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ABSTRACT

An assessment of the cost-effectiveness of an initiative to target 823,278 defaulted student loans in the Debt Collection Service (DCS) for consolidation into the Direct Loan Program concluded that it was not cost-effective. The study found that the Department of Education's cost to consolidate about 80,000 DCS borrowers into the program would be about $38 million due in large part to collection agency fees and service fees. Although the majority of the cost would be added to the borrower's principal loan balance, Income Contingent Repayment (ICR) collections would probably still not be sufficient to cover the cost of consolidation. In addition, while the borrower's loan was in the Direct Loan program the Department would lose revenue from involuntary collections. Based on the fact that DCS borrowers have a poor payment history, there is a strong possibility that these borrowers would default again or be allowed to make zero or minimal payments. DCS currently can accept payments based on the borrower's ability to pay and analysis of current collections indicates that the Department's expectations for the Direct Loans ICR plan may be overly optimistic. Also, DCS will soon have an ICR plan. The document includes information on the audit and its methodology, and Department of Education comments. (JB)

AUDIT REPORT

OFFICE OF INSPECTOR GENERAL

Cost Analysis of the Department's Initiative to Consolidate Debt Collection Service Loans Into the Direct Loan Program

ACN 11-50002

January 1996

OFFICE OF IMPROVEMENT SERVICES, CAPITAL AREA
WASHINGTON, D.C.

UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF INSPECTOR GENERAL

JAN 19 1996

MEMORANDUM

TO: Leo Kornfeld
Senior Advisor to the Secretary
for Direct Lending

FROM: Chelton T. Givens
Manager
Capital Area

SUBJECT: Audit Report Entitled, "**Cost Analysis of the Department's Initiative to Consolidate Debt Collection Service Loans Into the Direct Loan Program**" (ACN 11-50002)

Attached is our subject audit report that covers the results of our review of the Department's initiative to consolidate Debt Collection Service (DCS) loans into the Direct Loan Program. We received your comments concurring with the recommendations in our draft audit report and included them in their entirety in Appendix A to this report.

Please provide the Accounting and Financial Management Service/Audit Follow-up Branch and the Office of Inspector General (OIG)/General Operations Staff with semiannual 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 OIG are available, if requested, to members of the press and the general public to the extent information contained therein is not subject to exemptions in 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 shown us by your staff during the review. Should you have any questions concerning this report, please call me on (202) 245-4010.

Attachment

400 MARYLAND AVE., S.W. WASHINGTON, D.C. 20202

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Executive Summary

We have assessed the cost-effectiveness of the Department of Education's (Department) initiative to target 823,278 defaulted Debt Collection Service (DCS) borrowers' loans for consolidation into the Federal Direct Consolidation Loan (Direct Consolidation Loan) Program and concluded that it is not cost-effective to do so for the following reasons:

- The Department's cost to consolidate approximately 80,000 DCS borrowers into the Direct Consolidation Loan Program will be approximately $38 million. This is due in large part to collection agency fees and servicer fees. Although the majority of the cost will be added to the borrower's principal loan balance, we do not expect Income Contingent Repayment (ICR) collections to be sufficient to cover the cost of consolidation.

- While the borrower's loan is in the Direct Consolidation Loan Program, the Department will lose revenue from involuntary collections. Federal offset, the most effective collection method, resulted in revenues of approximately $548 million in FY 1995, of which $99 million were from the borrowers targeted in this initiative.

- Based on the fact that DCS borrowers have a poor payment history, there is a strong possibility that these borrowers will default again or be allowed to make zero to minimal payments. The demographics of the targeted borrowers indicate that they had been in default for approximately 8.4 years and had their loans held by DCS for approximately 3.7 years. Only 16 percent of these borrowers have made any payments while their debt has been held by DCS; only 8 percent have made a payment in the last year. These borrowers, moreover, were certified for Federal offset because they had not made a voluntary payment within 90 days preceding the certification.

