Income Contingent Repayment

Cost Attribution and Borrower Studies Could Assist to Meet the Objectives of Federal Financial Reporting and Program Management

FINAL AUDIT REPORT

Audit Control Number 07-70002
June 1998

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U.S. Department of Education
Office of Inspector General
Kansas City, MO

NOTICE

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

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Table of Contents

EXECUTIVE SUMMARY

This report sets out the results of our analysis and recommendations regarding the Federal Direct Loan Program's (FDLP), Income Contingent Repayment plan. The Income Contingent Repayment (ICR) plan allows FDLP borrowers to repay loans as a percentage of income. Policy makers considered many interrelated variables that have an impact on the costs to the Federal Government when they were designing the ICR plan with terms that would be attractive to borrowers. The ICR plan has been in effect for only a few years and the cost and benefits associated with the plan are not fully known. Nevertheless, we decided to provide as much information to program managers as possible at this time, along with our recommendations for additional studies of ICR plan costs and users. In order to better support future policy decisions, the Assistant Secretary for Postsecondary Education should collect the information and conduct the long-term studies recommended below:

- **Expand the accumulation of and report ICR costs separately from other FDLP costs in order to be able to attribute the costs to the original loan program.**

  In our opinion, the true cost of the various programs will not be reflected accurately unless the costs of the ICR plan are matched against benefitting programs. Although ICR is available only in the FDLP, many borrowers with education loans may consolidate their loans into the FDLP and elect to repay their new loan under the ICR plan.[1] In addition to loans made under the Department's major loan program, the Federal Family Education Loan Program (FFELP), education loans made under other Department of Education and Department of Health and Human Services programs are eligible for consolidation into the FDLP. Creating a separate cost center that identifies borrowers with their original loan program will provide data to help evaluate the FDLP, as well as the other loan programs.[2]

- **Expand the data collected to include a long-term study to determine the characteristics of ICR borrowers in order to better understand and address the needs of the population that the ICR plan serves.**

  Using March 31, 1997, Department of Education data, the General Accounting Office (GAO) reported that the ICR plan had higher delinquency and default rates than

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[1] Once consolidated, the consolidated loan is a new loan under the FDLP.

[2] Other loan programs include, Federal Family Education Loan Program (FFELP); Federal Insured Student Loans (FISL); Federal Perkins Loans; National Direct Student Loans (NDSL); National Defense Student Loans (NDSL); Health Professions Student Loans (HPSL); Auxiliary Loans to Assist Students (ALAS); Loans for Disadvantaged Students (LDS); Health Education Assistance Loans (HEAL); Nursing Loans made under the Public Health Service Act

borrowers using other repayment plans.[3] However, the GAO report noted that, a comparison of individual types of loans shows that ICR users do not have higher delinquency and default rates than users of all other repayment plans.[4] Similarly, our analysis of loan payment collections from July 1, 1994, to December 31, 1996, disclosed that borrowers using the ICR plan have higher overall delinquency and default rates than borrowers using the other FDLP repayment plans. Since these early statistics reflect the inclusion of defaulted Federal Family Education Loan Program (FFELP) loans that were consolidated into the FDLP from the Department's Debt Collection Service (DCS), they distort the results and may not reflect the repayment habits of the remainder of the ICR plan population. In our opinion, the Department should conduct a long-term study to gather information in order to develop a model to better understand the population that the ICR plan serves. This model would enable the Department to modify the ICR plan to better serve borrower needs.

C Continue to accumulate the cost of the ICR plan in order to better support important policy decisions.

The ICR plan has been in effect for only a few years and the costs associated with the plan are not fully known. There are variables, such as interest rates paid and charged, loan repayment periods, and debt written off, in the ICR plan that will affect total cost of the ICR plan. The Department should accumulate and monitor the cost of the ICR plan to both the government and the borrower so that it can determine if policies and regulations require modification to achieve the intended goals of the ICR plan.

The Department agreed with the report's focus on the importance of gathering and analyzing cost and borrower data related to the Direct Loan's ICR plan. The Department noted that it accumulates data on the FDLP income-contingent repayment plan through a number of Department systems. The Department's response is included as an Exhibit to this report.

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3 The GAO calculations based on Department of Education data as of March 31, 1997, identified the ICR plan's delinquency and default rates as 16 percent and 5 percent respectively, based on borrower counts.

4 GAO separated the FDLP loans into three Separate loan types: (1) consolidated loans, (2) non-consolidated loans, and (3) former DCS loans. GAO then analyzed the delinquency and default rates by repayment plans by type of FDLP loan.

