DEPARTMENT OF EDUCATION'S STUDENT LOAN PROGRAMS: ARE TAX DOLLARS AT RISK?

HEARING

BEFORE THE

SUBCOMMITTEE ON CRIMINAL JUSTICE, DRUG POLICY, AND HUMAN RESOURCES

OF THE

COMMITTEE ON GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTH CONGRESS

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DEPARTMENT OF EDUCATION'S STUDENT LOAN PROGRAMS: ARE TAX DOLLARS AT RISK?

THURSDAY, JUNE 17, 1999

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CRIMINAL JUSTICE, DRUG POLICY,
AND HUMAN RESOURCES,
COMMITTEE ON GOVERNMENT REFORM,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:10 a.m., in room 2154, Rayburn House Office Building, Hon. John L. Mica (chairman of the subcommittee) presiding.

Present: Representatives Mica, Gilman, Souder, Ose, Mink, Cummings, Kucinich, and Tierney.

Staff present: Sharon Pinkerton, deputy staff director; Steve Dilingham, special counsel; Andrew Greeley, clerk; Mason Alinger, professional staff member; Cherri Branson, minority counsel; and Jean Gosa, minority staff assistant.

Mr. MICA. I'd like to call this meeting of the Subcommittee on Criminal Justice, Drug Policy, and Human Resources to order. We'll have other Members joining shortly, and with the consent of the minority, we're going to proceed because we have several full panels, and we don't want to keep our witnesses. We'll be able, I think, to proceed in good order as the Members arrive.

I will read my opening statement, and then we'll submit others for the record, or, if the Members arrive, we will recognize them.

This morning's hearing is entitled, The Department of Education's student loan programs, and it asks a question: Are Tax Dollars at Risk? Faced with staggering college costs, the American family is increasingly dependent on student aid to finance higher education. The cost of a 4-year public education has escalated to almost $12,000 annually, and private schools can cost almost twice as much, now averaging $21,000 a year. Today, more than ever, the Federal Government's role in this process must be examined to ensure that both the student and the taxpayer are being well served.

As a subcommittee with oversight jurisdiction of the Department of Education, we have an important responsibility to see that the Office of Student Financial Assistance is operating with fiscal and managerial integrity. For almost 10 successive years, the General Accounting Office has labeled the Education Department's student financial aid programs as, "a high risk for fraud, waste, abuse, and mismanagement." The GAO tells us that the Department lacks the

ability to provide basic information about whether a student is enrolled, even after a student loan is awarded and thousands of dollars in student aid have been given. In other words, many students who are not eligible could be, and often are, receiving funds.

This kind of poor management not only hurts the taxpayer, but it ultimately takes away from funding from other eligible students. In an attempt to remedy some of these problems, the 1998 Higher Education Act reauthorized a bipartisan agreement that included some much-needed reforms for managing our student aid programs. Congress created the first Federal sector performance-based organization [PBO], this was in the 1998 law, to accomplish some clear goals and try to make the operations of the student loan program more efficient. The goals outlined in that statute are clear, let me cite some of them: to improve service, reduce costs, integrate systems, and improve data accuracy and program integrity.

We're here today to assess the PBO's progress to date. It's my understanding that we have some 1,200 plus people employed, and we're not sure how many contractors. We'd like to find out how many additional folks are involved in that process, in addition to full-time employees; how many contractors. We created these PBOs to initiate some of these changes, and today, we'll hear a little bit about what's taken place.

By improving service, we mean we do not want a repeat performance of the 3-month shutdown of the loan consolidation program. Systems can be integrated and reliably enhanced by consolidating the existing 12 stovepipe systems into one system with accurate and immediately retrievable data. What progress has been made on this issue? I hope we can find answers to that question today.

Now, I understand that the National Student Loan Data System [NSLDS], was created to improve the quality of student financial aid data and minimize fraud and abuse in these programs. However, according to a September 1998 GAO report, almost half of the schools are not using NSLDS's on-line functions. Is this data base working effectively? We also hope to find answers to that question.

We'll hear today from the Inspector General's office that the administrative costs in the Department of Education's direct loan program are 31 percent higher than private sector costs. This is bad news for the taxpayers. I'm very concerned that spending for student loan administration has jumped from $137 million a year to $401 million a year from 1992 to 2000. This is a 193 percent increase despite the fact that the Department's award workload has only increased some 28 percent. This is even more bad news for the taxpayer.

Qualified personnel should be in place to ensure that the programs are not subject to waste, fraud, and abuse. Since the Department has been repeatedly criticized for a lack of systems integration, are competent people in place to fix this problem? That's another question we hope to find an answer to today.

In addition to examining the Student Financial Assistance Office's progress in achieving those goals, I have some other very specific concerns. It's absolutely astounding to me that over $109 million in Pell grant over-awards were made in 1996 to students who fraudulently stated their income in order to be eligible for loans. The Higher Education Act of 1998 was supposed to fix this problem

by authorizing the Department of Education to verify a student's income with the IRS. What has the Department done to implement this solution? Another question we hope to find an answer to today.

As we delve into a recently released audit by the Inspector General's Office, even the most blase supporter of government bureaucracy has to be shocked by the fact that the Department has forgiven millions of dollars in loans to students on the basis of death or disability despite the fact that these students were neither dead nor disabled. In fact, in just one program that was examined, students went on to earn significant salaries after over $73 million in loans were forgiven for their supposed total and permanent disability. Some of the students, after having their loans forgiven, simply returned to school and received additional loans and grants.

Perhaps the most astounding thing about this report is that over $3.8 million in loans was forgiven for students who claimed to be dead but were alive and well. In fact, some forgiven disabled and so-called deceased borrowers were discovered to be doing quite well and enjoying salaries of over $50,000 a year. But what's so unbelievable is that the Department does not even require presentation of a certified copy of a death certificate before a loan is forgiven, just a simple act like that.

Once again, the taxpayer is fleeced by a loan program out of control. It really shocks, I think should shock, the conscience of every Member of Congress when we see this type of abuse within a system, particularly when there's so many of our students who are in need of financial assistance, and we have so many demands on education today.

I'm also concerned about reports that there are a rapidly growing number of loans going to students who attend foreign universities and misuse the loan money. In 1998, $200 million in loans were awarded for tuition at foreign schools, and the Inspector General has been after the Department for several years to do something about these students who get their checks but never show up for school.

I have a quote here from a former Assistant Inspector General in which she asserts that the Department had not moved aggressively to combat this fraud and that, in her opinion, ''the Department could do more to deal with this problem if they just made it a priority,'' and that's taken from the Chronicle of Higher Education, January 15 of this year.

In addition, while I understand that the default rate has come down slightly in recent years, I'm frankly troubled that there are still about $20 billion of loans that are in default. I'm also concerned that the default rate terminology and calculation can, in fact, be very misleading. It is defined generally by the Department to refer to the repayment of loans for a 2-year period, not whether the loan goes into actual default at a later date.

Congress, for the first time in history, provided a performance-based organization. It now has some 1,200 employees and contract personnel. We provided the PBO with personnel and also gave them contracting flexibility to facilitate operation of the PBO's hoped-for achievement of important educational financing goals.

Today, we'll ask many questions. We'll ask in particular how the Department has used those tools to do more, and efficiently, an ef-

fective management of our student loan programs. In a time when Congress is struggling to provide funds for students who are very much alive and classrooms and teachers who don't have adequate resources, it's absolutely outrageous that our Federal education bureaucracy would waste such an incredible amount of money.

[The prepared statement of Hon. John L. Mica follows:]

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Department of Education's Student Loan Programs: "Are Tax Dollars At Risk?"

OPENING STATEMENT

Chairman John L. Mica

June 17, 1999

Faced with staggering college costs, the American family is increasingly dependent on student aid to finance higher education. The cost of a four-year public education has escalated to almost $12,000 annually and private schools can cost almost twice as much, averaging $21,000 a year.

Today, more than ever, the federal government's role in this process must be examined to ensure that both the student and the taxpayer are being well served.

As the Subcommittee with oversight of the Education Department, it is our job to see to it that the Office of Student Financial Assistance is operating with fiscal and managerial integrity.

For almost ten successive years the General Accounting Office has labeled the Education Department's student financial aid programs as a "high risk for fraud, waste, abuse, or mismanagement." The GAO tells us that the Department lacks the ability to provide basic information about whether a student is enrolled, even after a student loan is awarded and thousands of dollars in student aid have been given. In other words, many students who are not eligible could be receiving funds. This kind of poor management not only hurts the taxpayer, but also ultimately takes away funding from other eligible students.

In an attempt to remedy some of these problems, the 1998 Higher Education Act reauthorization produced a bipartisan agreement that included some much needed reforms for managing student aid programs.

Congress created the first federal sector "performance-based organization" (PBO) in the 1998 law to accomplish some clear goals and try to make the operations of the student loan programs more efficient. The goals outlined in that statute are clear:

Improve service, reduce costs, integrate systems and improve data accuracy and program integrity.

We are here today to assess the PBO's progress to date.

By improving service we mean we do not want another repeat performance of the 3-month shut down of the loan consolidation program.

Systems can be integrated and reliability enhanced by consolidating the existing 12 stovepipe systems into one system with accurate and immediately retrievable data. What progress has been made on this issue?

Now I understand that the National Student Loan Data System (NSLDS) was created to improve the quality of student financial aid data and minimize fraud and abuse in these programs. However, a September 1998 GAO report indicates that almost half of the schools are not using the NSLDS's on-line functions. Is this database working effectively?

We will hear from the Inspector General's office that the administrative costs in the Education Department's Direct Loan program are 31% higher than private sector costs. This is bad news for the taxpayer.

I am very concerned that Departmental spending just for student loan administration has jumped from $137 million a year to $401 million a year (from 1992 to 2000).

This is a 193% increase despite the fact that the Department's award workload has only increased 28%. This is even more bad news for the taxpayer.

Qualified personnel should be in place to ensure that the programs are not subject to waste, fraud and abuse. Since the Department has been repeatedly criticized for a lack of systems integration, are competent people in place to fix this problem?

In addition to examining the Student Financial Assistance office's progress in achieving those goals, I have some other very specific concerns:

It is astounding to learn that over $109 million in Pell grant overawards was made in 1996 to students who fraudulently understated their income in order to be eligible for loans. The Higher Education Act of 1998 was supposed to fix this problem by authorizing the Education Department to verify a student's income with the IRS. What has the Department done to implement this solution?

As we delve into a recently released audit by the Inspector General's office, even the most blasé supporter of government bureaucracy is shocked by the fact that the Department has forgiven millions of dollars of loans to students on the basis of death or disability despite the fact that these students were neither dead nor disabled. In fact, just in the one program that was examined students went on to earn significant salaries after over $73 million in loans were forgiven for their supposed total and permanent disability. And, some of the students, after having their loans forgiven, simply returned to school and received additional loans and grants.

Perhaps the most astounding thing about this report is that over $3.8 million in loans was forgiven for students who claimed to be dead, but were really alive and well. In fact, some forgiven disabled and deceased borrowers were discovered to be doing quite well and enjoying salaries of over $50,000 a year. What is so unbelievable is that the Department does not even require presentation of a certified copy of a death certificate before a loan is forgiven. Once again the taxpayer is fleeced by a loan program out of control. OR Once again the taxpayer is fleeced by a bureaucracy out of control.

I am also concerned about reports that there are a rapidly growing number of loans going to students who attend foreign universities and misuse the loan money. In 1998 $200 million in loans were awarded for tuition at foreign schools, and the Inspector General has been after the Department for several years to do something about these students who get their checks but never show up for school. I have a quote here from a former Assistant Inspector General in which she asserts that the Department had not moved aggressively to combat this fraud and that in her opinion the Department could do more to deal with this problem if they just made it a priority. (The Chronicle of Higher Education, January 15, 1999).

In addition, while I understand that the default rate has come down in recent years, I am frankly troubled that there is still about $20 billion dollars of loans that are in default. I am also concerned that the "default rate" terminology and calculation can be misleading, as I understand that it is defined generally by the Department to refer to the repayment of loans for a two-year period, not whether the loan goes into actual default at a later date.

Congress, for the first time in history, provided the Performance Based Organization (PBO) with the tools of personnel and contracting flexibility to facilitate the PBO's achievement of important educational financing goals.

Today we'll ask how the Department has used those tools to more efficiently and effectively manage student loan programs.

In a time when Congress is struggling to provide funds for very much alive students and classrooms and teachers without adequate resources, it is outrageous that our federal education bureaucracy could waste such an incredible amount of money.

Mr. MICA. That concludes my opening statement. I'm pleased that we've been joined by our ranking member, the distinguished lady from Hawaii, Mrs. Mink, who is indeed one of the Congress's champions in education. I recognize her at this time.

Mrs. MINK. Thank you, Mr. Chairman. I apologize for being late and missing part of your opening statement.

Mr. MICA. That's OK. I'll give you a copy right here.

Mrs. MINK. Thank you.

Creating opportunities for young people to go on to college is an enormous responsibility, not only of the Federal Government, but of the State and local agencies. It's been one of the very, very significant efforts on the part of the Federal Government to open up opportunities for higher education through loan programs which have enabled many, many students, not only the low-income students, to go on to college. It has afforded relief to many middle-income families as well, as the Congress moved to recognize that the Nation as a whole was dependent upon its ability to offer higher educational opportunities and that financial barriers should never be the reason for persons not being able to go on to higher education.

I recognize the fact, Mr. Chairman, that there are always difficulties in the administration of any program and that there will be people who will attempt to sneak out the back door or indulge in fraud or misinformation. It is the responsibility of this subcommittee, I recognize, to investigate these matters, and for that reason I commend you for opening this hearing today. Perhaps it will lead us to ways in which we might tighten up the program, insist upon greater scrutiny and greater safeguards that the Federal funds invested in these programs are not wasted.

I look forward to the testimony of all the witnesses that have been called for this subcommittee hearing and must apologize, Mr. Chairman, if I have to leave in midperiod of the hearing as we are in the juvenile justice floor debate, and the chairman of my Education and the Workforce Committee has a major amendment which is coming up shortly and I need to be on the floor. But I will come back as soon as I've had my 2 minutes on the floor. Thank you very much.

Mr. MICA. Thank you so much, Mrs. Mink.

I recognize now the gentleman from Maryland Mr. Cummings.

Mr. CUMMINGS. Thank you very much, Mr. Chairman. I want to thank you, too, for holding this hearing. As one who has a daughter just about to enter college, I, too, am concerned about these loan programs as I am for the students at Johns Hopkins University in my district and many other colleges and, of course, the students in my district and students throughout the country.

As one who came from a mother and father who never passed the first grade, but were able to send all of their children to college, their seven children, trying to find ways to make sure that students are able to have the opportunity to go to college is something that is very near and dear to my heart. I would associate my words with that of our ranking member, I think we have to look at these things very carefully.

One of the things they taught us in criminal law my first year of law school, was that if there is a way to break the law, people

will find it, and I think that you are always going to have some problems. The question is whether you deal with those problems effectively so that the program continues on to do the good that it does. I think that it is our responsibility to look very carefully at the program to make sure they are functioning properly. In the process of doing that, I think we must be careful to keep in mind that these programs are making it possible for people to have opportunity.

The great educational scholar James Comber says that people can have will, they can have ability, but if they don't have opportunity, they're going nowhere fast. And so I hope that we'll look carefully at what we're doing here, that we will take appropriate actions where we deem them necessary, and we will strengthen the things that need to be strengthened and made better.

And so I want to thank the witnesses too, for being here today, and as I have said to witnesses many times, it is your testimony that makes it possible for us to do what we do. You are the ones who are on the front line. You are the ones who are dealing with the issues. You're the ones who have to go under the scrutiny, and sometimes, I must tell you, after sitting on this committee for over 3 years, sometimes the scrutiny is one-sided, and so it is good to have you here so that you can give us both sides. I've sat in this committee where you would have thought somebody had committed an offense that was worth 10 death penalties, and by the time we'd finished, there was nothing there, and I've seen that many, many, many times. So I sit here with open ears and open heart. Thank you very much.

Mr. MICA. I thank the gentleman.

[The prepared statement of Hon. Elijah E. Cummings follows:]

Statement
Congressman Elijah E. Cummings

Government Reform Subcommittee on Criminal Justice, Drug Policy and Human Resources

June 17, 1999

2154 Rayburn
10:00 a.m.

Mr. Chairman:

Thank you for holding this hearing and providing an opportunity to hear testimony regarding the U.S. Department of Education's student loan programs.

While it is important to determine the extent to which tax dollars are at risk, it is also equally as important to measure whether such risks outweigh the educational benefits to students.

In Baltimore, nine higher education institutions participate in the Direct Student Loan Program. Though the impact of such loan programs

varies from one institution to another, the universal benefit has been affordability and access to a higher education.

At Johns Hopkins University, the Federal Direct Student Loan Program helps to 'fill the financial gap' to ensure access to medical and health-related studies for working poor and middle class families. Hopkins students receive nearly $35 million in Federal direct student loans.

Morgan State University is another institution in my district that believes the Direct Student Loan Program has resulted in substantial improvements in the delivery of financial aid services. At Morgan State, three of every four students qualify for need-based Federal student financial assistance - with Direct Student Loans constituting 75% of the loans awarded. This institution credits this loan program for significantly reducing paperwork and facilitating timely loan origination and approval – usually within seven hours.

Based on the positive feedback received from higher education institutions in Baltimore regarding their experiences with the Direct Student Loan Program, I am very interested to hear testimony from this panel regarding tax risks associated with the programs as compared to their educational benefits.

Mr. MICA. No further opening statements at this time.

We'll turn to our first panel. Our first panel consists of Dr. John Berthoud, president of the National Taxpayers Union; Mr. Thomas A. Butts, the National Direct Student Loan Coalition; Dr. Fred J. Galloway, former director of the direct loan program evaluation, currently with Macro International, Inc.; and Mr. Steven A. McNamara, Assistant Inspector General for Audit, Office of Inspector General, Department of Education.

I think you're mostly new witnesses. This is an investigations oversight panel of Congress. We do swear in our witnesses, so if you'd please stand and raise your right hands.

[Witnesses sworn.]

Mr. MICA. The witnesses answered in the affirmative, and I'm pleased to welcome them.

Let me just tell you the ground rules first. If you have a lengthy statement, we're going to run the little clock here. We will be glad to submit this statement or additional information or reports for the record. It will be made a part of the record upon request. We ask that you summarize your remarks in about 5 minutes here, and we will begin.

I first recognize Dr. John Berthoud, president of the National Taxpayers Union. Welcome, and you're recognized, sir.

STATEMENTS OF JOHN BERTHOUD, PRESIDENT, NATIONAL TAXPAYERS UNION; THOMAS A. BUTTS, NATIONAL DIRECT STUDENT LOAN COALITION; FRED J. GALLOWAY, FORMER DIRECTOR, DIRECT LOAN PROGRAM EVALUATION, MACRO INTERNATIONAL, INC.; AND STEVEN A. McNAMARA, ASSISTANT INSPECTOR GENERAL FOR AUDIT, OFFICE OF INSPECTOR GENERAL, DEPARTMENT OF EDUCATION

Mr. BERTHOUD. Mr. Chairman, distinguished members of the committee, thank you very much. It's an honor to appear before you. As you said, Mr. Chairman, I'm John Berthoud, president of the National Taxpayers Union. We are a nationwide grassroots lobbying organization of taxpayers with 300,000 members.

I come before you today to state our views, and I will summarize my remarks as you requested, Mr. Chairman.

To state our views on the Federal direct loan program, we believe that the evidence shows that this program has been plagued by intractable administrative problems and inefficiencies. These inefficiencies in turn cost taxpayers directly today, and in the future could lead to greater losses if there are significant defaults on the program's loans. The Federal direct loan program has been the fastest-growing Federal loan program, yet until recently there has been little attention to this program or the Department of Education's management practices. We are very grateful at the National Taxpayers Union that you are holding this hearing today to shed some light on some of the difficulties.

One of the greatest problems for this program has been slipshod administration by the Department of Education. Mr. Chairman, you touched on some of the problems. I'll repeat a few others.

In a March 1999 study, the Inspector General of the Department of Education found inefficiencies in both the FDLP and the Federal family education loan program. Regarding the FDLP, the Inspector

General wrote, "To approximate the effect of these inefficiencies, we compared our estimates to the Department's cost to manage the FDLP, $17 per loan, to the average cost that we estimated, based on U.S. Treasury research, the large private lenders would have incurred to manage the FDLP, $13 per loan. A significant portion of the $4 difference may be due to inefficiencies; however, some of the difference may be due to other factors." As you said, I believe, Mr. Chairman, this is indeed bad news for taxpayers.

Beyond what the Inspector General found, there have been other troubling indications of waste. Since 1992, while student aid awards were up 28 percent, administrative spending is up about 200 percent, as your chart over here demonstrates. Two years ago, taxpayers were forced to pay $40 million in penalties because of the Department of Education's actions related to the FDLP. I think, as you indicated, the Department had to shut down the loan consolidation program from August 1997 to December 1997 because it couldn't keep up with the backlog of applications.

However, these were not the first warning signs for this program. An earlier report by the Inspector General of the Department of Education found other problems. They found problems and weaknesses in other areas, including student status reporting, electronic data processing controls, loan record accuracy, timeliness of reporting, cash management reconciliation, written policies and procedures, and quality assurance systems. The record of the Department of Education in running this program is clearly not one in which the administrators or taxpayers can take pride.

The question arises as to why we have these problems, and I know on the second panel you will hear from the Department of Education. They may assure you that if there have been problems, they will get better. We are not so confident of that. I think the problems, from a structural point of view, come from the fact that we are asking a bureaucracy to be something it is not, which is a bank. NTU believes that where the private sector can better fulfill a mission desired by the Congress and the President, it should be allowed to do so.