- DCS currently has the option of accepting payments based on the borrower's ability to pay. Analysis of current collections indicates that the Department's expectations for the Direct Consolidation Loan's ICR plan may be overly optimistic. In addition, an ICR plan will soon be available in DCS.

Conclusion

We conclude, based on current information, that this initiative is not cost-effective. Based on the Department's expectations of ICR, they believe this initiative may be cost-effective. To limit the financial risk to the Department, we recommend that the Department discontinue the active pursuit of consolidating DCS loans until a study is conducted to determine the economic viability of this initiative.

The Department provided comments on a draft of this report, which are reprinted in Appendix A. Although it is not in total agreement with the audit results, it agreed with our recommendations and plans to implement them.

Background

On August 10, 1993, the Student Loan Reform Act of 1993, part of the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) amended the Higher Education Act (HEA) to authorize the Federal Direct Student Loan (Direct Loan) Program. Included in the authorization of the Direct Loan Program was an amendment to Section 428C, paragraph 5, of the HEA to allow the Department of Education (Department) to establish a Federal Direct Consolidation Loan (Direct Consolidation Loan) Program.

In FY 1995, the Department decided to offer Direct Loan Consolidations to its Debt Collection Service (DCS) defaulted borrowers and have them repay through the Income Contingent Repayment (ICR) plan. Under the ICR option, the borrower's monthly payment is based on annual income, family size, and loan amount. The borrower must sign a waiver which allows the Department to obtain his Adjusted Gross Income (AGI) from the Internal Revenue Service (IRS). Any remaining loan balance will be forgiven after 25 years, excluding periods of forbearance and deferment.

The Department believes that this initiative will assist it in meeting the goals of reducing default costs, increasing collections on defaults, and providing defaulted borrowers the opportunity to make affordable payments. Further, the Department believed that the consolidation of DCS loans would aid in achieving the President's FY 1996 budget of 191,000 consolidations in FY 1995[1].

As of September 1, 1995, DCS offered 823,278 borrowers the opportunity to voluntarily repay their loans by consolidating them. Borrowers who refused would continue to face involuntary collection methods. The involuntary collection methods include Federal offset (formerly called IRS offset), wage garnishment, and litigation.

The DCS borrowers offered consolidation represent approximately 30 percent of the DCS portfolio. The following criteria were used to select the borrowers:

- have debts only with DCS;
- owe at least $500;
- have no judgements; and
- have been certified for Federal offset.

1 During FY 1995, the first year of the Direct Consolidation Loan Program, the Department consolidated 23,452 loans.

DCS's first mailing to these defaulted borrowers was on May 31, 1995. As of September 29, 1995, 148,000 borrowers had requested additional information. Of those, approximately 79,945 were mailed a Direct Consolidation Loan Packet. Due to technical difficulties only 440 borrowers' loans in this initiative were consolidated in FY 1995.

To consolidate DCS loans, the Department will make new Direct Consolidation Loans for the borrowers to "pay off" the old defaulted student loans. These consolidations result in the creation of new Federal debts to satisfy old Federal debts. Unlike defaulted borrowers who do not consolidate, the borrowers with new Direct Consolidation Loans will be eligible for additional student financial aid. The new consolidated loans include the principal plus accrued interest, other fees, and a collection agency fee, where applicable.

Audit Results

Consolidation of DCS Loans Not Cost-Effective

In our opinion, it is not cost-effe‹ ve to consolidate the targeted loans held by DCS for the following reasons:

- the cost to consolidate 79,945 borrowers' loans will be approximately $38 million;
- the Department will lose revenue from effective collection methods which amounted to $99 million collected in FY 1995;
- there is a strong possibility that the borrowers will default or be allowed to make zero to minimal payments on the new Direct Consolidation Loans; and
- similar income based payment options, available in the Direct Consolidation Loan Program, are currently available in DCS.

