



UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF INSPECTOR GENERAL

THE INSPECTOR GENERAL

**ED-OIG/A05-90024**

Mr. Greg Woods  
Chief Operating Officer  
Student Financial Assistance

SEP 28 2000

Dr. Lee Fritschler  
Assistant Secretary  
Office of Postsecondary Education

Dear Sirs:

This *Final Audit Report* (Control Number ED-OIG/A05-90024) informs you of the potential to reduce the risks and costs of consolidating defaulted loans in the Federal Consolidation Loan (Consolidation) Program within the Federal Family Education Loan (FFEL) program. Our objective was to determine if consolidating defaulted loans within the FFEL program is achieving its intended purpose at a reasonable cost.

**AUDIT RESULTS**

We found that approximately two-thirds of the borrowers who consolidated defaulted loans were in repayment or paid-in-full at the time of our analysis. However, we were unable to conclude whether the costs of consolidating defaulted loans in the Consolidation Program were reasonable. The risk involved in consolidating defaulted loans is that borrowers with a history of previous defaults are more likely to default again. When a Consolidation defaults, the U. S. Department of Education (Department) incurs increased reinsurance costs and the borrower's loan balance increases significantly. The risks and costs associated with Consolidations that include underlying defaulted loans are high compared to Consolidations that do not involve defaults. The default rate for Consolidations that include previously defaulted loans is 4.5 times larger than the default rate for Consolidations without previously defaulted loans. The Department has the potential to reduce the risks and costs associated with FFEL program Consolidations that include defaulted loans by (1) strengthening the definition of "satisfactory repayment arrangements" for consolidating defaulted loans and (2) obtaining more data on the potential benefits of emphasizing loan rehabilitation over Consolidations as the method borrowers can use to reinstate defaulted loans.

We provided Department officials a draft of this report. They provided comments regarding the contents of the report, stating they did not plan to address Recommendation 1 at this time, and concurred with Recommendation 2. We modified the report where appropriate and added a recommendation to address their comments. We paraphrased their comments after the finding and have included their response in its entirety as an Attachment.

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*Our mission is to ensure equal access to education and to promote educational excellence throughout the Nation.*

**Finding --- Potential to Reduce Risks and Costs of Consolidating Defaulted Loans**

Even though we were unable to conclude whether the costs of consolidating defaulted loans were reasonable, the associated risks and costs are high. Additional costs to the Department can be as much as 50 percent of the initial reinsurance claim. The costs to the borrower include increased debt and related costs. Current regulations allow defaulted borrowers to qualify for a Consolidation by making three relatively low payments in a time span as short as 32 days. Defaulted borrowers often consolidate their loans as a way to get past an event that requires a better credit history. The Department can reduce the risks and costs associated with Consolidations that include defaulted loans by strengthening the satisfactory repayment arrangement requirements and obtaining more data on the potential benefits of emphasizing loan rehabilitation.

The Higher Education Act (HEA) of 1965, as amended, allows borrowers who default to consolidate their loans if the borrowers have either made satisfactory repayment arrangements or agreed to repay the Consolidation under an income-sensitive repayment plan. Title 34 of the Code of Federal Regulations (CFR) Part 682.200 defines satisfactory repayment arrangements as the borrower making three consecutive, on-time, voluntary, full monthly payments on a defaulted loan. On-time is defined as within 15 days of the due date. The full monthly payments may not be more than is reasonable and affordable based on the borrower's total financial circumstances.

Our extract of the National Student Loan Data System (NSLDS) identified about 1,044,000 Consolidations guaranteed from October 1, 1993, through September 30, 1998, with a disbursed amount of approximately \$17 billion. These Consolidations include about 311,000 with underlying defaulted loans. At the time of our analysis, about 71,000 of these Consolidations had defaulted. The cumulative default rate was 10 percent for Consolidations overall, 5 percent for Consolidations without previously defaulted loans, and 23 percent for Consolidations with previously defaulted loans. The default rate for Consolidations that include previously defaulted loans is 4.5 times larger than the default rate for Consolidations without previously defaulted loans. This indicates that refinancing defaulted borrowers' debt is a greater risk to the Department.

