its procedures for calculating usage fees are consistent with the Agreement and generally accepted accounting practices. In the event that the Department issues new guidance with regard to such fees ECMC will, of course, fully comply with whatever procedures are promulgated or cease use of specific federal resources in instances where we find that such guidance results in costs which exceed market rates.

2. NSLDS Needs Timely Updates

   Since ECMC has not been provided any detailed information that supports the OIG's audit comments, we simply cannot respond to those comments except to state our conviction that ECMC's procedures fully confirm the accuracy of data we submit to NSLDS. We are prepared to review any specific data that the OIG believes contradicts the above conviction. The OIG Draft Audit report states that ECMC may have received overstated account maintenance fees as a result of NSLDS allegedly not reflecting true current outstanding balances. Current loan balances have absolutely no impact on the amount of account maintenance fees paid to ECMC. Account maintenance fees are paid on the sum of net guarantees and not the outstanding principal balance.

In conclusion, let me note our appreciation for the professional manner in which the Inspector General's staff conducted this review and interacted with our people. While we obviously disagree with some of the conclusions they reached, we believe such areas of disagreement can be resolved through further review of the facts and open discussion between ECMC and the OIG.

Sincerely,

Richard J. Boyle

Richard J. Boyle
President and CEO