Introduction

The Student Loan Reform Act of 1993, enacted on August 10, 1993, established the FDLP under the Higher Education Act of 1965, as amended. Under the FDLP, loan capital is provided directly to student and parent borrowers by the Federal Government rather than through private lenders Borrowers under the FDLP are provided a range of repayment options, including the ICR plan.

Under the ICR plan, the borrower's monthly repayment amount is generally based on total Direct Loan amounts, family size, and adjusted gross income (AGI), reported for the most recent year. The Secretary recalculates the borrower's repayment amount each year. The maximum repayment period is 25 years, after which the Secretary cancels the unpaid loan portion. Under certain conditions, borrowers may qualify for a repayment amount of zero under the ICR plan. Otherwise, the Secretary requires a minimum monthly payment of five dollars (effective July 1, 1996). Previously the minimum required payment was fifteen dollars. Because payment amounts can expand or contract with the borrower's ability to pay, ICR allows borrowers with low incomes or high debt to fit their student loan payments into their budget.

Scope and Methodology

The objectives of our audit were to:

Identify areas for improvement in the FDLP with an emphasis on the ICR plan, and consolidations. To accomplish these objectives we reviewed the loan consolidation process and analyzed FDLP collection information. This report sets out our findings and recommendations related to the ICR plan. With regard to our objective related to consolidation loans, we issued SFA Action Memorandum 97-09 to the Department on September 18, 1997.

Identify the FDLP collection process in order to provide the information to other OIG staff for the Department-wide financial statement audit and another OIG review. To accomplish this objective we made a site visit to the Direct Loan Service Center in Utica, New York.

To achieve our audit objectives, we relied on computer-processed data contained in the Department contractor's database. We performed testing for completeness and reasonableness of the computer processed data. Although we discovered some weaknesses in the data, we concluded that the data utilized in our analyses was sufficiently reliable to meet our audit objectives. However, we determined that the ICR plan, a new repayment option, and the data reviewed were too new to allow long-term projection. Nevertheless, we decided to provide as much information to program managers as possible at this time, along with our recommendations for additional studies of ICR plan costs and users.

Our audit covered the period July 1, 1994 through December 31, 1996. Our review was conducted from January 1997 through October 1997. We visited the Direct Loan Service Center (DLSC) in Utica, New York where we obtained an overview of collection procedures. We requested loan and collection data from the Department's Direct Loan contractor Computer Data Systems, Inc. (CDSI) located in Rockville, Maryland. We conducted a material portion of our fieldwork and our analysis of the data at our Seattle and Kansas City offices. In addition, we relied on information in a GAO report entitled, *DIRECT STUDENT LOANS, Analyses of Borrowers' Use of the Income Contingent Repayment Option*, dated August 21, 1997, which was an analysis of Department of Education records as of March 31, 1997. Our audit was conducted in accordance with generally accepted government auditing standards applicable to the limited scope of review described above.

Statement on Management Controls

We performed limited procedures regarding management controls at the Direct Loan Service Center in Utica, New York. We obtained a general understanding of the loan collection process but did not perform any substantive testing of procedures or operations. Our limited review did not identify any significant weaknesses. We performed a reliability assessment for the data used in our report and determined that it was sufficiently reliable to support the audit results and findings.

Because of inherent limitations, a study and evaluation made for the limited purposes described above would not necessarily disclose all material weaknesses in the control structure.

AUDIT RESULTS

As a result of our analysis of the FDLP's, ICR plan, we recommend that the Department: (1) expand the accumulation of and report ICR costs separately from other FDLP costs in order to be able to attribute the costs to the original loan program, (2) expand the data collected to include a long-term study to determine the characteristics of ICR borrowers in order to better understand and address the needs of the population that the ICR plan serves, and (3) continue to accumulate the cost of the ICR plan to both the government and the borrower, in order to better support important policy decisions.

ICR Costs Should Be Attributed To The Original Loan Programs

In our opinion, the costs of the ICR plan should be identified with the original loan programs. Section 68 of the Managerial Cost Accounting Concepts and Standards for the Federal Government, *Statement of Federal Financial Accounting Standards* (SFFAS) *No 4*, promulgated by the Federal Accounting Standards Advisory Board on July 31, 1995, provides the rationale for accumulating and reporting program and activity costs. It states:

> "To perform managerial cost accounting on a 'regular basis' means that entities should establish procedures to accumulate and report costs continuously, routinely, and consistently for management information purposes. Consistent and regular cost accounting is needed to meet the second objective of federal financial reporting which states information should be provided to help the user determine the costs of providing specific programs and activities and the composition of, and changes in those costs."