In my written testimony is discussion of the benefits of using the private sector in all facets of public policy. I will note that strong use of the private sector is a central component of the reinventing government concept that Vice President Al Gore often touts. Here, I will only note that beyond greater efficiencies through heavy use of the private sector, there are lower risks to taxpayers. There's also greater satisfaction among end users of the customers of government, as was demonstrated in the Macro International study.

Inefficiencies in the FDLP program lead to taxpayer costs and risks. The size of the program puts the extent of this risk in perspective. The FDLP is more than five times as large as the next biggest Federal direct loan program. Through last year it had issued more than $30 billion in loans, which is about one-third of all outstanding Federal loans. By 2004, just 5 years from now, it's projected the program will have issued more than $100 billion in student loans. Even if this program were small, there is no excuse for inefficiency, but the enormous size of the program magnifies the cost.

In conclusion, Mr. Chairman, it is not surprising that the Department of Education has not done well with this program. NTU believes education policy is best set by those closest to students and most concerned with results. To maximize efficiency and service delivery, program implementation should be turned over to the private sector wherever feasible.

While many are clamoring for yet more education spending on the K through 12 levels and higher, we see, as representatives of taxpayers, a huge run-up in education costs in recent years. In my testimony, you will see both numbers looking at K through 12 spending and overall Federal education spending. I think our message to you today, which is why these hearings are so important, is despite a lot of calls out there for yet more dollars to go to our education systems, the facts are clear that we have invested heavily in recent years in education. The time has come to not spend more, but to spend wiser. In light of this huge run-up, the National Taxpayers Union adamantly rejects the need for more dollars for education. Again, what we need is wiser spending. One small step in that direction would be rolling back the Department of Education's role in direct loans. As is often the case, much of what the government is doing currently could be handled more efficiently and effectively through the private sector. Thank you.

Mr. MICA. Thank you for your testimony. We'll withhold questions until we finish the panel.

[The prepared statement of Mr. Berthoud follows:]

Statement of John Berthoud, Ph.D.
President of the National Taxpayers Union

before the
U.S. House of Representatives
House Government Reform Committee
Subcommittee on Criminal Justice, Drug Policy, and Human Resources

on the
Federal Direct Student Loan Program

June 17, 1999

I. Introduction

Mr. Chairman and Members of the Subcommittee, my name is John Berthoud. I am President of the National Taxpayers Union, a nationwide grassroots lobbying organization of taxpayers with 300,000 members.

In addition, I should note that I am also a teacher in higher education. I am an adjunct lecturer at George Washington University, instructing students in the Masters degree program in Legislative Affairs.

I come before you today to state our views on the Federal Direct Loan Program. We believe that the evidence shows this program has been plagued by intractable administrative problems and inefficiencies. These inefficiencies in turn cost taxpayers directly today, and in the future could lead to greater losses if there are significant defaults on the program's loans.

II. Administrative Failings

The Federal Direct Loan Program (FDLP) has been the fastest-growing federal loan program, yet, until recently, there has been little attention given to the program or the Department of Education's management practices.

Given the inefficiencies that the National Taxpayers Union sees in the Department of Education's administration of this program, we are grateful for this hearing today and hopefully, a growing awareness of problems, both actual and potential.

One of the greatest problems for the program is its slipshod administration by the Department of Education. In a March 1999 study, the Inspector General of the Department of Education found inefficiencies in both the FDLP and the Federal Family Education Loan Program (FFELP). Regarding the FDLP, the Inspector General wrote:

> "To approximate the effect of these inefficiencies, we compared our estimates of the Department's cost to manage FDLP – $17 per loan – to the average cost that we estimated (based on US Treasury research) that large private lenders would have incurred to manage the FDLP – $13 per loan. A significant portion of the $4 difference may be due to inefficiencies; however, some of the difference may be due to other factors."[1]

These findings of inefficiencies are ironic, because the intention of the program when it was created was to be more cost-efficient than the FFELP.[2] Prior to the program's establishment in 1993, the Department of Education was full of promises of cost-savings.

It should be noted that the Inspector General's work was undertaken only after the Department had canceled an earlier cost study by Macro International.[3]

Beyond what the Inspector General found, there are other troubling indications of waste:

- Since 1992, while student aid awards are up 28 percent, administrative spending is up by 200 percent.
- Two years ago, taxpayers were forced to pay $40 million in penalties because of Department of Education actions relating to FDLP.
- The Department had to shut down the loan consolidation program from August 1997 to December 1997 because it couldn't keep up with the backlog of applications.

However, these were the first warning signs for this program. An earlier report by the Department of Education's Inspector General found other problems. The Inspector General wrote:

> "Our audits of 16 schools participating in the William D. Ford Federal Direct Loan Program (Direct Loan Program) disclosed weaknesses in the administration of the program at the individual schools. The 16 schools were a representative sample of schools participating in the Direct Loan Program, therefore, it is our opinion that the conditions we found at these schools are very likely to exist at other schools as well."[4]

The Inspector General found weaknesses in a number of areas including: 1) Student Status Reporting, 2) Electronic Data Processing Controls, 3) Loan Record Accuracy, 4) Timeliness of

Reporting, 5) Cash Management, 6) Reconciliation, 7) Written Policies and Procedures, and 8) Quality Assurance Systems.[5]

The record of the Department of Education in running this program is clearly not one in which administrators or taxpayers can take pride.

III. Why Is There A Problem?

It is hardly surprising that we find the above inefficiencies since we are asking a public agency to perform functions that are much more logically performed by the private sector.

Privatization expert Bob Poole of the Reason Foundation, notes that research into shifting services from government bureaucracies to the private sector shows "[t]he major advantages of privatization are seen as operating efficiencies and cost savings. Other benefits cited include higher service quality, shorter implementation time, and obtaining otherwise unobtainable services."[6]

The upshot of this and other research is that government agencies are often inherently less able to efficiently run programs. There are literally hundreds of federal, state, and local government programs where private sector delivery of a service – or at least allowing private sector competition with the public sector – would provide better service delivery at lower cost.

Given that private sector service delivery often can be done more cheaply and effectively, it is not surprising that we see the aforementioned differential in costs between DOE and private lenders. Along with lower costs and greater efficiency, private sector delivery of services often leads to greater "customer" satisfaction. In the case of FDLP loans, the Macro International study released in 1999 shows higher levels of satisfaction among FFELP schools compared to FDLP schools.

IV. Taxpayer Risk

Inefficiencies in the FDLP lead to taxpayer costs and risks. The size of the program puts the extent of this risk in perspective:

- The FDLP is more than five times as large as the next biggest federal direct loan program. Through last year, it issued more than $30 billion in loans – this is more than one-third of all outstanding federal loans.
- By 2004, it is projected that the program will have issued more than $100 billion in student loans.

Even if the program were small, there is no excuse for inefficiency. But this enormous size magnifies the problems for students when loans can't be processed. It also magnifies costs for taxpayers because of inefficient governmental administration.

Beyond the greater costs to the economy because of inefficiencies in the administration of the program, perhaps the most ominous cost to taxpayers is the potential threat from default. Since tens of billions of taxpayer dollars are at stake, a poorly-run program such as this could be a ticking time bomb for taxpayers.

V. Problems Are Endemic to the Department of Education

DOE's problems with FDLP are not atypical. A recent General Accounting Office study of the Department of Education found, "The Department's history is replete with long-standing management problems."[7] Public policy expert Herbert J. Walberg notes, "The U.S. Department of Education creates a great deal of red tape that has little to do with learning."[8]

While the topic today is one particular part of the Department of Education, NTU is on record as supporting abolition of the Department. No, we are not anti-education, but favor to the greatest extent possible a) moving program administration to the private sector, and b) a return of dollars and authority to state and local levels.

The inefficiencies in the FDLP and indeed throughout the Department are one of many good reasons for rolling back power, authority, and funds to state, local, and private hands.[9]

VI. Conclusion

In many senses, it is not surprising that the Department of Education has not done well with this program. NTU believes education policy is best set by those closest to students and most concerned with results. To maximize efficiency and service delivery, program implementation should be turned over to the private sector, whenever feasible.

While many are clamoring for yet more spending on education at the K-12 levels and for higher education, even a casual glance at the numbers reveals that there has been a huge run-up in spending at all levels. For example, between 1970 and 1995, K-12 per-pupil spending (in 1995 dollars) rose from $2,991 to $5,623.[10] This, despite mountains of evidence against even a tenuous link between high-spending and high student performance.

Overall federal education spending has risen substantially in recent decades as well. The federal education budget has skyrocketed up by over 182.4% since the creation of the Department

of Education in 1979, as shown in Table 1.[11] Surely the time has come for Congress to systematically evaluate the results of these myriad programs and eliminate those that are ineffective.

Table 1. Rising Education Spending - 1979 - 1999		
1979	1999	Increase
$12.167 billion	$34.360 billion	182.40%
Notes: -Source: Table 4.1, Historical Tables, FY 2000 Budget of the President. -Figures for 1999 are estimates.		

In light of this huge run-up, the National Taxpayers Union adamantly rejects the notion that yet more dollars are needed for education. What we need is *wiser* spending of the already massive amount of dollars going to our nation's schools.

One small step in that direction would be rolling back the Department of Education's role in direct loans. As is often the case, much of what the government is currently doing could be handled much more efficiently and effectively by the private sector.

Thank you.

Notes

1. "Study of Cost Issues: Federal Family Education Loan Program, Federal Direct Loan Program," U.S. Department of Education, Office of Inspector General, March 1999, Page 2.

2. When the National Association of State Universities and Land Grant Colleges advanced the idea of a federal direct student loan program in 1991, they hypothesized it would be less expensive. ("Study of Cost Issues: Federal Family Education Loan Program, Federal Direct Loan Program," U.S. Department of Education, Office of Inspector General, March 1999, Page 3.)

3. When the Department canceled the cost study portion of the Macro contract in 1997, it nonetheless continued all other provisions.

4. Inspector General, U.S. Department of Education, "Administration of the William D. Ford Federal Direct Loan Program by Schools," Final Report, October 1997, Page 1.

5. Ibid, Pages 2-4.

6. Bob Poole, "Using Privatization to Balance State Budgets," Chapter 6 in *The Crisis in America's State Budgets: A Blueprint for Budget Reform* (Washington, DC: The American Legislative Exchange Council, 1993), Page 125.

7. General Accounting Office, *Department of Education*, "Report to the Secretary of Education," GAO/HRD-93-47, Pages 2-3.

8. Herbert J. Walberg, "We Spend Too Much on Education, and Get Too Little," *Heartland Perspective*, Palatine, IL: The Heartland Institute, 1995.

9. The inefficiencies of the Department fly in the face of what supporters of creating an Education Department promised twenty years ago. For example, Representative Jack Brooks (D-TX) claimed that by creating a separate department, "We will have done what we always talk about doing; that is, just to make the Federal Government a bit more efficient, a bit more responsive." (*Congressional Record*, July 11, 1979, Page 18038.) For a further discussion, see John Berthoud, "Who Got It Right? What Proponents and Opponents of the Creation of the Department of Education Promised & Predicted," Arlington, VA: The Alexis de Tocqueville Institution, January 18, 1996.

10. "Report Card on American Education," Washington, DC: The American Legislative Exchange Council, 1996, Table 5.

11. For a discussion of the expansion of federal education spending since 1979, see John Berthoud, "The Budgetary Implications of Eliminating the U. S. Department of Education," Arlington, VA: The Alexis de Tocqueville Institution, May 1995.

Mr. MICA. Our next witness is Mr. Thomas A. Butts, with the National Direct Student Loan Coalition. Welcome, and you're recognized.

Mr. BUTTS. Thank you, Mr. Chairman. I am Thomas A. Butts, associate vice president for government relations at the University of Michigan. I was, at one time, the director of student financial aid at Michigan and have served as the Deputy Assistant Secretary in the U.S. Department of Education. I am pleased today to have the opportunity to appear before you on behalf of the National Direct Student Loan Coalition.

The Coalition is composed of institutions participating in the Federal direct student loan program. Its purpose is to assure the direct loan program accomplishes its goals and mission of providing outstanding service and accountability to students, institutions, and taxpayers. The chair of the Coalition executive committee is Marian Smithson, director of financial aid at Southern Illinois University.

The direct loan program was first authorized as a demonstration program as part of the 1992 reauthorization of the Higher Education Act and signed into law by President Bush. Recognizing the lower cost to the taxpayers and potential improved service to students and institutions, the direct loan program was expanded in 1993. Today, institutions have the choice of participating in either the government-guaranteed Federal family education loan or direct loan programs. Presently, more than 1,200 institutions participate in the direct loan program and originate about $11 billion per year in new loans to about 1.9 million students.

The University of Michigan was among the first 105 institutions to participate in direct lending. We originate about $130 million in direct loans each year and have had a very successful experience with the program. It has helped us streamline our student aid operations and deliver loans to our students in a timely, cost-effective manner. Like other direct loan institutions, we have been able to fully integrate the loan process with all of our financial aid and business processes. While there have been bumps along the way, as anyone experienced in large system change projects would expect, the Department of Education has really done a wonderful job in meeting its responsibilities to us and to our students. I believe the Michigan experience is typical, as demonstrated by the loyalty direct loan schools have shown to the program and its mission.

Direct loan institutions are also pleased by the fact that the competition that we introduced to the FFEL program has resulted in improved service to our colleagues who have chosen to say in FFEL. Although most dissatisfied institutions left FFEL for direct lending, it is good to see that satisfaction of those who remained has improved.

One of the reasons those involved in direct lending thought the program would be a success is that it permitted government to leverage the best of private market principles. Capital for the program is obtained essentially through the auction of government securities in the private capital markets, and the program is administered through competitive contracts with the private sector. This stands in stark contrast with FFEL, which essentially is a corporate welfare program masquerading as free enterprise. I had to

add that in light of the previous testimony. I'm sure the Department will be providing us with cost comparisons, which, when considering both administrative and subsidy costs, will show that direct lending is a good deal for taxpayers.

While the direct loan program is only completing the 5th year of operation, it captured one-third of the student loan market in its first 3 years. Some express concern that it seems to be on hold at that level. However, any private company that introduced a new product and went from zero to one-third of market share in 3 years would be the darling of Wall Street. The last couple of years have given the Department and the institutions the opportunity to adjust to rapid expansion. Under the new performance-based organization, we are expecting substantial improvements in all aspects of program operations, including cost.

We believe that the PBO authorized by the Department and being implemented will do much to improve service to direct loan institutions and students. Indeed, it should better the operation of all of the student financial aid programs. In my testimony, I further talk about some of the implementing activities of the performance-based organization. I think it is well on its way, as we'll hear, I presume, from the Department shortly, about what it is about.

We are also concerned that students receive equal access to benefits provided by the taxpayers and that all students in both programs be given similar terms and conditions on their loans. That is, their interest rates, fees, and so forth should be the same. To the extent that the Congress has chosen, through a system of mandatory payments to the lenders in the FFEL program, to evidently give more than is necessary to provide a reasonable profit and cover operating expenses in order for them to determine who should get taxpayer benefits, we believe the same should obtain in the direct loan program. The direct loan program for every $100 lent is $7 cheaper than FFEL when considering all of the subsidy costs and the administrative costs of both programs.

Mr. Chairman, thank you. I'd be happy to answer any questions.

Mr. MICA. Thank you. We will withhold questions until we've heard from everyone.

[The prepared statement of Mr. Butts follows:]

STATEMENT OF

THOMAS A. BUTTS

BEFORE THE

COMMITTEE ON GOVERNMENT REFORM

SUBCOMMITTEE ON

CRIMINAL JUSTICE, DRUG POLICY, AND HUMAN RESOURCES

JUNE 17, 1999

ON BEHALF OF

THE NATIONAL DIRECT STUDENT LOAN COALITION

Mr. Chairman and Members of the Subcommittee:

I am Thomas A. Butts, Associate Vice President for Government Relations at the University of Michigan. I was the Director of Student Financial Aid at the University and have served as the Deputy Assistant Secretary for student assistance in the U. S. Department of Education. I am pleased to have the opportunity to appear before you today on behalf of the National Direct Student Loan Coalition.

The Coalition is composed of institutions participating the Federal Direct Student Loan program. Its purpose is to assure that the Direct Loan program accomplishes its goals of providing outstanding service and accountability to students, institutions and taxpayers. The Chair of the Coalition Executive Committee is Marian Smithson, Director of Financial Aid, Southern Illinois University Edwardsville.

The Direct Loan Program was first authorized as a demonstration program as part of the 1992 reauthorization of the Higher Education Act and signed into law by President Bush. Recognizing the lower cost to the taxpayers and potential improved service to students and institutions, the Direct Loan program was expanded in 1993. Today, institutions have the choice of

participating in either the government guaranteed Federal Family Education Loan (FFEL) or Direct Loan Programs.

Presently, more than 1200 institutions participate in the program and originate about $11 billion per year in new loans to about 1.9 million students.

The University of Michigan was among the 105 institutions participating in the first year of the Direct Loan program - 1994-95. We originate about $130 million in direct loans each year and have had a very successful experience with the program. It has helped us to streamline our student aid operations and deliver loans to our students in a timely, cost effective manner. Like other direct loan institutions we have been able to fully integrate the loan process with all of our financial aid and business processes. While there have been bumps along the way, as anyone experienced in large system change projects would expect, the Department of Education has done a wonderful job in meeting its responsibilities to us. I believe the Michigan experience is typical as demonstrated by the loyalty direct loan schools have shown to the program and its mission.

Direct loan institutions are also pleased by the fact that the competition that we introduced to the FFEL program has resulted in improved service to

our colleagues who have chosen to stay in FFEL. Although the most dissatisfied institutions left FFEL for direct lending, it is good to see that satisfaction of those who remained in FFEL has improved.

One of the reasons those involved in direct lending thought the program would be a success is that it permitted government to leverage the best of private market principles. Capital for the program is obtained essentially through the auction of government securities in the private capital markets and the program is administered through competitive contracts with the private sector. This stands in stark contrast with FFEL. I am sure the Department will be providing the Committee with cost comparisons which, when considering both administrative and subsidy costs, will show that direct lending is a good deal for taxpayers.

While the direct loan program is only completing its fifth year of operation, it captured one third of the student loan market in its first three years. Some express concern that it seems to be on hold at that level. However, any private company that introduced a new product and went from zero to one third of market share in three years would be the darling of Wall Street. The last couple of years have given the Department and the institutions the opportunity to adjust to rapid expansion. Under the new

performance based organization (PBO) we are expecting substantial improvements in all aspects of program operations.

We believe that the PBO authorized by Congress and being implemented by the Department will do much to improve service to direct loan institutions and students. Indeed it should better the operation of all of the student financial aid programs. As a former Deputy Assistant Secretary for Student Assistance, I can particularly appreciate the fact that the Chief Operating Officer (COO) of the PBO reports directly to the Secretary. That alone will untangle many bureaucratic obstacles to getting the job done. Coupled with flexible contracting and personnel authority, the PBO has the tools necessary to make major improvements in the delivery and management of student assistance.

Some have raised questions about the fact that all student assistance employees under the Assistant Secretary for Postsecondary Education were moved immediately to the PBO. We think that was a wise move because it gives the COO the flexibility to build what he needs from the whole of student assistance and not be slowed down having to justify each new position he might need.

Others have raised the question about the role of the COO in policy, whatever that term means. Those that think one can have a clean break in this area don't understand how organizations function. Student aid, in particular, is so complex that it is nearly impossible to separate what CAN be done and HOW it might be done from what should be done. What is important is that key policy issues be made at the level of the Secretary/Deputy Secretary rather than by a person at the same level as the COO.

As the COO has begun to put his plan together, he has worked closely with the Coalition in seeking ideas for improvements that might be made. As part of that process the Coalition held focus groups among its members and worked hard to identify ideas for improvements.

Interestingly, the issue that was of greatest concern to our members had nothing to do with operations. Our members were most concerned that our students were not receiving the best possible terms and conditions for their loans. Students in FFEL recently have been given substantial discounts derived from taxpayer provided subsidies to lenders, guarantee agencies and secondary markets mandated by Congress. We are very pleased that the Secretary plans to make similar benefits available to students in direct lending.

Direct Loan supporters have consistently argued that taxpayer-funded subsidies should be provided equally among students in both the Direct and FFEL programs.

When the direct loan program was expanded in 1993, student origination/guarantee fees were cut from a maximum of 8% to 4% for students in both programs. Direct loan advocates called for equal benefits for students in both programs at a time when it was the cost efficient Direct Loan program that made the new benefits possible. The law called for equal terms and conditions.

During the course of the implementation of direct lending, many institutions have been subjected to a variety of different pressures to leave the program and return to FFEL. The following statement lays out the reasons why the University of Nebraska - Lincoln has chosen to remain in the program while under a great deal of pressure to leave. Their reasoning is typical of many direct loan institutions.

University of Nebraska – Lincoln
Direct Lending Experience

UNL Supports Direct Lending

University of Nebraska – Lincoln students and their families have relied on the Federal Direct Loan Program since 1995-96. Through our positive experiences and the positive feedback we continue to receive from students and parents we are more convinced than ever that the Direct Loan program is key to our offering the most efficient and responsive service to students.

Why UNL Supports Direct Lending

- We received and continue to receive very positive responses from both students and parents regarding the streamlined nature of direct lending; especially from students and parents who have experience with other colleges and universities who do not participate in Direct Lending. All but one of UNL's "Research I" peer group institutions participate in the Direct Loan program.

- Only Direct Lending can assure one "guarantor"; UNL attracts students from throughout the United States (especially in our graduate and professional programs). In the precursor to Direct Lending these students expected to borrow from their "home states" regardless of preferred lenders or guarantors, thus requiring our office to accommodate numerous variant processes, procedures, data processing specifications, and forms.