The Appendix illustrates that defaults of Consolidations that include underlying defaulted loans can be costly to both the Department and the borrower. In this hypothetical example, the borrower defaulted on two loans totaling \$10,000. Shortly after the default, the borrower included the defaulted loans in a Consolidation and defaulted nine months later. Next, the borrower included the defaulted Consolidation in a Federal Direct Consolidation Loan six months later. The Department's costs totaled \$14,291, about 50 percent more than the initial reinsurance claim of \$9,604. The borrower's debt also increased by over 60 percent from \$10,000 to \$16,140. This example demonstrates the full cycle of potential costs associated with consolidating defaulted student loans under the Consolidation Program. Individual Consolidation borrowers will be at various points within the cycle and all borrowers may not complete the full cycle.

The seven largest Consolidation guarantors guaranteed 77 percent of the Consolidations. We found that these guaranty agencies have recognized the financial risks related to consolidating defaulted loans and have taken steps to limit their risk. Six of the seven guaranty agencies will not accept a Consolidation with an underlying default unless they guaranteed and/or serviced one of the loans included in the Consolidation.<sup>1</sup> The other guaranty agency requires six payments if it did not guarantee any of the underlying loans. One guaranty agency strongly counsels borrowers to rehabilitate defaulted loans rather than consolidate them. This guaranty agency also does not pay a commission to its collection contractors for Consolidations. This practice provides an incentive for the collection agencies to pursue loan rehabilitation over Consolidation as a method to resolve defaulted loans. To qualify for loan rehabilitation, a borrower must make 12 consecutive, on time, reasonable and affordable monthly payments. This agency's default rate for loans rehabilitated during fiscal years 1995 through 1998 was 4 percent. Officials of this agency advised us that rehabilitation was better for the borrower because it removed the default from the borrower's credit history. After Consolidation, the credit history is only updated to show the default was resolved. They also stated that 12 consecutive payments provided a better indication of the borrower's ability to continue to make monthly payments. In addition, another three of the seven guaranty agencies also recommend loan rehabilitation over consolidation because it improves the likelihood of the borrower's success in repaying the loan and offers the borrower a more desirable credit rating.

The 17 largest Consolidation lenders disbursed 66 percent of the Consolidations. Our survey of four of these lenders found that two lenders stopped accepting Consolidation applications that include an underlying defaulted loan because the loans were more risky and costly. The other two lenders implemented requirements to limit their risk related to Consolidations with underlying defaults. These lenders require that the underlying defaulted loans be held by specific guaranty agencies. One of these lenders also requires that the payments be at least 1 percent of the outstanding balance including collection costs.

The largest Consolidation lender offers borrowers who have difficulty paying an alternative to consolidation. The alternative allows a graduated repayment option that minimizes the total loan costs in comparison to consolidation. It also provides interest rate reduction incentives for borrowers who meet repayment schedules.

We also noted that Student Financial Assistance's (SFA) Student Credit Management Collections (SCMC)<sup>2</sup> has implemented several controls over its collection contractors to increase the effectiveness of Consolidations as a collection tool by reducing the risk of subsequent defaults. SCMC requires three payments that are at least 1 percent of the amount consolidated or six payments that are equal to at least 0.5 percent. SCMC also established minimum and maximum time intervals between payments. If the contractor does not meet these requirements, SCMC will not pay the contractor a commission fee.

The difference between the default rates for Consolidations with and without underlying defaulted loans indicates that Consolidations that include previously defaulted loans are a greater

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<sup>1</sup> We did not evaluate whether agency practices to reduce the financial risk of Consolidations comply with the requirements of the HEA.

<sup>2</sup> SCMC was formerly known as Debt Collection Service.

risk to default. The current regulations allow a defaulted borrower to qualify for a Consolidation by making three relatively low payments in a time span as short as 32 days. Therefore, strengthening repayment requirements would seem appropriate.

Officials of three of the seven Consolidation guarantors and three of the four Consolidation lenders stated that borrowers generally consolidate defaulted loans as a way to clear their credit. These borrowers want to make a large purchase, regain Title IV eligibility to return to school, or get a professional certification. The borrowers can qualify for Consolidation by making three reasonable and affordable payments. In practice, guaranty agencies accept payments as little as \$50 dollars before requiring a borrower to submit financial data to justify a lower payment. This practice can cause the payments made under the satisfactory repayment arrangement to be significantly lower than the payments that are required after consolidation. Assuming an 8.25 percent interest rate and the maximum allowable repayment periods, \$10,000, \$20,000, and \$60,000 Consolidation balances would require monthly payments of \$97.01, \$170.41, and \$450.76, respectively under a standard repayment plan. (Several other repayment options are also available.) These payments range from 0.75 to 0.91 percent of the Consolidation amount. By consolidating, a borrower can resolve the default in slightly more than 30 days. Because it is a quick solution, it is common for the borrowers to default on the Consolidation once they get past their immediate problem.