Section 69 goes on to link the need for accumulating and reporting program and activity costs to both the Chief Financial Officers (CFO) Act of 1990 and Government Performance and Results Act (GPRA) of 1993:

> "The CFO Act of 1990 states that agency CFOs shall provide for the development and reporting of cost information and the periodic measurement of performance. In addition, the GPRA of 1993 requires each agency, for each program, to establish performance indicators and measure or assess relevant outputs, service levels, and outcomes of each program as a basis for comparing actual results with established goals. The nature of these legislative mandates requires reporting entities to develop and report cost information on a consistent and regular basis."

Consistently accumulating and reporting on program activity costs would allow the Department to report FDLP performance and results to Congress as required under the GPRA. Furthermore, mandated by the Student Loan Reform Act of 1993, the ICR plan may be used by borrowers from a variety of Department of Education and Department of Health and Human Service loan programs. Creating a separate cost center that identifies borrowers with their original loan program will provide data to help evaluate the FDLP, as well as the other loan programs.[5]

ICR Borrower Characteristics Should Be Identified

In our opinion, it is important for the Department to determine the population of borrowers actually using the ICR repayment plan.[6] A recent General Accounting Office (GAO) report based on March 31, 1997, data reported the ICR plan as having higher delinquency and default rates than borrowers using other repayment plans.[7] However, the GAO report notes that, "A comparison of individual types of loans shows that ICR users do not have higher delinquency rates than users of all other repayment plans." GAO goes on to state that "As with delinquencies, a comparison of individual types of loans shows that ICR users did not have higher percentages of loans in default across the board than users of other repayment plans." A long-term study to gather information to develop a model to better understand the population that the ICR plan serves may enable the Department to modify the ICR plan to better respond to borrower needs.

FDLP borrowers can select from several repayment options (see Appendix A). As stated in the GAO report cited above, "The ICR option is the most flexible. It allows borrowers to pay relatively small or no monthly payments when their incomes are low and to pay more when their incomes rise." Even though ICR is more flexible, our analysis of loan payment collections from July 1, 1994 to December 31, 1996, disclosed that borrowers using the ICR plan have higher delinquency and default rates than borrowers using the other FDLP repayment plans. Since these early statistics include defaulted Federal Family Education Loan Program (FFELP) loans that were consolidated into the FDLP from the Department's Debt Collection Service (DCS), they distort the results and may not reflect the repayment habits of the remainder of the ICR plan population.[8]

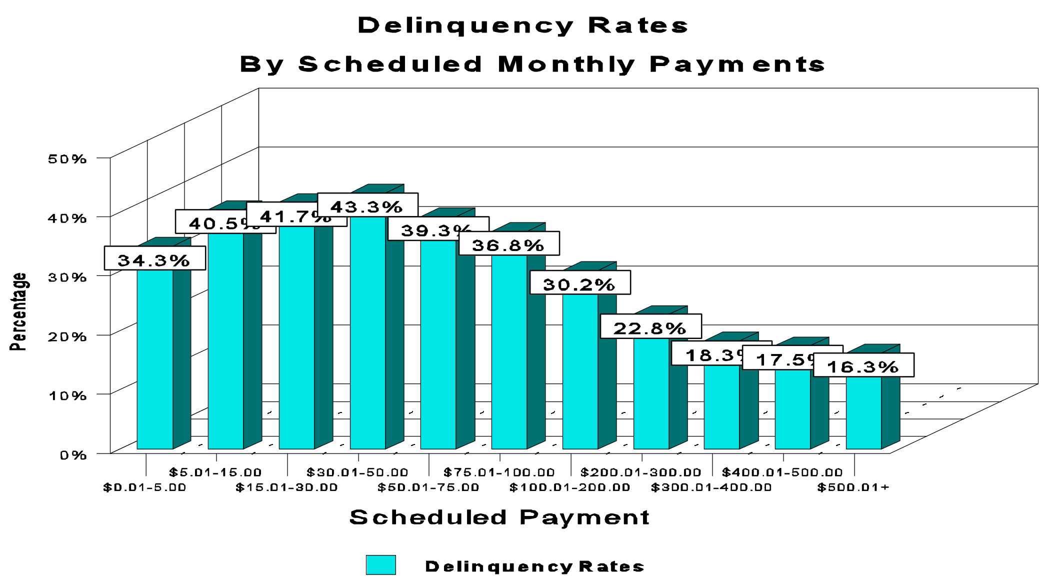
5 Other loan programs include, Federal Family Education Loan Program (FFELP); Federal Insured Student Loans (FISL); Federal Perkins Loans; National Direct Student Loans (NDSL); National Defense Student Loans (NDSL); Health Professions Student Loans (HPSL); Auxiliary Loans to Assist Students (ALAS); Loans for Disadvantaged Students (LDS); Health Education Assistance Loans (HEAL); Nursing Loans made under the Public Health Service Act

