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Senator Thomas Courtney and
Representative Vicki Lensing, Co-Chairs
Government Oversight Committee:

You requested an audit of the Iowa Student Loan Liquidity Corporation. Based on the information included in your initial request and our subsequent discussions, it became apparent an audit of the Iowa Student Loan Liquidity Corporation would not address the issues you desired to focus on. As a result, you provided a list of questions for which you wanted additional information.

Because of your request, we have reviewed various aspects of the Iowa Student Loan Liquidity Corporation and its operations. Based on our review, we do not believe responding to each individual question would provide the most meaningful information for your Committee to evaluate the Iowa Student Loan Liquidity Corporation and determine any action the Committee may wish to pursue. As a result, we have prepared this report to present our findings resulting from your individual questions in several categories after first providing some background information regarding the Iowa Student Loan Liquidity Corporation. Those categories are Financial Considerations, Organizational Considerations and Oversight Considerations.

Background Information

The Iowa Student Loan Liquidity Corporation (ISL) was established in 1979 at the request of the Iowa College Aid Commission (now the Iowa College Student Aid Commission) and Governor Robert D. Ray. It was established as an educational non-profit corporation whose purpose is to assure student loans are available to Iowa students. ISL maintains its office in West Des Moines.

According to its Articles of Incorporation, ISL has an 11 member Board of Directors who are appointed by the Governor. The Board of Directors is to be composed of the following:

- 2 Directors representing Iowa Banking Institutions,
- 1 Director representing Iowa Savings and Loan Institutions,
- 1 Director representing Iowa Credit Unions,
- 1 Director representing Iowa Regents Institutions,
- 1 Director representing Iowa Private Colleges and Universities,
- 1 Director representing Iowa Merged Area Schools,
- 1 Director representing the Iowa College Student Aid Commission,
- 2 Directors representing the General Public, and
- 1 Director who is the Superintendent of the Iowa Department of Banking.

The Board of Directors shall elect the officers of ISL, who shall consist of a President, a Vice President, a Secretary and a Treasurer. The officers are responsible for the day-to-day operation of ISL.

ISL is authorized by Section 7C.4A(3) of the Code of Iowa to sell tax exempt bonds for the purpose of acquiring loans made to students at Iowa educational institutions to help those students pay for college expenses. ISL may also sell taxable bonds for the same purpose. The bonds and related interest are payable from the principal and interest payments received from the student loans held by ISL. As of June 30, 2007, the most recently completed fiscal year, ISL held approximately \$3.3 billion of outstanding student loans, approximately 2/3 of which were federally guaranteed, and had approximately \$3.5 billion of outstanding bond debt, of which only 15% are tax exempt. During the year ended June 30, 2007, ISL received principal payments of approximately \$589 million on outstanding student loans and acquired approximately \$1 billion of new student loans.

ISL formed a for-profit subsidiary in 2001 known as ISL Service Corporation, which also maintains its offices in West Des Moines. The subsidiary was established to provide services which are not specifically related to ISL's primary non-profit purpose. These services include financial aid software development, maintenance of an electronic data transmission system and loan servicing for non-Iowa entities. ISL's net income from subsidiary activities during the year ended June 30, 2007 was approximately \$145,000, or approximately 1.2% of ISL's total operating income for the year. The subsidiary's total assets are less than .1% of ISL's total assets. Activities of the for-profit subsidiary do not represent a significant portion of ISL's overall activities.

Financial Considerations

ISL's financial activities are growing rapidly, as evidenced by the 203% increase in its operating revenues from the year ended June 30, 2003 to the year ended June 30, 2007 and the 68% increase in net assets over the same time period. Both increases are directly related to the growth in outstanding student loans receivable ISL held during that time period. Student loans receivable held by ISL increased from approximately \$1.4 billion at June 30, 2003 to approximately \$3.3 billion at June 30, 2007.

