Testimony of Kathleen S. Tighe, Inspector General

U.S. Department of Education

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Chairwoman Foxx, Ranking Member Hinojosa, and members of the Subcommittee, thank you for inviting me here today to discuss the U.S. Department of Education (Department) Office of Inspector General's (OIG) work involving the Department's Debt Management Collection System 2 (DMCS2). I appreciate the opportunity to share with you information on this issue and our efforts to ensure integrity and efficiency in the Federal student aid programs and operations.

As members of this Subcommittee know, the Federal student aid programs have long been a major focus of our audit, inspection, and investigative work, as they have been considered highly susceptible to fraud and abuse. The programs are large, complex, and inherently risky due to their reliance on numerous entities, the nature of the student population, and the amount of funding involved. Through its Federal Student Aid office (FSA), the Department disburses approximately $140 billion in student aid annually and manages an outstanding loan portfolio of $1 trillion. This makes it one of the largest financial institutions in the country. As such, effective oversight and monitoring of its operations are critical. As I will discuss today, OIG has identified issues relating to the lack of effective oversight and monitoring of FSA's student loan debt management system and the impact that has had on its operations.

Background on the Debt Management Collection System 2

FSA utilizes a debt management collection system to manage defaulted student loans. The system facilitates the storage, retrieval, and editing of debtor information and uses the information to help collect defaulted loans. When loans being serviced by FSA's loan servicers reach 360 days of non-payment, they are transferred to FSA's debt management collection system. Once a loan is in the debt management collection system, FSA notifies the borrower that the loan is in default and asks the borrower to make repayment arrangements. If there is no response from the borrower or if the borrower refuses to pay, FSA then assigns the loan to one of a number of collection agencies. FSA's debt management collection system also supports its contracts with these collection agencies.

On November 20, 2003, FSA entered into a contract with ACS Education Solutions, LLC, a company later purchased by Xerox in 2010 (ACS/Xerox), to service direct loans. The contract also included a requirement that it operate FSA's debt management system (the original Debt Management Collection System, or DMCS). In June 2010, ACS/Xerox agreed to update DMCS to DMCS2 to include specific baseline functional system requirements, which were specified in a contract modification. FSA originally planned to implement DMCS2 in October 2010 and FSA documentation stated it would do so no later than January 1, 2011. That timeframe was significantly delayed. ACS/Xerox did not test the transfer of defaulted loans to DMCS2 until January 2011 and FSA did not ensure that ACS/Xerox tested DMCS2 through the full life cycle of a defaulted loan. In September 2011, FSA began migrating files to DMCS2, and in October 2011, which was 9 months to a year after the planned launch date, DMCS2 went live.

OIG-Identified Concerns with DMCS2

In June 2012, during an OIG audit of the Title IV Additional Servicers (TIVAS) contracts, we became aware of issues surrounding the inability of DMCS2 to accept transfer of certain defaulted student loans from the TIVAS. During our site visits at two of the four TIVAS, Great Lakes Educational Loan Services, Inc. (Great Lakes) and Nelnet Servicing (Nelnet), we learned that some defaulted loans transferred to DMCS2 were rejected. FSA officials confirmed that this problem was also occurring with loans serviced by the other two TIVAS, the Pennsylvania Higher Education Assistance Agency and SLM Corporation, and by ACS/Xerox. The defaulted loans being rejected included redefaulted loans and loans held by borrowers with more than one defaulted loan.

If a defaulted loan cannot be transferred from a TIVAS to DMCS2 through no fault of the TIVAS, FSA pays the TIVAS $0.50 per borrower per month for continued servicing. However, the TIVAS are limited in their ability to actively service defaulted loans. Although the TIVAS can accept payments on defaulted loans, they cannot perform collection activities or advise borrowers on ways to remove their loans from default status. After a loan is transferred to DMCS2, FSA or an entity acting on its behalf (such as a collection agency) may pursue collection of the loan through a number of activities. For example, FSA can request offset or withholding of a borrower's Federal income tax refund and garnish the borrower's wages. If a loan is not transferred to DMCS2, FSA cannot undertake collection activities. The inability to transfer defaulted loans to DMCS2 also affects those borrowers who are eligible for loan rehabilitation, as they are unable to take steps to remove their loans from default, which GAO discusses in depth in its report.