We reviewed selected Consolidations as part of our data reliability testing and site visits to guaranty agencies and lenders. During this review, we noted that the satisfactory repayment arrangements for many of the borrowers who later defaulted on their Consolidations were often less than 1 percent of the debt consolidated and less than the payment amount required after consolidation. This indicates that the borrower did not establish adequate repayment discipline because the payments were not representative of the amount needed to service the debt after the consolidation. Also, about 24,000 of the 71,000 defaulted Consolidations with underlying defaults from our NSLDS extract defaulted within one year after they were guaranteed. The disbursed amount for these 24,000 Consolidations totaled \$200 million. These results confirm guaranty agency and lender officials' comments that borrowers consolidating defaulted loans frequently default shortly after getting the Consolidation.

An additional risk with the current regulations is that consolidating previously defaulted loans allows high risk borrowers to regain eligibility to obtain additional student loans. Our analysis of the 71,000 defaulted Consolidations that included previously defaulted loans showed that about 2,900 Consolidation borrowers obtained approximately \$19 million in additional loans (\$14 million) and grants (\$5 million) after the Consolidation. Also, about 4,700 of the defaulted Consolidation borrowers obtained Federal Direct Consolidation Loans totaling approximately \$80 million after the Consolidation.

While two-thirds of the borrowers who consolidated defaulted loans were in repayment or paid-in-full, the majority of the seven largest Consolidation guarantors stated that emphasizing loan rehabilitation is a better alternative. Loan rehabilitation requires borrowers to make 12 consecutive monthly payments. The majority of the seven largest Consolidation guarantors also indicated that increasing the number of required monthly payments to greater than three would establish better repayment discipline and reduce the likelihood of default for Consolidations that

include previously defaulted loans. The results of our limited review of payments made under the satisfactory repayment arrangements for Consolidations with underlying defaulted loans supports the need for stronger repayment requirements.

### **Recommendations**

The Department has the potential to reduce the risks and costs associated with FFEL program consolidations that include defaulted loans. To reduce the risks and costs, we recommend that

1. The Department consider regulatory changes to strengthen the definition of “satisfactory repayment arrangements” for the purpose of consolidating defaulted loans by
  - a. Increasing the number of payments from three to six or twelve, and
  - b. Requiring the payments to be at least 1 percent of the amount consolidated or an amount sufficient to avoid negative amortization, whichever is less.
2. Obtain more data on the potential benefits of emphasizing loan rehabilitation over Consolidations as the method borrowers can use to reinstate defaulted loans.
3. Determine whether the practices apparently used by Consolidation lenders to reduce the financial risk associated with Consolidations comply with the requirements of the HEA.

### **Department Comments and the Office of Inspector General Response**

Department officials provided several comments on the calculation of the potential costs related to consolidating defaulted loans presented in the Appendix. They also stated they were concerned that the Office of Inspector General (OIG) suggested that the Department adopt questionable methods used by a large Consolidation lender to prevent other lenders from buying this lender’s loans.

Regarding Recommendation 1, the Department officials stated they did not plan to consider regulatory changes at this time due to issues related to the negotiated rulemaking process. They were silent on whether they would consider the recommended changes later. The Department officials concurred with Recommendation 2.

**OIG Response** - We made several minor changes to the report to address the Department officials comments on the potential costs related to consolidating defaulted loans in the FFEL program. The report did not suggest that the Department adopt what may be questionable methods used by a large Consolidation lender. We described the practices we observed and did not determine if the practices were in compliance with the HEA. Therefore, we added a recommendation to address this comment.

While the Department officials do not intend to pursue the regulatory changes in Recommendation 1 at this time, we continue to think that it would be prudent to consider these changes. As we described in the report, program participants have recognized the risks related to

consolidating defaulted loans in the FFEL program and have taken steps to reduce the risks and related costs.