Consolidation Costs

Our analysis was based on the 79,945 consolidation applications mailed to the DCS borrowers as of September 29, 1995. The cost to consolidate will be approximately $38 million[2]. To recoup this cost over the maximum allowable period for ICR, 25 years, the Department would have to increase its current collection rate[3] by 1,100 percent each year.

Consolidation Fee

Upon consolidation, the Department will pay to the collection agencies a commission fee of 18.5 percent or 10 percent depending on the timing and number of payments made prior to consolidation. These commission fees are not based on the borrower's cash payments but will be paid by the Direct Loan Program through the creation of new debt. If the 79,945 loans are consolidated, the

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2 This amounts to approximately $471 per borrower.

3 The collection rate is the yearly voluntary collections of $18 million divided by the total loan portfolio of $3 billion which equals .59 percent. The collection rate of the targeted borrowers is significantly lower than DCS' collection rate for the entire portfolio.

collection agencies will be paid approximately $31.4 million. (See Table.)

Approximately 99 percent of the borrowers will be assessed an 18.5 percent fee regardless of the fee paid to the collection agency. The remaining 1 percent of the borrowers with loans at DCS's regional collection centers will not be assessed this fee. This fee, along with accrued interest and other applicable fees[4], will be capitalized and added to the borrower's principal loan balance.

In addition, the Department's Direct Loan contractor will be paid a fee of approximately $78 per consolidation. This amount will not be charged to the borrower. The Direct Loan Program will pay approximately $6.2 million to the Direct Loan contractor to consolidate 79,945 loans. (See Table.)

Cost to Consolidate 79,945 DCS Loans

Estimated Number of Loans[5] (1)	Collection Agency Commission Rate (2)	Average Loan Balance (3)	Collection Agency Commission [(2x3)x1] (4)	Direct Loan Contractor Fee ($78x(1)) (5)	Grand Total (4+5) (6)
799	0%	3,774	$0	$62,322	$62,322
4,749	18.50%	3,774	$3,315,704	$370,422	$3,686,126
74,397	10%	3,774	$28,077,428	$5,802,966	$33,880,394
79,945		3,774	$31,393,132	$6,235,710	$37,628,842

Other Consolidation Costs In order to perform this initiative, the Department will incur over $500,000 for: 1) mailing letters to solicit consolidation ($281,000)

4 These fees include Federal offset fees, litigation costs, etc.

5 The number of loans is split using the following procedures. The 799 loans represent an estimated 1 percent of total loans. This 1 percent is based on the number of borrowers that had their loans held by DCS's regional collection centers at September 1, 1995. The remaining loans are split 6 percent (4,749) and 94 percent (74,397) based on the statistics from all targeted borrowers that have made recent payments.

and 2) providing computer hardware, software, and personnel to the IRS to process the ICR certifications (approximately $253,000).

The Department started the DCS consolidation initiative without having the capability to allow for the expedited consolidation of DCS loans. This lack of preparedness contributed to inefficiencies and additional unquantifiable costs of consolidation. Over a two month delay occurred in sending consolidation applications to the first borrowers who responded to the Department's offer. Implementation problems included system development issues which resulted in a backlog of 20,000 loans. Moreover, due to ongoing technical difficulties in processing the IRS tape, which contains the borrowers' AGI, ICR was not implemented in FY 1995.

Recouping the Costs

DCS reports voluntary collections averaging $18 million per year, which results in an annual collection rate of .59 percent for the targeted borrowers. Over the maximum allowable period for ICR, 25 years, we estimate the Department would have to increase its collection rate by 1,100 percent each year to recoup the cost of this consolidation.

The Department believes that borrowers who are eligible for an earned income credit are most likely to benefit from ICR consolidation, since they are not currently earning enough to make substantial payments. Due to the borrowers' limited payments, it may not be cost-effective to consolidate these borrowers' loans. It would be more cost-effective to leave them in DCS since ICR will soon be available.