- Borrowers understand the direct lending model much more easily than its predecessor. Financial Aid staff do not have to explain to students and parents the roles of the lender, guarantor, school, loan servicing companies, secondary markets or lender consortiums. If there are questions or concerns about the direct loan process they are addressed appropriately to the school.

- Since Direct Lending, significantly fewer students need to request "emergency" short-term loans from the University to meet their needs while waiting for loan proceeds. UNL Business Affairs reports significant improvement in University cash flow for the same period of time.

- Hundreds of hours that Office of Scholarships and Financial Aid staff previously dedicated to telephone calls to lending institutions, guaranty agencies, and secondary markets regarding the status of student loan applications and disbursements are now redirected to serving students in other, more proactive ways. In-coming telephone calls to the financial aid office have decreased 40% since direct lending and the financial aid office has reduced temporary and part-time staff by more than 9 FTE (the equivalent of a 24% staff reduction since 1994).

Thank you, Mr. Chairman, for your consideration of our views. I would be happy to answer any questions you might have.

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Mr. MICA. We will now hear from Dr. Fred J. Galloway, former director of the direct loan program evaluation, with Macro International. You're recognized, sir. Welcome.

Mr. GALLOWAY. Thank you, Mr. Chairman. My name is Fred Galloway, and I appreciate the opportunity to appear before you today to share with you the results of the 5-year evaluation of the Federal direct loan program that I directed while at Macro International.

In my remarks today, I'll be touching on three topics of interest to the subcommittee: The structure of our evaluation, the research questions that drove the evaluation, and some of the results from the evaluation. I'll begin with the structure of the evaluation and try and limit my rather lengthy remarks between to 5 and 6 minutes.

The evaluation itself was a 5-year, $6.7 million project funded by the Department of Education. Its stated purpose was to evaluate the implementation and effectiveness of the direct loan program. The project began on October 1, 1993, and was scheduled to end on September 30, 1998, although final revisions to reports continue through the end of this year.

In the almost 3 years I spent running the evaluation, I can assure you that all of our work was done in a completely unbiased manner, and in no way did the Department of Education ever force us to change or manipulate any of our findings. However, as you will see in a moment, they did cancel part of our contract during the 4th year of the evaluation.

Now, we had four research questions that drove the evaluation: What do institutions think about direct lending; what do borrowers think about direct lending; how well has the Department of Education managed and administered the direct loan program; and what are the Federal costs of the direct loan program? I would like to spend approximately 1 minute on our answers to each of those questions to provide some context for you to help understand the program's successes and failures.

We asked what institutions think about direct lending. We conducted four annual surveys of over 3,000 direct loan and FFEL institutions. We started in academic year 1994–1995 and went through 1995–1996, 1996–1997, and concluded with academic year 1997–1998. We used a mail survey methodology with the option of completing the survey over the Internet, and our response rates ranged from 75 percent in 1995–1996 to 86 percent in 1997–1998, most importantly with no evidence of nonresponse bias.

We had two major findings from our four institutional surveys. First, we found that all schools, direct loan and FFEL schools, were increasingly satisfied with their respective loan programs. In fact, 81 percent in our last survey expressed their satisfaction. This is up from 68 percent in academic year 1994–1995, suggesting that, something I believe Mr. Butts said before, the competition between the two programs has seemed to improve both programs.

Our second finding over the last 4 years, institutional satisfaction with the direct loan program had fallen for 3 years before rebounding last year in academic year 1997–1998. Satisfaction with the FFEL program rose through all 4 years. In fact, during the first 2 years of our surveys, we found direct loan schools were sig-

nificantly more satisfied than were FFEL schools. In the last 2 years of our surveys, we found just the opposite, that FFEL schools were more satisfied than direct loan schools.

Now, we also had two minor findings from our institutional survey I'd like to briefly share with you. In terms of institutional satisfaction with the Department of Education and other service providers, in all four of our surveys, we found that direct loan schools were more satisfied with the services provided by the Department than were FFEL schools. Not surprisingly, FFEL schools were significantly more satisfied with the materials and training provided by lenders and guarantors than that provided by the Department of Education.

Our last finding, which is quite interesting among institutions actually participating in both programs, we found those institutions trying to do both were less satisfied with the direct loan program than all the institutions participating fully in the direct loan program, and they were less satisfied with the FFEL program than institutions participating fully in the FFEL program. For those schools trying to do both, it was a rough road to hoe.

Now, our second research question, what do borrowers think about direct lending? In this case, we conducted three borrower surveys, between 2,500 and 5,000 direct loan and FFEL borrowers. These were telephone surveys using computer-assisted telephone interviewing techniques. Our response rates ranged between 64 percent for our survey of borrowers in repayment to 77 percent for our last, our 1996–1997 survey. Again, there was no evidence of nonresponse bias.

Two major findings: Borrowers were extremely satisfied with their respective loan programs; 94 percent of students and 91 percent of parents expressed satisfaction during our last survey, suggesting that borrowers in both programs seemed quite satisfied with the loan programs.

We also found in all of our surveys that when we asked students and parents about specific aspects of the loan programs, they were also very satisfied. We found no significant differences, however, between direct loan and FFEL borrowers. Taken together, these findings also suggest the competition between the loan programs has improved both programs.

We also found two other things of interest. When we talked to borrowers in repayment, over 90 percent of them were satisfied with their contacts with the Department of Education and other service providers, so it seems things are working quite well here. Finally, and perhaps most interestingly, we found borrowers indicated a relatively low awareness of the terms and conditions of their loans. For example, only 15 percent of students and 19 percent of parents were able to recall or estimate the amount of their recent loan within 1 percent. Almost 6 out of every 10 students and almost half of all parent borrowers did not even know their loan amount within 50 percent of the actual amount. It's quite shocking. It turns out, what's even worse is borrowers have become less knowledgeable between 1994–1995 and 1996–1997. Fortunately, borrowers in repayment do seem to know a little bit more about this.

I would like to turn to our third research question, which is how well has the Department of Education administered and managed the program? To answer this question, we used our survey results together with between 40 and 50 interviews a year with individuals involved in the management, administration and oversight of the direct loan program to help shape our reports. Although we produced several reports, I'd like to concentrate on the structure content of our last and most retrospective report, direct loan program administration 1993 to 1998. However, rather than discuss the successes and failures that occurred, as documented in our report, I'd like to focus on the structure of the report, which the subcommittee may find useful helping to understand the context surrounding the Department's management and administration of the program.

We prepared this report in the spring of 1998. It was written largely for the new Chief Operating Officer, Greg Woods, although we didn't know who it was going to be at the time coming in to run the congressionally mandated performance-based organization. Our goal in producing the report was to provide a contextual understanding for some of the major events that occurred during the history of the program so the new chief operating officer could hit the ground running.

Specifically, we developed a framework that looked at three things. We looked at the effect of external or exogenous factors on departmental decisionmaking. We looked at operating constraints common to all Federal agencies, and finally, we looked at problem areas unique to the Department.

In developing this context, the two factors that the Department must take as given to their daily operations is the amount of money they have to operate the program and the level of political scrutiny that the program receives. Although to some extent, all Federal programs operated under these constraints, time and time again we were told by individuals in the Department that not having as much money as they needed to run the program, coupled with the increased level of political scrutiny that resulted from the 1994 congressional elections, forced many direct loan decisionmakers into adopting a risk-adverse posture when making key decisions.

Now, in addition to these outside factors, we looked at two factors prominent in most Federal agencies that the Department also has to grapple with: contracting issues and personnel issues. It's discussed in a number of the reports by the Inspector General and the General Accounting Office. Contractual oversight issues coupled with structural weaknesses in the technical skills of many employees make running a technologically sophisticated program like direct lending a tremendously challenging task.

Finally, we looked at several problem areas unique to the Department. These included such issues as organizational structure, systems problems and accountability, all of which affect the context that surrounds the management and administration of the program.

In our report, we used this contextual framework to help explain some of the major events in the history of the direct loan program, like the transition of loan origination from Utica to the Montgomery, the decision to move to multiple services that was subse-

quently reversed, and the difficulties associated with the consolidation process that occurred in the latter part of 1997.

We also looked at a host of smaller issues, and in our report we provide the historical perspective and discuss how the departmental decisionmaking was influenced by the context that the program operates within. If our report could be summed up in only one phrase, it might be that of a long-time observer of the Department who commented that the program was run better than we had thought, but not as well as was needed.

Now, our last research question, which will take less than a minute to discuss, because we didn't complete it, was what were the Federal costs of the direct loan program? In this we enlisted the help of Coopers & Lybrand to help us with some of the accounting information we obtained from the Department, and Economic Systems, Inc., to build a microsimulation model for us. Together our firms were engaged in the tasks of calculating the actual cost to the Federal Government of running the two loan programs, which involved gathering such information as the administrative costs from the general ledger accounts of the Department's primary accounting system. We also looked at invoices and analysis of the major Office of SFA program systems contracts and loan data from the National Student Loan Data System.

During the summer of 1997, we were hard at work estimating the Federal cost of the loan programs when our work was stopped by the Department of Education. We were told to turn over all our work documents and provide a summary of our work to date, which we did on August 15, 1997. The modification to our contract became official on September 19, 1997, and the Department reduced our contract amount by slightly more than 300,000 as a result of their cancellation of the cost component.

Within less than a month, we had signed a $20,000 contract with the Office of Inspector General to provide both materials and training necessary for OIG staff to prepare our report comparing the cost of the direct loan and FFEL programs. We completed our approximately 160 hours of training by the end of January 1998 and closed the books on our contract with the OIG at that time. I'd be happy to answer questions after the final statement.

Mr. MICA. We'll take the questions not in fast forward when we get back to you.

[The prepared statement of Mr. Galloway follows:]

Statement of

Dr. Fred J. Galloway

formerly Project Director, Direct Student Loan Evaluation
Macro International Inc.

currently Associate Dean and Tenure-Track Associate Professor
School of Education, University of San Diego

July 17, 1999

Subcommittee on Criminal Justice, Drug Policy and Human Resources

United States House of Representatives Committee on Government Reform

Mr. Chairman and Members of the Committee,

Good morning. I appreciate the opportunity to appear before you today to share with you the results of the five-year evaluation of the Federal Direct Loan Program that I directed while at Macro International. In my remarks today, I'll be touching on three topics of interest to the Subcommittee -- the structure of the evaluation itself, the research questions that drove the evaluation; and finally, what we learned from the evaluation. I'll begin with the structure of the evaluation and then move on to the other two areas before taking questions.

The evaluation itself was a five-year, $6.7 million project funded by the U.S. Department of Education, and its stated purpose was to evaluate the implementation and effectiveness of the Direct Loan Program. The project began on October 1, 1993 and was scheduled to end on September 30, 1998, although final revisions to reports continued until the beginning of 1999. In the almost three years I spent running the evaluation, I can assure you that all of our work was done in a completely unbiased manner, and in no way did the Department of Education ever force us to change or manipulate any of our findings. However, as you will see in a moment, they did cancel part of the contract during the fourth year of the evaluation.

In the evaluation itself, we used four research questions to guide the scope of our work. These questions were;

- What do institutions think about Direct Lending?
- What do borrowers think about Direct Lending?
- How well has the Department of Education administered and managed the Direct Loan Program?
- What are the Federal costs of the Direct Loan Program?

To answer these questions, the evaluation originally had five components;

- An Institutional Survey component, where we conducted four annual surveys of over 3,000 Direct Loan and Federal Family Education Loan (FFEL) Program institutions during academic years 1994-95, 1995-96, 1996-97, and 1997-98.
- A Case Study component, where we visited almost 40 schools and 5 Department of Education Regional Offices.
- A Borrower Survey component, where we conducted three surveys of borrowers, one for borrowers in repayment and the other two during academic years 1994-95 and 1996-97.
- An ED Assessment component, we where described and analyzed the Department of Education's administration and management of the Direct Loan Program
- The Cost component, where we analyzed the costs to the Federal government of the

Direct Loan Program and the FFEL Program.

For each of the components, every year we produced reports describing the year's activities and findings, and then submitted them to the Planning and Evaluation Services shop located within the Office of the Under Secretary at the U.S. Department of Education. After receiving clearance from the Department, the reports were then sent to Congress and released to the general public. Now, given the limited time I have available today, I'd like to briefly describe what we learned from our four research questions, beginning with;

What do institutions think about Direct Lending?

As I mentioned earlier, to answer this research question we conducted four institutional surveys, covering academic years 1994-95, 1995-96, 1996-97, and 1997-98. These surveys were administered to over 3,000 Direct Loan and FFEL institutions, as well as to institutions participating in both programs, and since we used the same sample over all four years, we were able to make real longitudinal comparisons. In conducting the surveys, we used a mail survey methodology with the option of completing the survey over the Internet, and used countless telephone calls and broadcast faxes to maximize our response rates, which ranged from 79 percent in 1995-96 to 86 percent in 1997-98. Most importantly, we found no evidence of any non-response bias.

Our four institutional surveys focused on the following areas; overall satisfaction with the loan programs; ease of administration, satisfaction with individual aspects of the loan programs; and satisfaction with the services provided by ED, and for the FFEL schools, their experiences with lenders and guarantee agencies. In analyzing the results of our surveys, tests for differences in satisfaction between Direct Loan and FFEL schools were done at the 5 percent level of significance *after* controlling for differences in both type and control and size among institutions participating in the same program. As a result, any observed differences can be attributed to actual programmatic differences, rather than differences in the composition of schools participating in the two programs.

Although our analysis of the four surveys revealed hundreds of interesting small findings, we identified seven major findings, which are briefly discussed below.

1. In all four of our surveys, few schools were dissatisfied with either of the two loan programs, with only 5 percent expressing any dissatisfaction in the most recent academic year, 1997-98. In fact, between academic years 1994-95 and 1997-98, there was a significant decrease in the number of schools expressing any dissatisfaction with the loan programs, falling from 9 percent to 5 percent.

2. In terms of satisfaction, 81 percent of schools expressed their satisfaction with the loan programs in academic year 1997-98, a significant increase from the 68 percent of schools that expressed their satisfaction during academic year 1994-95, suggesting that competition between the loan programs has increased overall institutional satisfaction.

3. During the last four years, institutional satisfaction with the Direct Loan Program fell for three years before rebounding during academic year 1997-98. Specifically, 89 percent of Direct Loan schools reported being satisfied during 1994-95, 83 percent in 1995-96, 64 percent in 1996-97, and then 71 percent in 1997-98. On the other hand, institutional satisfaction with the FFEL Program increased over all four years -- from 68 percent of schools in 1994-95, to 79 percent in 1995-96, to 83 percent in 1996-97, to 84 percent in 1997-98. In fact, in our first two surveys, Direct Loan schools were significantly more satisfied than were FFEL schools, while in our last two surveys, FFEL schools were significantly more satisfied than were Direct Loan schools.

4. In terms of administrative ease, in both the academic year 1994-95 and 1995-96 surveys, Direct Loan schools were significantly more likely to characterize the level of administrative effort required as "easy" than were FFEL schools. However, in our last two surveys, there were no reported differences between Direct Loan and FFEL schools. Interestingly enough, since the beginning of the Direct Loan Program in 1994-95, there has been a significant decline in the number of Direct Loan schools reporting that their program was easy to administer (61% in 1994-95 to 47% in 1997-98), while there has been a significant increase in the number of FFEL schools reporting that their program was easy to administer (29% in 1994-95 to 45% in 1997-98).

5. As far as the specific aspects of loan program administration, during our 1994-95 survey, Direct Loan schools were significantly more satisfied than were FFEL schools, however, in our last three surveys (1995-96, 1996-97, and 1997-98) there were no reported differences in satisfaction between Direct Loan and FFEL schools. In fact, for the last three years, both Direct Loan and FFEL schools were most satisfied with "answering general questions about loans and financial aid" and least satisfied with "record keeping and reporting".

6. In terms of satisfaction with the Department of Education and other service providers, in all four of our surveys we found that Direct Loan schools were significantly more satisfied with the communications and support provided by the Department of Education than were FFEL schools. Not surprisingly, FFEL schools were significantly more likely to be satisfied with the material and training provided by their lenders and guarantors than that provided by the Department of Education. Furthermore, the Direct Loan schools themselves felt that the materials and training provided by the Department of Education were more useful than timely.

7. Among institutions participating in both loan programs during either the 1996-97 or 1997-98 academic year, we found that these schools were less satisfied with the Direct Loan Program than those schools participating fully in the Direct Loan Program (73% vs. 48% in 1996-97 and 81% vs. 51% in 1997-98), and that the schools were also less satisfied with the FFEL Program than those schools participating fully in the FFEL Program (82% vs. 68% in 1996-97 and 84% vs. 72% in 1997-98).

Now let's move on to what we've learned from our second research question;

What do borrowers think about Direct Lending?

To answer our second research question, we conducted three borrower surveys, covering academic years 1994-95, 1996-97, and our final survey of borrowers in repayment. These surveys were administered to between 2,500 and 5,000 borrowers in both the Direct Loan and FFEL Programs, and to interview the student and parent borrowers, we used Computer Assisted Telephone Interviewing (CATI) techniques. Our response rates ranged from 64 percent for our survey of borrowers in repayment to 77 percent for our 1996-97 survey. As was the case with all of our institutional surveys, we found no evidence of any non-response bias.

Our first two surveys of both student and parent borrowers focused on the following areas; overall satisfaction and the perceived ease of program administration; satisfaction with the loan application process and servicing experiences; effectiveness of borrower counseling; satisfaction with the communications and support from the Department of Education and for FFEL borrowers, other service providers like lenders and guarantee agencies; and borrowers' understanding of the key terms and features of their respective loan programs. In addition to these five areas, our final survey of student borrowers in repayment also focused on the repayment experience and satisfaction with the consolidation process.

The results from our first two surveys suggest five major findings, which are briefly discussed below:

1. During the 1996-97 academic year, both Direct Loan and FFEL borrowers were highly satisfied with their respective loan programs, with 94 percent of students and 91 percent of parents expressing satisfaction with their overall experience. There were no differences between Direct Loan and FFEL borrowers.

2. The vast majority of both student and parent borrowers perceived their 1996-97 loan origination process as "very easy" or "somewhat easy", with 86 percent of students and 80 percent of parents expressing satisfaction. There were no differences between Direct Loan and FFEL borrowers. When compared with the results from our 1994-95 borrower survey, there were no differences in satisfaction between 1994-95 and 1996-97 in terms of loan origination.

3. Borrowers were generally satisfied with the timeliness of their 1996-97 funds. Although there were no differences between Direct Loan and FFEL borrowers, when compared with the results from our 1994-95 survey, we found that the satisfaction levels for Direct Loan borrowers increased by 4 percentage points between 1994-95 and 1996-97.

4. A large majority of borrowers were satisfied with their entrance and exit counseling as well as other contacts with the financial aid office. Again, no significant differences were found between Direct Loan and FFEL borrowers. However, when compared with the results from our 1994-95 survey, we found that borrowers were more satisfied with both entrance and exit counseling in 1996-97 than in 1994-95.

5. Borrowers indicated a relatively low awareness of the key terms and features of the loan programs. For example, only 15 percent of students and 19 percent of parents were able to recall or estimate the amount of their most recent loan within 1 percent, while almost six out of every ten students and almost half of all parent borrowers did not even know their loan amount within

50 percent of the actual amount. Although there were no differences between Direct Loan and FFEL borrowers, when compared with the results from our 1994-95 survey, it appears that borrowers have become less knowledgeable over time.

In addition to these findings, our final survey of borrowers in repayment produced five additional findings:

6. Overall, student borrowers in repayment reported high levels of satisfaction with their loan repayment experience, with 90 percent of borrowers expressing their satisfaction. There were no reported differences between Direct Loan and FFEL borrowers.

7. Student borrowers in repayment expressed great satisfaction with the effectiveness of exit counseling in helping them to understand the terms of their loans, with 91 percent of borrowers expressing their satisfaction. There were no reported differences between Direct Loan and FFEL borrowers.

8. Student borrowers in repayment indicated a greater awareness of the conditions required for a deferment and the consequences of default than did borrowers in our two previous surveys. For example, 49 percent of borrowers in repayment knew at least two of the conditions required for a deferment, compared to 36 percent of borrowers in the grace period during our academic year 196-97 survey. Again, there were no reported differences between Direct Loan and FFEL borrowers.

9. Overall, 91 percent of student borrowers in repayment were satisfied with their contacts with the Department of Education or their loan servicer. Again, there were no differences between Direct Loan and FFEL borrowers.

10. The majority of borrowers in repayment (82%) choose not to consolidate their loan. However, among those that did; 65 percent were successful; 14 percent were still in process; 17 percent were unsuccessful; and 5 percent initiated the process and then voluntarily withdrew. Among consolidators, 4 out of every 5 students choose the Direct Loan Program and 1 out of 5 choose the FFEL Program. We also looked at the reasons for consolidating and the length of time it took to consolidate, and found no differences between Direct Loan and FFEL student borrowers.

Now that we have addressed our first two research questions, we turn to the third research question;

How well has the Department of Education administered and managed the Direct Loan Program?

To answer this question effectively, we used our survey results, together with between 40 and 50 interviews a year with individuals involved in the management, administration, and oversight of the Direct Loan Program to help shape our reports. Although we produced several reports, I'd like to focus my remarks today on the structure and content of our last and most retrospective report, "Direct Loan Program Administration: 1993 - 1998" which many of you may have

already seen or read in draft form. However, rather than discuss all of the successes and failures documented in the report, I'd like to focus my remarks today on the structure of the report, which the Subcommittee may find useful in helping to understand the context surrounding the Department's management and administration of the Direct Loan Program.