## **BACKGROUND**

The HEA amendments of 1986 authorized the current Consolidation Program under the FFEL program. The Consolidation Program encourages loans to borrowers for the purpose of consolidating repayment obligations with respect to several Federally subsidized and unsubsidized student loan programs. The HEA amendments of 1992 expanded the Consolidation Program, effective January 1, 1993, to include borrowers with defaulted loans who have made satisfactory repayment arrangements.

The U. S. Department of Education, Student Financial Assistance is responsible for administering the Consolidation Program. Program participants include 36 guaranty agencies and numerous Consolidation lenders. The guaranty agencies are the primary holders of defaulted loans that are repaid through Consolidations. The Department reinsures the FFELs and Consolidations guaranteed by the guaranty agencies.

## **AUDIT OBJECTIVE, SCOPE, AND METHODOLOGY**

The objective of our audit was to determine if consolidating defaulted loans in the Federal Consolidation Loan Program is achieving its intended purpose at a reasonable cost. We determined this by comparing the default rate of Consolidations that include previously defaulted loans to those that do not. We limited the scope of the audit to a computer extract from the NSLDS of Consolidations guaranteed from October 1, 1993, through September 30, 1998, under the FFEL program. We developed a plan that we used to obtain the universe of Consolidations from the NSLDS and identified those Consolidations that include previously defaulted loans. We calculated default rates for the entire Consolidation universe, for Consolidations without and with previously defaulted loans. We also calculated these three default rates for the 7 largest Consolidation guarantors and 17 largest Consolidation lenders. We analyzed the extracted universe data including sorts by guaranty agency, lender, and loan status codes and frequency distribution stratifications by dollar amount. We visited 3 of the 7 largest Consolidation guarantors and 3 of the 17 largest Consolidation lenders. During these visits, we verified the accuracy of selected Consolidation data and obtained an understanding of the policies and procedures used in originating and guaranteeing Consolidations. We also interviewed officials from SFA, NSLDS, the three guaranty agencies and three lenders visited. In lieu of site visits, we obtained and analyzed written input from the remaining four of the seven largest Consolidation guarantors and the second largest Consolidation lender, regarding their Consolidation statistics, policies, procedures, and experiences.

To achieve our audit objective, we relied extensively on data contained in the NSLDS. We assessed the reliability of the data by performing limited tests of the data, that included comparing extracted Consolidation and related loan data to the consolidating lenders' records, and by reviewing PricewaterhouseCoopers' report on the "National Student Loan Data System Data Quality Assessment," dated January 1999. We also assessed the reasonableness of the extracted data and tested the extract logic by comparing the data to the Federal Student Loan

Programs Data Book and guaranty agency and lender records. Based on these tests and assessments, we concluded the data were sufficiently reliable to be used in meeting the audit's objective.

We conducted our field work at SFA's offices in Washington, DC, at the New York State Higher Education Services Corporation in Albany, NY, the Pennsylvania Higher Education Assistance Agency in Harrisburg, PA, the United Student Aid Funds, Inc. in Fishers, IN, and the Student Loan Marketing Association in Wilkes Barre, PA from March 9, 1999, through August 19, 1999. We conducted additional analyses at our Chicago, IL and St. Paul, MN offices during January 1999 through February 2000. We conducted our work according to government auditing standards applicable to the scope of work described above.

#### **STATEMENT ON MANAGEMENT CONTROLS**

As part of our audit, we made an assessment of the U.S. Department of Education's management control structure, policies, procedures, and practices applicable to determining if consolidating defaulted loans in the Federal Consolidation Loan Program is achieving its intended purpose at a reasonable cost. We did not test these controls because they were not significant to our audit objectives. Our assessment was performed to determine the level of risk exposure (that is, the likelihood that significant noncompliance with the law and regulations occurred), and to determine the extent of testing needed to accomplish the audit objectives.

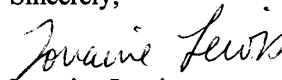
#### **ADMINISTRATIVE MATTERS**

Please provide the Supervisor, Post Audit Group, Office of the Chief Financial Officer and the Office of the Inspector General, with quarterly status reports on promised corrective actions until all such actions have been completed or continued follow-up is unnecessary.

