December 1992

Guaranteed Student Loans
In January 1990, in the aftermath of scandals at the Departments of Defense and Housing and Urban Development, the General Accounting Office began a special effort to review and report on federal government program areas that we considered "high risk."

After consulting with congressional leaders, GAO sought, first, to identify areas that are especially vulnerable to waste, fraud, abuse, and mismanagement. We then began work to see whether we could find the fundamental causes of problems in these high-risk areas and recommend solutions to the Congress and executive branch administrators.

We identified 17 federal program areas as the focus of our project. These program areas were selected because they had weaknesses in internal controls (procedures necessary to guard against fraud and abuse) or in financial management systems (which are essential to promoting good management, preventing waste, and ensuring accountability). Correcting these problems is essential to safeguarding scarce resources and ensuring their efficient and effective use on behalf of the American taxpayer.
This report is one of the high-risk series reports, which summarize our findings and recommendations. It describes our concerns over the Department of Education’s management of the Guaranteed Student Loan Program, especially regarding defaulted student loans. It focuses on the program’s structural flaws and the lack of adequate incentives that some participants have to prevent defaults. We have made numerous recommendations in the past, many of which have been implemented. We believe that other opportunities for improvement exist, specifically those aimed at improving program management and reducing risk, that should be considered and acted on.

Copies of this report are being sent to the President-elect, the Democratic and Republican leadership of the Congress, congressional committee and subcommittee chairs and ranking minority members, the Director-designate of the Office of Management and Budget, and the Secretary-designate of Education.

Charles A. Bowsher
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Overview

The Federal Family Education Loan Program (formerly known as the Guaranteed Student Loan Program), administered by the Department of Education, is designed to provide access to postsecondary education for those who cannot otherwise afford it, on the premise that, once educated, the borrowers will earn incomes sufficient to pay back the loan. In 1991, the program generated about 4.8 million new loans totaling over $13 billion for students attending over 7,500 schools.

These loans are currently made by 7,800 lenders and administered by 46 state-designated guaranty agencies. The government generally pays interest on the loans while students are in school. Also, the government, through the guaranty agencies, guarantees the loans and repays lenders if borrowers fail to do so.

The Problem

While the program has generally succeeded in providing access to money for education, it has been less successful in protecting the taxpayers' financial interest. In 1991, the federal government paid out $3.6 billion to make good its guarantee on defaulted student loans, continuing a trend of escalating losses.
The Causes

The increase in losses reflects fundamental problems in the student loan program's structure and management. In part, this stems from the tension between the goals of providing steadily increasing loan funds, often through expanded or new loan programs, to enable students to meet rising higher education costs and the need to maintain accountability to taxpayers. Over the years, the federal government has tended to emphasize access to loans at the expense of accountability.

The structure of the loan program is inordinately complex, and many participants have little or no incentive to prevent defaults. Lenders and guaranty agencies benefit from making loans, but generally do not bear any financial risk. Schools also bear little risk, and some use the program as a source of easy income, with little regard for students' educational prospects or the likelihood of their repaying the loans. Nearly all the risk falls to the federal government, whose only recourse is to pursue defaulters. Yet as loan volume and federal financial exposure grew, the government failed to establish adequate controls to minimize its losses.
Management weaknesses have plagued the Department's administration of the loan program. The Department has failed to weed out schools that collect tuition payments for marginal instruction. Its records have been inaccurate and incomplete, leading to erroneous payments and loans to ineligible borrowers. It had conducted little oversight of lenders and guaranty agencies, paying default claims without reliable documentation and failing to collect fees due the government. And it had inadequately trained and organized program staff.

The Congress, the Department, and the Office of Management and Budget (OMB) have recognized these problems and attempted to correct many of them. The Congress enacted more than 100 legislative provisions in 1992 to improve the program's operations. The Department has worked to correct staffing inadequacies, controls over schools, and oversight of lenders and guaranty agencies.

Among other steps, we have suggested that the Department further toughen its screening of schools seeking initial and continued participation in the program and
expedite its plan for ensuring that program data are more useful, timely, and accurate.