This report was prepared in the Spring of 1998, and was written largely for the Chief Operating Officer of the new Congressionally mandated Performance Based Organization within the Department. Our goal in producing the report was to provide a contextual understanding for some of the major "events" that occurred during the history of the Direct Loan Program, so that the new Chief Operating Officer could hit the ground running and not repeat some of the mistakes of his predecessors. Specifically, we developed a contextual framework that identified three sorts of factors that influenced decision-making in the Direct Loan Program. First, we looked at the effect of external or exogenous factors, second, we looked at operating constraints common to all Federal agencies, and finally, we looked at problem areas unique to the Department.

In developing this context, the two factors that the Department must take as given or exogenous to their daily operations are the amount of money they have to operate the program, and the level of political scrutiny that the program receives. Although to some extent, all Federal programs operate under these constraints, time and time again we were told by individuals in the Department that not having as much money as they needed to run the program, coupled with the increased level of political scrutiny that resulted from the 1994 Congressional elections, forced many Direct Loan decision-makers into adopting a risk-adverse posture when making many key decisions. Although we could make no comment in our report regarding the veracity of these statements, many individuals clearly felt that these actions contributed to the operating culture surrounding the program.

In addition to these outside influences, the Department also has to regularly grapple with two serious operational constraints common to most Federal agencies -- contracting and personnel issues. As discussed in a number of reports by the Inspector General and the General Accounting Office, contractual oversight issues, coupled with structural weaknesses in the technological skills of many employees, make running a technologically sophisticated program like Direct Lending a tremendously challenging task. In fact, one employee lamented that given the difficulty of firing anyone in the Department, managers are forced to rely constantly on a thin layer of capable people, who then often get burned out from being repeatedly called upon.

Finally, we looked at several problem areas somewhat unique to the Department. These included such issues as organizational structure, systems problems, and accountability, all of which affect the context that surrounds the management and administration of the Direct Loan Program. For example, the creation of the Direct Loan Task Force caused a lot of resentment among units necessary to the successful operation of the Direct Loan Program, while an over reliance on almost a dozen "stovepipe" systems supporting student financial aid often times resulted in internal inefficiencies as systems struggled to communicate with each other. Given this environment, the issue that usually captured attention was the "crisis de jour", further obscuring accountability as individuals were pulled from different service areas to solve the problem.

In our report, we used this contextual framework to help explain some of the major "events" in the history of the Direct Loan Program, like the transition of loan origination from Utica to Montgomery, the decision to move to multiple servicers that was subsequently reversed, and the difficulties associated with consolidation process that occurred in the latter part of 1997. We also examined a host of smaller issues within our contextual framework, including reconciliation, training, software, the multi-year promissory note, NSLDS, the Y2K problem, and SSCRs. For each of these issues, we provide a brief historical perspective, and then discuss how Departmental decision making was influenced by the context that the Program operates within. If our report could be summed up in only one phrase, it might be that of a long-time observer of the Department who commented that "the program was run better than we had thought, but not as well as was needed." For a more detailed discussion of these issues, the Subcommittee is urged to consult the report itself.

We now turn to our final research question, which will most certainly be the easiest to discuss since that portion of the study was canceled by the Department before we were finished;

What are the Federal costs of the Direct Loan Program?

To help us evaluate the Federal costs of the Direct Loan Program, we enlisted the help of two subcontractors -- Coopers & Lybrand, to help with some of the accounting information, and Economic Systems Inc., to help build a PC-based microsimulation model that could be used with data extracted from the NSLDS. Together, our three firms were engaged in the methodological task of calculating the actual costs to the Federal government of running the two loan programs, which involved gathering such information as the administrative costs from the general ledger accounts of the Department's Primary Accounting System; invoices and analysis of the major Office of Student Financial Assistance Programs systems contracts; and loan data from the NSLDS. We planned to use this information in the following manner -- first, to calculate the Department of Education's administrative costs for both the Direct Loan and FFEL Programs, second, to produce an analysis of the Direct Loan's loan servicing contractor to calculate servicing costs for the Direct Loan Program, and finally, to combine this information in a microsimulation model with a sample of both Direct and FFEL loans from the NSLDS to calculate actual per-loan costs for both programs over the various life-cycle stages of a loan (origination, in-school, repayment, default/delinquency).

During the summer of 1997 we were hard at work estimating the Federal costs of the loan programs when our work was stopped by the Department of Education. We were told to turn over all of our work documents and to provide a summary of our work-to-date, which we did on August 15, 1997. The modification to our contract became official on September 19, 1997, and the Department reduced our contract amount by slightly more than $300,000 as a result of their cancellation of the cost component. Within less than a month, we had signed a $20,000 contract with the Office of the Inspector General (OIG) to provide both the materials and training necessary for OIG staff to prepare a report comparing the costs of the Direct Loan and FFEL Programs. We completed our approximately 160 hours of training by the end of January 1998, and closed the books on our contract with the OIG at that time.

At this time, I will be happy to answer any questions you may have.

Mr. MICA. I'm going to interrupt before we get to you, Mr. McNamara, because Mr. Gilman has joined us and may have to leave for another hearing.

Mr. Gilman, I'd like to recognize you for your statement.

Mr. GILMAN. Thank you, Mr. Chairman. I'll be very brief. I want to commend you, Chairman Mica, for conducting this hearing, and when we see a deficit of $11 billion at the end of this year, and possibly by the year 2004 going to $100 billion, it certainly warrants a very thorough review of this whole process and possibly moving it to the private sector. I want to commend the panelists for being here to give us the benefit of their thinking, and I want you to know that many of us are very much concerned about this kind of a deficit at a time of our budgetary constraints.

So I would like to ask that my opening remarks be made part of the record. I thank you for allowing me to.

Mr. MICA. Without objection, so ordered.

[The prepared statement of Hon. Benjamin A. Gilman follows:]

Rep. Benjamin Gilman
Opening Statement
June 17, 1999

MR. CHAIRMAN. I WOULD FIRST LIKE TO APPLAUD THE CHAIRMAN FOR BRINGING THIS IMPORTANT ISSUE BEFORE THIS SUBCOMMITTEE TODAY AND WOULD LIKE TO WELCOME THE PANEL. I AM CONFIDENT THAT THEIR TESTIMONY WILL SHED A GREAT DEAL OF LIGHT ON THE DEPARTMENT OF EDUCATION'S FEDERAL DIRECT STUDENT LOAN PROGRAM.

BY THE END OF 2004, THE DEPARTMENT OF EDUCATION WILL HAVE ISSUED MORE THAN $100 BILLION IN TAXPAYER FINANCED STUDENT LOANS AND HAS PROVIDED AN INVALUABLE SERVICE TO THOUSANDS OF STUDENTS WHO NEEDED FUNDING TO PURSUE A COLLEGE EDUCATION.

THE REASON FOR TODAY'S HEARING IS TO EXAMINE THE DEPARTMENT OF EDUCATION AND DETERMINE HOW WELL THE DEPARTMENT IS MANAGING THE FEDERAL DIRECT STUDENT LOAN PROGRAM AND ASSESS THE RISK TO THE TAXPAYER UNDER THIS LOAN PROGRAM.

WHILE THE DEPARTMENT OF EDUCATION CLAIMS THAT THE DIRECT LOAN PROGRAM PRODUCES 2¢ ON EVERY $1 OF DIRECT STUDENT LOAN DISTRIBUTED, DURING 1998, THE DEPARTMENT ACTUALLY PAID $11 BILLION MORE THAN IT COLLECTED IN FEES, INTEREST AND PAYMENTS. IN FACT, THE RECENT DEPARTMENT OF EDUCATION INSPECTOR GENERAL REPORT HAS FOUND THAT THE DEPARTMENT CANNOT PERFORM AS EFFICIENTLY AS THE PRIVATE SECTOR AND THAT WHILE IT WAS ORIGINALLY THOUGHT THAT THIS PROGRAM WOULD SAVE THE GOVERNMENT

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MONEY, IT MAY ACTUALLY BE DOING JUST THE OPPOSITE.

WE ARE HERE TO EXAMINE WHY THE BUDGET DIFFERS FROM ACTUAL PROGRAM OPERATIONS AND TO SEE HOW EFFECTIVE THE DEPARTMENT IS AT ENSURING THE REPAYMENT OF THESE LOANS. I LOOK FORWARD TO HEARING FROM OUR PANEL AND ONCE AGAIN WOULD LIKE TO COMMEND THE CHAIRMAN FOR HOLDING TODAY'S HEARING.

Mr. MICA. I appreciate your patience, Mr. McNamara, you are our last witness in this panel. Steven A. McNamara, who is the Assistant Inspector General for Audit, Office of Inspector General, the Department of Education. Welcome, sir. You're recognized.

Mr. MCNAMARA. Good morning, Mr. Chairman and members of the subcommittee. Thank you for the opportunity to discuss issues and costs affecting the Federal loan programs. My name is Steven McNamara, and I am the Assistant Inspector General for Audit at the Department of Education, Office of Inspector General. Today, I am representing the Office of Inspector General because our new Inspector General, Lorraine Lewis, was just sworn in on Monday of this week. She regrets not being here today to provide our testimony, but she has not yet had sufficient time to become familiar with the details of our report entitled, Study of Cost Issues, Federal family education loan program and Federal direct loan program, which is the focus of my testimony today.

Mr. Chairman, with your permission, I would like to provide a brief oral summary of my statement and submit my complete statement for the record.

Mr. MICA. Without objection, the entire statement will be made part of the record.

Mr. MCNAMARA. Thank you, Mr. Chairman.

Before discussing what the study did say, let me put to rest some misconceptions about what we didn't say. We did not conclude that one program is inherently cheaper than the other. We did not conclude that eliminating the direct loan program would save the government money. We did not state that the inefficiencies affect only one of the programs. And finally, we did not state that private lenders making student loans are more efficient than the government contractors serving the direct loan program.

Let me say just a little bit about how we did our study, which was not an audit of either program. We obtained cost information for both programs as reported in the Department's published financial statements for fiscal years 1996 and 1997. Consistent with the Credit Reform Act, we segregated costs into two primary categories, subsidy costs and administrative costs, and we addressed them separately in our study. Subsidy costs include interest expense, loan origination fees, default costs, and other fees, and they constitute by far the majority of the direct loan and FFELP costs. The Department has limited control over subsidy costs because the economy and Congress exert the greatest influence on these costs.

Administrative costs are those that the Department incurs in managing both the FFELP and the direct loan program, and they include such costs as contracting, personnel, travel, and others. The Department can largely control these administrative costs through effective management. Because the Department lacks a cost accounting system, it does not allocate administrative costs to the various financial aid programs. Consequently, we allocated administrative costs to the particular loan program in light of the activities and services actually performed.

Our study reached two principle conclusions: No. 1, in any given year, either the direct loan program or the FFELP program total cost may be greater, given the effect of prevailing economic conditions on subsidy cost. Since costs may be higher or lower at any

one point in time, the total cost figure for any one year does not definitively answer the question of whether FFELP or direct loans are more expensive over a longer period of time.

Second, we concluded that inefficiencies likely affect the Department's administrative costs for both loan programs. We base this conclusion on cost calculations that we made in this study and reviews that we had done in previous audits. For the direct loan program, we estimated the Department's cost to administer the loan portfolio to be $17 per loan. We compared our estimate of the Department's cost to the benchmark average cost of $13 that we derived based on a Treasury study of servicing costs of large lenders. We believe that a significant part of the $4 difference may be due to inefficiencies. These inefficiencies can largely be controlled by improved access to reliable information, increased technical and contract management expertise, and compatible automated data processing systems. We do recognize, however, that some of the differences are due to such uncontrollable factors as Federal procurement policies and personnel rules. We were unable in our study to estimate what portion of the FFELP administrative costs result from inefficiencies. This was the case because we didn't have any comparable private sector entity to compare the Department's FFELP administrative costs to.

I do want to be perfectly clear on one essential point. We are not taking the position that either program over an extended period of time is cheaper than the other. The intent of the study was to serve as a beginning with the expectation that the Department would refine our cost estimates as it strives to improve the management of both loan programs. We suggested four actions the Department could take to improve the administration of the loan programs: No. 1, institute an activity-based cost accounting system; two, track employees' time to the programs that they work on; three, develop models to predict borrower behavior; and four, take actions to address possible reasons for cost inefficiencies which we cited in the report.

We are encouraged that the Department has begun efforts to develop a managerial cost accounting system, and the OIG is working with them as they go forward. Further, the PBO has initiated several actions to address areas where we have found inefficiencies in our past audits.

Mr. Chairman, this concludes my statement, and I would be happy to respond to any questions on this issue or other work products.

Mr. MICA. Thank you, Mr. McNamara.

[The prepared statement of Mr. McNamara follows:]

Statement of

STEVEN A. MCNAMARA

ASSISTANT INSPECTOR GENERAL FOR AUDIT SERVICES
OFFICE OF INSPECTOR GENERAL
U.S. DEPARTMENT OF EDUCATION

Before the
SUBCOMMITTEE ON CRIMINAL JUSTICE,
DRUG POLICY AND HUMAN RESOURCES

Committee on Government Reform
United States House of Representatives

Regarding

STUDENT LOAN PROGRAMS

JUNE 17, 1999

Mr. Chairman and Members of the Subcommittee:

Thank you for the opportunity to discuss issues, costs and the efficiency of the Federal Direct Loan Program (FDLP). My name is Steven A. McNamara, and I am the Assistant Inspector General for Audit Services at the Office of Inspector General, Department of Education. I am representing the Office of the Inspector General today because our new Inspector General, Lorraine Lewis, was just sworn in Monday, June 14, 1999. Ms. Lewis regrets not being here today to provide our testimony, but she has not had a sufficient opportunity to become thoroughly familiar with the details of our recent report, "Study of Cost Issues, Federal Family Education Loan Program and Federal Direct Loan Program," which is the focus of my testimony today. I offer a copy of the report for the record.

In the study that led to the report, the Office of Inspector General (OIG) objective was to study and compare cost issues of the two student loan programs. We reviewed the Department's actual costs for Fiscal Years 1996 and 1997, along with audits, information reports, congressional testimony and other related documents bearing on the issues that affect FDLP and the Federal Family Education Loan Program (FFELP) costs. Our goal was to arrive at a reasonable estimate of the costs of the programs rather t ıan precise figures.

Before discussing what the study did say, let me put to rest some misconceptions about it that have come to our attention. First, our study did not conclude that one program is inherently cheaper than the other. Second, we did not conclude that eliminating the FDLP will save the government money. Third, we did not state that the inefficiencies affect only one of the programs. Finally, our study did not state that private lenders making student loans are more efficient than the government contractors serving the FDLP.

Background

In October of 1996, we began to study the costs of the FFELP and the FDLP as an internal OIG project and for future use if we were asked about the issue. As part of our initial analysis, we reviewed various prior cost studies, but found them inadequate to address the complex and changing state of the student loan programs. Several factors in particular made it difficult to perform a conclusive analysis of program costs, including the newness of the FDLP and the possible long-term affects of income contingent repayment.

We proceeded to a second phase to attempt to arrive at a reasonable cost estimate of the two programs based on the best available data. This was a study, not an audit, of either program.

Overview of Cost Study Methodology

We obtained the incomplete study results and workpapers of Macro International Inc., a private contractor that the Department had retained to study the costs of the two loan programs. We expanded on Macro's previous work on FY 1996 costs by collecting cost and other financial data from the Department for FY 1997 for the loan programs.

Consistent with the Credit Reform Act of 1990, we segregated costs associated with all Student Financial Assistance Programs into two primary categories -- subsidy and administrative costs -- and addressed them separately in our study. Subsidy costs include interest expense, loan origination fees, default costs and other fees. Subsidy costs constitute by far the majority of FDLP and FFELP costs. The Department has limited control over subsidy costs, because the economy and Congress exert the greatest influence on these costs. For example, changing economic conditions can result in interest rate volatility that will make subsidy costs rise and fall. Subsidy costs are also subject to yearly re-estimations that make them fluctuate, sometimes significantly. Congress affects subsidy costs by its legislative decisions, such as setting borrower

and lender origination fees. Administrative costs are those that the Department incurs in managing the FFELP and FDLP, including such expenses as contracting, personnel, rent, travel, communication and others. The Department can largely control these costs through effective management.

Because the Department lacks a cost accounting system, as recently required by Federal accounting standards, it does not allocate administrative costs to the various financial aid programs. Consequently, we reviewed and analyzed each of the Department's reported administrative costs and allocated them to the particular loan program in light of the activities and services actually performed, regardless of when the Department received billing invoices or what funding source it used to pay them. As an attempt to benchmark these costs, we compared the Department's cost to administer FDLP loans to what we calculated, based on a U.S. Department of Treasury study, it would cost large lenders to administer these same loans.

During the years covered by our study, the FDLP was only in its third and fourth years of existence, meaning that FDLP administrative servicing costs had not yet reached maturity. For example, servicing costs will rise over time as more borrowers enter repayment status. Consequently, it was necessary that we project FDLP administrative costs to reflect a mature program.

Results

We reached two principal conclusions. First, in <u>any</u> given year the FFELP or FDLP total costs (administrative and subsidy) may be greater, given the affect of prevailing economic conditions on subsidy costs. Since costs may be higher or lower at any one point in time, a total cost figure for any one year does not definitively answer the question of whether the FFELP or FDLP is more expensive.

Second, we concluded that inefficiencies likely affect the Department's administrative costs of both loan programs. We based this conclusion on cost calculations that we made in this study and the reviews of our audit reports and those of the General Accounting Office. The two-year average cost per loan to administer FDLP and FFELP is $24 and $17, respectively. While the Department's FDLP administrative costs per loan were higher than its FFELP administrative costs per loan, this is due to the additional functions performed by the Department for FDLP. To assess the reasonableness of the FDLP portfolio management costs, which are loan origination, servicing and consolidation, we reduced the FDLP $24 administrative cost by $7, which is the cost to perform inherently governmental functions; the remaining $17 represents the Department's costs of managing the FDLP loan portfolio. We compared our estimate of the Department's cost to manage the FDLP - $17 per loan - to the benchmark average cost of $13, that we derived based on a U.S. Department of Treasury study of lender servicing costs that large private lenders might incur. We believe that a significant portion of the $4 difference may be due to inefficiencies. These inefficiencies can largely be controlled by effective management and include such matters as access to reliable information; having qualified technical and contract management; and using compatible automated data processing systems. We recognize that some of the differences are due to such uncontrollable factors as federal procurement policies and personnel rules.

We were unable to estimate what portion of the FFELP administrative costs result from inefficiencies, because no private sector entity performs a similar oversight function.

I want to be perfectly clear on an essential point: we are not taking the position that either program, over an extended period, is cheaper than the other. What our report does conclude is that in any given year, depending upon prevailing economic conditions that affect

subsidy costs, either FDLP or FFELP may be cheaper. However, the Department can achieve significant savings in administrative costs through improved administration of both loan programs. A Performance-Based Organization (PBO) was recently established to do just that.

We submitted this report to the Department for comment before it was made public. They did not disagree with our primary conclusions. While they did disagree with some of our administrative cost allocation decisions for the two loan programs, we concluded that the disagreements would result in less than a penny per loan difference in administrative costs. We consider our results to be a reasonable estimate of costs, not a precise answer.

Suggested Actions

To improve its administration of the loan programs (and the other Student Financial Assistance programs) and to comply with accounting standards and legislative mandates, our report suggests that the Department:

- institute an activity-based costing system;
- institute interim procedures to track employees' time to the program and activity they work on;
- develop models to predict borrower behavior, loan volume projections, and the cost effects of management decisions; and
- consider and take appropriate actions to address possible reasons for cost inefficiencies as discussed in the report.

The Department has begun efforts to develop a managerial cost accounting system, and the OIG is working with them as they go forward. Further, the PBO has initiated several actions to address areas where we have found inefficiencies in our past audits. For example, plans for modernizing their information technology systems are being developed. It is too soon to tell the

ultimate effect of this and other actions.

This concludes my statement and I would be happy to respond to any questions that you or other members of the Subcommittee may have on this issue or other work products of the OIG.

Mr. MICA. I'll start out real quickly. Mr. McNamara, this is the study that was produced. It says, Study of Cost Issues, Federal family education loan program.

[The information referred to follows:]

U.S. Department of Education
Office of Inspector General

Study of Cost Issues

Federal Family Education Loan Program

Federal Direct Loan Program

March 1999

CN S13-70001

UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF INSPECTOR GENERAL

March 18, 1999

MEMORANDUM

TO : Greg Woods
Chief Operating Officer
Office of Student Financial Assistance Programs

FROM : Thomas Carter
Director
Planning and Management Services

SUBJECT : FINAL REPORT - STUDY OF COST ISSUES: FFELP and FDLP

This is the OIG final report regarding the cost issues that impact the Department's William D. Ford Direct Loan Program (FDLP) and Federal Family Education Loan Program (FFELP). Because this is not an audit report, you are not required to respond to our suggestions for improvements to the Department's administration of the loan programs or track any actions taken by your office to implement these suggestions.

We have received comments from your office and the Budget Service. These comments do not disagree with our conclusions:

1) That either the FDLP or FFELP may cost more in any given year depending upon prevailing economic conditions.

2) That inefficiencies likely affect the Department's administration of the two programs.

Your response indicates that you disagree with the possible reasons for the inefficiencies. We look forward to reviewing your internal analysis regarding this matter.

We also understand that your office has some problems with the factors we used to calculate the administrative costs of the two loan programs. As mentioned in the report, our cost figures are offered as reasonable estimations based upon the Department's available financial data and OPE's labor allocations. We intended our study to serve as a beginning, and expected your office to refine our cost estimations as part of implementing a cost accounting system. Further, we believe that this study provides the readers a reasonable estimation of program costs. The vast majority of the two programs' administrative costs are direct costs recorded by the

Department in its financial systems. The cost allocations that you have questioned reflect indirect costs that, if re-allocated, would only exert a minor impact on overall administrative costs.

