



March 2014

FEDERAL STUDENT LOANS

Better Oversight Could Improve Defaulted Loan Rehabilitation

GAO Highlights

Highlights of [GAO-14-256](#), a report to congressional requesters

Why GAO Did This Study

As of fiscal year 2013 about \$94 billion—over 11 percent of federal student loan volume in repayment—was in default, which generally occurs when a borrower fails to make a payment for more than 270 days. Loan rehabilitation was established as an option to help Education collect defaulted student loans, and borrowers address the adverse consequences of default, such as repairing damaged credit. GAO was asked to review Education's loan rehabilitation process. This report examines how: (1) Education assists borrowers in rehabilitating defaulted student loans; (2) the upgrade of its defaulted loan information system affected loan rehabilitation; and (3) Education oversees private collection agencies in implementing loan rehabilitation.

GAO reviewed Education's policies, procedures and guidance; contracts and monitoring records for the defaulted loan information system contractor and 22 collection agencies; collections and rehabilitation data; and relevant federal laws and regulations. GAO interviewed Education officials, representatives of borrower advocacy groups, and visited 6 selected collection agencies, based on their loan volume and geographic location.

What GAO Recommends

GAO recommends that Education take steps to track loan rehabilitation performance data and improve oversight of its system contractor and collection agencies. Education agreed with GAO's recommendations.

View [GAO-14-256](#). For more information, contact Melissa Emrey-Arras at (617) 788-0534 or emrearrasm@gao.gov.

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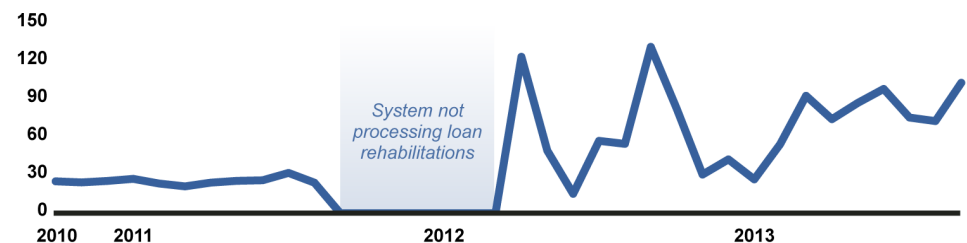
What GAO Found

The Department of Education (Education) relies on collection agencies to assist borrowers in rehabilitating defaulted student loans, which allows borrowers who make nine on-time monthly payments within 10 months to have the default removed from their credit reports. Education works with 22 collection agencies to locate borrowers and explain repayment options, including rehabilitation. From fiscal years 2011 to 2013, Education collected about \$9 billion on over 1.5 million loans through rehabilitation, most of which was recovered by collection agencies.

For more than a year after the October 2011 upgrade of its defaulted loan information system, Education was unable to provide most borrowers who completed rehabilitation with timely benefits, such as removing defaults from their credit reports. GAO found the delays largely attributable to gaps in Education's oversight of its system contractor. For example, despite concerns about the contractor's unreliable performance on previous system development efforts, Education conducted limited oversight until the contractor began missing deadlines. In addition, system testing was not sufficient for Education to detect key problems prior to the upgrade. As a result, no rehabilitations were processed until April 2012, and officials said they needed until January 2013 to clear the resulting backlog. During this time period, Education reported rehabilitating loans for about 200,000 borrowers, but it has not developed performance data to assess the number or extent of individual borrower delays. Further, Education has acknowledged that the system still requires workarounds and a substantial amount of development work will need to be completed under a new contract, which was awarded in September 2013, to address remaining system issues.

Number of Loan Rehabilitations Processed, Fiscal Years 2011 through 2013

Number of loans rehabilitated (in thousands)



Source: GAO summary of Education data.

Education has developed tools for overseeing collection agencies, but key weaknesses reduce its ability to effectively monitor their performance. Specifically, to ensure collection agencies provide borrowers with accurate information, Education monitors their interactions with borrowers through quarterly reviews of loan rehabilitation phone calls. However, GAO found that Education has not consistently completed such call reviews. While Education provides the results of its reviews to each collection agency, it does not ensure corrective actions are taken and does not systematically analyze results over time or across collection agencies to inform its oversight activities. As a result, it may be difficult for Education to ensure that borrowers receive accurate information regarding loan rehabilitation.

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Abbreviations

| | |
|-----------|-------------------------------|
| CSB | Common Services for Borrowers |
| Education | Department of Education |
| FFEL | Federal Family Education Loan |
| HEA | Higher Education Act of 1965 |

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March 6, 2014

Congressional Requesters

To help students and their families pay for college, the Department of Education (Education) provides billions of dollars in federal student loans each year through programs authorized under Title IV of the Higher Education Act (HEA) of 1965, as amended.¹ However, as of September 2013, about one out of seven student loan borrowers had defaulted on their loan within 3 years of beginning repayment, and approximately \$94 billion of over \$814 billion in outstanding federal student loans in repayment was in default.² Education has acknowledged that as its student loan portfolio grows, more borrowers are expected to default, increasing the financial risk to the federal government. Borrowers who default on student loans face serious consequences, including damaged credit ratings and difficulty obtaining affordable credit in the future. However, one way borrowers can get their loans out of default is through loan rehabilitation, a repayment option in which borrowers who make nine on-time monthly payments within 10 months have the default removed from their credit reports. The federal government has an interest in ensuring that the loan rehabilitation process works well given the potential savings from returning defaulted loans to repayment. However, when Education upgraded its defaulted loan information system in October 2011, there were reports that some loans remained in default after borrowers had made enough payments to rehabilitate the loans, raising questions about Education's ability to rehabilitate loans. In addition, because Education relies on information in the system to manage the work of collection agencies, questions have been raised about the impact of the system upgrade on its ability to oversee debt collection activities. In light of these questions, you asked us to examine Education's rehabilitation of defaulted student loans. This report examines: (1) how

¹Pub. L. No. 89-329, 79 Stat. 1232-1254, codified at 20 U.S.C. §§ 1070-1099d and 42 U.S.C. §§ 2751-2756b.

²Default generally occurs when a borrower fails to make a payment for more than 270 days; 20 U.S.C. § 1085(l); 34 C.F.R. §§ 682.200(b) and 685.102(b). However, Education generally identifies defaulted loans as those that are 360 days or more past due, because the department allows loan servicers 90 days to transfer Direct Loans to Education's Default Resolution Group and Federal Family Education Loan (FFEL) lenders up to 90 days to file a default claim.

Education assists borrowers in rehabilitating defaulted student loans; (2) how the upgrade of Education's defaulted loan information system affected loan rehabilitation; and (3) how Education oversees collection agencies in implementing loan rehabilitation.

In conducting this work, we focused our review on loans included in Education's defaulted loan information system.³ We reviewed the contract, contract modifications, and monitoring records for Education's system contractor. We also reviewed contract documentation applicable to all 22 collection agencies. We reviewed relevant federal laws and regulations to gain an understanding of requirements related to loan default and rehabilitation and debt collection as well as Education's policies, procedures, and guidance related to defaulted student loans. We interviewed officials from Education, its defaulted student loan system contractor, and borrower advocacy and consumer protection groups. During these interviews we examined issues related to Education's system upgrade, debt collection process, contractor management and oversight, and communication with borrowers. We also reviewed Education's collections and rehabilitation data, from fiscal year 2011 through 2013, to gain a better understanding of rehabilitation before and after the system upgrade. We assessed the reliability of these data by (1) performing electronic testing of required data elements, (2) reviewing existing information about the data and the system that produced them, and (3) interviewing agency officials knowledgeable about the data. We determined that the data were sufficiently reliable for the purpose of this report. Finally, we conducted site visits to a nongeneralizable sample of six collection agencies, selected based on factors such as loan volume and geographic location, and reviewed Education's monitoring records for them.