While such improvements are essential, they would be unlikely in themselves to fix all the program's problems. Addressing the program's underlying flaws and reducing taxpayers' risks may require structural reform. In particular, we believe that the Congress should consider simplifying the loan program—perhaps by increasing the risk among participants. A pilot program to test a direct lending arrangement, which would eliminate lenders and guaranty agencies, is a possible step.
Federal Family Education Loan Program Operation: A Complicated, Cumbersome Process

The Federal Family Education Loan Program functions through a complicated and cumbersome system of rules and requirements involving millions of students and thousands of schools, lenders, and other entities. As shown in figure 1, following the maze of responsibilities is difficult. The program basically involves five parties: students, schools, lenders, guaranty agencies, and the Department of Education. In the sections below, we highlight some of the key responsibilities each group performs.

The Student

The student, as borrower, initiates the loan process. The student applies to a lender for the loan, arranges for repayment with the lender, and repays the loan. Most students receive a federal subsidy throughout the period of their loans, including a low interest rate, and make no interest payments while they attend school. Generally, when the student completes or otherwise leaves school, he or she starts repayment. Between fiscal years 1966 and 1991, the number of student loans guaranteed each year increased from 89,000 to 4.8 million.
Figure 1: Federal Family Education Loan Program: A Complicated and Cumbersome Process

1. Student provides school with financial information and school determines loan eligibility and counsels student.
2. Student generally obtains loan application from lender, fills out his or her portion and forwards it to school; school completes application forwards it to lender.
3. Lender provides information to guaranty agency; agency verifies student eligibility and agrees to guarantee loan; lender sends promissory note to student; student returns signed note to lender.
4. Lender issues check to be endorsed by both school and student.
5. School periodically confirms borrower's continued student status.
6. Lender bills the Department of Education for interest subsidy, reports loan origination fees collected, and provides summary information on its guaranteed loan portfolio.
7. Lender bills student when repayment starts, collects payments, and conducts statutory loan collection services if borrower becomes delinquent or in default.
8. Guaranty agency reimburses lender for defaulted loans and receives reinsurance and an administrative cost allowance from the Department. The agency also receives an insurance premium from students. The agency pays the Department a loan reinsurance fee, shares collections on defaulted loans, and provides the Department with summary information of loans it guaranteed.
The School

The school verifies students' eligibility and determines that the loan amount does not exceed students' cost of attendance. The major types of schools participating in the program are: 2-year public, 2-year private, 4-year public, 4-year private, and proprietary (for-profit trade and vocational) schools. In 1991, over 7,500 schools participated in the program, and 3,100 were proprietary schools.

The Lender

The lender makes loans and under the program's guaranty provisions, must exercise proper care in making, servicing, and collecting them and follows the applicable program requirements. The lender also collects from the student a loan origination fee for the Department and an insurance premium for the agency guaranteeing the loan. The lender bills the Department each quarter for the federal interest subsidy payment for the loans it holds. These payments normally include the students' interest while they are in school. Also, during the life of the loan, the lender receives an interest supplement that is intended to provide it with a market rate of return. If the borrower fails to make required payments, the lender files default claims with the guaranty agency, but cannot be
The guaranty agency carries out several tasks, including: (1) issuing guarantees on qualifying loans so that if a borrower fails to repay his or her loan due to death, disability, bankruptcy, or default, the lenders can be reimbursed for their claims; (2) charging students an insurance premium of up to 3 percent of the loan; (3) verifying that lenders properly service and attempt to collect loans before the agency pays default claims; and (4) remitting to the Department its portion of monies the agency subsequently collects from defaulted borrowers.
Guaranty agencies generally receive 100-percent reinsurance from the Department on the default claims amounts paid to lenders. The Department also pays the agencies a 1-percent administrative cost allowance based on the principal amount of the loans they guarantee. Guaranty agencies can also operate as a secondary market and purchase loans from lenders, as well as service loans for others. There are 46 guaranty agencies—state agencies or private nonprofit organizations—that administer the program in the 50 states, the District of Columbia, the Pacific Islands, Puerto Rico, and the Virgin Islands.