We are pleased that your staff plans to build upon our work as part of developing baseline administrative costs for the two loan programs. We understand that your office, as we had hoped, plans to refine these factors. You also indicated that you would welcome our review of the methodology you use to determine OFSA baseline figures, prior to their finalization. We look forward to such an opportunity.

We appreciate the cooperation given us during our study. If we can be of further help, please contact us. If you have any questions about the study or related matters, please call me at 205-9327 or Russell Young at 205-9970.

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HIGHLIGHTS

We have conducted a study of cost issues to assess their impact on the U.S. Department of Education's (Department) William D. Ford Direct Loan Program (FDLP) and the Federal Family Education Loan Program (FFELP). The FDLP and FFELP provide essentially the same type of products and may be considered one program with two different delivery systems. In accordance with the Credit Reform Act (CRA), we categorized the Department's costs as either subsidy or administrative. We reviewed the Department's costs for fiscal years 1996 and1997, along with audits, information reports, congressional testimony, and other related documents to aid in our understanding of issues that may impact FDLP and FFELP costs. Our study was not an audit of either program.

The Department has limited control over subsidy costs

Subsidy costs include interest expense, default costs, interest subsidy expenses, etc., and constitute the majority of FDLP and FFELP costs. The Department has limited control over subsidy costs. The economy exerts the greatest influence on these costs. For example, changing economic conditions can result in interest rate volatility that will make subsidy costs rise and fall accordingly. Additionally, subsidy costs are subject to yearly re-estimations (recalculations of earlier projections) which also make them fluctuate, sometimes significantly.

The Department can exercise control over administrative costs

Administrative costs are those incurred by the Department to manage the FFELP and FDLP. The Department can largely control these costs through effective management. While the Department can control its administrative costs, it does not know the fully allocated costs of each program because it does not have a cost accounting system that properly allocates administrative costs among its various financial aid programs. Accordingly, we focused primarily on identifying and allocating FDLP and FFELP administrative costs.

OIG's study resulted in conclusions on costs

We reached two principal conclusions. First, in any given year either FFELP or FDLP total costs (administrative and subsidy) may be greater, given the impact of prevailing economic conditions on subsidy costs. Since costs may be higher or lower at any one point in time, a total cost figure for any one year does not definitively answer the question of whether the FFELP or FDLP is more expensive.

Secondly, we concluded that inefficiencies likely affect the Department's administration of the two programs. To approximate the effect of these inefficiencies, we compared our estimate of the Department's cost to manage the FDLP – $17 per loan – to the average cost that we estimated (based on US Treasury research) that large private lenders would have incurred to manage the FDLP – $13 per loan. A significant portion of the $4 difference may be due to inefficiencies; however, some of the difference may be due to other factors. We believe that the Department's inefficiencies affect its administration of the FFELP, but we were unable to estimate the extent because no private sector entity performs comparable oversight functions like the Department performs for the FFELP.

The cost figures are reasonable estimations based upon the Department's available financial data and Office of Postsecondary Education's labor allocations. The intent of this study was to serve as a beginning, with the expectation that the Department would refine our cost estimations as it strives to improve its management of the two loan programs.

OIG offers its observations and suggestions

Our report identifies areas or issues that may give rise to cost inefficiencies including: a lack of critical information necessary to make management and policy decisions; a lack of necessary technical and contracting qualifications by certain key management and staff; and that the Department's systems are incompatible and lack data standards and common identifiers. Our report also describes accounting standards and legislative mandates which require the Department to have and maintain proper cost data for managing its programs. It does not presently have such data.

To improve its administration of the loan programs (and the other Student Financial Assistance programs) and to comply with accounting standards and legislative mandates, our report suggests that the Department:

- institute an activity-based costing system;
- institute procedures to track employees' time to the program and activity they work on;
- develop models to predict borrower's behavior, loan volume projections, and the cost effects of management decisions; and
- consider and take appropriate actions to address possible reasons for cost inefficiencies as discussed in the body of this report.

BACKGROUND

Organizations call for changes

In 1991 the National Association of State Universities and Land Grant Colleges proposed a federal direct student loan program which they believed would be less costly than the existing Federal Family Education Loan Program (FFELP). When Congress reauthorized the Higher Education Act (HEA) in 1992, it included legislation that created the Federal Direct Loan Demonstration Program which was to begin on July 1, 1994. The Demonstration Program never began because, in 1993, Congress enacted the Student Loan Reform Act (SLRA), which mandated a transition from the FFELP to the Federal Direct Loan Program (FDLP) and also legislated an entitlement for federal administrative costs.

In 1997 the American Association of State Colleges and Universities and the American Council on Education (ACE) questioned whether any federal agency possesses state-of-the-art private-sector practices that would enable it to manage the effective delivery of an annual $50 billion financial services program. ACE recommended that Congress examine alternative organizational forms for improved program delivery.[1]

Meanwhile, the Advisory Committee for Student Financial Assistance recommended that Congress improve the delivery system of federal financial assistance programs by amending the HEA to provide for a new Performance Based Organization (PBO).[2] Congress, in its 1998 HEA Amendments, created a discrete management unit--a PBO--responsible for managing the operational functions supporting the Title IV programs.

Attempts made to identify savings

Direct loan program supporters and opponents have waged an ongoing argument about which program more effectively serves students and which is more cost-efficient. Direct loan advocates maintain that FFELP is costly and complex and that direct loans would be cheaper with savings going to students; loan delivery and servicing would be simpler; and program oversight would be enhanced. Direct loan opponents questioned the Department's ability to manage the program and whether real cost savings could be achieved. Additionally, various published studies show savings in the FDLP, while others find FDLP more expensive.

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1 Advisory Committee on Student Financial Assistance, "What Form Fits? An Analysis of Student Aid Organizational Innovations" Briefing Document, July 1997, p. 1.

2 Ibid.

Congress, as part of the SLRA, provided funds to assess the FDLP annually. The Department selected Macro International for the evaluation, and as a part of its contract, Macro began a cost study: "....to benchmark the two programs at a particular point in time so that the changes in costs over time can be put into context." Macro stated that it was essential to have "... an accurate and defensible allocation of administrative and contractor servicing costs between the two Programs..."[3] In 1997 the Department canceled the cost study provision of the Macro contract while continuing all other provisions.

After the cancellation of the cost portion of the Macro contract, we began this study.

OVERVIEW OF OBJECTIVE, SCOPE, AND METHODOLOGY

Objective and scope of study

Our objective was to study and compare FDLP and FFELP cost issues. In performing this study we followed the President's Council on Integrity and Efficiency (PCIE) "Quality Standards for Inspections," dated March 1993. Our study was of costs for fiscal years1996 and 1997 and included a review of audits, information reports, testimony, and other related documents to aid in our understanding of issues that may impact FDLP and FFELP costs. We did not perform an audit.

Methodology

We began this project by obtaining Macro's (and its subcontractors') incomplete study results, supporting work papers, and accumulated records through fiscal year 1996, including the following information and data for both loan programs: 1) administrative costs from the general ledger accounts of the Department's Primary Accounting System (PAS); 2) invoices and analysis of major Office of Student Financial Assistance Programs (SFAP) system contracts; 3) loan data from the National Student Loan Data System (NSLDS), and 4) cost allocation methodology.

We expanded Macro's work to include FY 1997 costs by obtaining from the Department the same type of data and information that Macro obtained for FY 1996. We analyzed this data

3 U.S. Department of Education Direct Loan Evaluation Macro International Inc. *Third Annual Report on Cost Issues, Vol I*, March 1997, p. 1.

following the basic methodology that Macro established, which we expanded to include a projection of FDLP administrative costs to reflect a mature program in order to more equitably compare the loan programs.

The Credit Reform Act of 1990 (CRA) segregates loan program costs into two primary categories: subsidy (for which the Department can only exert minimal control[4]); and administrative (which the Department can largely control[5]). Because subsidy and administrative costs consist of different components, we addressed subsidy and administrative costs separately.

Factors impacted our methodology

Several factors were significant enough to impact the methodology we designed for our study.

- FDLP was only in its third and fourth years of existence during fiscal years 1996 and 1997 so certain program costs had not reached maturity (e.g., servicing costs will rise over time as more borrowers enter repayment status).

  What we did--To provide an equitable cost comparison of the programs, we projected FDLP costs that have not yet reached maturity. Although this required that certain assumptions be made, FDLP and FFELP similarities provided a reasonable basis for making those assumptions.

  > Because FDLP and FFELP loans have similar terms and conditions,[6] their default rates are similar, and the risk categories of borrowers who receive them are also similar,[7] we assume it is reasonable to use FFELP data to project FDLP costs.

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4 The Department may exert limited influence on certain subsidy costs; for instance, to the extent that default reduction measures are successful default costs will decrease.

5 The Department's control of its administrative costs is limited by certain factors. For instance, servicing costs will always rise as volume increases, even though the Department may limit these cost increases.

6 FFELP advocates claim that the Income Contingent Repayment Plan (ICR), found only in the FDLP, provides an unfair advantage to the FDLP. However, since ICR, through consolidation into the FDLP, is available to borrowers in several federal loan programs, we consider it to be a separate cost center, giving neither program an advantage. See *Income Contingent Repayment: Cost Attribution and Borrower Studies Could Assist to Meet Objectives of Federal Financial Reporting and Program Management*, ACN 07-70002, May 1998.

7 The Congressional Research Service recognized the loan program similarities when it noted: "FFELP and DL provide the same loans on essentially the same terms and conditions, and may be thought of as simply two delivery systems for one program." CRS, *Student Loans: What is the Problem With Converting to the 10 Year Interest Rate Benchmark*, July 25, 1997.

The Department also uses FFELP data to project FDLP costs, as illustrated by this comment in its FY 1997 audited financial statements: "The Department believes that for a given loan type (e.g., Stafford) and risk category (e.g., proprietary schools), the characteristics of direct loan borrowers and FFELP borrowers are substantially similar. Therefore, the Department has used assumptions for repayment, distribution, defaults, and collections that were developed using FFELP data to make estimates of allowances for direct loans receivable."[8] This statement demonstrates that the Department recognizes the program similarities, and has used FFELP data to project out-year FDLP subsidy costs. We used FFELP data to estimate administrative costs for a fully mature FDLP program (i.e., the percentage relationship of in-school to in-repayment loans is stable) in fiscal years 1996 and 1997.

Finally, we based our assumed level of a mature FDLP on Departmental information. In its FY 1999 budget proposal, the Department projected that FDLP would sustain its current loan origination levels for the next few years--34 percent of all new loans originated and 35 percent of all new loan dollar volume ("all loans" defined as the total of all FFELP and FDLP loans). Because we believe this projection is reasonable,[9] we assumed: 1) FDLP loan originations have reached maturity, which in turn means that FFELP originations have reached maturity; and 2) FDLP percentages of total outstanding loans and default dollars will also mature over time and reflect the 34 and 35 percent origination percentages stated above.

- Subsidy costs for FDLP and FFELP may vary substantially from year to year because of economic factors and any Congressional legislative changes. This means that subsidy costs for a mature (projected) FDLP are difficult to predict.

  What we did-- We considered subsidy costs separately and provided a recalculation of the Department's subsidy costs for discussion purposes only.

- The Department lacks a cost accounting system.

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8 U.S. Department of Education, *Annual Accountability Report Fiscal Year Ended September 30, 1997*, "Notes to Consolidated Financial Statements, September 30, 1997," July 21, 1998, p. 10.

9 The FDLP origination percentage varied very little between fiscal years 1996 and 1997: 32 percent in fiscal year 1996 and 34 percent in fiscal year 1997.

What we did--We reallocated administrative costs to reflect the activities and services actually performed to operate each program, regardless of when billing invoices were received or what funding source the Department used to pay them. We only considered Office of Postsecondary Education (OPE) costs or costs directly charged to OPE, eliminating overheads such as the Office of General Counsel and Office of Chief Financial Officer. We also compared the Department's cost to administer FDLP loans to what we projected it would cost large lenders to administer these same loans.

We assumed that the PAS data and OPE budget information we used is reasonably correct, specifically regarding correct object classes[10] and program funding sources. This information was used to create the Department's fiscal years 1996 and 1997 published financial statements.

STUDY RESULTS

Introduction

Subsidy Costs - We observed that the Department can only exert minimal control over subsidy costs. For instance, subsidy costs are impacted by subsidy parameters set by Congress, such as borrower and lender origination fees and lender reinsurance rates for defaulted loans. Additionally, the economy directly impacts subsidy costs by driving interest rates which dictate interest expenses, which is a primary subsidy cost. Further, subsidy costs are subject to yearly re-estimations (recalculations of earlier projections) which also make them fluctuate, sometimes significantly. (See Appendix A for a more detailed discussion of subsidy costs.) The FFELP and FDLP subsidy cost factors are: 1) interest rates; 2) loan origination; and 3) other subsidies (including defaults and Death, Disability, and Bankruptcies (DD& B)). FFELP subsidy costs also include other fees, such as lender fees.

Administrative Costs - The Department's cost to manage FDLP and FFELP contractor costs (servicing, etc.), and its other administrative costs, are costs the Department can reasonably control through effective management. These costs include labor, contracting costs, rent, etc. The Department records its administrative costs based on funding source (appropriation account), with limited allocation of overhead costs (common support cost). The Department does not

10 The Department uses object classes to identify the nature of its revenues and expenses.

know the fully allocated costs of each program, because it does not have a cost accounting system that properly allocates administrative costs among its various financial aid programs.

OIG's Conclusions

Conclusion 1: ***In any given year either FFELP or FDLP total costs (administrative and subsidy) may be greater, given the impact of prevailing economic conditions on subsidy costs. Since costs may be higher or lower at any one point in time, a total cost figure for any one year does not definitively answer the question of whether the FFELP or FDLP is more expensive.***

Subsidy costs have the greater impact on cost

Subsidy costs constitute the majority of both the Government's FDLP and FFELP costs, and as such have the greatest impact as to which program is more expensive. CRA requires that subsidy costs be an estimation of the net present value of all future cash flows resulting from loan originations. This entails having to predict future economic conditions that impact the cash flows for both the current cohort year and re-estimates of prior cohort years. From one cohort year to the next, economic predictions can be different, causing subsidy costs to vary. As such, subsidy costs in any one year reflect both future and past costs and can vary significantly from one year to the next.

Economic conditions determine which program has greater subsidy cost

It is not a problem to calculate a subsidy cost figure. However, it is a problem to calculate a subsidy cost figure that fairly represents the loan programs' costs. The economic conditions present at the time of any calculation determine which program is more expensive, not whether one program or the other possesses characteristics that ultimately will produce cost savings.

Some argue that there are characteristics that make the FDLP cheaper. They state that since the Department operates the FDLP, it may earn a surplus generated by the interest spread between what the borrower pays to the Department and what the Department pays to the Treasury. If a surplus is earned, it reduces FDLP subsidy costs.[11] Given the similarities of the two programs and the fact that the Department may retain any FDLP surplus, they assume the federal government's FDLP subsidy costs could be less than its FFELP subsidy costs if current economic

11 In the FFELP, private lenders retain any surplus earned because they, rather than the federal government, provide the necessary loan capital.

conditions continue.[12] However, they fail to realize that any possible savings may be reduced because the Department's FDLP administrative costs are greater than its FFELP administrative costs due to additional FDLP servicing costs.[13]

Using total costs, either program's costs could be greater

Consequently, if administrative costs and subsidy costs are added together, at any point in time FFELP or FDLP total costs may be greater given prevailing economic conditions. However, even though one program's costs may be higher or lower at any one point in time, we do not believe that a total cost figure for any one given year definitively answers the question of whether FFELP or FDLP is more expensive.

* * * * * * * * * *

Conclusion 2: ***We believe that inefficiencies likely affect the Department's administration of the two programs.***

Our general approach

To determine if inefficiencies exist, we first determined the administrative cost of the two programs. In order to derive a reasonable estimate of FDLP and FFELP administrative costs, we differentiated and allocated administrative costs based on actual program resource usage.
The objective of our administrative cost allocation methodology was to allocate the Department's administrative costs to reasonably reflect the activities and services performed to operate the FFELP and a mature FDLP in fiscal years 1996 and 1997. To attain this objective, we:

- obtained accounting data from Department records;
- distributed costs between the two programs based on actual program usage;
- differentiated FDLP development (start-up) costs from ongoing administrative costs; and
- increased FDLP volumes to reflect a fully mature program and projected FDLP costs accordingly.

12 The FDLP has only been in operation a few years; therefore, a long-term study of interest costs and their effect on subsidy costs would be necessary to affirm this conclusion.

13 The Department only incurs FFELP servicing costs for subsidized loans while students are in school through subsidy payments to lenders. The Department incurs all FDLP servicing costs.

We used a three-phase Cost Allocation Methodology which is described in more detail in the sections that follow.

Phase 1: Define Administrative Cost Criteria

The relevant cost criteria we used to support our administrative cost analysis objective is described below.

> ***Data Sources***: The Cost Allocation Methodology utilizes FDLP and FFELP administrative costs as tracked by the Department's accounting systems. We obtained these costs for fiscal years 1996 and 1997 through general ledger accounting records in the Department's Primary Accounting System (PAS). These are the same accounts the Department used to create its published fiscal years 1996 and 1997 FDLP and FFELP financial statements.
>
> ***Cost Categories***: Based on line items reported in the fiscal years 1996 and 1997 financial statements, we defined cost categories to organize the detailed fiscal years 1996 and 1997 cost records into manageable subsets of data. These categories are: labor; personnel benefits; travel and transportation; rent, communication, and utilities; printing and reproduction; contract services; supplies and material; equipment, land, buildings, and investments; and subsidies.
>
> ***Program Costs***: We separated detailed FDLP and FFELP costs into three groups or "buckets": FFELP operating costs, FDLP operating costs, and FDLP development costs.

Phase 2: Collect and Analyze Fiscal Years 1996 and 1997 Cost Data–four activities

The specific procedures we used to collect and analyze cost data for each cost category varied depending upon the nature of the costs. The following describes the four activities we performed to collect and analyze the fiscal years 1996 and 1997 cost data.

> **Activity 1 - Collect Detailed Accounting Data**
>
> We collected fiscal years 1996 and 1997 PAS data separately for all expense accounts. The Department records FDLP and FFELP costs, as well as other program costs, separately by Internal Machine Numbers (IMNs) in its general ledger accounts. Both the FDLP and FFELP have unique IMNs assigned to them.

Once we abstracted the cost data, we incorporated year-end adjustments included in the Department's fiscal years 1996 and 1997 financial statements. We then allocated all OPE costs to the various OPE offices, and then to the OPE programs, including FDLP and FFELP. (We allocated direct costs to the programs based on which program benefitted from an organization's labor; for all indirect costs we performed the allocations based on the labor formulas discussed in "Activity 3 - Labor Cost Analysis.") This cost allocation served as our initial basis for calculating FDLP and FFELP administrative costs.

To ensure that the Department's FDLP and FFELP PAS data was reliable, we tracked the administrative cost data to the Department's published fiscal years 1996 and 1997 financial statements. While we noted minor differences, the impact was insignificant.

Activity 2 - Understand the Department's "Allocation" Methodologies

The objectives of this activity were to gain an understanding of how the Department allocated administrative costs to the programs and determine what cost variables "drive" the various cost categories in order to provide a basis to reallocate PAS costs for the FDLP and FFELP to the proper group--FFELP operating costs, FDLP operating costs, and FDLP development costs.

> ***The Department's Cost Allocations***: Because the Department lacks a cost or management accounting system, it distributes costs based on the funding account from which it pays expenses. This practice is not a real allocation of costs because it is not based on which program is actually requiring resources; rather, it is simply a reiteration of what was originally planned through the budget exercise. After reviewing PAS data, we made major cost re-allocations from the FDLP to the FFELP to accurately reflect the true operating costs of both programs.
>
> The cost allocations that the Department made to the FDLP in PAS for administrative costs incurred by FFELP are explained by Section 458 of the Higher Education Act, which allows the Department to use money appropriated to the FDLP for the FFELP. As a result, the Department uses funds under the FDLP budget "umbrella" to pay for certain FFELP costs.
>
> ***Cost Drivers***: To properly allocate program costs it is necessary to understand what variables "drive" the various cost categories. For example, the number of loans processed may determine the amount a contractor charges the Department each month for its services. These variables are called cost drivers and are integral to the cost analysis.

We found that two cost variables drive the majority of the FDLP and FFELP administrative costs: (1) labor costs; and (2) contract services provided.

Activity 3 - Analyze Labor Cost

As a starting point, we reviewed how the Department derives its budgeted OPE labor costs. We found that OPE assigns each employee a payroll code that ties employee salary to a budget fund or funds.[14] We found that once OPE assigned labor costs to the corresponding funding source(s), it performed no further cost allocations. Because we found nothing to indicate that OPE was not allocating costs to the proper appropriation budget fund(s), we accepted their reported labor costs as accurate.

Because OPE had not allocated the labor costs to the organizations/programs that generated them, we performed the following processes to accomplish this goal: (Also see Appendix C for an illustration of the processes).

- We obtained from the Office of Personnel the Department's labor files for calendar years 1996 and 1997, which included data for all permanent, part-time, and contract employees.[15]

- We abstracted OPE employee data to obtain OPE labor costs, and traced these costs to the sub-organizations (offices) where the employees worked.

- We combined and allocated the sub-organization labor costs (both direct and indirect[16]) into one of the four primary OPE organizations--PPI (Planning, Policy, and Innovation), HEP (Higher Education Programs); SFAP (Student Financial Assistance Programs), or HBCU (Historically Black Colleges and Universities).

14 The funds may be budgeted from a single program like FFELP, or from multiple programs like the FDLP and program administration funds.

15 We tested whether the calendar-year payroll data would differ significantly from data recorded in PAS, which is based on fiscal year. We found no significant differences.