We conducted this performance audit from August 2012 to March 2014 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our

³According to Education, this includes about \$55 billion in Direct and FFEL program loans held by the department. We determined that the \$39 billion in defaulted FFEL loans held and serviced by guaranty agencies—state or nonprofit entities that perform certain administrative functions in the FFEL program—were outside the scope of this review, because they are not included in Education's defaulted loan information system. Guaranty agencies usually transfer defaulted FFEL loans that are not in repayment to Education for collection after 4 years.

findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

Student Loan Default Resolution, Including Loan Rehabilitation

Once a student loan goes into default the entire unpaid balance of the loan plus accrued interest becomes due.⁴ The federal government has several voluntary and involuntary methods for collecting on defaulted loans (see table 1).

Table 1: Options to Repay Defaulted Federal Student Loans

Voluntary options – borrower agrees to repayment

| Option | Definition |
|---------------------|---|
| Payment in full | Borrower agrees to pay the entire balanced owed. |
| Compromise | Borrower agrees to a reduced overall payment to satisfy the debt(s) in full and generally must submit the payment within 90 days. |
| Loan consolidation | Borrower agrees to combine multiple federal student loans into one loan and resume repayment. |
| Loan rehabilitation | Borrower agrees to make nine on-time monthly payments within 10 months. |

Involuntary options – federal government takes action to collect from the borrower

| Option | Definition |
|-------------------------|--|
| Treasury offset program | After notification from Education, the Department of the Treasury or states (through agreements with the Department of the Treasury) offset certain federal or state payments owed to the borrower, such as federal or state income tax refunds. |
| Wage garnishment | Education requires borrower’s employer to withhold funds from borrower’s pay and send the funds to Education. |
| Litigation | After referral from Education, Department of Justice begins litigation against the borrower. |

Source: GAO summary of Education documents.

Borrowers who are unable to repay defaulted loans in full may be able to negotiate a lower amount as a part of a compromise agreement with the department. Education also provides borrowers with options to resolve their defaulted loans through loan consolidation or loan rehabilitation by

⁴Borrowers are also obligated to repay late fees and collection costs. 34 C.F.R. §§ 682.102(e)(1) and 685.207(a)(1).

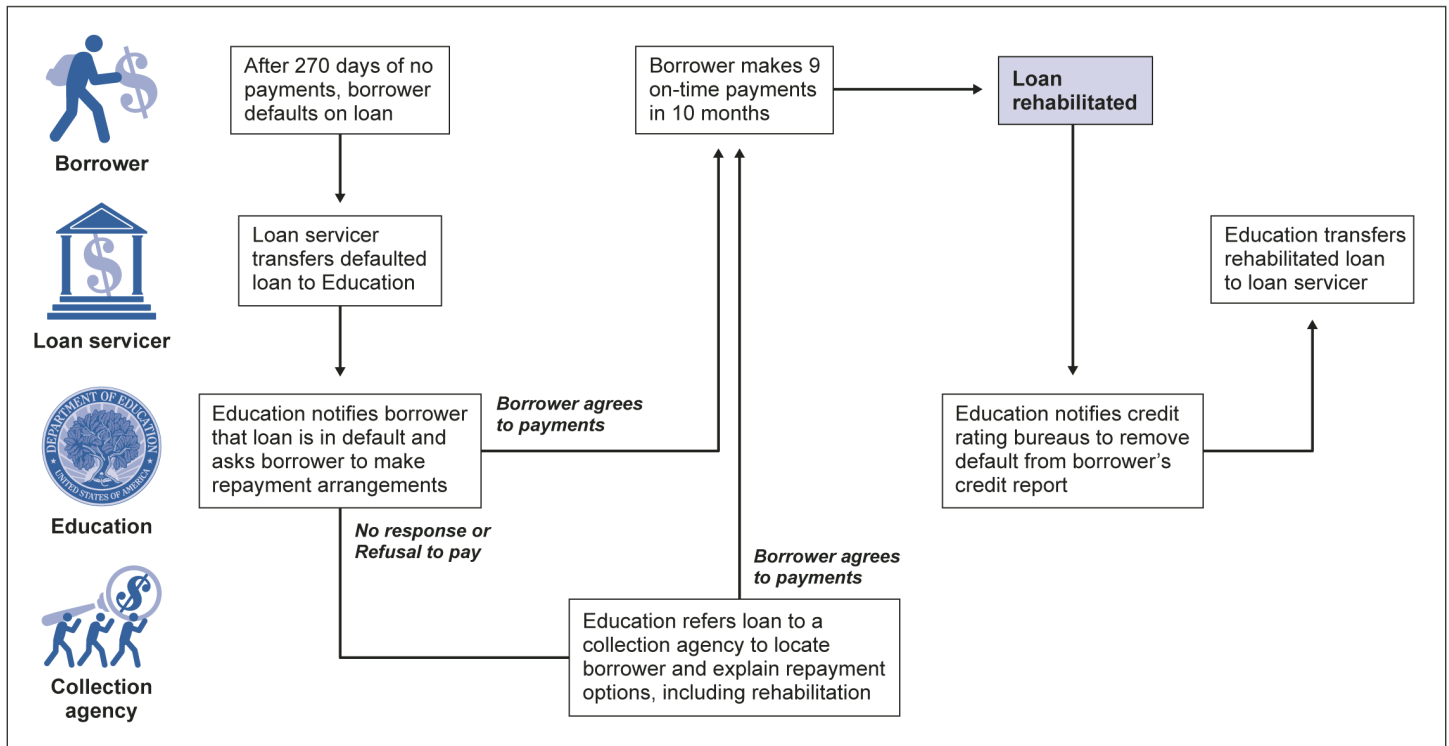
making a series of voluntary on-time monthly payments. For example, borrowers who make at least three on-time monthly payments can pay off defaulted loans by consolidating one or more loans into a single loan with a fixed interest rate.⁵ Borrowers who make nine on-time monthly payments within 10 months may be eligible for loan rehabilitation, which entitles them to have the default removed from their credit report.⁶ However, borrowers may rehabilitate a loan only once.⁷ The loan rehabilitation process is shown in figure 1.

⁵34 C.F.R. §§ 682.200(b) and 685.102(b).

⁶20 U.S.C. §1078-6(a)(1)(A); 34 C.F.R. §§ 682.405(a)(2) and 685.211(f)(1). To be considered on time, the borrower must make the payment within 20 days of the due date each month. Borrowers who default on FFEL or Direct Loan programs loans are not eligible for Title IV federal student aid. However, Title IV eligibility may be reinstated after the borrower makes six on-time monthly payments or if the borrower resolves the default through other means, such as loan consolidation or paying the loan in full.

⁷20 U.S.C. § 1078-6(b); 34 C.F.R. §§ 682.405(a)(3) and 685.211(f)(4).

Figure 1: The Loan Rehabilitation Process



Source: GAO analysis of Education documentation.

Education has additional tools to collect on defaulted loans when borrowers do not make voluntary repayment arrangements. For example, the Treasury Offset Program allows the federal government to collect on defaulted student loans by withholding money from certain federal or state payments to borrowers, including federal or state income tax refunds and Social Security benefits. Through wage garnishment, Education is generally able to collect up to 15 percent of a borrower's disposable pay and apply those funds toward the defaulted loan.⁸ Before using wage garnishment, Education must notify the borrower and provide him or her with the opportunity to have a hearing to object to the

⁸20 U.S.C. § 1095a. For these purposes, disposable pay is defined as the part of an individual's compensation from an employer that remains after the deduction of any amounts required to be withheld by law. *Id.* at § 1095a(e).

garnishment by showing, for example, that it would cause a financial hardship. Payments made through involuntary collections do not count toward payments borrowers must make to rehabilitate their loans. Also, there is no limit on how long the government can attempt to collect on defaulted student loans and, unlike other types of consumer debt, student loans cannot be eliminated during bankruptcy proceedings unless the court finds that repayment would constitute an undue hardship on the borrower and the borrower's dependents.⁹

Education's Common Services for Borrowers Contract

In 2003, Education entered into a 5-year, performance-based contract¹⁰ known as Common Services for Borrowers (CSB) to improve the management of student loans following disbursement, including loan servicing, which includes tracking loans and accepting payments from borrowers. The CSB contractor was the sole loan servicer for the department's Direct Loan program and was also expected to modernize and integrate four separate information systems for loan servicing, consolidation, disability discharge requests,¹¹ and debt collection. The base contract had an estimated cost of over \$1 billion and allowed the government to extend the contract up to 5 more years, increasing the potential cost to about \$2 billion.