Loss of Effective Collection Methods

If DCS borrowers consolidate their loans into the Direct Consolidation Loan Program, current collection methods, such as Federal offset and wage garnishment, would not be used, provided the borrower remains in satisfactory repayment status. However, under ICR, borrowers in satisfactory repayment status may be allowed to make zero to minimal payments.

Federal Offset

In a Federal offset the borrowers have their tax refund involuntarily applied to their outstanding loan balance. The borrowers in this initiative were certified for Federal offset because they had not made a voluntary payment within 90 days preceding the certification. In FY 1995, Federal offsets were approximately $548 million, of which $99 million were from 118,483 borrowers targeted in this initiative.

The effectiveness of Federal offset can be shown by comparing it to voluntary payments. During the 3.7 years these loans were held by DCS, a reported $69 million of voluntary payments were collected from the targeted borrowers, averaging $18.6 million per year.

The importance of the Federal offset was also highlighted in a 1987 Chemical Bank analysis of the marketability of DCS loans. They concluded that the portfolio of loans was not marketable to private industry because of the uncertainty of collection. Chemical Bank determined that the main value of these loans was the Federal offset collection option, which is only available within the Department.

The Department believes that it should not offset defaulted borrowers who are eligible for an earned income credit. This initiative, however, does not address all borrowers subjected to this practice. If the Department does not want to offset defaulters who are eligible for the earned income credit, they should address this issue outside of this initiative.

Wage Garnishment

Wage garnishment, another successful involuntary collection tool, resulted in collections of over $2 million since its inception in FY 1993. Over $1.5 million was collected from 2,633 borrowers during FY 1995. Currently, one of the goals contained in the Department's strategic plan is to perform 10,000 wage garnishments per month. If DCS achieves its wage garnishment goal, approximately $68 million per year could be collected.

Possibility of Default on New Direct Consolidated Loans

Based on the fact that DCS borrowers have a poor payment history, there is a strong possibility that these borrowers will default again.

Demographics

The demographics of the 823,278 borrowers offered Direct Loan Consolidations indicate that the borrowers' loans:

- have been in default for 8.4 years; and
- have been held by DCS for 3.7 years.

Only 16 percent of these borrowers have made any payments while their debt has been held by DCS; only 8 percent have made a payment in the last year.

The majority of these borrowers are not repaying their loans despite having the option of making affordable payments. The Department has given the borrowers the option of consolidating or facing further involuntary payment methods. Acceptance of the consolidation offer, which requires no payments, will immediately restore eligibility for additional loans and will postpone involuntary collections. It is difficult to assess if the borrowers intend to repay the loans without requiring them to make payments before consolidation.

Income Based Payment Options Available in DCS

DCS currently has the option of accepting payments based on the borrower's ability to pay. Analysis of current collections indicates that the Department's expectations for the Direct Consolidation Loan's ICR plan may be overly optimistic.

Income Based Payments

The HEA states that the Secretary shall not demand from a defaulted borrower a monthly payment amount that is greater than what is reasonable and affordable based upon the borrower's total financial circumstances. Currently, DCS accommodates these borrowers by encouraging them to make negotiated reasonable and affordable payments. DCS believes that ICR offers a verifiable way to determine reasonable and affordable payments based on income.

DCS has the ability to use, and to require its collection agencies to use, various collection methods. These methods include ICR, income sensitive, and economic hardship payment plans. Further, the HEA permits the Department to offer a borrower forbearance which permits the temporary cessation of payments, an extension of time for making payments, or accepting smaller payments than were previously scheduled.

The Department believes that ICR, an income based payment plan, will increase revenues from low income defaulted borrowers. However, as stated previously, DCS has received limited voluntary payments despite the availability of various income based payment plans.

Summary

To consolidate 79,945 DCS loans the Department will incur costs of approximately $38 million and will lose revenues from effective collection methods. There is also a high probability of default on the new loans. In addition, income based payment options are available in DCS; ICR will soon be implemented in DCS. This initiative simply transfers DCS debt to the Direct Loan Program with no assurance of increased collections.