The Department is responsible for administering the program and for overseeing the activities of the various participants. It determines which schools can participate (commonly referred to as the "gatekeeping" function), establishes loan collection requirements for lenders and guaranty agencies, pays lenders interest subsidies, and reinsures guaranty agencies for up to 100 percent of lenders' claims. To partially offset program costs, the Department charges borrowers an origination fee and receives a reinsurance fee from the guaranty agencies.
Program Structure Is Flawed

The federal government’s risk of losses has increased greatly as the program has evolved. The original plan was for a simple program involving unsubsidized loans that had no needs test and relied on states to guarantee the loans. This approach fell apart almost immediately because many states were reluctant to establish guaranty agencies. The program was replaced by the present system of interest subsidies and full federal guarantees.

Originally targeted to middle-income students, the program shifted to low-income students. Also, the loan program expanded to include students attending proprietary schools. The government also substantially increased its financial exposure when it provided interest subsidies to lenders, as well as full reimbursement to lenders and guaranty agencies for any default claims. In addition, when the growth of program participants exploded, the government failed to establish adequate controls to minimize its risk.
Program Structure Is Flawed

Original Focus Has Changed Dramatically

The program was originally intended to serve middle-income students, a relatively low-risk group, by helping them finance their education. It was meant to provide help to those experiencing cash flow problems. The loans were not meant to be subsidized and the program was expected to entail few, if any, costs.

As budget constraints reduced the availability of grants for low-income students, however, students from low-income families turned increasingly to the loan program to finance a postsecondary education. Establishing needs tests resulted in fewer middle-income students being eligible for program loans. A great debt burden was placed on those who often had little or no means to repay. This shift would normally have a minimal effect on the program if students, regardless of their income, would have received a quality education.

Expansion to Proprietary Schools Escalated the Risk

The program was also originally intended to finance a traditional college education. The program expanded to include other education and training institutions, such as proprietary schools, some of which have not always provided a high-quality education for
Incentives to Promote Access Have Been Costly

their students. Many students attending these schools are eligible not only for loans but also for other kinds of federal student financial aid, such as Pell Grants. The lure of plentiful financial aid for proprietary school students, as well as abusive practices of some proprietary schools—including fraud—has had a disproportionate impact on defaults. For example, in 1990, students attending these schools represented 41 percent of borrowers, but 77 percent of those that defaulted. The employment outcomes—and the probability of repayment of the loan—for some of these students are much less certain.

A fundamental tension exists within the program between its primary goal—providing access to a postsecondary education to students who otherwise could not afford it—and minimizing costs to U.S. taxpayers.

The government's assumption of some financial risk was recognized at the outset, but the program was not initially designed for the federal government to bear all the financial risks. States were to establish guaranty agencies—that initially shared 20 percent of the risk for all defaulted
loans—to operate programs in their states and, among their other responsibilities, encourage lenders to make loans to eligible student borrowers and pay for any defaults that occurred. Lenders, with guarantees provided by the agencies, were expected to make, service, and collect loans.

However, not enough states were establishing guaranty agencies and lenders were not making enough loans, so the Congress made several amendments to the Higher Education Act. It increased financial incentives—and reduced the limited financial risks—in order to get greater lender and guaranty agency participation. The financial risks, therefore, shifted almost entirely to the federal government, and U.S. taxpayers became the guarantor and assumed the risks of default. The government has paid a high price for the resulting increase in access to the program.

In addition, some guaranty agencies are engaged in, or extended their activities into, areas that have inherent conflicts of interest. Such conflicts occur when a guaranty agency is a loan servicer or it operates a secondary market for loans that it guarantees. The agencies in these cases are in the position of being both a lender servicing loans and a
guaranty agency auditing and overseeing lenders' responsibilities. These situations create environments in which an agency's financial transactions are "less than arms-length" because there is no clear separation of responsibilities among the entities.