While we have not attempted to determine every reason for the significant increase in student loans receivable between these dates, it is likely the increase is attributable to the following:

- a) The increase in tuition and other costs to attend college,
- b) Increased willingness and/or need of students to finance college expenses through debt rather than other resources, and
- c) The ability of ISL to offer favorable loan terms because of its non-profit status and its ability to issue tax-exempt debt to acquire funds to provide student loans.

ISL has obtained the financial resources for the increase in student loans receivable through issuance of debt. Because the debt is repayable solely from the repayment of student loans and other income of ISL, each debt issuance results in an evaluation of ISL's financial condition and its ability to repay both the existing and the proposed debt by potential buyers of ISL debt. Each debt instrument typically requires reserves to be established. The reserves help ensure the debt will be repaid by ISL, but they also reduce the interest rate ISL would otherwise have to pay on the debt if sufficient reserves were not established.

Maintaining adequate reserves is a prudent management philosophy and practice for ISL, just as it is for other lending institutions and even the State. By maintaining reserves, necessary programs can be preserved when unanticipated expenses occur or expected revenue does not materialize and programs which will provide benefits over a multi-year period can be implemented when the costs to provide those benefits in the future are not currently known.

As with any lending institution, ISL's finances are affected by major factors such as investment earnings and loan delinquency rates. While lenders exercise some control over these factors through the operating practices they follow, lenders do not have complete control over such factors. For example, investment earnings will fluctuate depending on changes in interest rates and the amount and type of investments held. Loan delinquency rates may be affected by such factors as the salaries borrowers receive once they graduate and must begin repaying their student loans, the amount of credit card debt the borrowers must repay or whether the borrowers have an adjustable rate mortgage with increasing payments. While lenders may provide incentives for borrowers to place a priority on repaying specific debt, they can not assure that will happen. These factors become increasingly important considerations for ISL as the amount of student loans it holds which are not federally guaranteed increases.

We did not attempt to determine if ISL's reserves were adequate, inadequate or excessive. ISL's reserves are reviewed annually during the financial statement audit of ISL which determines if the reserves are sufficient to meet the requirements of the bond issues ISL has entered into. In addition, ISL is subject to an annual examination by the Iowa Division of Banking, audits under various Federal programs in which ISL participates and an annual examination of ISL's compliance with student loan servicing requirements. The appropriateness of any reserves beyond the legally

required minimum reserves is a matter of professional judgment and must consider the long-term plans of ISL. ISL has developed a methodology to analyze the adequacy of its reserves and reviews the reserves on an ongoing basis.

As reported in the Legislative Services Agency's *Issue Review* of ISL dated February 6, 2007, the President/CEO of ISL was paid \$207,000 during the fiscal year ended June 30, 2005. Three other officers were paid amounts ranging from \$117,000 to \$128,000. As part of our analysis, we reviewed a 2004 executive compensation survey performed for ISL by Reimer Consulting of Eden Prairie, Minnesota.

The executive compensation survey, which covered 11 State/Quasi State entities and 12 Private Non-Profit entities which provide services similar to those provided by ISL, reported the following:

<u>Salary Level</u>	<u>Number of CEOs</u>	
	<u>State/Quasi State</u>	<u>Private Non-Profit</u>
Less than \$100,000	2	0
\$100,000 to \$150,000	5	3
\$150,000 to \$200,000	2	4
\$200,000 to \$250,000	0	2
More than \$250,000	<u>2</u>	<u>3</u>
Total	<u>11</u>	<u>12</u>

Based on comparative information on total assets and annual loan volume for the entities included in the salary survey, ISL's total assets and annual loan volume exceeded the averages for both categories for both State/Quasi State and Private Non-Profit entities.

In addition to his salary, the President of ISL was the beneficiary of a deferred compensation trust established on June 1, 2001. The initial deferred compensation amount was \$50,000 to vest over a four-year period. Increases in the deferred compensation amount of \$5,000 were authorized by the Board on November 20, 2001 and November 23, 2002 and a \$100,000 increase was approved on March 27, 2003. The vesting period was extended to five years and the payout date was extended to July 31, 2006. In accordance with the trust agreement, a taxable distribution slightly in excess of \$200,000, including trust earnings, was made to the President in 2006.