In addition to problems with transfers to DMCS2, we also identified problems with transferring loans from DMCS2 to the TIVAS. If a borrower rehabilitated a loan residing on DMCS2, the system could not transfer the loan to a TIVAS to resume normal repayment servicing. As a result, the student could not be removed from default status. FSA officials acknowledged that there were loans affected by this problem. Great Lakes officials identified a related problem that DMCS2 did not always permit a TIVAS to recall a loan transferred to DMCS2 if the TIVAS subsequently received documentation proving that the loan was not in default, such as when a borrower is deceased or received a loan deferment. These borrowers may have been adversely affected by collection activities, such as income tax withholding and administrative wage garnishment, because their loans were transferred to DMCS2 and could not be recalled.

Due to the seriousness of the issues with DMCS2, we issued an alert memorandum in December 2012 that highlighted the concerns mentioned above, noting that more than 190,390 loans totaling more than $1.1 billion had been impacted. These concerns were further detailed in the fiscal year (FY) 2012 FSA financial statement audit (performed by an independent public accountant under OIG oversight), which noted that FSA had experienced significant difficulties with DMCS2 since it went live in October 2011. These included the inability of the system to process certain types of transactions, the untimely preparation of certain reconciliations, untimely reporting of interest accrual calculations, untimely reporting of transactions from DMCS2 to the Department's financial management system, and ineffective information technology controls and oversight of FSA's contractor responsible for DMCS2. These issues contributed to a material weakness in internal control over financial reporting of Federal student aid data that was reported in FSA's FY 2012 financial statement audit.

The problems with the DMCS2, however, went beyond accounting for the defaulted loans. In May 2013, we issued an alert memorandum that highlighted yet another concern that arose from problems with DMCS2. During the course of an OIG audit examining FSA's handling of borrower complaints against private collection agencies (PCAs), we learned that DMCS2 could not provide the information necessary for FSA to calculate actual commissions and bonuses for PCAs. As a result, FSA paid $448 million in commissions and $8.3 million in bonuses to PCAs in FY 2012 based on estimates. In FY 2012, FSA had individual contracts with 23 PCAs to perform collection services on defaulted student loans. PCAs are paid commissions based on successfully collecting on defaulted loans, and a PCA qualifies for bonuses based on its performance relative to other PCAs. Before it transitioned to DMCS2 in September 2011, FSA used its previous system to calculate PCA commissions and bonuses based on actual collections data contained in the system. However, because DMCS2 has been unable to produce the data necessary to calculate commissions and bonuses, FSA allowed PCAs to submit invoices, without supporting documentation, to calculate and pay estimated commissions and paid estimated bonuses based on bonus payments made in previous years.

Further, more than a year after we first identified problems with DMCS2, issues still remained, as indicated in the FY 2013 FSA financial statement audit. Although no longer considered a material weakness, the independent public accountant performing the financial statement audit still designated it as a "significant deficiency" needing immediate attention and improvement.

The report noted ongoing problems with the transfer of some defaulted loans to DMCS2, untimely recording of the default loan transfer transactions to the general ledger, errors affecting the interest rate and calculation of interest on defaulted loans, errors and delays in recording cash receipts during the year resulting in differences with U.S. Treasury reporting, and errors and delays during the year that resulted in aged balances of unapplied loan payments.