After the CSB contract was awarded in 2003, we reported that Education had not yet fully determined how the department would integrate the four information systems.¹² In response, Education officials said they would rely on the contractor to develop these solutions. However, the department's CSB contractor experienced significant software development delays and did not identify and resolve problems in a timely manner. As a result, in fiscal year 2005 the department issued a cure

⁹11 U.S.C. § 523(a)(8).

¹⁰Performance-based contracts specify the desired outcomes and allow the contractor to determine how best to achieve those outcomes, rather than prescribe the methods contractors should use.

¹¹A borrower who becomes totally and permanently disabled may be eligible to have their student loans discharged thereby releasing the borrower from the obligation to repay the loan. 20 U.S.C. § 1087(a); 34 C.F.R. §§ 682.402(c)(1) and 685.213.

¹²GAO, *Office of Federal Student Aid: Better Strategic and Human Capital Planning Would Help Sustain Management Progress*, [GAO-05-31](#) (Washington, D.C.: October 2004).

notice, which informs the contractor that the government considers the contractor's failure to make progress as endangering performance of the contract or the contractor has failed to perform contractual provisions other than delivery of supplies or performance of services.¹³

Subsequently, the department canceled the systems integration effort in May 2007 through a contract modification and the remaining contract work focused on loan servicing and maintenance and operation of the separate systems.

The CSB contractor was the department's sole loan servicer until 2009, when Education entered into contracts with four additional servicers to handle increased loan volume following passage of the Ensuring Continued Access to Student Loans Act of 2008.¹⁴ Education began allocating Direct Loans to the additional servicers in 2010 following passage of the SAFRA Act, which terminated the authority to make or insure new FFEL loans after June 30, 2010.¹⁵ In addition, the SAFRA Act required Education to award contracts to eligible not-for-profit servicers to assist the department with servicing the increased number of Direct Loans.¹⁶

¹³The cure notice specifies a period (typically 10 days) for the contractor to remedy the condition. If the condition is not corrected within this period, the cure notice states that the contractor may face the termination of its contract for default. 48 C.F.R. § 49.402-3.

¹⁴Pub. L. No. 110-227, 122 Stat. 740. The act provided Education with the authority to purchase or enter into commitments to purchase Federal Family Education loans (FFEL) from lenders and secondary markets to help ensure continued access to federally guaranteed student loans in the wake of the economic downturn. *Id.* at § 7, 122 Stat. 746.

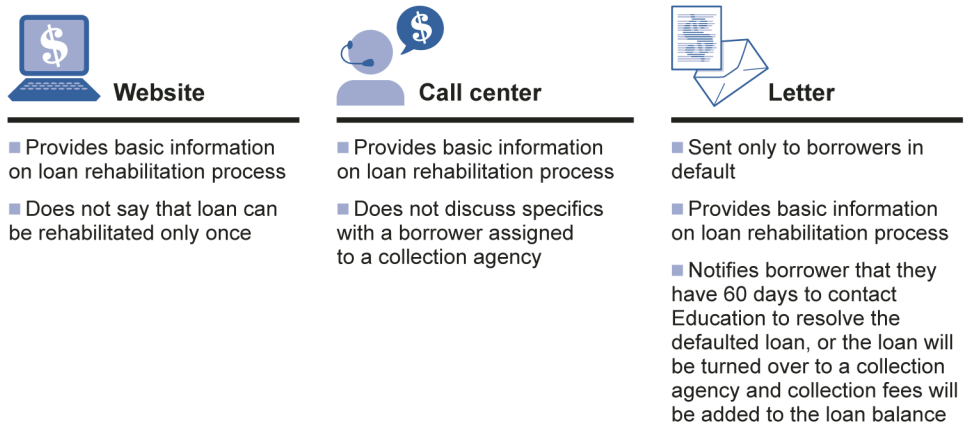
¹⁵Pub. L. No. 111-152, § 2201, 124 Stat. 1029, 1074. The SAFRA Act was enacted as part of the Health Care and Education Reconciliation Act of 2010. Education will continue to administer FFEL loans until the loans are repaid or discharged.

¹⁶*Id.* at § 2212, 124 Stat. 1029, 1078. The Bipartisan Budget Act of 2013 eliminated the requirement that Education contract with eligible not-for-profit servicers. Pub. L. No. 113-67, Div. A, § 502, 127 Stat. 1165, 1187. However, the explanatory statement accompanying the Consolidated Appropriations Act, 2014, Pub. L. No. 113-76, directed Education to continue to comply with the terms of its existing contracts with not-for-profit servicers through Fiscal Year 2014.

Education Relies on Collection Agencies to Assist Borrowers in Rehabilitating Defaulted Student Loans

Education provides information about loan rehabilitation and relies on collection agencies to assist borrowers in rehabilitating defaulted student loans. Education provides general information about loan rehabilitation on its website, through its call center, and in written notices it sends to borrowers when they default (see figure 2).

Figure 2: Ways Education Communicates Information about Loan Rehabilitation



Source: GAO summary of Education documentation and interviews with agency officials.

Borrowers who contact Education and make repayment arrangements within 65 days of being notified of a default can rehabilitate their loans without being turned over to a collection agency and incurring collection costs. Education contracts with 22 collection agencies to locate and explain repayment options to borrowers who do not make such repayment arrangements. Collection agency representatives we interviewed told us they use information from Education (e.g., home and work phone numbers, mailing address) and proprietary databases to locate borrowers. However, they said it can be difficult to contact defaulted borrowers, because their contact information on file with Education may be out-of-date or they may not answer the collection agency’s phone calls.¹⁷ Education has taken steps to establish a data

¹⁷Borrowers are required to maintain current contact information; see 34 C.F.R. §§ 682.401(b)(5)(iv) and 685.206(b).

matching agreement with the Internal Revenue Service to obtain mailing addresses on borrowers with defaulted loans, and officials said they plan to implement the agreement after making system changes. Education officials also said they plan to use that agreement as the basis for reestablishing an agreement with the Department of Health and Human Services to obtain employer address and borrower salary information through the National Directory of New Hires.¹⁸

When collection agencies make contact with borrowers—usually by phone—they discuss options for addressing default, including loan rehabilitation. For example, representatives of five collection agencies we interviewed said that, in speaking to such borrowers, they emphasize that rehabilitating a defaulted student loan also removes the default from the borrower’s credit report, a key benefit to the borrower. Officials from two borrower advocacy associations agreed that removing the default is indeed a key benefit of rehabilitation, but it may not be as advantageous as some believe since the borrower’s history of missed payments remains on the credit report. Collection agency representatives said they also explain that a loan can only be rehabilitated once. The representatives also said that borrowers they make contact with are generally receptive to learning about loan rehabilitation, particularly once they understand there are affordable payment options.