Averaging the 2006 deferred compensation distribution over the five-year vesting period during which it was earned would result in approximately \$40,000 per year of additional annual compensation. When this \$40,000 amount is added to the President's salary of \$207,000 for the year ended June 30, 2005, the total compensation is still less than reported for CEOs of some comparable entities in the 2004 executive compensation survey. In addition, ISL's legal counsel has stated the President's total compensation would not be considered unreasonable by the Internal Revenue Service.

ISL's Board Members are also compensated for services they render to ISL. Although it is common for Board Members to be paid for their services, some Board Members serve on the ISL Board to represent specific State departments or local governments. These include the Superintendent of Banking, the Iowa College Student Aid Commission and the State Board of Regents at the State level and the merged area schools at the local government level. While the Iowa College Student Aid Commission and the State Board of Regents can appoint someone who is not a state employee to represent them on the ISL Board, the Superintendent of Banking can only be a state employee. The merged area schools could also appoint an individual who is not an employee of a merged area school as their representative to the ISL Board.

We are aware of no specific guidance as to whether State or local government employees serving on ISL's Board to represent the State departments and local governments identified above are expected to perform the required services as part of their normally assigned employee duties and salary. Alternatively, the services could be performed outside the scope of the normally assigned employee duties and be eligible for additional compensation from ISL.

We are aware the Iowa Ethics and Campaign Disclosure Board has initiated a state-wide review of situations such as described above. Therefore, we did not attempt to determine whether any of the payments made by ISL to Board Members who were State or local government employees were retained by the individuals or were remitted to their governmental employer. However, we believe State and local government employees should not receive compensation from outside sources when they are specifically representing their governmental employer.

Organizational Considerations

While the State does not control ISL to the extent it does state agencies, it certainly has the ability to significantly influence ISL. This influence can be attributed to the Governor's authority to appoint the Board Members of ISL and the requirement the Board include individuals representing the Regents Institutions and the Iowa College Student Aid Commission, as well as the Superintendent of Banking. It is reasonable to believe the Governor would appoint members of the Board who support the Governor's positions regarding ISL activities, regardless of which constituency group the member is being appointed to represent. It is also reasonable to believe the Board Members who represent State agencies would advocate for positions supported by the Governor, which is entirely proper.

From our perspective, the Board Member who represents the most significant potential conflict of interest is the Superintendent of Banking because the Banking Division of the Department of Commerce, supervised by the Superintendent of Banking, is responsible for performing annual examinations of ISL after ISL received its regulated loan license in 1995. As a result, employees of the Division of Banking must evaluate activities resulting from decisions in which the head of their agency has participated. This is the same type of situation which would exist if the Insurance Commissioner was a Board Member of an insurance company which was subject to regulation by the Insurance Commissioner's department. We believe oversight and regulation of ISL would be enhanced by removing the Superintendent of Banking from ISL's Board. Even if removed from ISL's Board, the Banking Superintendent would still be available for consultation and advice to ISL, just like any other entity supervised by the Banking Superintendent.

From our perspective, the Board Member who represents the Iowa College Student Aid Commission (the Commission) also represents a potential conflict of interest. One of the primary duties of the Commission is to develop, in conjunction with the Board of Regents, a program which informs parents about the options available to finance a college education and the need to accumulate the financial resources to pay for a college education. The Commission is also the guarantor agency for federally guaranteed student loans, which may be issued by a multitude of lenders. Serving as the guarantor agency includes approving lenders as eligible lenders upon the Commission finding the lenders meet the Commission's standards.

Commission membership on the Board of ISL but not similar organizations which provide or acquire student loans does not present the appearance of impartiality, as should be expected of a State department. We also believe representation on the Board of ISL makes it more difficult for the Commission to review ISL's compliance with requirements related to federally guaranteed loans for the same reasons cited for the Superintendent of Banking above.