OIG Recommendations and FSA Response

Our December 2012 alert memorandum on DMCS2 made five recommendations to FSA, including (1) that FSA identify each problem related to the DMCS2 loan transfers, the source of each problem and the entire population of loans adversely affected, and (2) that FSA determine whether DMCS2 can become a fully operational system that will meet all of the baseline functional system requirements, and if it will not, that FSA develop a plan to address the deficiencies or determine whether to obtain a replacement debt management system. In addition, the FY 2012 FSA financial statement audit report made five recommendations, including that FSA ensure that the DMCS2 contractor resolves and completes the remaining system requirements in order to bring the system into a fully operational status. Both reports recommended that FSA establish temporary work-around solutions for all identified DMCS2 problems until permanent solutions were implemented.

In response to our December 2012 alert memorandum, FSA stated that it was committed to resolving outstanding problems with DMCS2 as quickly as possible; however, it has yet to provide us with an acceptable corrective action plan on our recommendation to address how it will ensure that it has a fully operational debt management system. With regard to the recommendations made in the FY 2012 FSA financial statement audit, FSA originally stated that all corrective actions related to DMCS2 were complete. However, the FY 2013 FSA financial statement audit, issued in December 2013, noted that action on four of the recommendations made in the previous year's report were still in process and not yet completed. It also made six additional recommendations for needed improvements to the system. FSA has submitted a corrective action plan for these six recommendations, although no actions have been completed at this point.

Further, in our May 2013 alert memorandum regarding the commissions and bonuses paid to PCAs, we recommended that FSA calculate any overpayments or underpayments of PCA commissions and bonuses based on actual data, require PCAs to return any overpayments to the Department, address any underpayments, and require PCAs to submit supporting documentation for all commissions invoiced since October 2011. FSA stated that it has developed a workaround for calculating bonuses and correcting overpayments and underpayments and that its corrective action for calculating commissions and reconciling the commissions would be completed in April 2014.

Current and Planned OIG Work

My office is very concerned with the problems posed by DMCS2 and FSA's apparent lack of oversight and monitoring of this system. As a result, we initiated an evaluation of DMCS2's functionality to determine whether FSA accurately assessed the operating status of the DMCS2 functions that it indicated to be fully or partially functioning, including workaround procedures. We look to complete this audit in the coming months and will share our findings with you once final. Also, due to the issues we identified with DMCS2, we determined that it was necessary to take a broader look at FSA's oversight, management, and monitoring of its data systems. Our FY 2014 Annual Plan, which presents the work we intend to conduct throughout the year, includes two audits specific to this issue: an audit of FSA's oversight of the development and enhancement of its information technology products and systems, and an audit of FSA policies and procedures for oversight and monitoring of its contracting process. We expect to begin these audits in the coming months. We also highlighted the problems with DMCS2 in our FY 2014 Management Challenges Report and added a new management challenge related to the Department's information technology system development and implementation.

My office has also been taking a closer look at FSA's oversight of PCAs. In May 2013, we issued an alert memorandum to FSA's Chief Operating Officer that FSA was not enforcing a contract requirement that PCAs report verbal complaints from borrowers. We became aware of the issue during our audit of the handling of borrower complaints against PCAs. The contracts between PCAs and FSA provide that each PCA will adhere to FSA complaint procedures. Those procedures mandate specific actions a PCA must take when it receives a complaint from a borrower, including verbal complaints, such as suspending collection activity on the account. During our site visits at three PCAs—Pioneer Credit Recovery, Performant Financial Corporation, and NCO Financial Systems, Inc.—we learned that none considered verbal complaints to be actual complaints because they believed that they had been able to appease the borrower and defuse the complaint. In addition, we found that no PCAs tracked or reported verbal complaints. As a result, FSA was unaware of the number or severity of verbal complaints filed by borrowers against PCAs and how those complaints were resolved. We expect to issue our final report on the handling of borrower complaints in the coming months.

Closing

In closing, I would like to thank the Subcommittee again for inviting me to participate in this hearing today, and I look forward to working with all of you to help ensure that the Federal student aid programs meet the needs of America's students and families. This concludes my written statement. I am happy to answer any of your questions.