Lack of Adequate Controls Has Increased Costs

Congressional and administration efforts, either by tightening the standards for participation or by sharing the risk with others, have not done enough to control the program's risks. Tremendous program growth in the availability of guaranteed student loans and the number of program participants followed congressional actions providing financial incentives to lenders and guaranty agencies. However, these incentives were not followed by actions necessary to limit the federal government's financial exposure. Rather, the Department's way of doing business basically remained the same and failed to keep pace with the growth.

Other changes, such as requiring greater risk sharing by lenders and guaranty agencies, were not authorized by the Congress, and this has also hampered the Department's ability to effectively manage the program.
The federal government, therefore, has been in the undesirable position of being financially liable for the actions of schools, lenders, and guaranty agencies who could do more to control the risk.
Federal requirements lack adequate incentives to encourage the participants to do more to prevent defaults. This lack of incentives also increases the government's risks. Schools, lenders, and guaranty agencies face few consequences for defaulted loans and can profit from defaults, yet students are heavily penalized if they do not repay. The absence of adequate incentives for default prevention through better loan origination and servicing has contributed to the default problem.

Many people believe that students who typically default on their loans got a good education for their money, became doctors or lawyers, and simply chose not to repay. While this happens sometimes, the more common situation is far different. Many defaulters are poor, attended a proprietary school, dropped out of their course of instruction, and have little or no means to repay. Some were “pressured” by unscrupulous recruiters to enroll in proprietary schools that provided a poor-quality education and dismal employment prospects. As a result, many such students failed to get value for their money and are reluctant or unable to repay their loans.
Students who fail to repay their loans, however, may suffer greatly for that default. They may (1) be denied other federal student aid, (2) receive a negative credit rating, (3) have their income tax refunds seized, and (4) have their wages garnished.

Some schools, particularly proprietary schools whose profits come from student tuition payments, have had a strong incentive to sign up students whose tuition is heavily financed by federally guaranteed loans. Partly because they were not accountable for their students' performance, these schools often did not use outcome measures, such as completion and job placement rates, to evaluate whether their students received the education and skills they were promised.

Some schools were also not overly concerned about the frequency of defaults by their students. That changed somewhat in 1990 and again in 1992, when the Congress mandated default rate thresholds for schools that, if exceeded, can result in future ineligibility for guaranteed student loans. However, the schools still lack incentives to further reduce their default rates below the legislative thresholds.
Alternatives are needed to encourage more default prevention efforts by lenders and guaranty agencies. The lack of an effective risk-sharing mechanism for these participants has contributed to the loan default problem. Current loan collection requirements are detailed and prescriptive, emphasizing form over substance. Increased risk-sharing would persuade lenders and guaranty agencies to pay more attention to the kinds of schools their students attend and students' repayment practices.

Guaranty agencies are not guarantors in the truest sense. The name implies a financial protection that in reality does not exist. In general, neither the guaranty agencies themselves nor the states that designated the agencies have any capital at risk. If a guaranty agency experiences financial difficulties and is unable to perform its functions, especially in paying lenders' default claims, taxpayers, through the federal government—not the state—become the true guarantor. As a result, the "guaranty" agencies function primarily as loan processors. In addition, they have lacked incentives to manage their activities on behalf of the government in a cost-effective manner.
Department Mismanagement Contributed to Problems

The Department of Education has had a history of mismanagement and poor oversight of the program's activities. It generally (1) has used ineffective procedures for determining which schools can participate, (2) has had inadequate financial and management information systems that contain inaccurate and incomplete data, (3) has conducted little oversight of the lenders and guaranty agencies, (4) has experienced high turnover in key management positions and has not hired staff with adequate skills, and (5) has had a management structure that inhibited program improvements. Not adequately addressing these problems could jeopardize the Department's implementation of the direct loan demonstration program.

The Department's management and program deficiencies have been the subject of congressional hearings, reports by GAO and the Department's Office of Inspector General (OIG), and other studies and evaluations. Both GAO and OMB have identified this program as one of the government's high-risk areas. In addition, OMB and the Department conducted a review that concluded that the Department's management practices contributed to high
loan default rates, as well as fraud and abuse in the federal student aid programs.