In July 2012, Education developed additional guidelines to better ensure borrowers could rehabilitate their loans based on reasonable and affordable monthly payments.¹⁹ While a standard monthly payment would be about one percent of the loan balance, Education’s guidelines allow certain borrowers to qualify for lower monthly payments. Depending on their income and family size, borrowers’ monthly payments may be as low as \$5. In March 2013, Education also modified its contracts with collection agencies to help ensure that they offer borrowers reasonable and affordable payments. Previously, collection agencies earned a \$150

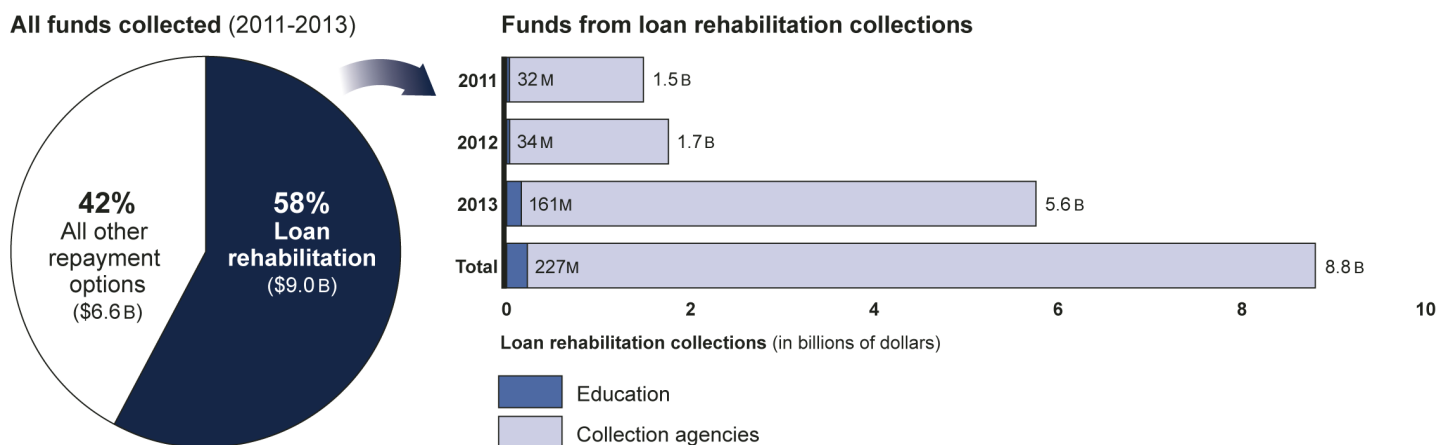
¹⁸At the time Education’s agreement expired in 2010, the Department of Health and Human Services had made changes to the security requirements and safeguards agencies must have in place to obtain the data.

¹⁹Education issued regulations in November 2013, with an effective date of July 1, 2014, addressing reasonable and affordable payments: Student Assistance General Provisions, Federal Perkins Loan Program, Federal Family Education Loan Program, and William D. Ford Federal Direct Loan program, 78 Fed. Reg. 65,768 (Nov. 1, 2013) (codified at 34 C.F.R. pts 668, 674, 682 and 685).

administrative fee for lower payments. Representatives of a borrower advocacy group we interviewed expressed concern that this practice created an incentive for collection agencies to tell borrowers they had to pay more than was actually required. Education now pays collection agencies a flat commission for rehabilitated loans based on the type of loan regardless of payment size. Education also lowered the commission rates for rehabilitated loans from 12.5 to 11.75 percent for Direct Loans and 15 percent to 13.25 percent for FFEL and other types of loans. Education officials said the department lowered the commission rates after observing a substantial increase in loan rehabilitation enrollment following the introduction of the guidelines, explaining that if it is easier for collection agencies to enroll borrowers they may incur lower costs.

From fiscal year 2011 through 2013, loan rehabilitation accounted for more than half of the \$15.6 billion Education collected on defaulted loans—more than all other repayment options combined. With regard to loan rehabilitation collections, collection agencies recovered 97 percent of \$9 billion collected on over 1.5 million defaulted loans, and collections in fiscal year 2013 represented more than half of all rehabilitation collections during the 3-year period (see figure 3).

Figure 3: Defaulted Loan Collections, Fiscal Years 2011 through 2013



Source: GAO summary of Education data.

Note: Borrowers who contact Education and make repayment arrangements within 65 days of being notified of a default can rehabilitate their loans without being turned over to a collection agency.

Limited Planning and Oversight of Education's Defaulted Loan Information System Upgrade Adversely Affected Loan Rehabilitation

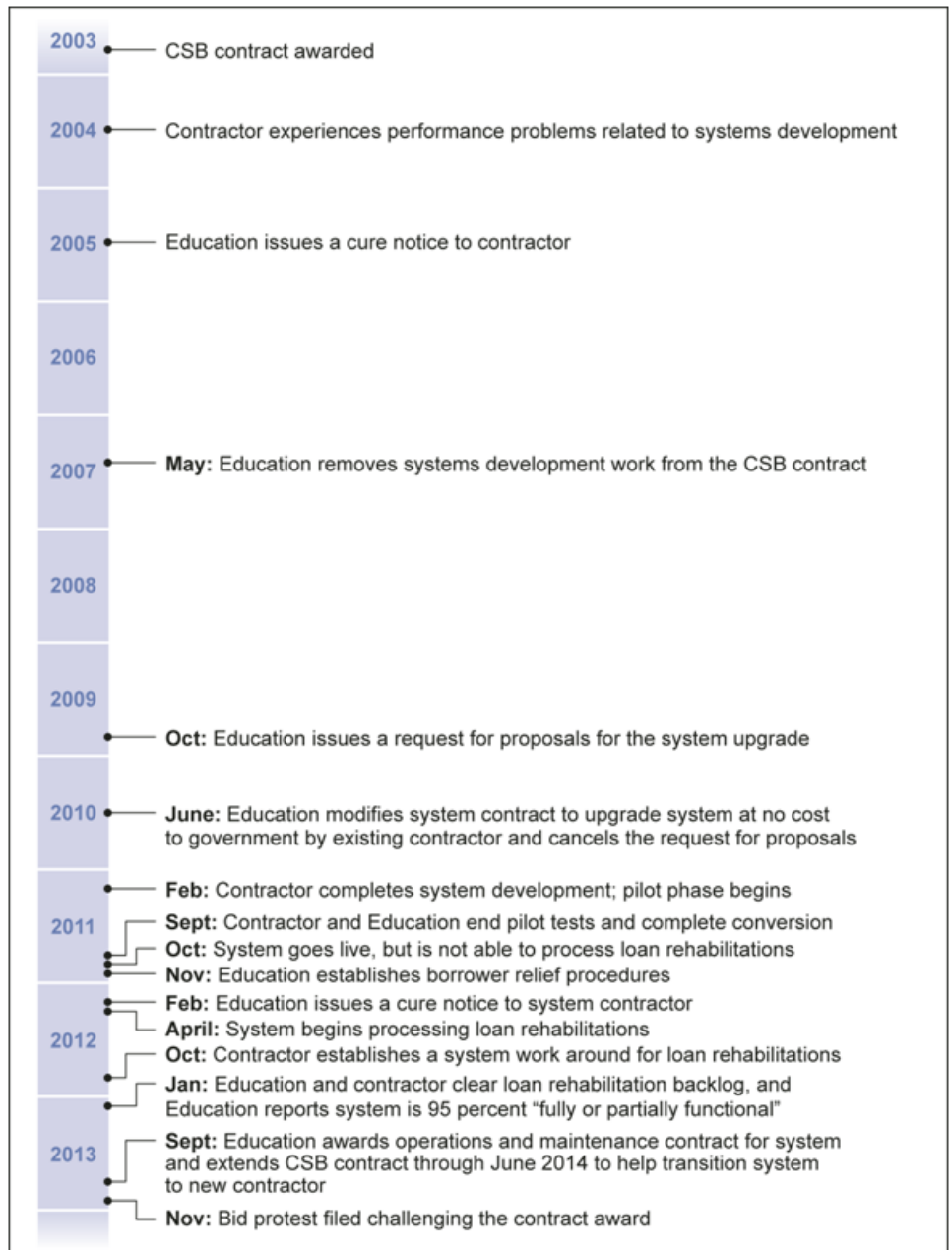
Education's Limited Planning and Oversight Did Not Address Risks of System Upgrade

As a result of limited planning and oversight, Education was unable to provide most borrowers who completed loan rehabilitation with timely benefits, such as removing defaults from their credit reports, for more than a year following the October 2011 upgrade of its defaulted loan information system. Education reported that the system, which had been in place since 1989, had become costly to maintain and many manual workarounds had been developed over the years to address emerging requirements. Education officials said it was also necessary to upgrade the system to handle increased loan volume the department was responsible for servicing.²⁰ Education began exploring options for upgrading the system in 2009, and selected six firms to participate in the second phase of a two-phase request for proposals in December 2009. The original CSB contractor, which was among the firms selected to submit a proposal, subsequently offered to upgrade the system at no additional cost to the government. The offer stipulated that Education would guarantee the contractor a minimum of 5 million non-defaulted borrowers to service through the end of the CSB contract. Despite previous concerns about the contractor's performance related to systems development work, Education accepted the offer. Education officials explained that their decision was based on the contractor's experience with the original system, its proposal to develop the upgrade in 6 months, the ease of upgrading through an existing contract, and the contractor's willingness to perform the work at no additional cost to the government. In June 2010, Education modified the original system contract to include the

²⁰Education anticipated an increase in the number of borrowers with Direct Loans, from about 7 million borrowers to about 13 million borrowers.

upgrade and canceled the request for proposals. Figure 4 presents a timeline of key milestones related to the system upgrade discussed in this report.