6 The Income Contingent Repayment (ICR) plan allows FDLP borrowers to repay loans as a percentage of income, so they can choose their career of preference. Policy makers considered many interrelated variables that have an impact on the costs to the Federal Government when they were designing the ICR plan with terms that would be attractive to borrowers.

7 The GAO calculations based on Department of Education data as of March 31, 1997, identified the ICR plan's delinquency and default rates as 16 percent and 5 percent respectively, based on borrower counts.

8 In a 1996 audit, we recommended that the Department discontinue active pursuit of consolidating Debt Collection Service (DCS) loans into the Direct Consolidation Loan Program.

We believe long-term tracking would assist the Department in managing the ICR plan. For example, the correlation between low monthly payment amounts and higher delinquency rates could be useful information for ICR managers. One of the ICR plan's advantages is to allow borrowers with lower incomes to make smaller monthly payments. However, over 34 percent of the borrowers with calculated monthly payments of 5 dollars or less (excluding zero-payment borrowers) were 31 or more days delinquent.[9] The delinquency rates continued to increase as the payment amounts increased and peaked at over 43 percent for borrowers in the $30.01-50.00 payment range. Thereafter, the delinquency percentage decreased as the monthly payment amounts increased. In the $500.01 and up range the delinquency rate was 16.25 percent.



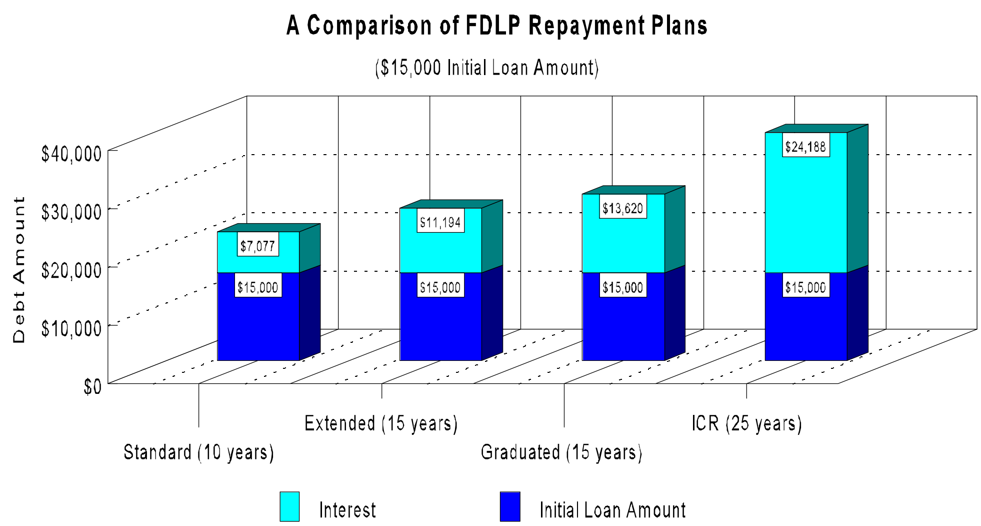
In addition, while not typical, the Department should consider tracking costs that appear unusual and warrant additional investigation. For example, our analysis identified 660 borrowers with a Principal Balance Outstanding (PBO) over $100,000 of which 102 had a calculated monthly payment amount of zero. In addition, there were many borrowers with very low scheduled payments. For example, one borrower with a loan of over $315,000, which includes $230,000 of Health Education Assistance Loans, was only required to pay $126 a month. This borrower's debt currently increases almost $2,000 every month. If this situation were to continue, at the end of the 25 year repayment period the total loan amount and accrued interest would be almost $1 million. The taxpayer subsidy in this instance could be $600,000.

[9] For borrowers whose calculated monthly payment is $0.01-5.00, the minimum required payment is $5.00.