16 We allocated the OPE indirect labor costs based on the direct labor costs of the three OPE organizations--PPI, HEP, and SFAP (note: OPE treats HBCU as a separate entity therefore no costs were allocated). The formula we used was--the individual organizations' direct labor costs divided by the total direct labor costs for the three organizations, which produced a percentage for each organization.

- Because PPI provides services for HEP and SFAP, we allocated PPI labor costs to HEP and SFAP (using HEP and SFAP direct labor percentages previously calculated), which produced new SFAP and HEP labor cost totals.

- Based on which program an organization's work benefitted, we allocated SFAP labor costs[17] (both direct and indirect) to the student-aid programs--FDLP, FFELP, and Campus Based/Pell Grant.

- Finally we allocated the labor costs of two OPE service programs--IPOS (Institutional Participation Oversight Service) and DCS[18] (Debt Collection Service).[19]

Activity 4 - Analyze Contract Cost

To allocate contract costs properly, it was necessary to ensure that the results reflected the activities and services performed to operate the FFELP and FDLP programs during fiscal years 1996 and 1997, regardless of when payment invoices were received (such as after the end of the fiscal year) or what funding source was used to pay them. When we reviewed the Department's contract cost summary data (in PAS) for fiscal years 1996 and 1997, we realized that reported contract expenses might not reasonably reflect actual contract activities. For example, 93 percent of reported fiscal year 1996 costs for the GSL/DCS System were allocated by the Department to the FDLP, despite the fact that this contract supports mainly FFELP. While a few direct loans were in the Debt Collection Subsystem at this time, an allocation of 93 percent of the costs to FDLP does not reasonably reflect actual operating activity. During our discussions with OPE budget office personnel we learned that funding source determines how ED allocates PAS cost, including contract invoice costs, to the loan programs.

We performed a detailed invoice analysis of fiscal years 1996 and 1997 contract invoices to both account for invoices received after the close of the fiscal year and to appropriately

17 HEP costs were no longer relevant to our study as they do not pertain to the FDLP and FFELP programs.

18 IPOS regulates schools eligible to have their students receive federal financial student aid (including loans), while DCS attempts to collect unpaid financial aid amounts by borrowers who do not honor their loan commitments.

19 To allocate IPOS costs we used the only common denominator available--dollar amount of student loans originated in each loan program in a given year as a percentage of overall dollars originated in a given year for all the financial aid programs. To allocate DCS costs we also used the only common denominator available--dollar amount of student loans collected for each loan program in a given year as a percentage of overall dollars collected for all student aid programs.

allocate FDLP and FFELP program costs. We relied on portions of work that Macro performed in their Fiscal years 1996 contract cost analysis.

Allocation Methodology: To analyze contract invoice costs and allocate them in a manner that reflects the amount of resources that a program(s) required, it is important to understand how contract costs are billed to the Department and allocated by the Department between programs. The majority of costs associated with contract services are based on contractor services performed and billed through invoices. Once a contractor performs work, whether on a monthly or task order basis, that contractor sends an invoice to the Department. The Department approves the invoice for payment and allocates a portion of cost to each loan program, based on funding source(s).

The OIG performed an analysis of invoices based on a judgmental sample of fiscal years 1996 and 1997 FDLP and FFELP systems' contracts used to provide student financial aid (SFAP) and information necessary to run the SFAP programs. This sample represents six major FDLP and FFELP contracts that comprised approximately 75 percent (on average) of total FDLP and FFELP contract costs reported in PAS for fiscal years 1996 and 1997. Besides comprising a majority of total FDLP and FFELP contract costs, we also selected the six contracts for invoice review for one or more of four reasons. The contract(s):

- supported both loan programs, so we needed to separate cost by program;
- supported only FDLP, but because loan servicing costs are volume-driven[20] they must be separated from other contract costs--origination, consolidation, and central database--to increase them to reflect a mature FDLP;
- supported both programs, but because certain costs are volume driven, FDLP costs must be identified as either fixed or variable and increased to reflect a mature FDLP; and/or

20 As noted by the Department in "ADP Costs Related to Student Financial Assistance," Budget Service, February 11, 1997.

- supported only FDLP, but program development (start-up) costs must be separated so that we can capitalize and then amortize their costs over the life of the contract.

While the actual cost allocation steps varied by contract, our invoice analysis for each of the six contracts included an examination of: 1) project documentation to determine the contract objective and period of performance, billing methods (i.e., pricing schedules), purposes of any contract amendments, etc.; and 2) pricing schedules, task order descriptions, and individual invoices to determine services received, program(s) benefitted, FDLP development costs, and how to allocate program costs.

Our contract voucher reviews also provided needed assurance that the Department, in general, was correctly recognizing the total amount of dollar costs for the largest contracts (even though they allocated these costs by funding source).

We allocated all other contract costs (for all contracts other than the six we reviewed) between FDLP and FFELP during our initial allocation of PAS data, with the exception of contract costs funded from OPE's FDLP funding account, the portion allocated for Student Aid Management (SAM). Because OPE uses SAM to fund FFELP costs, we reallocated these costs from the FDLP to FFELP.

Phase 3: Reallocate Administrative Costs

Table 1 below shows administrative costs based on unchanged information in the Department's records,[21] and is the starting point for our cost reallocation. Table 2 below, meanwhile, presents our cost reallocation of the Department's FDLP and FFELP administrative costs for Fiscal years 1996 and 1997 based on actual program resource usage.[22] For example, we reallocated an average of $80 million for each fiscal year to the FFELP that the Department charged to the FDLP in its financial statements. The result is that FFELP administrative costs per loan are increased while FDLP administrative costs per loan are lowered, which more accurately reflects true program resource usage.

21 The cost data came from the financial statements and the volume data came from the "Data Book."

22 To derive our estimated FFELP administrative costs, we reclassified guarantee agency administrative costs from a subsidy to an administrative cost.

Table 1 - Administrative Cost

	FFELP -96	FDLP - 96	FFELP -97	FDLP -97
Outstanding Loan Volume (000's omitted)	46,206	3,275	48,972	6,691
Administrative Cost (000's omitted)	$176,715	$237,330	$137,865	$321,610
Administrative Cost per loan	$4	$72	$3	$48

Table 2 - OIG Estimated Administrative Costs for a Mature FDLP

	FFELP -96	FDLP - 96	FFELP -97	FDLP -97
Outstanding Loan Volume (000's omitted)	46,206	24,880	48,972	26,370
Administrative Cost (000's omitted)	$823,017	$625,928	$755,998	$614,374
Administrative Cost per loan	$18	$25	$15	$23

We consider our estimation of the Department's administrative FDLP costs to be conservative because we limited the types of variable costs that we increased in representing a mature FDLP to contract costs. Specifically, we increased contract costs and loan volume projections, but did not increase internal Department costs such as labor, postage, supplies, travel, and other similar costs (these costs are relatively minor) that may increase as the number of outstanding FDLP loans increase. We did not increase these costs because we recognize that the Department might achieve efficiency gains as the number of outstanding FDLP loans increases, which might offset any additional costs realized.

While the Department's FDLP administrative costs per loan were higher than its FFELP administrative costs per loan, this seems reasonable because of the difference in functions performed by the Department, as follows.

- In the FFELP the Department performs two functions: 1) oversight of schools, lenders, and guaranty agencies; and 2) default collections.

- In the FDLP the Department performs three functions: 1) oversight of schools; 2) default collections; and 3) management of the FDLP, including origination, servicing, consolidation, and other costs that lenders incur in the FFELP.

The two-year average of the Department's FDLP administrative costs is $24 per loan. Of the $24 total, $7 is used to perform oversight and default collections, while the remaining $17 represents FDLP management costs. To assess the reasonableness of the FDLP management costs, we compared the Department's cost to manage the FDLP--$17 per loan--to the average cost that we estimated that large lenders would have incurred to manage the FDLP program--$13 per loan (see Table 3 in Appendix B). Given the similarities of the two programs and the results of the audits we reviewed (see Appendix E), we believe that a significant portion of the $4 difference may be due to inefficiencies. However, we recognize that some of the difference may be due to other factors.[23]

Because there was no basis to compare the Department's incurred FFELP administrative costs (no other entity performs a similar oversight function), we were unable to estimate what portion of these costs result from inefficiencies. However, based upon our review of other related studies and audit reports (referenced in the next section), it is likely that any inefficiencies that affect the FDLP affect all the SFAP programs.

Possible reasons for administrative inefficiencies

Although we did not conduct an audit, we did attempt to determine the reasons why there appear to be inefficiencies in the operation of the student assistance programs. We reviewed many reviews, audits, and studies that have been conducted to address various Departmental SFAP management issues. (Please see Appendix E for an extensive list of these documents.) Based upon our review of these studies, we believe the following are possible reasons for Departmental inefficiencies that may generate higher SFAP management costs.

Lack of Critical Information

Critical to effective management are reliable information systems. In our cost study we found that management has not instituted a cost accounting system to accurately identify

23 For example, the Department had to follow certain federal procurement rules.

the costs incurred by the various SFAP programs.[24] Additionally, an OIG review of the Department's oversight of the FDLP found that the Department did not possess sufficient data to effectively oversee participating FDLP schools.[25]

Management and Staff Qualifications

Because systems contracts are highly technical and require competencies beyond program knowledge, qualified technical and contract management at all levels is essential if the PBO is to rely on its multiple contractors to operate and modify existing systems, design new systems, and provide customer service. At least in the beginning, the PBO will be staffed by current SFAP employees. A 1996 OIG management report, however, disclosed that some senior and lower-level managers in the Program Systems Service did not possess computer science degrees, and expressed similar qualification concerns about certain contract administration staff.[26] This contributed to several widely publicized problems, including interruptions in services to students,[27] inability to bring systems online on a timely basis,[28] and the awarding of unneeded contracts.[29]

Incompatible Systems

Contractors, participating institutions, General accounting Office (GAO), OIG, and the Advisory Committee have examined the Department's systems and found many of them

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24 "... Education has not defined a process for how it will assemble and analyze the data and how it will prepare the performance reports required by the Government Performance and Results Act (GPRA) of 1993." - U.S. Department of Education, *Annual Accountability Report Fiscal Year Ended September 30, 1997*, "Report on Internal Controls" July 21, 1998, p. 58.

25 Office of Inspector General *Review of the Department's Oversight of Schools Participating in the William D. Ford Federal Direct Loan Program*, ACN 04-70016, September 1998, pp. 1-7.

26 Office of Inspector General, *Coming Together to Face the Challenges of an Uncertain Future*, ACN S03-60001, June 1996, p. 8.

27 In 1996 a contractor's inability to perform as specified forced Free Application for Federal Student Aid (FAFSA) processing delays - The Chronicle of Higher Education, "U.S. Says 1.5 Million Student-Aid Applications Are Delayed," March 8, 1996, A27.

28 Loan origination system problems resulted in delays, additional costs, and reduced customer service - Letter from The Honorable William F. Goodling, Thomas Petri, Howard McKeon and Pete Hoekstra to The Honorable Richard Riley, July 22, 1998.

29 Canceled FDLP Multiple Servicer Contracts cost the Department more than $40 million. These contracts were awarded even though the Department was advised that the volume projections supporting these contracts may have been overstated . The OIG held a series of interviews prior to the issuance of the contracts awards.

incompatible, and lacking data standards and common identifiers.[30] The lack of system uniformity complicates data matching between systems. For example, identification of student records across systems may require not only a Social Security number, but additional and sometimes different data fields.[31]

Legislative mandates and accounting standard

With the advent of the new PBO, the new Chief Operating Officer (COO) has a fresh opportunity to examine past operational difficulties. He can institute measures to provide important cost information to more effectively manage the SFAP programs. In fact, the COO will need to obtain relevant SFAP program cost information to comply with the Statement of Federal Financial Accounting Standard (SFFAS) No. 4, "Managerial Cost Accounting Concepts and Standards for the Federal Government," as well as the CFO Act of 1990 and Government Performance and Results Act of 1993 (GPRA).

The Office of Management and Budget, in a July 31, 1995 publication, explained the nature of the relationship between cost information and the SFFAS and legislative requirements:

> "The requirement for managerial cost accounting on a regular and consistent basis supports recent legislative actions. The CFO Act of 1990 states that agency CFOs shall provide for the development and reporting of cost information and the periodic measurement of performance. In addition, the Government Performance and Results Act (GPRA) of 1993 requires each agency, for each program, to establish performance indicators and measures or assess relevant outputs, service levels, and outcomes of each program as a basis for comparing actual results with established goals. The nature of these legislative mandates requires reporting entities to develop and report cost information on a consistent and regular basis." [32]

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30 GAO, *Student Financial Aid Information, Systems Architecture Needed to Improve Programs Efficiency,* July 1997, p. 1;
Advisory Committee, Briefing Document, " Opportunities for Consolidation/Reengineering of the Department of Education's Title IV Delivery System" March, 1996;
OIG, Testimony to Subcommittee on Human Resources, Committee on Government Reform and Oversight, "Significant Management and Programmatic Issues Confronting the U.S. Department of Education," April, 1997.

31 GAO, *Systems Architecture Needed to Improve Program's Efficiency*, July, 1997.

32 Executive Office of the President, Office of Management and Budget, "Managerial Cost Accounting Concepts and Standards for the Federal Government," July 31, 1995, p. 26.

Moreover, as clearly stated in the PBO legislation, Congress requires improvements to both accounting and managerial systems. Congress expects improved services to students and other participants, reduced costs to the federal government, increased accountability of officials administering operational aspects of the programs, greater flexibility in the management of operational functions, integration of the informational systems, implementation of a common, integrated delivery system, and development and maintenance of a system that contains complete, accurate and timely data.[33]

OIG SUGGESTIONS

We suggest that the COO implement the following to manage the SFAP programs more effectively and to comply with SFFAS No. 4, the CFO Act of 1990, GPRA, and congressional intent regarding the PBO.

Institute an activity-based costing system (ABC)

While the Department's current method of "allocating" its costs based on funding source allows it to account for its Congressional appropriations, the method does not meet the accounting[34] and legislative requirements for cost information discussed above, nor does it provide any needed cost information that managers could use to improve SFA delivery mechanisms. Activity-based costing (ABC), however, would provide a suitable mechanism to generate the required cost information, because it allows service organizations to measure the costs of its activities. As one government consultant stated, "The government environment is tailor-made for Activity-Based Costing and its rapidly growing corollary, Activity-Based Management."[35]

A properly designed activity-based costing system would allow the COO to gather financial and operating information that reflects the *performance of activities*. It would also supply management with relevant information to plan, manage, control, and direct the activities of business in order to improve processes and products, help eliminate waste, and execute business operations and strategies.[36]

33 1998 Amendments to the HEA, Section 141(a)(2).

34 The fifth paragraph of the FASAB Statement of Recommended Accounting Standards # 4 states, "Each reporting entity should accumulate and report the costs of its activities on a regular basis for management information purposes."

35 John M. Vann, *Armed Forces Comptroller*, "Government Uses of Activity-Based Costing," Winter 1997.

36 John Miller, Journal of Cost Management, "Designing and Implementing a New Cost Management System (Winter 1992): pps. 41-53.

Some government agencies have begun using activity-based costing to "determine the true costs of their goods and services."[37] The Department of Defense, for instance, used ABC to determine the cost of military labor to perform public works functions.[38] The Internal Revenue Service (IRS) used ABC to reduce tax-processing costs while improving customer services (e.g., providing accurate answers to taxpayer inquiries in a single call).[39]

Additionally, at least one of the PBO's chief loan industry competitors has begun using activity-based costing. The Student Loan Marketing Association (Sallie Mae), which currently holds the largest amount of outstanding student-loan dollars among all institutions, including the PBO, has begun using ABC to improve its loan servicing operations. Sallie Mae has used ABC to help determine how much time their employees spend on various activities. Additionally, Sallie Mae uses ABC to determine the cost of a loan in different repayment statuses, which means that if the economy changes and more loans go into delinquent or claim status, managers can determine the change in costs due to shifting of loans from current to delinquent or claim status.[40]

Institute procedures to track employees' time to program and activity

Tracking employees' time to the program and activity they work on will allow the PBO to tie labor costs to activities performed and to better measure the true administrative costs of the various SFAP programs. Additionally, it provides an objective method to measure employee performance for the purpose of determining appropriate pay levels and rewards. It is critical, we believe, that the COO implement a Time and Tracking System.

Develop models to predict borrower behavior, loan volume projections, and the cost effects of management decisions

As noted earlier, the Department lacks critical information needed to manage the SFAP programs. An activity-based costing system would provide the Department needed financial data, while an employee tracking system would provide information detailing employee activity. However, there are other informational needs, such as: borrower behavioral patterns to better serve them, loan volume projection data to project the number of needed servicing centers, and cost projection data in order to budget. Further, two provisions in the 1998 HEA Amendments require the COO to help the Secretary determine both the costs of providing specific programs, and the composition of and changes in those costs. The Secretary, in consultation with the

37 Vann, Ibid.
38 Vann, Ibid.
39 John B. MacArthur, RIA Group, "Cost Management at the IRS," 1998.
40 Faheem Zuberi and John Antos, RIA Group, "Interest in ABC Rates High at Sallie Mae," 1998.

Treasury Secretary, may sell direct loans to lenders and use the proceeds to offer incentives for on-time repayment by borrowers if the Secretary determines that doing so is in the federal financial interest and does not result in any cost to the federal government.

By using tools such as behavioral, cost and volume models, the COO would be able to project the impact of these and other changes contemplated by the 1998 Amendments, and to manage the PBO more efficiently. The COO could also use these models to assist the Secretary in developing the required five-year performance plan that establishes measurable objectives.

Consider and take appropriate actions to address possible reasons for cost inefficiencies

The COO now has the opportunity to evaluate the possible reasons that have created likely inefficiencies in the operation of SFAP. This includes deciding what management information systems are needed, assessing management capabilities, and determining the level of integration needed for the computer systems.

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We recognize the difficulty of the tasks that we have suggested the Department undertake. We hope that the COO will find our study and its underlying methodology useful as he implements the PBO. We believe it can provide a basis to improve and track the overall efficiencies of both the FDLP and FFELP.

SUBSIDY COSTS

Introduction

Any attempt to calculate a subsidy cost per loan is hindered by the volatile nature of subsidy costs and the current lack of FDLP maturity. These hindrances make it difficult to determine a stable per loan subsidy cost that fairly represents the true costs of the FDLP and FFELP.

CRA guides cost methodology

The Credit Reform Act of 1990 (CRA) establishes the methodology for determining subsidy cost calculations for budgeting purposes. CRA requires an estimation of the net present value of all future cash flows resulting from loan originations. This entails having to predict future economic conditions that impact the cash flows for both the current cohort year and re-estimates of prior cohort years. From one cohort year to the next economic predictions can be different, causing subsidy costs to vary. As such, subsidy costs in any one year reflect both future and past costs and can vary significantly from one year to the next. This constant fluctuation of subsidy costs makes it difficult to calculate a total subsidy cost per loan that provides a definitive answer as to which program is more expensive. Future economic uncertainty also makes it very difficult to project the additional subsidy costs associated with the increased number of outstanding loans projected for a mature FDLP.

Subsidy cost per loan does not represent the programs' costs

It is not a problem to calculate a subsidy cost per loan figure. However, it is a problem to calculate a subsidy cost per loan figure that fairly represents the loan programs' costs. The economic conditions present at the time of any calculation determine which program is more expensive. Consequently, we do not believe that it is possible, at this time, to calculate a definitive subsidy cost per loan. However, a long-term study of the relationship between the economy and the loan programs may shed some light on this issue.

To illustrate these points we provide the following discussions:

- Definition of credit reform.
- Accounting for subsidy costs.
- The effect of re-estimation on subsidy costs.
- Impact of interest rates.

Analysis of Subsidy Costs

Definition of Credit Reform

CRA's definition of cost

The CRA requires agencies to calculate subsidy costs on a net present value basis. Section 502 of the act defines the term "cost" as follows:

> (5)(A) The term "cost" means the estimated long-term costs to the Government of a direct loan or loan guarantee, calculated on a net present value basis, excluding administrative costs and any incidental effects on governmental receipts or outlays.
>
> > (B) The cost of a direct loan shall be the net present value, at the time when the direct loan is disbursed, of the following cash flows:
> > (i) loan disbursements;
> > (ii) repayments of principal; and
> > (iii) payments of interest and other payments by or to the Government over the life of the loan after adjusting for estimated defaults, prepayments, fees, penalties and other recoveries
> >
> > (C) The cost of a loan guarantee shall be the net present value when a guaranteed loan is disbursed of the cash flow from -
> > (i) estimated payments by the Government to cover defaults and delinquencies, interest subsidies, or other payments, and
> > (ii) the estimated payments to the Government including origination and other fees, penalties and recoveries.
> >
> > (D) Any Government action that alters the estimated net present value of an outstanding direct loan or loan guarantee (except modifications within the terms of existing contracts or through other existing authorities) shall be counted as a change in the cost of that direct loan or loan guarantee. The calculation of such changes shall be based on the estimated present value of the direct loan or loan guarantee at the time of modification.

CRA defines accounts

The CRA defines the following accounts:

502(6) - The term "credit program account" means the budget account into which an appropriation to cover the cost of a direct loan or loan guarantee program is made and from which such cost is disbursed to the financing account.

502(7) - The term "financing account" means the non-budget account or accounts associated with each credit program which hold balances, receives the cost payment from the credit program account, and also includes all other cash flows to and from the Government resulting from direct loan obligation or loan guarantee commitments made on or after October 1, 1991.

502(8) - The term "liquidating account" means the budget account that includes all cash flows to and from the Government resulting from direct loan obligations or loan guarantee commitments made prior to October 1, 1991. These accounts shall be shown in the budget on a cash basis.