In accordance with the Freedom of Information Act (Public Law 90-23), reports issued by the Office of Inspector General are available, if requested, to members of the press and general public to the extent information contained therein is not subject to the exemptions of the Act. Copies of this audit report have been provided to the offices shown on the distribution list enclosed in the report.

We appreciate the cooperation given us in this review. If you have any questions concerning this report, please contact Gerald Michalski, Acting Regional Inspector General for Audit, at 312-886-6503. Please refer to the control number in all correspondence related to the report.

Sincerely,



Lorraine Lewis

Attachments



UNITED STATES DEPARTMENT OF EDUCATION

WASHINGTON, D.C. 20202- \_\_\_\_\_

SEP 7 2000

Mr. Kenneth R. Luhring  
Acting Regional Inspector General for Audit  
Office of Inspector General  
111 N. Canal Street, Suite 940  
Chicago, IL 60606-7204

Dear Mr. Luhring:

Thank you for the opportunity to review and comment on the Office of Inspector General (OIG) draft report that informs Student Financial Assistance (SFA) and the Office of Postsecondary Education (OPE) of the potential to reduce the risks and costs of consolidating defaulted loans in the Federal Consolidation Loan Program within the Federal Family Education Loan programs (Control Number ED-OIG/A05-90024), dated August 9, 2000.

We are pleased with your finding that consolidations that include underlying defaulted loans have generally been successful. Further, we appreciate your recognition that SFA's Collections area has implemented several controls over its collection contractors to increase the effectiveness of consolidating loans as a collection tool.

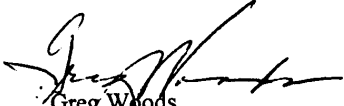
There are many benefits to consolidations that include defaulted loans. In some situations, the act of consolidating loans leads to significant improvement in borrower behavior. There are also situations in which it is more advantageous to borrowers, and to taxpayers, to rehabilitate defaulted loans. Thus, it is important to have a number of tool-choices available for borrowers in different circumstances. For this reason, while we understand the OIG's assertion that the Department can reduce the risks and costs associated with consolidations that include defaulted loans, we are concerned that cost considerations alone may be used to determine what changes should be made. We do agree that it would be useful to obtain more data on the potential benefits of emphasizing loan rehabilitation. Please see the enclosed Appendix for detailed comments on the report and recommendations.




Page 2—Mr. Kenneth R. Luhring

Again, we appreciate the opportunity to review and comment on the draft report.

Sincerely,



Greg Woods  
Chief Operating Officer  
Student Financial Assistance



Dr. Lee Fritschler  
Assistant Secretary  
Office of Postsecondary Education

Appendix

cc: Lorraine P. Lewis  
Patrick Howard  
Jeanne VanVlandren  
Jim Lynch  
Maureen McLaughlin

## APPENDIX

### **Finding -- *Potential to Reduce Risks and Costs of Consolidating Defaulted Loans***

We understand the Department's Office of General Counsel (OGC) has provided comments on some of the calculations and information contained in the draft audit report. We concur with OGC's comments and request that the OIG make the corrections noted, prior to issuing the final audit. For example, the OIG should make corrections in its calculation of the costs associated with a defaulted loan (see the Appendix to the report). First, the OIG uses an incorrect reinsurance rate (98% instead of 95%). Secondly, the OIG assumes that the collection cost for a loan is based on rate of 18.5% of the principal and interest owed and that it applies to all loans. In fact, the assessment is equal to the agency's actual collection costs, which cannot exceed 18.5%. Thirdly, the OIG incorrectly includes a calculation of the Secretary's equitable share on the consolidation amount. Finally, the OIG adds the collection costs to the balance of the loan to be consolidated. This should not be considered a "cost" to the Department because the borrower eventually pays these costs.

In addition, we are concerned that the OIG has suggested that ED adopt some questionable methods used by a large Consolidation lender to prevent other lenders, including the Department in the case of Direct Loan, from buying this lender's loans. It is important to remember that this approach helps the lender avoid paying the consolidation offset fee because these loans skirt the definition of what a consolidation loan is. We do not believe that either factor is particularly relevant to the Department's practices with regard to the consolidation of defaulted loans.

