United States Government Accountability Office

GAO

Report to the Chairman, Committee on Education and Labor, House of Representatives

July 2007

FEDERAL FAMILY EDUCATION LOAN PROGRAM

Eliminating the Exceptional Performer Designation Would Result in Substantial Savings without Adversely Affecting the Loan Program

GAO-07-1087

Contents

Letter		1
Appendix I	**Briefing Slides**	5
Appendix II	**Comments from the Department of Education**	24

Abbreviations

FFELP	Federal Family Education Loan program
NSLDS	National Student Loan Data System

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United States Government Accountability Office
Washington, DC 20548

July 26, 2007

The Honorable George Miller
Chairman
Committee on Education and Labor
House of Representatives

Dear Mr. Chairman:

The federal government guarantees loans in the Federal Family Education Loan program (FFELP) so that private lenders that participate in the program will be reimbursed if a borrower defaults, and about $4.6 billion was spent in fiscal year 2006 to repay lenders for defaulted loans. To retain the guarantee on their loans, all FFELP lenders must comply with minimum due diligence requirements for servicing loans, including establishing a borrower's first repayment due date and making a certain number of attempts to contact delinquent borrowers. Lenders that adhere to these requirements are eligible to receive at least a standard reimbursement rate of 97 percent of the outstanding principal and accrued interest for defaults. However, pursuant to a provision of the Higher Education Amendments of 1992, the Secretary of Education has the authority to designate lenders and loan servicers as "exceptional performers" in servicing FFELP loans, and loans serviced by those with the exceptional performer designation qualify for a 99 percent reimbursement rate. The amendments also provided authority to the Secretary of Education to terminate the exceptional performer program following a GAO study, if such termination is in the fiscal interest of the United States.[1]

To obtain the exceptional performer designation, loan servicers have to obtain an initial audit, by independent auditors, demonstrating at least 97 percent compliance with due diligence requirements for a random sample of loans they service, and they must continue to demonstrate compliance through quarterly and annual audits to maintain the designation. The first exceptional performer designation that Education granted took effect in January 2004, and 18 organizations that service

[1]The Higher Education Amendments of 1992 provided for a GAO study of the exceptional performer designation to be conducted within 3 years of enactment of the legislation, but the study could not be undertaken until recently because no organizations had received the designation.

about 90 percent of all FFELP loans currently have the exceptional performer designation.

You asked us to conduct a review of the exceptional performer program to answer the following questions: (1) To what extent is the exceptional performer program meeting its objectives of improving loan servicing and decreasing defaults? (2) What are the costs and benefits of the exceptional performer program?

We briefed your staff on the results of our analysis on June 28, 2007. This report formally conveys the information provided during that briefing. In summary, we reported the following findings:

- The exceptional performer program has not materially affected loan servicing, and default claims have not declined in the years following the first exceptional performer designation. Specifically, representatives from each of the exceptional performers we interviewed told us they did not make substantive changes to their loan servicing to obtain the designation, and technological advances made prior to the first exceptional performer designation automated much of loan servicing, which simplified compliance with due diligence requirements. Additionally, both the number and dollar amount of default claims relative to all out-of-school FFELP loans increased from fiscal years 2004 to 2006.

- The federal government incurs substantial costs, while lenders receive most of the benefits for the exceptional performer program. The Congressional Budget Office estimates that the federal government will spend $1 billion during the next 5 years on the extra 2 percent reimbursement for default claims on loans serviced by exceptional performers.

Providing an extra 2 percent reimbursement rate for default claims serviced by exceptional performers is not in the fiscal interest of the federal government because lenders are being paid a premium to perform due diligence activities that are already required of all lenders. The risk of having default claims rejected already provides lenders with sufficient incentive to comply with due diligence requirements. Further, the criteria established in 1992 for the exceptional performer designation do not indicate exceptional performance today because technological advances have made it easier for lenders to meet these criteria.