Under CRA, the "financing account" is the account through which all program expenses and receipts flow, and all outstanding balances are recorded. If the net present value of all cash flows of a single cohort year is negative, the funding to offset that negative balance is obtained through the "program account." Ultimately, all expenses and receipts flowing in and out of the "financing account" should equal zero. Further, when the financing account becomes out of balance due to changes in the initially projected cash flow calculations, which might occur when economic conditions change, re-estimations are performed to bring the balance back to zero.

Accounting for Subsidy Costs

The Department properly follows the Statement of Federal Financial Accounting Standards (SFFAS) No. 2, "Accounting for Direct Loans and Loan Guarantees" when accounting for its subsidy costs. The purpose of SFFAS No. 2 is to apply the concept of credit reform to the Federal Government's accounting of subsidy costs.

The subsidy expense portion of program costs includes provisions for loan defaults, interest subsidies, fees, and other borrower related expenses. For subsidy expenses the Department projects the cash flows that will occur over the entire life of loans originated in any one year, or what is referred to as a "cohort year." In order to derive subsidy expense the Department performs two calculations, current-year estimates and re-estimates. To perform these calculations, the Department has developed a model which includes more than 1600 assumptions, including interest rates, type of loan, borrower repayment patterns, etc.

The first calculation establishes subsidy expenses for the current-year originated loans. The second calculation provides re-estimations of prior-year subsidy expense calculations. Re-estimations are necessary because projections about interest and default rates and other variables that affect loan program costs change over time. These re-estimations are charged to the current year financial statements without changing past-year financial statements. For example, the fiscal year 1997 re-estimation is an adjustment of program costs for periods prior to 1997.

The Effect of Re-estimation on Subsidy Costs

To illustrate the impact of the effect of re-estimation on total costs, Table 1 below presents FDLP and FFELP program cost per loan for fiscal years 1996 and 1997. We obtained the program costs from the Department's fiscal years 1996 and 1997 Financial Statements. We do not consider this table to be a definitive representation of program cost per loan. Rather, the table is presented for discussion purposes to illustrate the effect that yearly re-estimations have on program costs. The difference between row one and row two is that row two includes the re-estimation of prior program costs.

Table 1 - OIG's *Illustrated* Effect of Re-estimations

(Per loan)	FFELP - FY 96	FDLP - FY 96	FFELP -FY 97	FDLP - FY 97
Program Cost -current cohort year	$63	$112	$71	$28
Program Cost - with re-estimations	$84	$176	$56	$85

As reflected in the second row above, we added the Department's yearly re-estimations from fiscal years 1996 and 1997 to the program costs reflected in the first row. This significantly impacted the program costs. For example, fiscal year 1997 FDLP program costs per loan, which were lower than fiscal year 1997 FFELP costs per loan in the first row, are now greater. Therefore, the Department's reported program costs are not a stagnant total; rather, they are subject to yearly re-estimations based on changing economic conditions. As shown above in Table 1, re-estimations may make one program's subsidy cost per loan appear less then the other at any point in time.

Impact of Interest Rates

The most significant variables that can affect loan subsidy expenses are interest rates, default rates, and loan volumes (if the makeup of borrowers changes significantly). Given the short history of FDLP, default rates and loan volumes have not caused significant differences in the Department's program costs because they have been similar in both programs.

However, based on timing and magnitude, interest rate changes can significantly affect the Department's FDLP subsidy costs.[41]

A major FDLP expense the Department cannot control is interest on Treasury borrowing. Congress decides the applicable funding instrument upon which the Department's costs of funds is based--the 10-year Treasury note. Private industry (FFELP lenders), however, can use a blend of short and long-term debt, issue stock and use earnings to minimize their interest costs and reduce risk. This means that private lenders are less sensitive to interest rate changes than the Department, whose borrowing costs will rise faster when long-term interest rates increase and drop faster when they decrease. If Congress provided the Department the option of financing its loan funds through other sources, the Department may or may not save money based on its ability to obtain the lowest funding rates available.

Interest Rate Spread

The most significant impact interest rates have on FDLP costs is the difference between the interest that borrowers pay and the Department's cost of capital. For example, in fiscal years 1996 and 1997 the 91-day T-bill rate used to calculate the borrowers' Stafford interest rate was 5.16 percent. The borrowers were charged the 91-day T-bill rate plus 2.5 percent (or 7.66 percent) while in-school and 3.1 percent (or 8.25 percent[42]) while in-repayment. The interest rate the Department paid the Treasury for both years was 6.77 percent, based on the 10-year Treasury note. Therefore, the Department's spread between the rate it paid the Treasury and what borrowers were charged was .89 percent for in-school students and 1.48 percent for students in-repayment. The difference between the spread the Department is currently earning, and what it should cost to administer loans, provides a surplus (a profit in private industry) to offset its FDLP subsidy and administrative costs. The existence and the size of a surplus, however, depends solely on the current interest rates.

Interest Rate Volatility

The Congressional Research Service[43] (CRS) has noted that the spread between 10-year Treasury and the 91-day T-bill notes has been volatile over the last 15 years. They noted the spread between the two has varied from a very narrow 0.1 percentage points to a very wide 4.5 percentage points. When this spread narrows the Department earns more money from FDLP loans because the borrower may pay a premium above the 91-day T-bill rate.

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41 Interest rate increases or decreases also affect the Department's FFELP subsidy costs.

42 There is a legislative cap of 8.25 percent on borrower interest.

43 CRS Report for Congress "Student Loans: What is the Problem With Converting to the 10-Year Interest Rate Benchmark?" p. 2, July 25, 1997.

However, if the spread increases, FDLP loans become more expensive because what the borrower pays is capped at 8.25 percent.

Given the cost volatility of the relationship between 91-day T-bills and 10-year Treasury notes, we estimated the FDLP interest costs to include the impact that three different interest spreads (1.61 percent (current), .1 percent, and 4.5 percent) would exert on a mature FDLP. To accomplish this we did the following:

1. For actual outstanding FDLP loan dollars we applied the current interest rate.

2. In establishing a mature FDLP we increased loan volumes. As noted earlier, one difficultly in projecting subsidy costs is economic uncertainty, which may cause interest rates to rise or fall. To illustrate this volatility, we calculated interest expenses that reflect three different interest rate spreads for the additional loan volume.

We included these interest expense calculations in our Table 2 subsidy cost calculations shown below, which are presented on an accrual basis. We do not consider Table 2's subsidy cost calculations to be a definitive representation of actual subsidy costs incurred. Rather, Table 2 is presented for discussion purposes to illustrate the dramatic effect that interest rate changes have on FDLP subsidy costs.

Table 2 - OIG's *Illustrative* Effect of Interest Changes

	FDLP - 96	FDLP -97
Outstanding Loan Volume - Mature FDLP (000's omitted)	24,880	26,370
Current Interest Spread--1.61%		
Subsidy Cost (000's omitted)	$1,992,494	$1,570,944
Subsidy Cost per loan	$80	$60
Interest Spread of 4.5%		
Subsidy Cost (000's omitted)	$3,348,137	$2,832,150
Subsidy Cost per loan	$135	$107
Interest Spread .1%		
Subsidy Cost (000's omitted)	$1,177,608	$911,975
Subsidy Cost per loan	$47	$35

DATA TABLES

The following tables for FY 1997 and FY 1996 provide a detailed breakdown of our estimated administrative costs for FFELP and a mature FDLP. (Note that "FDLP IPOS/DCS" columns refer only to the portion of those costs incurred due to the FDLP, and that in Tables 4, 5, and 6 these costs are reflected in the overall "FDLP" per loan cost column.)

Table 1 - Estimated Administrative Cost FY 1997

1997 (000's)	FDLP	FFELP	FDLP IPOS/DCS
Total Labor Cost	45,616	35,960	8,860
Total Travel & Transportation	2,683	1,243	104
Total Rent, Communct. & Utilities	21,490	6,426	27
Total Printing & Reproduction	3,798	3,481	315
Total Contract Services	393,613	172,647	9,383
Default Collection Cost	144,816	336,867	144,816
GA Cost	-	198,091	-
Total Supplies & Material	697	465	52
Total Equipment	1,661	818	63
Grand Total	$ 614,374	$ 755,998	$ 163,620

Table 2 - Estimated Administrative Cost FY 1996

1996 (000's)	FDLP	FFELP	FDLP IPOS/DCS
Total Labor Cost	37,996	32,720	8,766
Total Travel & Transportation	1,868	1,878	122
Total Rent, Communct. & Utilities	23,058	17,537	36
Total Printing & Reproduction	5,962	6.774	419
Total Contract Services	364,239	216,526	6,202
Defaulted Loans Collection Cost	188,685	335,818	188,685
GA Cost	-	209,869	-
Total Supplies & Material	2,036	1,210	64
Total Equipment	2,083	685	76
Grand Total	$625,928	$823,016	$204,370

This table presents our calculation of what it would cost private industry to service a mature FDLP.

Table 3 - Private Industry Servicing Cost

	2-year average
Total Loan Volume Outstanding	25,625
In-School & Deferred	$ 20,975,176
Cost to service percentage[44]	0.32%
Estimated Industry Cost to Service	66,771
In-repayment	$ 24,542,896
Cost to service percentage[45]	0.95%
Estimated Industry Cost to Service	233,158
In-repayment Consolidation	$ 7,801,514
Cost to service percentage[46]	0.47%
Estimated Industry Cost to Service	$ 36,667
	-
Total servicing cost per loan	$ 336,580
Servicing cost per loan	$13

44 U.S. Treasury Report "The Financial Viability of the Government Guaranteed Student Loan Program", February 1998 - table 4.

45 Ibid.

46 Ibid.

The following Tables show our calculation of the per loan administrative cost.

Table 4 - Two Year Average of Administrative Cost

Two Year Average (000's)	FDLP	FFELP	FDLP IPOS/DCS	FDLP Minus IPOS/DCS Cost
Total Outstanding loan Volume	25,625	95,178	25,625	25,625
Total Cost	620,151	789,508	183,995	436,156
Cost Per Loan Outstanding	$ 24	$ 17	$ 7	$ 17

Table 5 - FY 1997 Administrative Cost Per Loan

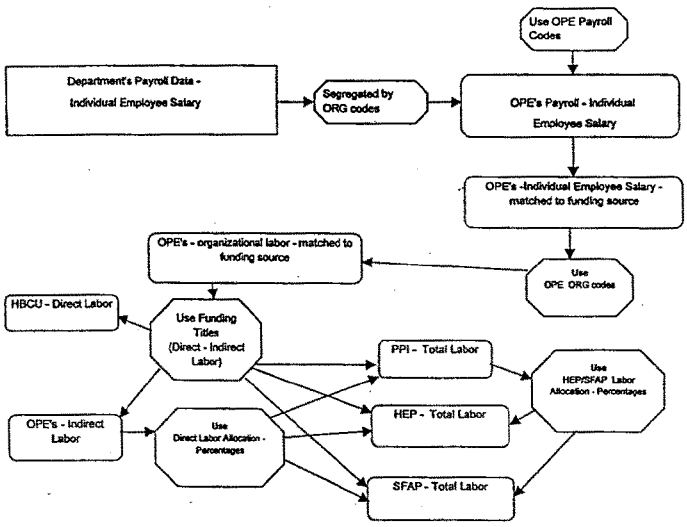
1997 (000's)	FDLP	FFELP	FDLP IPOS/DCS
Total Outstanding loan Volume	26,370	48,972	26,370
Total Cost	614,374	755,998	163,620
Cost Per Loan Outstanding	$ 23	$ 15	$ 6

Table 6 - FY 1996 Administrative Cost Per Loan

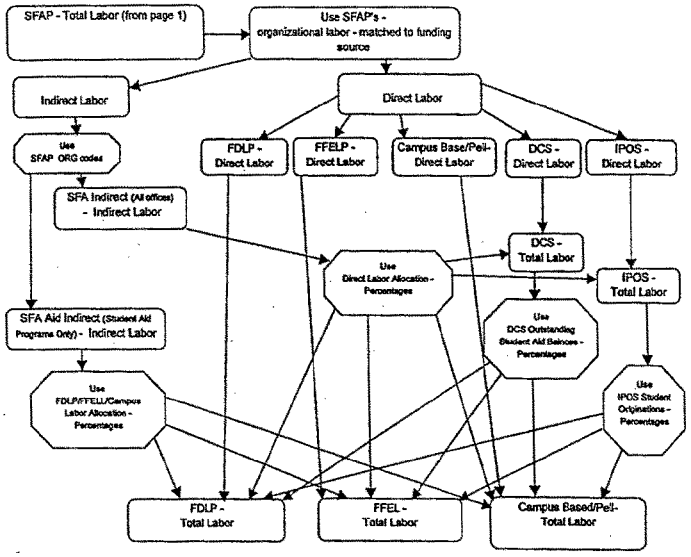
1996 (000's)	FDLP	FFELP	FDLP IPOS/DCS
Total Outstanding loan Volume	24,880	46,206	24,880
Total Cost	625,928	823,017	204,370
Cost Per Loan Outstanding	$ 25	$ 18	$ 8

LABOR ALLOCATION

Payroll Allocation - The flow chart below is a representation of the process we used to allocate labor.

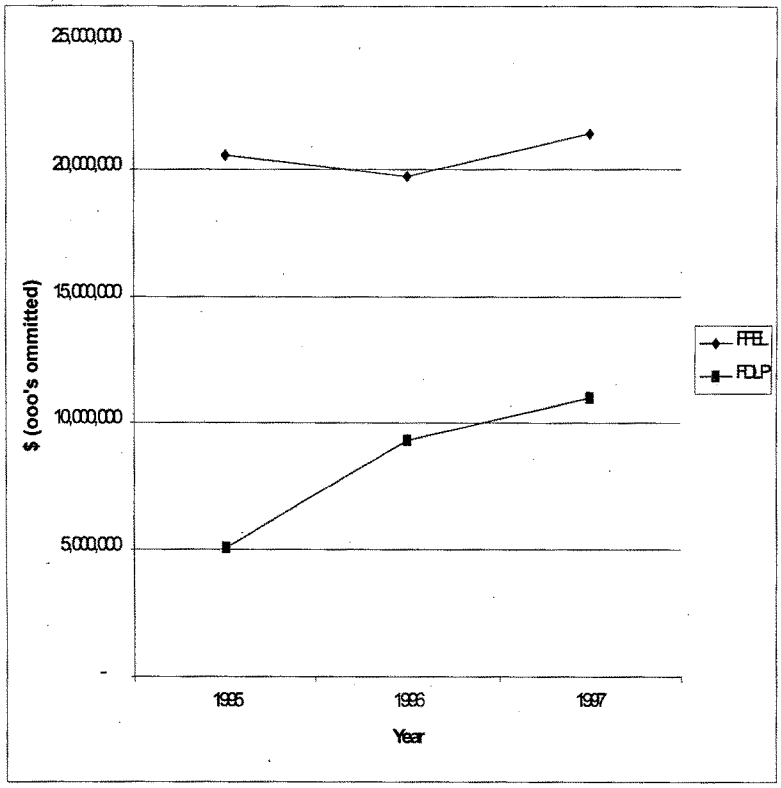


SFAP allocation is on the next page

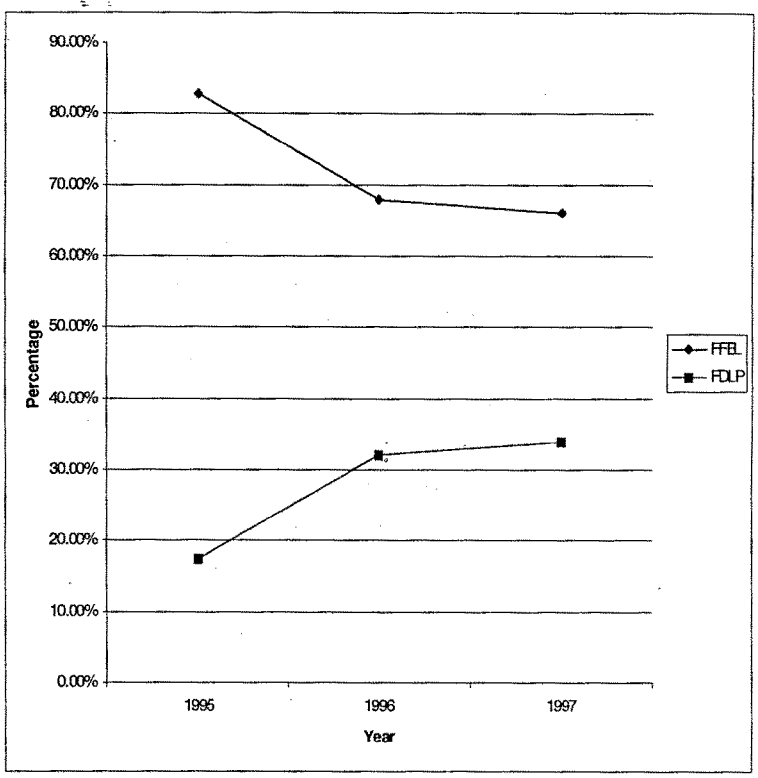

SFAP - Total Labor (from page 1)
Use SFAP's - organizational labor - matched to funding source
Indirect Labor
Direct Labor
Use SFAP ORG codes
FDLP - Direct Labor
FFELP - Direct Labor
Campus Base/Pell- Direct Labor
DCS - Direct Labor
IPOS - Direct Labor
SFA Indirect (All offices) - Indirect Labor
DCS - Total Labor
Use Direct Labor Allocation - Percentages
IPOS - Total Labor
SFA Aid Indirect (Student Aid Programs Only) - Indirect Labor
Use DCS Outstanding Student Aid Balances - Percentages
Use FDLP/FFELL/Campus Labor Allocation - Percentages
Use IPOS Student Originations - Percentages
FDLP - Total Labor
FFEL - Total Labor
Campus Based/Pell- Total Labor

GRAPHIC DISPLAY - LOAN ORIGINATIONS

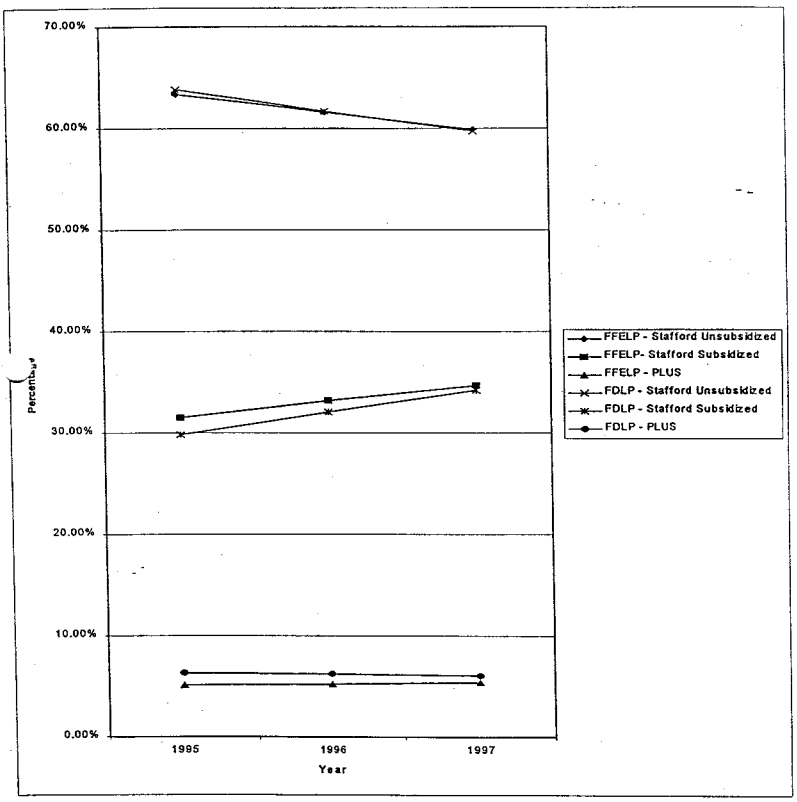
Comparison of Dollar Amount of Loans Originated



Comparison of Percentage of Loans Originated



Percentage of Loan Originations by Loan Type



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OSFAP COMMENTS ON THE COST STUDY

UNITED STATES DEPARTMENT OF EDUCATION
WASHINGTON, D.C. 20202-_____

MEMORANDUM

MAR 18 1999

TO : Thomas Carter
Director, Planning, Analysis, & Management
Office of Inspector General

FROM : Greg Woods
Chief Operating Officer
Office of Student Financial Assistance

SUBJECT : Draft Study of Cost Issues – FDLP and FFELP (CN 13-70001)

This memorandum provides our response following our review of an Office of Inspector General (OIG) draft report on a study conducted to assess the impact of subsidy and administrative costs on the Department of Education's (ED) William D. Ford Direct Loan Program (FDLP) and the Federal Family Education Loan Program (FFELP). Based on the results of your study, you concluded that the subsidy costs (interest expense, default costs, interest subsidy expenses, etc.), for which the Department has limited control, constitute the majority of FDLP and FFELP costs. You noted that the Department can control its administrative costs, and concluded that inefficiencies likely affect the Department's cost of administering the two programs. It should be noted that one of the main reasons the Higher Education Amendments of 1998 recently established the Office of Student Financial Assistance (OSFA) as a Performance-Based Organization (PBO) was to reduce the costs of administering the student financial assistance programs authorized under Title IV. Our performance measures will be focused on meeting this as well as other important goals.

Your work provides a lot of information on some of the major costs involved in administering the two student loan programs. However, in our preliminary review of some of the auditors' working papers supporting the study, we found problems with the methodology used to allocate the costs to the two programs. Internal analysis of loan servicing shows our costs are competitive with industry costs. The assumed inefficiencies may be due to the allocation of costs of other processes within the government that are not done on a commercial basis. Until our managerial cost accounting solution is implemented, we will not be able to determine the extent or the net effect of improper allocations. Therefore, if you must issue this report, we urge you to caution your readers that, if they rely on the report for comparison purposes, the numbers may not be as accurate as their presentation may imply.