Better Gatekeeping Needed

The Department's gatekeeping procedures for determining which schools can participate—and whether they should continue participating—in federal student aid programs have been weak. The Department must rely on others with limited accountability to U.S. taxpayers—such as state licensing organizations and school accrediting bodies—for assuring the quality of the education being offered. Little federal oversight has been directed at determining whether schools—especially proprietary schools—have the fiscal and administrative capability to provide a quality education. As a result, procedures for determining which schools participate in the program have been generally ineffective in weeding out abusive practices, such as collecting tuition payments for marginal instruction.

Accurate Financial and Management Information Systems Are Vital

Many of the Department's financial problems have been repeatedly cited in GAO and OIG reports, as well as in the Department's own reports required by the Federal Managers' Financial Integrity Act. The act requires federal agencies to evaluate and report on
their internal accounting and administrative controls annually. These problems stemmed from the Department's emphasis on program execution—quickly getting funds out to students—rather than fiscal accountability. For example, records supporting the Department's payments to lenders and guaranty agencies have been, at times, missing, incomplete, or inaccurate. Also, the Department has relied heavily on an honor system in its financial management activities. It pays over $5 billion annually to lenders and guaranty agencies based on unaudited summary billings. This extends the risk the federal government—and ultimately the taxpayer—assumes.

Department, independent, and state auditors do not conduct in-depth examinations of the accuracy and validity of lenders' and guaranty agencies' claims for interest subsidies, defaulted loans, and administrative cost allowances. Generally, audits also fail to provide a positive attestation to the claims submitted or to the adequacy of the lenders' and guaranty agencies' internal controls structure. As a result, the federal government has little assurance that the "bills" it pays are proper.
The Department’s management information systems contain data that are not always timely and accurate, which limits these systems’ use for compliance and evaluation purposes. The limitations have hampered the Department’s ability to effectively manage and monitor the guaranteed student loan programs, especially those activities concerning loan defaults and collections. As a result, millions of dollars in new loans have been made to borrowers for amounts exceeding statutory limits, or to borrowers who are already in default and, therefore, ineligible for additional loans.

However, the Department has made slow progress in improving its information systems, and the National Student Loan Data System, authorized by the Higher Education Amendments of 1986, will not be implemented until, at best, December 1993. This system could meet many of the Department’s student loan information management needs and be an important tool in determining students’ loan eligibility.

More Effective Oversight Needed

Lenders and guaranty agencies have received little oversight and view their primary mission as getting loan monies to students. Until recently, as loan volume...
increased, the number of Department reviews of participants generally decreased. In part, because of the large number of lenders and guaranty agencies, the Department’s review efforts generally were not focused on those with the largest default volumes. In addition, when violations were found, the Department was slow at times to resolve them.

Also, better oversight could be obtained with fewer lenders and guaranty agencies. The advent of electronic fund transfers and automation improvements has reduced the need for the number of lenders and guaranty agencies that were once necessary to help ensure student access to the program.

More effective oversight could provide an increased focus on the Department’s failure to collect origination fees due the government, accurately pay interest subsidies, require sufficient default prevention efforts in paying default claims for lenders, and ensure that borrowers obtain loans within statutory limits.

A shortage of qualified Department personnel has also plagued program management. The Department has not had
adequately trained staff, and some lacked appropriate skills. For example, it has had few people with financial or accounting backgrounds to administer over $13 billion in new loans made annually. Its staff have lacked experience, training, and proficient skills in finance, information systems, data analysis, planning, and policy making.

Improved Management Structure Needed

The Department's organizational structure has not adequately emphasized fiduciary responsibilities, but has focused instead on promoting services to participants. Responsibility for federal student aid has been divided among various offices. This fragmented management had contributed, at times, to inadequate communication and decision-making that, in turn, resulted in (1) delays in issuing guidance and regulations, (2) duplicate program compliance responsibilities, (3) reduced opportunities to develop comprehensive program and system changes, and (4) the failure to use Department resources and processes in a coherent and effective manner.
Existing Problems Could Hamper Implementing Direct Loan Demonstration

The Higher Education Amendments of 1992 created a direct lending demonstration program. Under direct lending, the federal government becomes the lender, and private lenders and guaranty agencies—in their present form—would no longer be needed. Schools, acting as agents for the federal government, would use federal funds to make loans to qualifying students. The Department of Education would service and collect the loans, presumably by contracting with private firms.