Congress has included language to eliminate the exceptional performer designation as part of proposed legislation on federal student aid. The House and Senate each passed different versions of this legislation that would eliminate the provision, and action is pending on final legislation.[2] On the basis of our findings, we agree that the exceptional performer program should be eliminated. If the proposed legislation is not enacted by the end of the current session of Congress, we recommend that the Secretary of Education use her existing authority to eliminate the exceptional performer program.

We provided copies of a draft of this report to the Department of Education for review and comment. In written comments, Education agreed with our recommendation to eliminate the exceptional performer program and said it was hopeful that Congress would do so through reauthorization of the Higher Education Act. See appendix II for the department's comments.

We used the following methodologies to develop our findings. To understand the history and requirements of the exceptional performer program, we reviewed relevant laws, regulations, and guidance related to the exceptional performer program. To determine whether the exceptional performer program is meeting its objectives and the costs and benefits of the program, we conducted semistructured interviews with officials at the first 7 organizations that received the exceptional performer designation, 3 loan servicers that have not applied for the designation, and 6 of the 35 state-designated guaranty agencies that administer most aspects of the FFELP program. To ensure that the guaranty agencies we interviewed did not have a vested interest in the exceptional performer program, we selected guaranty agencies that do not have organizational components or affiliates that make or service FFELP loans that could be eligible to become exceptional performers. Further, we selected guaranty agencies from different regions in the country. We also conducted interviews with two trade associations representing FFELP lenders and servicers, two leading financial research services that provide credit ratings of lenders and securities issued by lenders, and officials at the Department of Education.

To assess changes in defaults on FFELP loans since the exceptional performer designation was granted, we analyzed data from the National

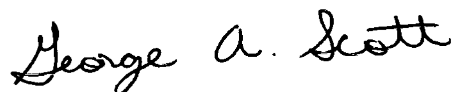
[2]The legislation being considered is H.R. 2669, the College Cost Reduction Act of 2007.

Student Loan Data System (NSLDS) covering fiscal years 1998 to 2006. To control for portfolio growth, we analyzed defaulted loans relative to all out-of-school loans, that is, all loans that were in repayment, deferment, forbearance, and default. To assess the reliability of NSLDS data, we talked with agency officials about data quality control procedures and reviewed relevant documentation. We determined the data were sufficiently reliable for the purposes of this study. We conducted our work from October 2006 through June 2007 in accordance with generally accepted government auditing standards.

We are sending copies of this report to relevant congressional committees, the Secretary of Education, and other interested parties and will make copies available to others upon request. In addition, this report will be available at no charge on GAO's Web site at www.gao.gov.

If you or your staff have any questions about this report, please contact me at (202) 512-7215 or scottg@gao.gov. Contact points for our Office of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report include Debra Prescott (Assistant Director), Kathy Peyman (Analyst-in-Charge), Carlo Salerno, Jeff Appel, Jessica Botsford, Crystal Bernard, Doreen Feldman, Cynthia Grant, Jean McSween, and Charles Willson.

Sincerely yours,



George A. Scott
Director, Education, Workforce, and
Income Security Issues

Appendix I: Briefing Slides

Eliminating the Exceptional Performer Designation Would Result in Substantial Savings Without Adversely Affecting the Loan Program

Briefing for the Chairman,
House Committee on Education and Labor
June 28, 2007

1

Overview

- Introduction
- Research Questions
- Scope and Methodology
- Summary of Findings
- Background
- Research Findings
- Conclusions

2

Introduction

Introduction

- The federal government insures loans in the Federal Family Education Loan program (FFELP) so that lenders are reimbursed at least 97 percent of the loan's outstanding principal and accrued interest if a borrower defaults. In fiscal year 2006, the federal government spent about $4.6 billion reimbursing lenders for defaults.
- The Higher Education Amendments of 1992 included provisions for designating lenders and loan servicers for exceptional performance in servicing FFELP loans. Loans serviced by exceptional performers receive a higher reimbursement rate--99 percent–if the loan defaults.
- Because about 90 percent of FFELP loans are now serviced by lenders and servicers with the exceptional performer designation, concerns have been raised about the need for such a program and Congress has introduced legislation to eliminate it.

3

Research Questions

1. To what extent is the exceptional performer program meeting its objectives of improving loan servicing and decreasing defaults?