Figure 4: Defaulted Student Loan System Upgrade Timeline



Source: GAO analysis of Education documentation.

In moving forward with the upgrade, Education did not have plans for monitoring the contract to ensure successful completion of the work and increased its oversight only after the contractor began missing deadlines for developing the system. Education's Departmental Directive: Contract Monitoring for Program Officials identifies several risk factors that indicate greater contract oversight may be needed, and we found three of seven risk factors were applicable to the system upgrade (see table 2).²¹

Table 2: Risk Factors Associated with the Defaulted Student Loan System Upgrade

| Risk factor | Explanation |
|--|---|
| Contractor with no performance history or an unreliable or unstable performance history or financial condition | CSB contractor had an unreliable performance history and received a cure notice in 2005. The CSB contractor was subsequently acquired by a company that had no performance history with the department. |
| Whether multiple subcontractors provided services to the contractor | Multiple subcontractors provided a range of services to the contractor during the upgrade. |
| Degree of interrelatedness with other contracts or projects | The system is set up to receive transfers of defaulted student loans from Education's loan servicers and provides reports that are used to calculate compensation for collection agencies. |

Source: GAO analysis of Education documentation.

Note: Education's directive identifies four additional potential risk factors which we determined did not apply to the system upgrade: (1) a variable-price contract (the contract was fixed-price, presenting less cost risk to the government); (2) newly-incorporated or emerging organizations; (3) a high dollar amount (the contractor agreed to upgrade the system at no-additional cost to the government as part of broader negotiations on this contract); and (4) a contract with poorly defined objectives, unclear acceptance criteria, or contract requirements that are constantly changing.

Two of the three risks were associated with the selection of the CSB contractor to perform the system upgrade. For example, the contractor had an unreliable performance history on the contract. From 2004 to 2006, Education documented concerns regarding the contractor's ability to identify and resolve software development issues. After issuing a cure notice in 2005 requiring the contractor to complete certain steps or risk defaulting on the contract, Education modified the contract in 2007 to remove the systems development work. In addition, the contractor was acquired by another company that had no prior experience working with Education in February 2010, a few months before the contract was modified. Also, the contractor reported that it relied on nine sub-contractors to provide a range of services for the upgrade, including project management, database administration, and system development.

²¹U.S. Department of Education, OCFO 02-108 (Washington, DC: 2009).

The degree to which the system was interrelated with other contracts presented a third risk that would have supported greater monitoring. Specifically, Education's loan servicers are contractually required to transfer defaulted loans that are 360 days past due to the system. Education officials said they expected additional loan servicers would be needed to handle the increased volume of Direct Loans following the termination of the authority to make or insure new FFEL loans after June 30, 2010. Education instructed the new not-for-profit loan servicers that were expected to begin servicing loans in October 2011 to ensure their systems were compatible with the specifications for the upgraded defaulted loan information system. In addition, Education relies on the system to support its contracts with 22 collection agencies. Specifically, information in the defaulted student loan information system is critical for managing collection activities, including compensating collection agencies and assessing their performance.

Despite these risks, Education officials said they did not create a formal monitoring plan for the system upgrade. While Education had a monitoring plan in place for the 2003 CSB contract, officials acknowledged that it was not relevant for overseeing the upgrade work. Education updated its contract monitoring plan in 2011, about a year after the upgrade work began and performance problems, such as missed deadlines, had occurred. For example, the system development work the contractor was scheduled to complete in December 2010 was not finished until February 2011, and the system was launched 3 months later than scheduled. Education reported increasing its oversight during this time period, for example, by getting more frequent updates from the contractor.

However, we found limited evidence of oversight in our review of contract documentation related to the upgrade. Federal regulations require the government to conduct quality assurance activities, such as monitoring, to ensure that the services received conform to contract requirements.²² Education's Directive also outlines contract monitoring activities, such as reviewing or inspecting deliverables, reviewing invoices, and placing telephone calls, among other things. This guidance also notes that Education officials must document any instances where the official learns the contractor is failing to perform as required or make sufficient progress.

²²See generally, 48 C.F.R. § 46.401.

Education officials said they initially monitored the upgrade by tracking the contractor's progress in meeting deadlines. However, they said they shifted their focus to reviewing the quality and timeliness of deliverables after the contractor expressed concern that progress reporting, among other things, affected its ability to focus on the required work. Education officials also acknowledged that they did not document many of these monitoring activities.

In 2011, we reported that Education had not developed and implemented detailed procedures essential to ensuring that its contract monitoring policy directives are effectively carried out, including documenting contract monitoring activity.²³ Based on our recommendation, Education issued a new policy in June 2011 that outlined how contract monitoring activities and results should be documented, retained, and shared. In our review of contract files related to the system upgrade, which included files from May 2007 through December 2012, we found emails in which Education officials questioned the contractor's justifications for specific tasks in their proposals; however, we did not find documentation of status reports, deliverables received, or plans for addressing upgrade-related problems as required by Education's Directive and June 2011 policy.

System Testing Was Insufficient to Detect Loan Rehabilitation Problems

Education began pilot testing the upgraded information system with several thousand borrower accounts in February 2011 to ensure the system worked correctly. According to officials, Education did not expect to test every function through its full lifecycle before going live, but instead focused on testing key functions with a limited number of new borrower accounts to reduce the potential for account duplication between the new and old systems. While the system was tested to ensure that monthly billing was correctly established for borrower accounts entering rehabilitation, its ability to identify and process loans that were eligible for rehabilitation was not tested. Officials reported that using accounts for new defaulted borrowers and conducting testing in a 7-month time frame did not allow loan rehabilitation to be fully tested because a borrower would need to make nine on-time payments in 10 months before the loan could be rehabilitated. While some system issues were found during the pilot tests, Education officials reported that key functions, such as loan

²³GAO, *Improved Oversight and Controls Could Help Education Better Respond to Evolving Priorities*, [GAO-11-194](#) (Washington, D.C.: Feb. 10, 2011).