Therefore, we believe it would also be appropriate to remove the Iowa College Student Aid Commission member from ISL's Board. The Commission's ISL Board membership is contrary to its primary mission and potentially detrimental to its ability to work cooperatively with ISL when needed. Likewise, ISL membership on the Commission should be removed.

ISL and the Commission entered into two agreements under the provisions of Chapter 28E of the Code of Iowa for the establishment of a student loan guaranty communications system and the establishment of a student loan guaranty agency servicing center. The agreement for the communications system is still in effect but the agreement for the servicing center is not. A third agreement, which was not entered into under the provisions of Chapter 28E of the Code of Iowa, provided for the sale of delinquent loans by ISL to the Commission and has been completed. Having representatives on the Board of the other complicates the ability of both ISL and the Commission to function at arms length when attempting to negotiate and implement agreements which could be mutually beneficial to each organization. This is due to potential conflict for the

overlapping members if the positions taken by the two organizations differ and potential sharing of information which reduces the arms length nature of the negotiations. If both organizations are in complete agreement, negotiations can be successfully conducted even without overlapping Board members. If the organizations are not in agreement on various issues, they are able to more effectively communicate and advocate their individual positions if the organizations do not have overlapping Board Members.

The operations of both ISL and the Commission could be enhanced by removing the Commission representative from ISL's Board and the ISL representative from the Commission. According to ISL's Articles of Incorporation, the composition of the Board of Directors and the Officer positions of ISL may not be changed without the approval of the Commission. We believe the Commission should approve the recommended Board Member modifications. Removing the ISL representative to the Commission, however, requires legislative action to amend section 261.1(5) of the Code of Iowa.

If there is consensus the number of Board Members for either ISL or the Commission needs to remain at the current level rather than being reduced by the number of members we recommend be removed, we believe replacement members should be appointed from members of the general public who currently have outstanding student loans or who had student loans they have paid off.

Oversight Considerations

As stated previously, there are already a number of mechanisms in place for the State to provide oversight of ISL. These include, but are not limited to, annual financial statement audits, annual examinations by the Division of Banking and oversight of ISL's compliance with requirements related to federally guaranteed loans by the Commission. However, other opportunities to provide additional public awareness of ISL's activities are possible.

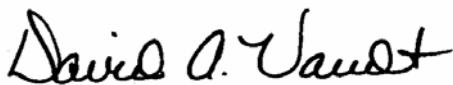
One opportunity is to require the annual audit of ISL to be filed with the Office of Auditor of State, where it would become a public record and be available to anyone interested in reviewing the audit report. The Office of Auditor of State could also be authorized to review the audit reports filed by ISL and conduct any additional investigations or reviews deemed appropriate, provided a funding mechanism to perform the additional investigations or reviews is also authorized.

Another opportunity is to stipulate ISL is subject to the Open Meetings provisions contained in Chapter 21 of the Code of Iowa, provided ISL could maintain confidentiality of proprietary information which could be beneficial to its competitors if publicly disclosed. This would require legislative action to amend Chapter 21 of the Code of Iowa.

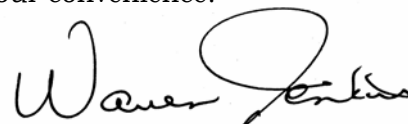
By legislative action, ISL could also be required to prepare an annual or biennial report, to be filed with the Governor and General Assembly, which discusses its operations, its financial status and the outlook for the future and describes how ISL activities serve its non-profit mission to assure student loans are available to Iowa students.

Additionally, the Commission could be required to accumulate and periodically report information regarding available student loan interest rates and loan terms to help potential borrowers evaluate various lenders' loan programs. Doing so would enable the Commission to serve as a clearinghouse which could facilitate public disclosure of available student loan terms and help borrowers better determine which available lender provides the most favorable loan terms for their individual circumstances.

We hope this information is helpful to you and the Committee. We shall be pleased to discuss any questions you may have about this report at your convenience.



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