2. What are the costs and benefits of the exceptional performer program?

4

Scope and Methodology

Scope and Methodology

To address our research objectives, we:

- Reviewed relevant laws, regulations, and guidance related to receiving the exceptional performer designation.
- Conducted interviews with: the first 7 organizations to receive the exceptional performer designation, 3 organizations that have not received the designation, 6 guaranty agencies that do not have ties to organizations that make or service FFELP loans, 2 trade associations representing FFELP lenders and servicers, 2 leading financial research services that provide credit ratings of lenders and securities issued by lenders, and the Department of Education (Education).
- Analyzed trends in default claims while controlling for portfolio growth using data from the National Student Loan Data System (NSLDS) covering fiscal years 1998-2006. We found the data sufficiently reliable for the purposes of this study.
- Conducted our work from October 2006 through June 2007 in accordance with generally accepted government auditing standards.

5

Summary of Key Findings

Despite High Costs, the Exceptional Performer Program Has Not Benefited the Federal Government

- The exceptional performer program has not materially affected loan servicing, and default claims did not decline in the years following the first exceptional performer designation.
- The program's costs are borne primarily by the federal government – approximately $1 billion over the next 5 years for the higher reimbursement rate paid on default claims – while lenders receive most of the program's benefits.

6

Background

Under FFELP, Private Lenders Provide Federally Insured Loans to Students

- Lenders can either service their own loans or contract these activities out to a third-party loan servicer.
- Thirty-five guaranty agencies administer most aspects of the program, including the review of default claims.
- Using federal funds, guaranty agencies currently insure all lenders for at least 97 percent of the loan's outstanding principal and accrued interest. The agencies also work with lenders and borrowers to prevent loan defaults and collect on loans after they default.

7

Background

All Lenders Must Adhere to Minimum Due Diligence Requirements to Retain FFELP Loan Guarantees

- Establish each borrower's first repayment due date and convert the borrower to repayment within specified time frames.
- For delinquent borrowers lenders must also:
  - Send a required number of collection letters, make a required number of telephone calls, and ensure there are no gaps greater than 45 days between attempts to contact the borrower.
  - Perform a process called "skip tracing" to obtain a borrower's current address or telephone number whenever the lender learns it has incorrect contact information.
  - Seek default aversion assistance from the guaranty agency between 60 and 120 days of delinquency.
  - Send a final demand letter requiring repayment of the loan in full on or after 241 days of delinquency.
- File default claims with guaranty agencies within a specified time frame.

8

Background

The Exceptional Performer Provisions Developed During a Period of Concern over High Loan Defaults

- When Congress enacted the Higher Education Amendments of 1992, which contained the provision for the Exceptional Performer designation, the most recently reported cohort default rate was very high — about 22 percent.[1]
- In 1994, when it issued regulations for the exceptional performer designation, the Department of Education stated that it expected the designation to reduce the cost of defaults by encouraging lenders and loan servicers to improve their servicing and collection of FFELP loans.

[1]The Department of Education calculates a cohort default rate based on the percentage of borrowers who enter repayment during a particular fiscal year and default before the end of the next fiscal year.

9

Background

After the First Designation, the Number of Designated Organizations Grew Quickly

- Twelve years after the provision was enacted, Education granted the first exceptional performer designation to take effect January 2004.
- Today, there are 18 designated Exceptional Performers that service about 90 percent of all outstanding FFELP loans.

10

Background

Exceptional Performer Designation Focuses on Adherence to Due Diligence Requirements

- The 1992 statutory provisions for the exceptional performer designation grew out of lenders' concerns that the due diligence requirements for servicing delinquent loans were too rigid and resulted in claim rejections and disproportionate financial penalties.

- To obtain the designation, lenders and loan servicers have to obtain an initial audit demonstrating at least 97 percent compliance with due diligence requirements for a random sample of loans they service. Exceptional performers must continue to have quarterly and annual audits to maintain the designation.