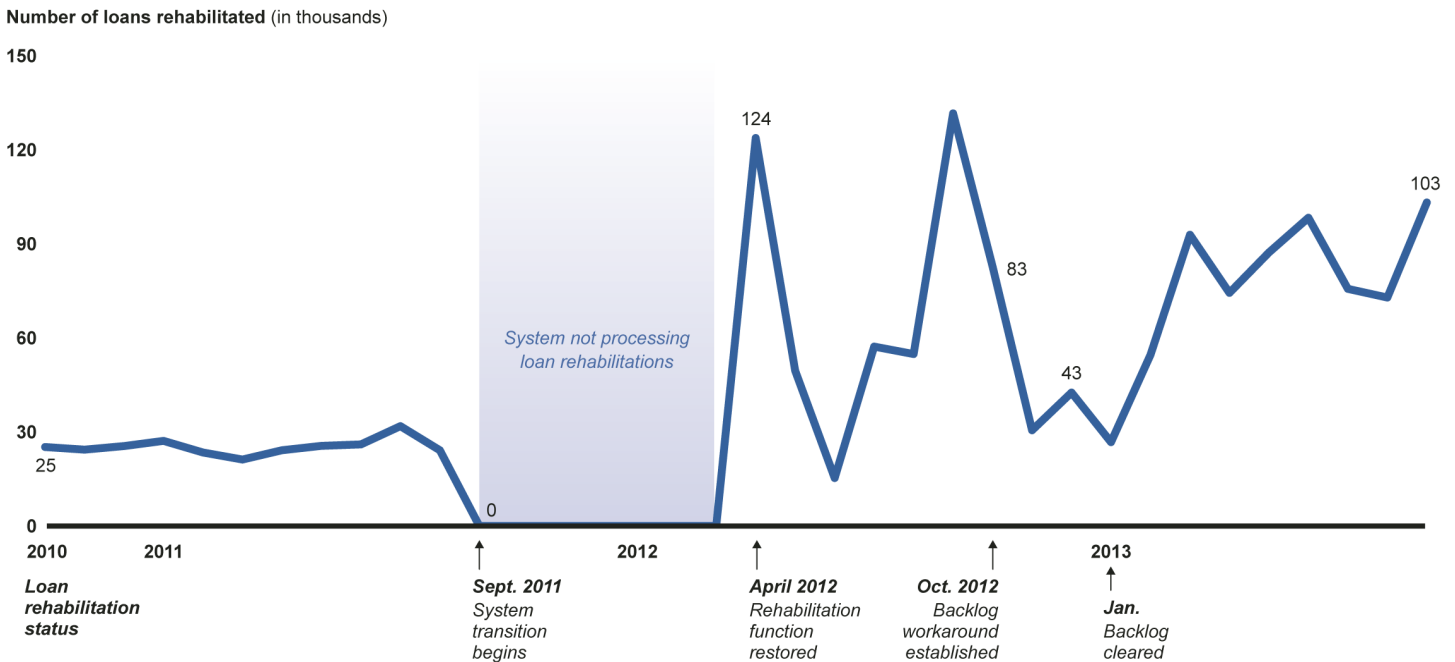
rehabilitation, were working sufficiently to justify proceeding with the launch to ensure the system was ready by October 2011. Officials said the timing was intended to coincide with the department's conversion to a new loan servicing system for non-defaulted borrowers and implementation of contracts with the not-for-profit servicers.

Education realized shortly after the launch that two key functions necessary for loan rehabilitation were not working as intended. The system was not accepting transfers of defaulted loans from Education's loan servicers, which delayed the start of collection activities, including rehabilitation. In December 2012, Education's Office of Inspector General reported that servicers accumulated more than \$1.1 billion in loans that should have been transferred to Education for management and collection. Also, while Education continued collecting on defaulted loans that were already in the system, loans were not being rehabilitated because the system did not recognize when borrowers had satisfied the requirements.

As a result of the system challenges, no loan rehabilitations were processed from September 2011 through March 2012, and Education officials said they needed until January 2013 to clear the resulting backlog. Education processed about 20,000 to 30,000 loan rehabilitations a month in fiscal year 2011, prior to the upgrade (see fig. 5). While Education was not able to track loan rehabilitations by borrower prior to the upgrade, officials estimated that approximately 80,000 borrowers were affected during the time the system was not processing rehabilitations.²⁴

²⁴Education officials said they have estimated that borrowers who use loan rehabilitation typically have two to three defaulted loans.

Figure 5: Number of Loan Rehabilitations Processed, Fiscal Years 2011 through 2013



Source: GAO summary of Education data.

While Education worked with its CSB contractor to identify and correct the problems, it also took steps to assist borrowers. Although Education could not process rehabilitated loans through the system, it established procedures in November 2011 to assist eligible borrowers by removing defaults from their credit reports or reinstating their eligibility for student aid. However, borrowers had to contact the department or their collection agency in order to receive the assistance. Education officials said they provided such benefits to about 7,600 borrowers beginning in November 2011, but the rehabilitations were not processed through the system until April 2012 or later. Moreover, Education officials acknowledged they did not systematically track when this assistance was provided.

Education took some steps to hold the contractor accountable for the system problems. In September 2011, Education began assessing the contractor financial penalties due to implementation delays, as specified in the contract modification for the upgrade. While the system upgrade was completed at no additional cost to the government, the contractor also provided other services under the contract, such as loan servicing, operating the defaulted loan information system and providing Education

with access to its data centers. In February 2012, when the problems were still not resolved, Education notified the contractor via a cure notice that it could default on the contract unless adequate progress was made on the upgrade issues. Education officials reported that the cure notice resulted in increased contractor efforts, such as the contractor providing weekly status updates on the most critical upgrade issues at meetings between senior contractor and department officials. As of November 2013, Education reported that it has withheld approximately \$14 million from total payments to the contractor for other services rendered under the contract.²⁵ Education also planned to continue withholding \$125,000 per month until the contractor made the agreed-upon system enhancements and upgrades.

Education Has Made Progress Addressing Problems since System Upgrade, but Lacks Data to Measure Its Performance

When Education's upgraded information system began processing loan rehabilitations in April 2012, the system still did not always recognize that eligible accounts had satisfied the requirements for loan rehabilitation. As a result, Education began manually processing loan rehabilitations. This required collection agencies to identify and provide the department with information on borrowers eligible for rehabilitation, which Education staff then verified before recording the rehabilitation in the system. According to officials, the system was processing 90 percent of all eligible borrowers for rehabilitation by October 2012, with the remaining 10 percent being processed through a workaround that required some manual processing. Education officials reported that they used manual processing until the workaround was automated in September 2013. They acknowledged that a substantial amount of development work needs to be completed to address the remaining issues; work they expect to be completed under the new contract. For example, officials reported that the new system contractor will need to complete development work to ensure that the system identifies all rehabilitation-eligible borrowers. While Education awarded a new contract in September 2013, a bid protest challenging the contract award was filed with GAO in November 2013.²⁶ At the time of our review, the new contract award had not been finalized, and Education did

²⁵Education documented the settlement agreement it reached for withholding payments from the contractor based on implementation delays in a December 2012 contract modification.

²⁶B-409249.2. The protest was withdrawn on February 19, 2014, prior to a decision being issued.

not have timelines for when work might begin or a final contract monitoring plan in place that we could review. To help manage the transition of the system to the new contractor, Education extended the CSB contract through June 2014 through a contract modification.

While Education has made progress in developing data on the number of borrowers it has assisted with loan rehabilitation since the upgrade, it lacks data that would inform its performance with respect to its strategic goals for providing superior service and information to borrowers and safeguarding taxpayer interests. According to The Office of Federal Student Aid's Fiscal Year 2011-2015 Strategic Plan, Education needs to be able to collect, analyze, and use customer data to achieve its goals of providing superior service and information to students and ensuring program integrity and safeguarding taxpayers' interests. For instance, while Education reported rehabilitating about 600,000 loans for 200,000 borrowers from April 2012 to January 2013, it does not have other data to track its loan rehabilitation performance, such as the number of borrowers that experience delays in having their loans rehabilitated or the length of delays. Similarly, Education does not have data on the extent to which borrowers who rehabilitate their loans stay out of default. Without these data and related performance measures, Education cannot assess its performance in serving borrowers using loan rehabilitation or how effective rehabilitation is in minimizing the risk defaulted loans present to the federal government.

Oversight Weaknesses Reduce Education's Ability to Effectively Monitor Collection Agency Performance

Education has developed several mechanisms for overseeing collection agencies, but key weaknesses reduce its ability to effectively monitor their performance related to loan rehabilitation and other collection activities. Education tracks the overall performance of collection agencies using data that measures loan rehabilitations as well as other collection activities.²⁷ Specifically, Education calculates a performance score for each agency based on the total dollars collected, the number of accounts serviced, and the number of accounts that are resolved through other means such as administrative resolutions.²⁸ The department uses these data to determine how efficiently collection agencies manage the borrower accounts they are allocated and to allocate more accounts to higher-performing collection agencies. However, Education has experienced delays in assessing collection agencies' performance because quarterly data on the number of accounts managed by each collection agency have been unavailable since the defaulted loan information system was upgraded in October 2011. As a result, Education has not been able to measure collection agency performance on a quarterly basis as contractually required. In addition, there have been implications for Education's ability to accurately determine collection agency compensation. In May 2013, Education's Office of the Inspector General issued an Alert Memorandum raising concerns that Education paid commissions and bonuses to collection agencies based on estimated data.²⁹ In the absence of quarterly data, Education established a temporary workaround and modified collection agency contracts in June 2013 to retroactively assess collection agencies' fiscal year 2012 performance based on the cumulative number of accounts assigned to each collection agency throughout the year. As of November 2013, Education officials reported plans to retroactively assess collection agencies' fiscal year 2013 quarterly performance after completing and validating system repairs in April 2014.