We are also concerned that you have suggested that the Department should treat the consolidation of defaulted loans more like the banking industry treats restructuring of distressed loans. When restructuring a distressed loan, lenders generally require sufficient financial information and repayment projections to support a sound credit decision. Sound credit practices in dealing with defaulted loans probably would minimize the risk of defaults and the related costs for both the borrower and the Department. However, such an approach would result in a more personalized counseling approach and would greatly expand the Federal government's role in the student loan programs. In most cases the Higher Education Act and the structure and intent of the Federal loan programs, moreover, do not authorize the Department or FFELP lenders to base the determination of whether to permit a borrower to receive a loan on a "sound credit decision."

As we indicated in the exit conference, we think it is important to place the regulatory requirement of three payments in context. At the time the regulations were promulgated in 1994, requiring more than three payments would have placed borrowers into a Catch-22 with the statutory provisions then in effect.

Recommendation 1: *The Department consider regulatory changes to strengthen the definition of "satisfactory repayment arrangements" for the purpose of consolidating defaulted loans by (a) Increasing the number of payments from three to six or twelve, and (b) Requiring the payments to be at least one percent of the amount consolidated or an amount sufficient to avoid negative amortization, whichever is less.*

In the report, you indicated you were unable to conclude whether the costs of consolidating defaulted loans were reasonable. If you have data that shows the benefits either of increasing the number of payments from three to six or twelve or of requiring that payments be at least one percent of the amount consolidated, we would like to review it.

The Department has not yet decided whether to conduct negotiated rulemaking prior to next year. If we do, we must first negotiate the list of issues. It is unlikely that we would be able to achieve agreement to include these items on the list of issues to negotiate. The list of items to negotiate this year will likely be a short list of critical issues given that we will need to make more significant changes to our regulations early next year when Congress enacts technical amendments to the HEA. Thus, we do not plan to consider these regulatory changes at this time.

Recommendation 2: *Obtain more data on the potential benefits of emphasizing loan rehabilitation over Consolidations as the method borrowers can use to reinstate defaulted loans.*

Although we believe consolidation of defaulted borrowers is a good concept from a policy standpoint, we concur that additional analysis of rehabilitation of student loans would be useful as we begin to plan for the next reauthorization of the Higher Education Act. We would like to discuss such analysis further with the OIG .

## APPENDIX

### Calculation of Costs for Hypothetical Consolidation Example

<u>Description</u>	<u>Capitalized Loan Balance</u>	<u>Potential Costs to the Department</u>	<u>Calculation of Amount to the Left</u>
Default:	\$10,000	\$9,604	(((\$10,000 x 98%) x 98% <sup>1</sup> )
Interest Accrual	<u>395</u>		
Consolidation: (\$10,000 + \$395) 18.5% Collection Costs Assessed	10,395 <u>1,923</u>		(\$10,395 x 18.5% <sup>2</sup> )
Consolidation Amount (\$10,395 + \$1,923)	12,318		
Secretary's Equitable Share		-10,395	(\$12,318 - \$1,923 (GA Retention)
Interest Accrual (9 months)	<u>762</u>		((((\$12,318 x 8.25% <sup>3</sup> ) / 12) x 9)
Consolidation Default: (\$12,318 + \$762)	13,080	12,562	(((\$13,080 X 98%) X 98% <sup>1</sup> )
Interest Accrual (6 months)	<u>540</u>		((((\$13,080 x 8.25% <sup>3</sup> ) / 12) x 6)
FDSLPL Consolidation: (\$13,080 + \$540) 18.5% Collection Costs Assessed / GA Retention	13,620 <u>2,520</u>	<u>2,520</u>	(\$13,620 x 18.5% <sup>2</sup> )
<b>Total</b>	<b>\$16,140</b>	<b>\$14,291</b>	

**Footnotes:**

- 1 - The Department reinsures guaranty agencies losses due to defaults at a maximum of 100, 98, or 95 percent depending on the date the loan was disbursed. We used 98 percent in this example because it was applicable during the audit period and continues to be applicable to loans disbursed during October 1, 1993 through September 30, 1998.
- 2 - Title 34 CFR Part 682.401(b)(27)(i) allows guaranty agencies to add collection costs not to exceed 18.5 percent. Collection costs represent additional costs to the Department if the borrower does not repay the Consolidation loan after default.
- 3 - The interest rate on a new consolidation is the weighted average of the loans consolidated rounded up to the nearest 1/8th percent with a cap of 8.25 percent.

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