Recommendations

We recommend that the Senior Advisor to the Secretary for Direct Lending take the following actions:

1. Discontinue active pursuit of consolidating DCS loans into the Direct Consolidation Loan Program.

2. Conduct a study of the DCS loans that have been consolidated to determine 1) if the loan payments collected justify the costs of consolidation, and 2) the percentage of borrowers that are defaulting.

3. Use the study to determine if the Department should change its regulations to require defaulted borrowers who request consolidation to make three consecutive affordable monthly payments prior to consolidation.

4. Continue to use DCS collection methods. If the Department perceives the use of the Federal offset to be inequitable, the issue should be addressed in DCS.

Evaluation of the Department's Comments

The Department provided comments on a draft of this report, which are reprinted in Appendix A. Although it is not in total agreement with the audit results, it agreed with our recommendations and plans to implement them.

One of the disagreements involved the definition of the "cost of consolidation." The Department's analysis reflects a definition of "cost of consolidation" inconsistent with the components of cost considered in our analysis. The Department does not take into consideration loss of revenues from DCS and interest accruing on the consolidated loans. These factors must be taken into account to determine the cost-effectiveness of this initiative.

Another issue involved the Department's agreement to stop active pursuit of DCS consolidation. However, its detailed analysis indicates that DCS plans to continue to market DCS consolidation. Any marketing is considered active pursuit. Further, active pursuit refers not only to DCS but to all DCS collection agents.

Although the Department agreed to implement our recommendations, it still believes that this initiative is advantageous and low risk. Current evidence does not support this. A substantial increase in voluntary collections, which is currently less than 1 percent per year, is necessary to recoup the consolidation costs. Any future benefits will only be determined by long term studies.

Objectives, Scope and Methodology

Audit Objective

The objective of our review was to evaluate the cost-effectiveness of consolidating defaulted DCS loans into the Direct Consolidation Loan Program.

Audit Scope

Our audit scope was limited to 823,278 (30 percent of the portfolio) defaulted loans currently being serviced by the Department's Debt Collection Service. Our review was conducted from July 1995 through September 1995. The audit was conducted in accordance with generally accepted government auditing standards.

Methodology

To accomplish our audit objectives, we reviewed audit working papers prepared by the Department's Office of Inspector General, Region V Office, during their Debt Collection Service Performance Audit. We interviewed personnel of the Office of Postsecondary Education, the Direct Loan Task Force, DCS, and Budget Services. We reviewed departmental regulations, policy and procedures manuals, accounting records, and other related documents and reports. We analyzed DCS data relating to the targeted borrowers and developed consolidation cost estimates.

Report on Management Controls

Since the scope of this audit was limited to determining the cost-effectiveness of transferring defaulted DCS loans to the Direct Consolidation Loan Program, we did not consider the effectiveness of management controls. As such, we did not perform a review of management controls and therefore do not render an opinion as to their effectiveness.

Appendix A - Department's Comments

UNITED STATES DEPARTMENT OF EDUCATION

WASHINGTON, D.C. 20202

December 8, 1995

TO: Chelton T. Givens
Manager, Capital Area
Office of Inspector General

FROM: Leo Kornfeld
Senior Advisor to the Secretary Leo
for Direct Lending

SUBJECT: Draft Audit Report Entitled: "Cost Analysis of the Department's Initiative to Consolidate Debt Collection Service Loans into the Direct Loan Program" (ACN 11-50002)

In response to the subject audit report I had a conversation with Steve McNamara. I advised Steve that it is my view that we should:

1. Discontinue active pursuit of additional Debt Collection Service Loans (DCS), only consolidating DCS loans into the Direct Loan Program where borrowers have responded to our initial consolidation offer.

2. Conduct a study of the DCS loans that are consolidated to determine if loan payments collected justify the costs of consolidation and the percentage of consolidated borrowers that are defaulting.