²⁷Information generated through the performance assessment process is used to compensate collection agencies for work they complete each quarter and reward high performing agencies with bonuses.

²⁸Examples of administrative resolutions include canceling the debt due to the borrower's death, disability, or incarceration.

²⁹United States Department of Education, Office of Inspector General, *Federal Student Aid Paid Private Collection Agencies Based on Estimates*, ED-OIG/L02N0002 (May 15, 2013).

Beyond tracking quantitative measures of performance, Education also monitors the quality of collection agency interactions with borrowers by reviewing borrower complaints against collection agencies. When collection agencies receive a verbal or written complaint from borrowers they are required to suspend collection activity on the account and forward a copy of the complaint and their response to Education for review. However, Education's Office of Inspector General issued an Alert Memorandum in May 2013 after finding that three collection agencies it visited were not reporting verbal complaints to the department as contractually required.³⁰ Education subsequently addressed the Inspector General's recommendations to develop a quality assurance program to verify that it is receiving all verbal complaints and begin enforcing contract requirements related to verbal complaints.

While Education also monitors collection agencies' interactions with borrowers by reviewing their phone conversations with borrowers, its approach to conducting these reviews limits its ability to determine if collection agencies are providing borrowers with accurate information about loan rehabilitation.³¹ For example, Education has not conducted quarterly reviews of each collection agency as stated in its guidance and procedures since it began reviewing loan rehabilitation calls in 2011. Specifically, we examined call review reports issued between September 2011 and March 2013 for the six collection agencies we visited. Although Education officials told us that quarterly reviews should have been conducted during this period, they were unable to provide documentation for 11 of the 42 reviews that should have been performed. Education officials said the reviews may not have been completed due to competing priorities, such as needing to reassign staff to manually process loan rehabilitations following the system upgrade. In addition, we found Education's guidance for conducting rehabilitation call reviews was limited in that it did not specify key information, such as how calls should be selected or the number of calls that should be reviewed. In contrast,

³⁰United States Department of Education, Office of Inspector General, *Verbal Complaints Against Private Collection Agencies*, ED-OIG/L06M0012 (May 8, 2013).

³¹Education's call review guidance specifies that the call review process is to assure (1) that collection agencies are placing and answering calls in compliance with the Fair Debt Collection Practices Act and the Privacy Act of 1974; (2) that information provided to borrowers and others is accurate and appropriate to the nature of the call; and (3) that the contents of borrower calls are accurately updated to collection agencies information systems.

Education's guidance for reviewing all other collection agency conversations with borrowers says that staff should randomly select an initial sample of 40 calls per agency and review 30 of those calls. Education staff we interviewed did not use a consistent approach for selecting calls for the initial sample, and not all were using random sampling techniques. In addition, staff varied in the number of calls they reviewed, from as few as 10 to as many as 30. After we discussed these issues with the department in November 2013, Education revised its guidance to specify that staff should typically review 20 calls from an initial sample of at least 40 calls randomly selected from a list of all calls made by each collection agency on one day in the prior quarter.³²

We also found that Education is not making full use of the results of call reviews to inform its oversight. The 31 call review reports we examined documented a range of errors for each of the six collection agencies we visited, including providing borrowers with inaccurate or misleading information about rehabilitation program requirements and options. Among other things, Education documented instances where collection agency representative(s):

- did not explain rehabilitation provisions such as the one-time opportunity to rehabilitate a loan, that payments must be made within 20 days of the due date to be considered on time, or options for obtaining a reasonable and affordable payment;
- continued to push loan rehabilitation after the borrower said he was unemployed and was unable to make payments; and
- provided false or misleading information, such as incorrectly telling borrowers that a down payment or debit card was required to rehabilitate a loan.

While Education provides feedback on the results of its call reviews to each collection agency, it does not ensure that collection agencies take corrective actions or use the information to assess collection agencies' performance. Education officials reported that the department monitors collection agencies to ensure corrective actions are taken. However, Education's call review guidance does not include procedures for such monitoring, and Education staff we interviewed told us they rely on collection agencies to address problems identified during the call review

³²The guidance states that workload issues and other priorities may require an adjustment to the final number of calls to be reviewed.

process. Education officials reported that its process for assessing collection agency performance relies on objective metrics, such as the amount of collections and the number of borrowers reached. Officials said that while the current collection agency contracts were established with the main goal of maximizing collections for the government, they expect new contracts to be awarded in 2014 to include additional language about call monitoring and actions the department can take against a collection agency if problems are identified in the call review process. Education officials told us they have examined call review results for selected agencies to determine the types of errors agencies are making, although they acknowledged that they have not done so systematically for all collection agencies. Without a systematic approach to monitoring the results of call reviews, Education may be missing opportunities to target its oversight and improve program performance by identifying performance issues across collection agencies or over time.

Conclusions

Education collects more funds on defaulted loans through loan rehabilitation than any other collection method, making rehabilitation an important tool for helping borrowers get out of default and reducing the financial risk to the federal government. Given the challenges Education has in reaching borrowers who have defaulted on their loans and the one-time opportunity rehabilitation presents, it is important to ensure that borrowers seeking to rehabilitate their loans have a seamless experience throughout the process. As Education worked with its contractor to address problems following the upgrade of its defaulted loan information system, it monitored overall loan rehabilitation levels and took steps to process the backlog of loans eligible for rehabilitation. However, absent accurate data regarding the timeliness of loan rehabilitation and the number of borrowers affected by rehabilitation delays it will be difficult for Education to assess its progress in addressing system challenges related to loan rehabilitation.

Education relies substantially on contractors and collection agencies to provide key functions in support of the management and collection of defaulted loans, including loan rehabilitation. To ensure that Education is addressing its strategic goals for providing the highest levels of customer service to borrowers and safeguarding taxpayer interests, it is critical for Education to effectively oversee contract performance. The substantial delays that many borrowers experienced getting their loans out of default after satisfying the requirements for rehabilitation are largely attributable to Education not providing oversight appropriate for the risks associated with the system upgrade. Without incorporating a risk-based approach to

oversight into its planning for systems contracts and modifications, the department may continue to receive products and services that are delivered late and of unacceptable quality. Moreover, as Education is transitioning the defaulted loan information system to a new contractor, the ongoing system challenges the new contractor will be expected to resolve provide a compelling case for Education to take steps to strengthen its oversight. Education's oversight is also important to ensuring that collection agencies provide accurate information to borrowers. However, the results of Education's reviews of selected recorded phone calls between collection agencies and borrowers provide little such assurance, given the number of incomplete call reviews and the limited use of the information.

Recommendations

To strengthen Education's oversight of the loan rehabilitation process, we recommend the Secretary of Education direct the Office of Federal Student Aid's Chief Operating Officer to take the following three actions:

1. develop an approach for tracking loan rehabilitation performance. This approach could include options for developing data and related performance measures for tracking timely rehabilitation of loans;
2. take steps to ensure that the final monitoring plan for the new defaulted loan information system contract identifies risks presented by the contractor or contract work and the oversight activities planned to address those risks; and
3. take steps to improve its collection agency call review process. For example, Education could take steps to ensure that quarterly rehabilitation call reviews are completed, establish procedures for monitoring collection agency corrective actions, and utilize call review results to inform its oversight of collection agencies activities.