The 1992 amendments also require that we evaluate the costs and experiences of the schools, students, parents, and the Department of Education participating in the direct loan demonstration program. The evaluation will also include a comparison with a control group of schools that are not participating in the demonstration program. We are to issue an interim report in January 1997 on our evaluation, with a final report due in May 1998.

We estimate that direct loans could save the federal government $4.8 billion over the first 5 years of implementation. But the inventory of known problems in the Department’s administration of guaranteed student loans raises questions about its ability to
Department Mismanagement
Contributed to Problems

adequately manage a direct lending program. The Department needs accurate financial and information management systems for it to not only manage the guaranteed loan program, but to properly implement the demonstration program.
Conclusions and Action Needed

The problem of billions of dollars in student loan defaults has not been ignored. The Congress and the Department have attempted to improve the integrity of the Federal Family Education Loan Program through many incremental legislative and regulatory reforms. For example, the Congress enacted over 100 legislative provisions in 1992 to improve default prevention, loan collections, and overall program integrity. Also, the Congress expanded loan eligibility to more middle-income families, while authorizing additional grant funds. Although some of these changes are dependent on available funding, they could help reduce the government's loan default risk.

The Department also has been taking many steps to improve its management and reduce the government's financial exposure. For example, the Department's staffing inadequacies have lessened since it has begun hiring staff with financial skills, while targeting its resources to areas with major problems. It has been strengthening its gatekeeping function and establishing stricter controls over which schools can participate in federal student aid programs. In addition, it has been improving its monitoring of lenders and guaranty agencies,
Conclusions and Action Needed

specifically in determining the guaranty agencies’ financial stability. These actions should help improve program and fiscal integrity, as well as aid in the Department’s implementation of the direct lending demonstration. We recognize that these improvements are in various stages of implementation and that other actions are planned or underway. We encourage the Department to continue implementing these efforts.

Better management alone, however, may not fix the program’s problems. Structural reform may be necessary to simplify this complex program. Part of this reform may need to involve reducing the number of lenders and guaranty agencies through some form of consolidation or reorganization. In the interim, steps to strengthen the program through simplification, reorganization, and risk-sharing and better oversight of schools, lenders, and guaranty agencies should be considered.

Actions the Congress should consider in enhancing the existing program include:

- Reorganizing the roles of lenders and guaranty agencies, including having them
assume a greater share of the risk.

- Strengthening the incentives for effective loan servicing and default prevention by lenders and guaranty agencies, and establishing results-oriented default prevention incentives.

Actions the Secretary of Education should consider in enhancing the existing program include:

- Further strengthening the Department's gatekeeping procedures to more effectively determine the fiscal and administrative capabilities of schools seeking initial and continuing approval for participation in federal student aid programs. Part of this effort should include the use of outcome measures, such as completion and job placement rates, in recording the performance of such schools (especially those providing proprietary/vocational training).

- Ensuring that the Department expeditiously implements the recommendations contained in the joint OMB/Department study of the program.
Conclusions and Action Needed

- Requiring that independent public accountant audits of lenders and guaranty agencies include: (1) a positive attestation to the claims for payment that these parties submit to the federal government and (2) an opinion on the overall adequacy of the program's internal controls.

- Expediting efforts to develop a comprehensive plan to identify and correct longstanding problems in the Department's financial management of the program.

- Expediting efforts to implement an information resources management strategy and plan that will have as its primary focus improving program data so that these data are more useful, timely, and accurate.

- Proceeding cautiously with the implementation of the direct lending demonstration program to ensure its proper implementation and subsequent evaluation.
Related GAO Products

- Financial Audit: Guaranteed Student Loan Program's Internal Controls and Structure Need Improvement (GAO/AFMD-93-20, forthcoming).

- Student Loans: Direct Loans Could Save Billions in First 5 Years With Proper Implementation (GAO/HRD-93-27, Nov. 25, 1992).


## High-Risk Series

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