3. Use the study to determine if the Department should change its regulations to require defaulted borrowers who request consolidation, to make three consecutive affordable monthly payments prior to consolidation.

4. Continue using DCS collection methods, including offering income contingent repayment plans within DCS's Debt Management and Collection System.

Therefore, although we are not in total agreement with your draft audit results, we are in agreement with the recommendations in your draft audit.

Please see the attached analysis of the audit results prepared by DCS staff. We believe this analysis clearly shows that efforts to offer Direct Loan Consolidation to defaulters has considerable advantages for the borrowers and the taxpayers, as well as very low risk.

cc: S. McNamara
T. Pestka

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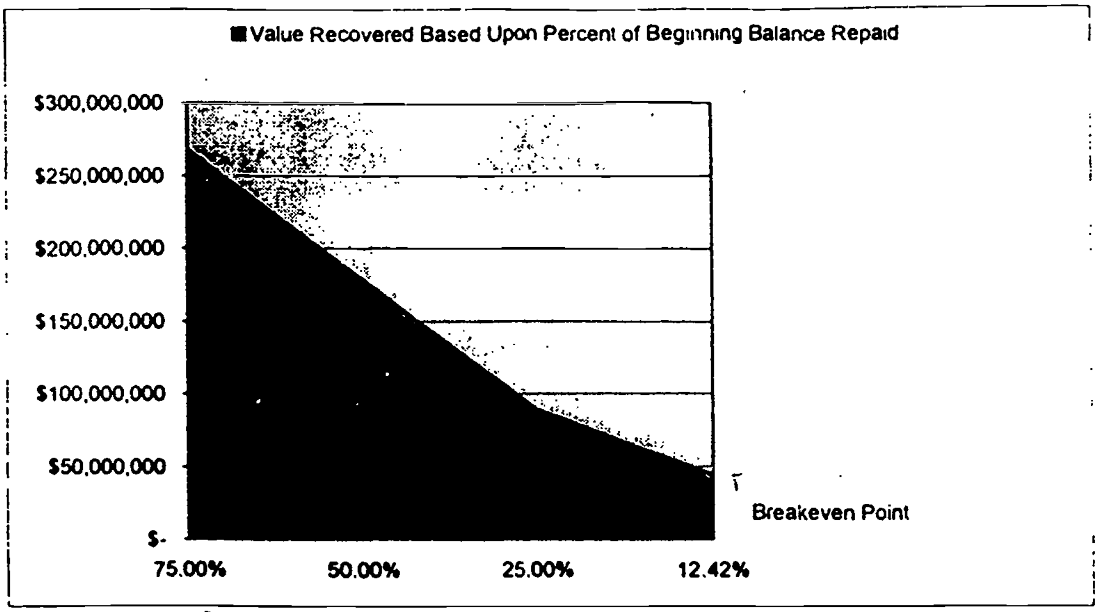
Appendix A