Agency Comments and Our Evaluation

We provided a draft copy of this report to Education for review and comment. In written comments, Education agreed with our recommendations, stating that it shares the concerns raised in the report and recognizes its key role in ensuring borrowers receive high-quality service and serving as an effective steward in managing the student loan portfolio. Education stated that it has already taken some actions in response to the recommendations and has plans in place to further improve its oversight of the loan rehabilitation process. For example, Education reported it has begun developing additional metrics for overseeing loan rehabilitation performance, including information on the extent to which borrowers with rehabilitated loans default again and

statistics to help it more quickly identify and resolve rehabilitation process issues. To strengthen its oversight of the defaulted loan information system, Education stated that it has established a contract monitoring plan that tracks key risk areas and identifies risk mitigation strategies, and is implementing new project management tools to enhance its monitoring. Finally, Education highlighted steps it has taken to strengthen its oversight of the collection agency call review process, including revising its procedures to improve documentation of corrective actions taken by collection agencies and developing a database to track collection agency errors and associated corrective actions. While these are positive steps, given their preliminary nature, it will be important to track how Education builds upon and sustains these actions over time to ensure it is providing appropriate levels of oversight. Education's written comments appear in appendix I. Education also provided technical comments which we incorporated into the report as appropriate.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies to the Secretary of Education, relevant congressional committees, and other interested parties. In addition, this report will be available at no charge on GAO's Web site at <http://www.gao.gov>.

If you or your staff have any questions about this report, please contact me at (617) 788-0534 or emreyarrasm@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix II.

Melissa Emrey-Arras

Melissa Emrey-Arras, Director
Education, Workforce, and
Income Security Issues

List of Requesters

The Honorable Lamar Alexander
Ranking Member
Committee on Health, Education, Labor, and Pensions
United States Senate

The Honorable John Kline
Chairman
Committee on Education and the Workforce
House of Representatives

The Honorable Virginia Foxx
Chairwoman
Subcommittee on Higher Education and Workforce Training
Committee on Education and the Workforce
House of Representatives

The Honorable Tom Coburn, M.D.
United States Senate

The Honorable Michael B. Enzi
United States Senate

Appendix I: Comments from the Department of Education



February 14, 2014

Ms. Melissa Emrey-Arras
Director, Education Workforce,
and Income Security Issues
United States Government Accountability Office
Washington, DC 20548

Dear Ms. Emrey-Arras:

Thank you for providing the Department of Education (Department) with an opportunity to review and respond to the draft copy of the Government Accountability Office (GAO) report, "FEDERAL STUDENT LOANS: Better Oversight Could Improve Defaulted Loan Rehabilitation" (GAO-14-256). We share the concerns raised in your report and recognize our key role both in ensuring that federal student loan borrowers receive high-quality service and prompt access to loan rehabilitation and other entitlements and benefits, as well as in serving as an effective steward for the taxpayer in managing the over \$1 trillion student loan portfolio.

As you note, the transition to the new Default Management and Collection System (DMCS) faced a number of challenges, particularly during its initial months of operation in late 2011 and early 2012. Addressing these challenges has been a major focus of Federal Student Aid (FSA) management, and we are proud of the successes noted in your report, which include a more than three-fold increase in the annual volume of loan rehabilitations since the new system came on line. Rehabilitation functionality was restored in April 2012 and the backlog of borrowers whose rehabilitation was delayed was completely eliminated by December 2012. Over 525,000 borrowers have rehabilitated more than \$9 billion in defaulted student loans since functionality was restored, including a record \$5.6 billion in FY 2013 alone. (In comparison, annual rehabilitations never exceeded \$1.6 billion under the legacy system). We continue to build on steps taken to streamline the rehabilitation process, working with private collection agencies (PCAs) and loan servicers to help borrowers who have rehabilitated make a smooth transition to normal repayment.

More broadly, DMCS has supported record overall collection totals in both FY 2012 and FY 2013. Collections have grown from \$3.4 billion in FY 2011 to \$3.7 billion in FY 2012 and \$8.5 billion in FY 2013. While these increases reflect programmatic changes and significant growth in the Department's loan portfolio, they are also a clear indication that DMCS has the capacity to effectively support the Department's collection activities.

We concur with the three recommendations included in your report to strengthen the Department's oversight of the loan rehabilitation process. In fact, we have already taken action consistent with each recommendation and have plans in place for further improvements or refinements in our monitoring and oversight efforts. The Department's response to the recommendations follows.

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To strengthen Education's oversight of the loan rehabilitation process, we recommend the Secretary of Education direct the Office of Federal Student Aid's Chief Operating Officer to take the following three actions:

Recommendation 1: *Develop an approach for tracking loan rehabilitation performance. This approach could include options for developing data and related performance measures for tracking timely rehabilitation of loans.*

Response: We concur with this recommendation. The Department has already begun to develop additional metrics for use in overseeing rehabilitation performance. These will include information on the extent to which rehabilitated borrowers redefault. We also are working with both PCAs and our loan servicing contractors to develop statistics to help more quickly identify and resolve process issues affecting loan rehabilitations.

Recommendation 2: *Take steps to ensure that the final monitoring plan for the new defaulted loan information system contract identifies risks presented by the contractor or contract work and the oversight activities planned to address those risks.*

Response: We concur with this recommendation. The Department has already established a contract monitoring plan for DMCS that tracks explicit deliverables related to key risk areas. The new DMCS contract also requires that the vendor use Lifecycle Management Methodology (LMM) in managing any development activity. The LMM process includes the production and ongoing monitoring of detailed risk logs and mitigation strategies for all projects. In addition, FSA has procured an independent verification and validation (IV&V) service for DMCS to work with the new vendor to ensure that all appropriate processes and controls are in place. While we believe these steps will significantly reduce risks associated with DMCS, we will continue to review our monitoring and oversight processes and plans to determine whether additional actions are needed.

Recommendation 3: *Take steps to improve its collection agency call review process. For example, Education could take steps to ensure that quarterly rehabilitation call reviews are completed, establish procedures for monitoring collection agency corrective actions, and utilize call review results to inform its oversight of collection agencies activities.*

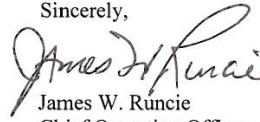
Response: We concur with this recommendation. The Department has already taken a number of steps to strengthen its collection agency call review process. Loan rehabilitation calls are monitored regularly, with a target of once per quarter for each PCA. Monitoring procedures have been revised to improve the documentation of corrective actions by PCAs. We have developed a database to track errors discovered in PCA reviews and easily identify PCAs that have repeated the same error; this database will also be the repository for documenting PCA corrective actions. We are also considering additional improvements, such as more extensive trending and data analysis, to enhance our use of call review results to inform our oversight of collection agency activities. The corrective actions tracked in the new database will also contain each error identified in each review, allowing oversight FSA staff to analyze PCA performance to better identify and address problem areas and poor performers. While we believe these steps will

Page 3 - Ms. Melissa Emrey-Arras

significantly improve the call review process, we will assess their impact to determine whether additional actions are needed.

Thank you for the opportunity to review and comment on the draft report.

Sincerely,



James W. Runcie
Chief Operating Officer
Federal Student Aid

Enclosure: Technical Comments

Appendix II: GAO Contact and Staff Acknowledgments

GAO Contact

Melissa Emrey-Arras, (617) 788-0534 or emreyarrasm@gao.gov

Staff Acknowledgments

In addition to the contact named above, individuals making key contributions to this report were Debra Prescott, Assistant Director; Kurt Burgeson; Maria Gaona; and Jason Palmer. In addition, key support was provided by James Bennett, Deborah Bland, Jessica Botsford, Jason Bromberg, Timothy DiNapoli, Holly Dye, Hedieh Fusfield, Kristine Hassinger, Anne McDonough-Hughes, Melissa Jaynes, Lara Laufer, Charlene Lindsay, Jean McSween, Christie Motley, Kathryn O'Dea Lamas, Dae Park, David Perkins, Kenneth Rupar, Linda Sanders, Sylvia Schatz, Brian Schwartz, and Charles Youman.

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