ICR Costs Should Be Determined

As discussed in the GAO report cited above, there is no single answer to whether a borrower will pay more or less under the ICR plan compared with other repayment plans. Borrowers with a limited ability to pay could pay more as a result of larger total interest cost over the full term of their loans and tax liability on the amount they were unable to repay within the 25 year repayment period. ICR may be less costly for borrowers who have the ability to repay their loans over a shorter period of time than the extended or graduated repayment plans. The additional cost to borrowers is primarily the result of the increased amount of interest paid on the debt over time.

As illustrated in the chart below, the ICR plan could be more costly to borrowers compared to the other repayment plans when borrowers use the full period available to repay their debt. Borrowers on the standard repayment plan would pay the least amount of interest on their $15,000 loan compared to the other repayment plans. For the ICR plan, of the $39,188 total amount paid, the borrower's payments would total $36,048. Under existing rules, the unpaid balance of $3,140 is forgiven by the Department but considered as income to the borrower for tax purposes. Using a 15 percent marginal tax rate, the borrower would have a tax liability of $471 on the $3,140, while the taxpayer would pay the remaining amount of $2,669.



Comparison of Student Loan

Repayment Plans - Assumptions

All calculations are for a single borrower. Interest rate remains constant at 8.25 %. Maximum allowable payback period for the Graduated and Extended repayment plan examples. Borrower's income starts at $15,000 and grows 5 % annually for the ICR plan example. The Initial Monthly Payment for each repayment plan example is: Standard - $184, Extended - $146, Graduated - $105, and ICR - $106. (**Source:** Analysis by National Council of Higher Education Loan Programs, Education Finance Council, and the Coalition for Student Loan Reform entitled "An Examination of the Long-Term Costs to Student Borrowers of Income Contingent Repayment under the Federal Direct Loan Program", dated, November 1996.)

The ICR plan has been in effect for only a few years and the costs to the government associated with the plan are not fully known. There are variables, such as interest rates paid and charged, loan repayment periods, debt written off, in the ICR plan that will affect total cost of the ICR plan. The Department should accumulate and monitor the cost of the ICR plan to both the government and to the borrower so that it can determine if policies and regulations require modification to achieve the intended goals of the ICR plan.

The Compounding Effects of Interest Increase Borrowers' Debt. As of December 31,1996, 30 percent of ICR borrowers (representing over $193 million of PBO) had zero monthly payments. These borrowers may be eligible to go 25 years without making any payments while interest is capitalized and accrued. At the current interest rate, borrowers reach the 10 percent limit in about 14 months and the loan amount doubles in slightly more than 12 years.

Capitalized and accrued interest increase borrowers' debt. Our analysis shows that nearly 44 percent of all ICR borrowers' monthly scheduled payment amounts do not cover the interest on their outstanding principal amounts. As designed, unpaid interest is capitalized until it reaches 10 percent of the original loan amount and is accrued thereafter.[10] Over the 25 year repayment period, borrowers can end up accruing more in interest costs than the original principal amount borrowed.

After 25 years the borrower's unpaid ICR loan amount is forgiven. In this situation, the borrower is liable for the income tax on the forgiven amount and the government will be covering the remainder. Appendix B illustrates the costs for the borrower and government on the selected unpaid loan balances.

ICR is unique in that it is the only student loan repayment plan that does not require the borrower to at least cover interest costs (excluding deferment and forbearance periods).[11] Thus, the government is responsible for the interest on the money that the Department borrows from the Treasury for the ICR loans when the borrower's payment does not cover the interest accruing on the outstanding loan balance. For example, in 1996 the Treasury charged the Department 6.64 percent interest while the Department charged borrowers 8.25 percent. However, as previously stated, almost 44 percent of ICR borrower payments do not cover the interest on their loans. As a result, the government must cover the additional expense of borrowing funds from the Treasury.

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[10] During deferment periods borrowers with Unsubsidized Direct Loans can choose to pay the interest or have it capitalized. Also, borrowers who request that interest payments be forborne will have their interest payments capitalized.

[11] The alternative plan allows borrower payments to be less than the accrued interest amount. However, for our audit period, we did not identify any borrowers on the alternative repayment plan.

Recommendations

We recommend that the Assistant Secretary for Postsecondary Education:

1. Expand the accumulation of and report ICR costs separately from other FDLP costs in order to be able to attribute the costs to the original loan program.

2. Expand the data collected to include a long-term study to determine the characteristics of ICR borrowers in order to better understand and address the needs of the population that the ICR plan serves.

3. Continue to accumulate the costs of the ICR plan to both the government and the borrower in order to better support important policy decisions.