ANALYSIS--DRAFT AUDIT REPORT
(ACN: 11-50002)
CONSOLIDATION OF DCS LOANS

OIG	DCS
CONSOLIDATION OF DCS LOANS NOT COST-EFFECTIVE, COSTS WILL BE $38 MILLION	CONSOLIDATIONS COST $471 EACH ON AVERAGE, MOST OF WHICH IS CHARGED TO THE BORROWERS. THE ATTACHED BREAKEVEN ANALYSIS SHOWS THAT AT LEAST 12% OF CONSOLIDATING BORROWERS MUST REPAY FOR ED TO BREAK EVEN.
FEDERAL OFFSETS FOR TARGETED BORROWERS RESULTED IN $99 MILLION COLLECTED IN 1995.	DCS ANALYSIS SHOWS THAT INDIVIDUAL BORROWERS ARE OFFSET THE SECOND YEAR AT A RATE LOWER THAN 33% OF THE FIRST YEAR AND AT A RATE IN THE THIRD YEAR AT ABOUT 10% OF THE FIRST YEAR.
WAGE GARNISHMENTS RESULTED IN $1.5 MILLION IN FY 1995 AND ARE EXPECTED TO GROW	WAGE GARNISHMENTS WILL GROW SUBSTANTIALLY. DCS MUST GET 300,000 BORROWERS IN ICR TO MEET THE HEA REQUIREMENT. THAT LEAVES 2.7 MILLION BORROWERS SUBJECT TO THE FULL RANGE OF DCS COLLECTION EFFORTS. DCS WILL CONTINUE TO PURSUE ALL ITS COLLECTION OPTIONS.
LOSS OF EFFECTIVE COLLECTION METHODS	"LOSS" OVERSTATES REALITY. THE WORST-CASE SCENARIO, IF BORROWERS RE-DEFAULT, MEANS COLLECTION METHODS ARE MERELY DELAYED.
POSSIBILITY OF DEFAULT ON THE NEW DIRECT CONSOLIDATED LOANS	DEFAULTS WILL OCCUR. IF THEY OCCUR AT LESS THAN THE 88% LEVEL, ED BREAKS EVEN. IF THEY OCCUR AT THE 50% LEVEL, ED MAKES A TON OF MONEY.
INCOME BASED PAYMENT OPTIONS AVAILABLE IN DCS	THE HEA REQUIRES ED TO PLACE AT LEAST 10% OF DEFAULTS IN ICR. SINCE ED IS NOT ABLE TO COMPEL BORROWERS TO SIGN THE WAIVER TO PERMIT IT TO OBTAIN AGI, DCS IS MARKETING BOTH ICR CONSOLIDATION AND ICR WITHIN DCS WITH THE GOAL OF ACHIEVING OR EXCEEDING THE REQUIRED 10%.
TRANSFERS DCS DEBT TO THE DIRECT LOAN PROGRAM	THE DEBT TRANSFER IS NOT A PROBLEM. THE BUDGET SERVICE TELLS US THAT THERE ARE BUDGET ADVANTAGES TO FDSLP CONSOLIDATION AS OPPOSED TO FFEL CONSOLIDATION. FURTHERMORE, BORROWERS WHO CONSOLIDATE MUST WAIT THE REQUISITE SEVEN YEARS BEFORE THEIR LOANS CAN BE DISCHARGED IN BANKRUPTCY.

Appendix A

Analysis of OIG Audit - Direct Loan Consolidation of DCS Loans



Analysis Elements:		
a. DCS Loans Consolidated		79,945
Average Balance	$	3,774
Aggregate Value	$	301,712,430
b. Collection Agency Fees	$	37,628,842
c. Servicing Cost ($78 Per Loan)	$	6,235,710
d. IRS Fee	$	253,000
e. Mailing Cost	$	281,000
Total Cost As Projected By OIG	**$**	**44,398,552**

Breakeven Analysis:	
a. Projected Beginning Balance on Consolidated Loans Plus 18.5% Cost	$357,529,230
b. Value if 75% of Balance is Repaid	$268,146,922
c. Value if 50% of Balance is Repaid	$178,764,615
d Value if 25% of Balance is Repaid	$ 89,382,307
e. Value if 12.4% of Balance is Repaid	$ 44,398,552

(NOTE: Interest accrued after consolidation is not included in this presentation)

OIGRESP.XLS 11/15/95

Contributors to this Report

Audit Team Under the leadership of Area Managers Chelton T. Givens and Charles J. Brennan, the audit team was comprised of the following members:

G. John Rabil, Supervisory Auditor
Russell Young, Auditor
Chris Dyson, Auditor

Others The audit team would also like to acknowledge the contributions of the following OIG staff members:

Patrick Howard, Acting Branch Chief
Judith Morrill, Program Analyst
Ken Dion, Auditor
Gary Whitman, Auditor

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