11

Background

Exceptional Performer Program Shifts Oversight of Due Diligence Compliance from Guaranty Agency to Audits

- For standard performers, guaranty agencies review all default claims filed to ensure compliance with due diligence requirements. When violations are identified, guaranty agencies can reject the claim or impose penalties that reduce the claim amount depending on the nature of the violation.

- For exceptional performers, the audits serve as evidence that due diligence compliance has been met. Guaranty agencies cannot reject claims or impose penalties that reduce the size of the claim for due diligence violations on loans serviced by an exceptional performer.

12

Question 1: Improving Loan Servicing

The Exceptional Performer Program Has Not Materially Affected Loan Servicing

- Representatives from each of the exceptional performers we interviewed told us that they did not make substantive changes to their loan servicing in order to obtain the designation. However, they said undergoing regular audits of their due diligence compliance helped their organizations strengthen internal controls over due diligence.

- Both exceptional and standard performers we interviewed said that they go beyond the minimum due diligence requirements by, for example, making additional contact attempts with delinquent borrowers.

- Guaranty agency officials told us that they observed no difference between exceptional and standard performers with respect to due diligence compliance.

13

Question 1: Improving Loan Servicing

Compliance with Due Diligence Was Simplified Before Any Exceptional Performers Were Designated

- Technological advances over the years, such as more sophisticated software and autodialers automated many aspects of required due diligence activities before any organizations received the exceptional performer designation. Such advances also simplified generation of the data that organizations need to demonstrate that they met the required 97 percent compliance rate.

- In December 1992, the due diligence requirements were revised to be less rigid. For example, prior to these changes, due diligence attempts to contact borrowers had to be completed within specified 30-day periods, but now lenders have more flexibility as long as they do not wait longer than 45 days between contact attempts.

14

Question 1: Reducing Defaults

Default Claims Have Not Declined Since Fiscal Year 2004, When the First Exceptional Performer Designation Was Granted

- In the period after the program was enacted but before the first exceptional performer designation was granted, cohort default rates on FFELP loans steadily declined for various reasons, such as barring schools with high cohort default rates from participating in FFELP.

- The requirements for obtaining and retaining the exceptional performer designation relate to complying with due diligence processes and not improving outcomes such as reducing defaults.

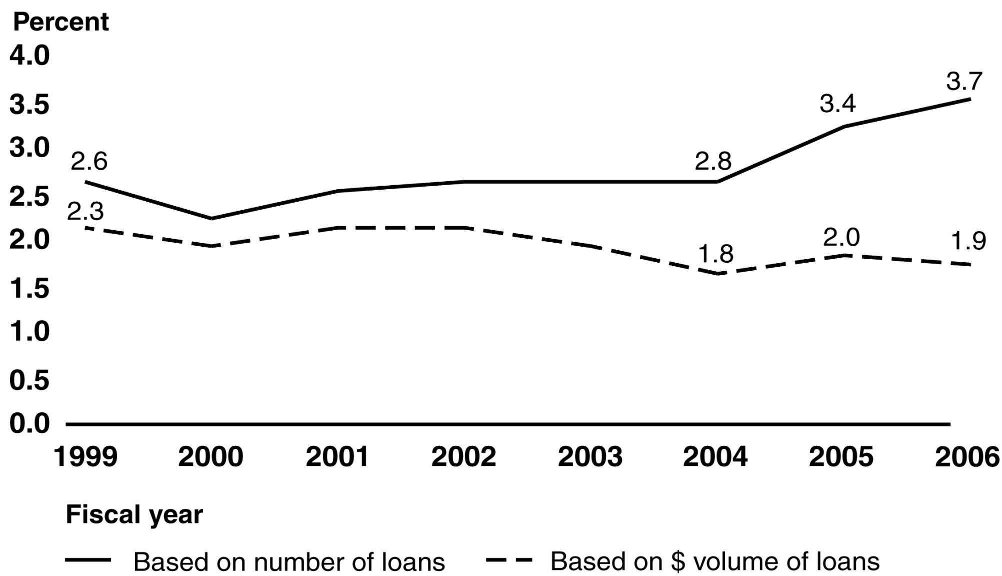
- From fiscal years 2004 through 2006, the volume of outstanding loans serviced by exceptional performers grew to about 90 percent, according to Department of Education officials. For the same time period, we analyzed FFELP default claims relative to outstanding FFELP loans and found
  - the number of default claims increased from 2.8 percent to 3.7 percent, and
  - the dollar amount of default claims increased from 1.8 percent to 1.9 percent of loan volume.