Department of Education Response and Auditor Comments

The Department strongly agreed with the report's focus on the importance of gathering and analyzing cost and borrower data related to the Direct Loan's income contingent repayment plan. The Department noted that they accumulate data on the FDLP income-contingent repayment plan through a number of Department systems. This issue was discussed at the exit conference. However, the Department was unable to provide the data requested. While the Department accumulates the data in various data systems, we emphasize the need to accumulate the information in the manner we recommend to ensure that the data collected is complete and reliable so that the Department can: (1) accumulate the ICR cost separately from other FDLP costs in order to attribute the costs to the original loan program; (2) prepare a long-term study to determine borrower characteristics in order to better understand and address the needs of the population that the ICR plan serves, and (3) continue to accumulate the costs of the ICR plan to both the government and the borrower in order to better support important policy decisions.

Appendix A

Repayment Plans

Standard

, Up to 10 years to repay; Fixed, monthly payments; $50 minimum monthly payment

Extended

, Between 12 and 30 years to repay(excluding deferment and forbearance periods) depending on loan amount; Fixed, monthly payments; $50 minimum monthly payment [See table below for repayment periods]

Graduated

, Between 12 and 30 years to repay(excluding deferment and forbearance periods) depending on loan amount; Monthly payment = the monthly interest accrual or 50% of the amount required under standard repayment, whichever is greater; Monthly payments may range from 50-150% of payments under standard plan; payments increase every two years. [See table below for repayment periods]

Income Contingent

, 25 years to repay; After 25 years, unpaid loan portion is forgiven; Monthly payments based on adjusted gross income (AGI) and recalculated annually

Alternative

, Special approval by the Secretary; 30 years to repay; if monthly amount does not cover interest, it is capitalized (to 10%) and accrued thereafter (like ICR)

Loan Amount and Repayment Period (Maximum Number of Payments)	
If the Direct Loan Amount is:	**The Repayment Period/Maximum Number of Monthly Payments Is:**
less than $10,000	**12 Years / 144 Monthly Payments**
$10,000 - 19,999.99	**15 Years / 180 Monthly Payments**
$20,000 - 39,999.99	**20 Years / 240 Monthly Payments**
$40,000 - 59,999.99	**25 Years / 300 Monthly Payments**
$60,000 or more	**30 Years / 360 Monthly Payments**

Appendix B

ICR Cost Analysis For Borrower and Government						
Amount Borrowed	**Amount Paid by Borrower Over 25 Years**	**Unpaid Balance Forgiven by ED at End of 25 Years[12]**	**Borrower's Estimated Tax Liability on Forgiven Loan Balance**	**Total Cost of Repaying Loan Under ICR**	**Repayment Costs to be Paid by Borrower**	**Portion of Total Repayment Costs to be Covered by Taxpayers**
$2,500	$6,009	$520	$78	$6,529 100%	$6,087 93%	$442 7%
$10,000	$24,032	$2,094	$314	$26,126 100%	$24,346 93%	$1,780 7%
$15,000	$36,048	$3,140	$471	$39,188 100%	$36,519 93%	$2,669 7%
$20,000	$47,596	$7,431	$1,115	$55,027 100%	$48,710 89%	$6,316 11%
$25,000	$57,373	$21,631	$3,245	$79,004 100%	$60,618 77%	$18,386 23%
$30,000	$65,526	$31,977	$4,797	$97,503 100%	$70,322 72%	$27,180 28%
$40,000	$77,469	$52,752	$14,771	$130,221 100%	$92,240 71%	$37,981 29%
$50,000	$84,261	$78,573	$22,000	$162,834 100%	$106,262 65%	$56,573 35%
$75,000	$86,751	$157,559	$44,117	$244,310 100%	$130,868 54%	$113,442 46%
$100,000	$86,751	$239,035	$66,930	$325,786 100%	$153,681 47%	$172,105 53%

[Assumptions: Single borrower; initial income = $15,000 (rising 5% annually); Interest rate = 8.25%; inflation = 3% annually]

Source: Analysis by National Council of Higher Education Loan Programs, Education Finance Council, and the Coalition for Student Loan Reform entitled "An Examination of the Long-Term Costs to Student Borrowers of Income Contingent Repayment under the Federal Direct Loan Program", dated November 1996.

12 NOTE: The 25 years refers to the maximum loan repayment period for ICR loans.

EXHIBIT

Department of Education Response to the Draft Report

REPORT DISTRIBUTION LIST
Audit Control Number A07-70002

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