15

Question 1: Reducing Defaults

Default Claims Have Not Declined Since Fiscal Year 2004, When the First Exceptional Performer Designation Was Granted (cont'd.)

FFELP Default Claims as a Percentage of All Outstanding "Out of School" Loans[a]



Source: GAO analysis of NSLDS data.

[a]Out of School loans are loans classified as being in repayment, deferment, forbearance or default.

16

Question 2: Costs and Benefits

Substantial Program Costs Are Borne Largely by the Federal Government, Benefits Accrue Primarily to Lenders

Federal Government

- The primary cost of the program to the federal government is the extra 2 percent in lender reimbursement. The Congressional Budget Office estimates the extra 2 percent will cost the federal government about $1 billion from fiscal year 2008 through fiscal year 2012.
- In addition to these costs, the federal government foregoes the assessment of interest penalties for due diligence violations by exceptional performers.

Guaranty Agencies

- Guaranty agencies told us they incurred minor system reprogramming costs associated with managing separate review processes for exceptional and standard performers as well as marginally higher costs associated with reimbursing claims serviced by exceptional performers at the higher reimbursement rate.
- Some guaranty agencies reported marginal time and labor savings because they are not reviewing exceptional performers' claims for due diligence compliance.

17

Question 2: Costs and Benefits

Substantial Program Costs Are Borne Largely by the Federal Government, Benefits Accrue Primarily to Lenders (Cont'd.)

Exceptional Performers

- Exceptional performers main cost is the audits needed to obtain and retain the designation. Costs for these audits ranged from $80,000 to $400,000, according to estimates provided by exceptional performer officials.
- Lenders receive two financial benefits for default claims on loans serviced by exceptional performers: the 2 percent higher reimbursement rate and the absence of interest penalties for due diligence violations.
- Because their claims cannot be rejected for due diligence violations, exceptional performers save administratively from not having to resubmit claims or address guaranty agencies' questions about due diligence compliance.
- Also, exceptional performers reported that the designation provides public recognition and can be used for marketing purposes.

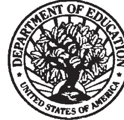
18

Conclusions

- Providing lenders an extra 2 percent reimbursement rate for default claims serviced by exceptional performers is not in the fiscal interest of the federal government in light of findings that the exceptional performer program has not materially improved loan servicing and default claims have not declined in the years following the first designation.
  - The federal government is paying lenders a premium to perform due diligence activities that are already required of all lenders.
  - The risk of having default claims rejected and incurring penalties for due diligence violations already provides lenders incentives to fully comply with due diligence requirements.
  - Federal expenditures for the program are not justified by the time and labor savings from expedited claim review that some guaranty agencies and exceptional performers reported.
- The criteria established in 1992 for the exceptional performer designation do not indicate exceptional performance today, because technological advances have made it easier for lenders to meet these criteria.

19

Appendix II: Comments from the Department of Education



CHIEF OPERATING OFFICER

JUL 20 2007

Honorable David M. Walker
Comptroller General
Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Walker:

In accordance with 31 U.S.C. 720, I am writing to respond to conclusions presented in the Government Accountability Office (GAO) report, "Federal Family Education Loan Program: Eliminating the Exceptional Performer Designation Would Result in Substantial Savings without Adversely Affecting the Loan Program" (GAO-07-1078).

The Department concurs with the recommendations of the report, and we are hopeful that Congress will eliminate the exceptional performer program through reauthorization of the Higher Education Act. Thank you for the opportunity to respond.

Sincerely,

Lawrence Warder
Acting Chief Operating Officer
Federal Student Aid

830 First St. N.E., Washington, DC 20202
www.FederalStudentAid.ed.gov
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