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

Page 2 - Memorandum to Thomas Carter

Thank you for the opportunity to comment on this study. It is obvious that much thought and work has gone into producing the final product. We are currently developing baselines to be used to measure our success in reducing the costs of administering all of the OSFA programs and for benchmarking against other entities performing similar functions. We will welcome the OIG's participation in the development of these baselines and of a managerial cost accounting system that will support the goals of the PBO. If we can provide any additional information at this time, please call Linda Paulsen on 708-4664.

cc: Diane Rogers
Thomas P. Skelly
Linda Paulsen

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Mr. MICA. On page 17 it says, ''the 2-year average of the Department's FDLP administrative cost is $24 per loan. Of the $24 total, $7 is used to perform oversight and default functions, while the remaining $17 represents FDLP management costs. To assess the reasonableness of the FDLP management costs, we compared the Department's cost to manage the FDLP, $17 per loan, to the average cost that we estimated the large lenders would have incurred to manage the FDL program, $13 per loan,'' and you refer to a table and an appendix.

The report goes on to say, ''Given the similarities of the two programs and results of the audits we've reviewed''—and another appendix—''we believe a significant portion of the $4 difference may be due to inefficiencies.''

Now, I'm not a rocket scientist. I didn't do extremely well in math, but the administrative costs appear to be 31 percent higher for the government program; is that correct?

Mr. MCNAMARA. Yes, Mr. Chairman, the difference between the $17 and the $13.

Mr. MICA. Now, what's gotten a lot of publicity isn't something that we've uncovered here, but rather what we've watched on television. Some of it is probably sensational, but some of the reports are that we have $73 million gone astray for forgiven disability payments and $3.8 million forgiven payments for students that really didn't die. Can you explain what's going on there?

Mr. MCNAMARA. Yes, Mr. Chairman.

Mr. MICA. Are those inaccurate figures?

Mr. MCNAMARA. Yes, Mr. Chairman.

Mr. MICA. Tell us what the figures are.

Mr. MCNAMARA. The figures are pretty much as you described. What we found in doing an audit——

Mr. MICA. The figures are as I described: $73 million forgiven for folks who weren't disabled, $3.8 million for students that weren't dead.

Mr. MCNAMARA. Let me check that very quickly.

Mr. MICA. Am I in the range?

Mr. MCNAMARA. Yes, Mr. Chairman. During the period July 1994 through December 1996, our audit determined that $216 million in student loans were discharged for death; $292 million in student loans were discharged for total and permanent disability. Nearly $77 million, or approximately 14 percent, were forgiven for these individuals who we later found appeared to have earned income.

Mr. MICA. That's more, $77 million, 14 percent. Again, it's very hard for me to understand. I empathize with Mr. Cummings and the ranking member. Their concern is my concern, that these dollars should be going to students who are in need, that's the reason we set this up. But when you tell me in your testimony that we really don't have a problem, that there's not much difference, then you testify that there's a 31 percent difference, the 14 percent of those given to disability are forgiven on a wrong basis, there's something dramatically wrong with the program.

Mr. MCNAMARA. Mr. Chairman, I would point out that the numbers I'm quoting are for the FFELP program. We think the under-

lying cause would be the same for both, so it doesn't relate to the administrative cost of the direct loan program.

Mr. MICA. I don't care if it's for the government or for the private sector. It's still just not an acceptable level, and again, I don't mean to give you a hard time, but what we're trying to do is find out—if the information is correct, and are the reports we're getting correct. Is this happening?

Mr. MCNAMARA. Yes.

Mr. MICA. Thank you.

Mr. Butts, you're from the University of Michigan, and you had some laudatory things to say about the direct program. That's correct?

Mr. BUTTS. Yes.

Mr. MICA. Is it true that the University of Michigan in 1995 and 1996 could not reconcile its books on this program?

Mr. BUTTS. I'm not sure exactly what you're referring to, Mr. Chairman.

Mr. MICA. Isn't one of the requirements that when you participate in the direct loan program that you reconcile your books?

Mr. BUTTS. It's my understanding that all of our records are reconciled, and all cash has always been reconciled.

Mr. MICA. Is it not also true that more than $100,000 is given out in 1 fiscal year that could be collected by your university?

Mr. BUTTS. I'm not aware of that.

Mr. MICA. I would appreciate it if you go back and check and see if 1995 and 1996 have even yet been reconciled.

Mr. Galloway, you conducted this extensive—sounds like a consumer survey. How much did that cost? What was the total cost of finding out whether these folks are satisfied or not?

[The information referred to follows:]

THE UNIVERSITY OF MICHIGAN
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June 24, 1999

The Honorable John L. Mica
Chairman
Criminal Justice, Drug Policy and Human Resources Subcommittee
U.S. House of Representatives
B-373 Rayburn House Office Building
Washington DC 20515

Dear Chairman Mica:

Please find enclosed the response to your question, regarding the processing of direct loans at the University of Michigan, which I agreed to supply for the record. I am grateful to your staff for providing me with the written question and I hope the information provided is helpful.

Thank you for the opportunity to testify, on behalf of the National Direct Student Loan Coalition.

Sincerely,

Thomas A. Butts
Associate Vice President for
Government Relations

enclosure

Mr. Mica:

TOPIC: Loan Reconciliation Problems

One of the critical responsibilities in a student loan program is keeping track of the monies being borrowed and monies being paid back. I understand that in spring of 1998, the Department issued numerous directives and letters to Direct Loan schools notifying them of the need to submit required loan close-out information. I understand that the schools did not meet the deadlines, and that no penalties were issued, despite the extreme delays in close-outs of more than two years. The inability to ensure timely close-outs calls into question the accuracy of its records about the volume of loans awarded. For example at University of Michigan, I am informed that during the period FY 1995 and FY 1996, over $100,000 more dollars was given out than was expected to be collected. If this problem occurs at many of the 1,300 Direct Loan schools, the dollar discrepancies become even more serious.

Q: Don't these problems illustrate that the National Student Loan Data System (NSLDS) needs serious improvement? When will improvements be completed?

Mr. Butts:

A: With respect to the University of Michigan (UM), the Accounting and Financial Management Services of the Department of Education has confirmed that all campuses of the UM have successfully closed the books for 1994-95, 1995-96 and 1996-97 for the Direct Loan program. For the two years in question, the UM originated $ 238.2 million in direct loans. We were unable to locate the $100,000 amount you questioned in our records. During the course of each year there are many transactions between the campuses and the ED. A snap shot at any given point could show a discrepancy. The important point is that cash is fully reconciled and promissory notes are on file with the Department's contractor when the books are closed at the end of a year. The UM never originates a loan that it does not expect the Department's contractor to collect. If, for some reason, the UM should make a mistake in meeting its responsibilities, it is the UM that would be liable - not the federal taxpayer.

As I indicated in my testimony, there were some bumps in the first couple of years getting all of the systems to work smoothly. The principle difficulties occurred during the change from one origination contractor to another. Those problems have been resolved and, as a result, we have an improved process today.

The Direct Loan program has had successful audits every year of its operation and the taxpayers know where the money has gone. The FFEL program in contrast could not be successfully audited until FY 97. The FFEL program was authorized in 1965. We are pleased that the Direct Loan program overcame its startup challenges in three years while I understand it took FFEL over thirty years.

I expect that the Department will provide further clarifications for you on this and the National Student Loan Data System.

Mr. GALLOWAY. Our institutional surveys which we conducted for them, the cost varied between $215,000 and $300,000 per survey.

Mr. MICA. The total amount contracted over the period of years for your activities, all of your activities?

Mr. GALLOWAY. Put together were about $6.3 million.

Mr. MICA. You ended by saying that you felt that there were still problems. In fact, some of the problems you cited you said—and this is from your testimony "structural weaknesses in the technological skills of many employees make running a technologically sophisticated program like direct lending a tremendously challenging task." Were you trying to say it's hard for a government bureaucracy to be a bank? Is that what you said, Mr. Berthoud?

Mr. BERTHOUD. Yes, it is, Mr. Chairman.

Mr. MICA. Is that basically what it boils down to?

Mr. GALLOWAY. That's part of it. The other part of it, there's a lot of systems requirements in running the direct loan program, and it seems a lot of people told us they really had trouble getting people with cutting-edge technical skills.

Mr. MICA. You also said that given the difficulty of firing anyone in the Department I'm very familiar with that, I chaired the Civil Service Subcommitee for 4 years. Mr. Cummings was one of my ranking members. We found it was almost impossible to fire anyone in the Federal work force. Managers are forced to rely constantly on a thin layer of capable people. Now, these aren't my words. This is your testimony; is that correct? Is that one of the problems?

Mr. GALLOWAY. If I could add one word to that, I would be glad to say it's correct. Some managers—not every manager has that problem, but a lot of managers talked to us about having problems with some people who couldn't get the job done, and they kind of shove them off in a corner of the room, and they rely on the people who could get the job done.

Mr. MICA. Still on the payroll, and then we tax the ones who are able to—

Mr. GALLOWAY. It's tough for the people who have the skills because they get called on all the time.

Mr. MICA. Mr. McNamara, one final question. There's also been a number of stories and reports about the problem with foreign schools, people getting loans and not attending school or something wrong with the school. What's the problem there in a nutshell?

Mr. MCNAMARA. In a nutshell, Mr. Chairman, foreign schools operate differently than schools in the United States. The check goes directly to the student, and currently there isn't any process in place to verify either before the student gets the loan or while they're in school that they actually are attending the school.

Mr. MICA. So there's still no mechanism in place to check up on this?

Mr. MCNAMARA. As of this moment, no, but I'm aware the Department is in the process of setting up a website. They could tell you more about the exact status. There is no mechanism in place to prevent the student from initially getting the fraudulent loan.

Mr. MICA. Thank you.

I'd like to yield now to the ranking member, Mrs. Mink.

Mrs. MINK. Thank you very much.

Mr. McNamara, the Chair has raised some disturbing statistics about discharges from liability to repay loans on the grounds of total permanent disability or death or other reasons where the government is allowed to discharge the debts rather than by payment. Are there any safeguards in the law which—upon audits such as the one that was performed—which disclosed all of these figures allowing the government to go back and reclaim the loan payments due? Or is the discharge and waiver that's issued final and permanent even though the circumstances upon which those waivers were given turn out not to be true?

Mr. MCNAMARA. I believe if we could determine that people that applied for disability did so based on fraud, we could prosecute them criminally or civilly and attempt to——

Mrs. MINK. In the absence of fraud, is there any way in which the law would permit a recovery of the loan payments due?

Mr. MCNAMARA. The regulations would not permit us to go back and do that right now.

Mrs. MINK. So if, at the date of discharge of the loan liability, the person was indeed disabled, perhaps, as indicated from these notes, collecting Social Security disability, and then subsequently was able to recover, get a job notwithstanding that disability—I mean, blind people are employed, and they do earn sufficient moneys. Persons that are disabled in many ways can go back to school, become trained in computer technology or something and become gainfully employed. Under those circumstances there's no way that the government is able to go back then and recover the loan liability if subsequently the person became an earner, and therefore liable for taxes under IRS? Because I assume that the IRS is the one that disclosed some of these figures.

Mr. MCNAMARA. Actually, we obtained these figures by matching everyone who had received a discharge with the Social Security master earnings data base. It certainly could be the case that someone could be declared permanently disabled and then perhaps recover. The Department's regulations right now state that, and I think they're on the chart on the wall—on the board over there, basically you have to be so disabled that it's unlikely you can either return to work or go to school or that you're going to die. So it's pretty extreme.

Mrs. MINK. So is there any ability, under the loan regulations that exist, for the government to go back and reclaim the loan liability?

Mr. MCNAMARA. Currently, no.

Mrs. MINK. So would it be your recommendation that we correct the discrepancy or omission in the law and allow the government to go back and reopen this liability?

Mr. MCNAMARA. I think if it can be proven that there was fraud, definitely.

The other question, the previous regulations dealt with that, if you were going to get a new loan, your previous loan would be reinstated. That regulation changed, I think, in 1995, that's clearly a policy question but we would support that.

Mrs. MINK. Now, on the cost basis which your inspector's report indicated as a $4 difference in terms of operational costs, to what do you directly attribute the $4 difference?

Mr. MCNAMARA. We attributed that to possible inefficiencies surrounding access to the necessary information to run the programs. The Department didn't always have necessary management information. As has been mentioned earlier by other members of the panel, the Department is aware that it needs to make improvements in its technical and contracting expertise. We've met with the new PBO Chief Operating Officer, Greg Woods, on that regard, and he has brought in people that have this expertise. And finally, the last inefficiency would be basically the timely information coming in that would allow you to make the management decisions you needed to make.

Mrs. MINK. How do you determine what the cost of the loan is if the basis of the determination is lack of information, lack of a cost accounting system, or lack of relevant data? How do you make an assessment on what the true cost is for the program?

Mr. MCNAMARA. We use the audited financial statements for fiscal years 1996 and 1997, so we started with a full deck. Then basically, we just allocated it down to one program or the other, and we came out with a bottom line.

Mrs. MINK. So if you had the true data, it might turn out to be quite different?

Mr. MCNAMARA. We did have the true data.

Mrs. MINK. You had the true data in terms of how to distribute the administrative costs to each type of loan?

Mr. MCNAMARA. Yes, ma'am.

Mrs. MINK. You have confidence that the $4 difference is a true difference?

Mr. MCNAMARA. I have confidence in what the actual costs were for fiscal years 1996 and 1997. The $4 difference is derived by a projection that we made using a U.S. Treasury study that estimated the cost of a large private lender to service a similar portfolio. We used that as a benchmark, and we compared that to the actual cost.

Mrs. MINK. Which is the large private vendor that was used as a benchmark?

Mr. MCNAMARA. There was no particular lender. This was a Treasury study done to try to determine how much FFELP lenders should be paid last year when there was a lot of controversy about the interest rates and what they should get. This was their approximation of what it would cost a hypothetical large lender to service loans.

Mrs. MINK. The decision of the Congress to go into the direct loan program was basically to save money. As I recall the deliberations in my committee, there was an assumption that there would be a $4 billion savings in establishing a direct loan program which the universities would administer directly rather than going through the private lenders route. Has that savings panned out?

Mr. MCNAMARA. I could comment on the results of our study. The savings, I guess, would depend on what previous study you were quoting and whether they said it would cost more or less. Studies we looked at fell out on both sides. I think one of the major flaws we found in all the studies we looked at was that some of them were made before the law was passed. They were assumed to be 100 percent direct loan program, for example, and other sig-

nificant changes Congress made really invalidated the assumptions of many of those studies. We know what we found, and I really couldn't compare it to the earlier studies because they didn't use the same assumptions.

Mrs. MINK. What is your conclusion then in terms of whether there have been any budgetary savings overall by the transfer to a direct loan program?

Mr. MCNAMARA. We didn't make that conclusion. What our conclusion was that in any given year, and that really subsidy costs drive it, either program could cost more or less. I think there are projections available, and depending on what interest rates you use going into the future, you could project one to be more or less than the other.

Mrs. MINK. I have just one final question, Mr. Berthoud, representing the National Taxpayers Union. Certainly I appreciate your comments with respect to the attention which your National Taxpayers Union directs to the cost of various programs.

I just wanted, Mr. Chairman, to note that when this matter was being debated in the Congress, specifically in my committee, the author of the program was Congressman Robert Andrews, with the support of our then chairman, Mr. Ford. We have a letter from the record dated September 20, 1991, from the National Taxpayers Union endorsing the bill that Mr. Andrews introduced, H.R. 3211. The letter commends him for introducing it because it would yield taxpayers savings of $1.5 billion a year. I'd ask unanimous consent to have this inserted in the record.

Mr. MICA. Without objection so ordered.

Mrs. MINK. Thank you very much.

[The information referred to follows:]

NATIONAL TAXPAYERS UNION
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Washington, D.C. 20003

(202) 543-1300 Tel.
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James Dale Davidson
Chairman

September 20, 1991

The Honorable Robert Andrews
U.S. House of Representatives
Room 1005, Longworth Building
Washington, DC 20015

Dear Rep. Andrews:

On behalf of the National Taxpayers Union's 200,000 members, I am writing to commend you for introducing H.R. 3211, the Middle Income Educational Opportunity Act. By converting the Guaranteed Student Loan program into a direct loan program, H.R. 3211 would yield taxpayer savings of approximately $1.5 billion per year. It would not require that these savings be spent on additional student loan subsidies.

NTU wishes to endorse H.R. 3211. At the same time, we strongly urge that any resulting savings be returned to the Treasury for the purpose of deficit reduction.

Please let me know if NTU may be of assistance to you in advancing this important bill to reduce the cost of the Guaranteed Student Loan program.

Sincerely,

James Dale Davidson
Chairman

Mr. MICA. I'd like to now recognize the gentleman from Indiana, Mr. Souder.

Mr. SOUDER. I thank the chairman, and I also thank him for this hearing. This has been a difficult topic as we move through the higher education bill over in the education committee, and it's important that we continue to monitor this issue.

First, I'd like to ask Dr. Berthoud in general, I was on the small business program, and every time we expanded small business lending, people said, well, this is free. We have this little portion that we can expand. Don't you see this phenomena happening across the government, that at the time we have economic good times, we're expanding all the risk of the Federal Government, and we're not really having an analysis of what this could cost the taxpayers long term?

Mr. BERTHOUD. I think that's absolutely right. The Congress in recent years has made important steps on better accounting of its loan and direct loan and loan guarantee programs. But in many cases, with Federal and State governments loans, loan liabilities, the tremendous unfunded liabilities of the Social Security program and others, there are a lot of long-term fiscal concerns that we have.

Mr. SOUDER. Many conservatives such as you and I, favored moving toward loans from some grants and having accountability and responsibility, but there also needs to be a balance of what amount at risk the government would have if there was a downturn. I've never seen such a projection in any forecasting. We see the total cumulative, but not the differential cost to the government if there's a recession or a growth rate of *X* amount. It simply isn't in our budgetary calculations. We see the large hundred billion exposed, $11 billion annually, but we don't see what that actually means in the bad debt allowance that a private company would have to be projecting, assuming an average bad debt ratio over time. We assume a fixed bad debt ratio even if the exposure increases.

Mr. Butts, when the program was first conceived, was there any consideration given to that variance in the amount of bad debts and how that would be calculated in the budget?

Mr. BUTTS. The assumptions were that the defaults should be—would be roughly similar, and that the Department of Education needed to do everything it could to reduce the default rates, and as direct lending comes on-line, it should have and maintain a loan rate. You'll note that in the last few years the overall default rate in student loans has dropped from something like 22 percent to under 10 percent now.

Mr. SOUDER. But isn't this exactly where the administrative costs come into play, because if you have fixed overhead plus the bad debts, it's no longer a savings because we don't absorb—in other words, if all of a sudden we have a recession and the bad debts go up, we don't ask the private lenders that we have to pay their overhead.

Mr. BUTTS. The private lenders are guaranteed 98 percent of repayment on their loans and are guaranteed an entitlement, mandatory payment from the Congress, a subsidy for every loan they make, which would appear to be more than is necessary to make

a reasonable profit and to cover their overhead costs for administration.

The direct loan program, it was anticipated—we're in our 5th year. We're making over $10 billion a year in new loans. And students are beginning to come into repayment, so it is only logical that the servicing costs should be increasing as that volume comes on-line. That was anticipated when the program was enacted, and the administrative funding that was put into the law anticipated those costs.

If you look at the administrative costs of the program that the Department has, one of the things that we don't have is a comparison of what those real administrative costs are in the FFELP program because it's so diverse, it has never been studied. We've not had a good study of the subsidies. The Congressional Budget Office has studied those issues with the Treasury, and I have some concerns here. But the latest methodologies that I've seen from the OMB and the CBO, if you take into account the subsidy payments in both FFELP and direct lending and the administrative costs to the Department, it is roughly $7 per $100 loaned cheaper to do a direct loan than to do a FFELP loan, and if you reduce direct loan volume, taxpayer costs will increase. If you increase direct loan volume overall, they will decrease.

Mr. SOUDER. I already have the yellow light. I want to make a couple of points. One is that, in a factual basis, we've had a loan increase since 1992 of 28 percent and an administrative increase of 212 percent. Now, there may be many different reasons, but we've heard a number today. This program was sold that it was going to save the Federal Government money. At best, the Inspector General seems defensive in his report in saying he's not saying that the private loan programs are cheaper to administer. In other words, at best you're saying it's a draw. Is that a misrepresentation of what you said, Mr. McNamara?

Mr. MCNAMARA. We didn't conclude it was a draw. We simply said we didn't draw a conclusion on the difference.

Mr. SOUDER. In fact, you did draw a conclusion in the sense you said it could be higher under one program one year, and it could be lower under another program, which means it could go back and forth. But you did not suggest that, in fact, the way the program was sold, which is that it was going to save the government money, was a definitive conclusion.

Mr. MCNAMARA. Correct. We didn't conclude that.

Mr. SOUDER. And that furthermore, if this was a private government audit—and we heard things, as the chairman already pointed out, structural weaknesses in the technological skills of many employees, which is because the Department of Education is not expected to be a bank; the difficulty of firing anyone in the Department, which is true because it's government; and as was also pointed out by those from Dr. Galloway and Mr. McNamara, having access to reliable information.

Well, yes, government departments aren't private sector organizations that necessarily have this equipment, having qualified technical aid and contract management, because they're not a bank using compatible automated data processing systems. We have that throughout the government, and it's the danger of trying to expand

and take over additional private sector things; we're not going to be able to afford all the data processing systems, including uncontrollable factors as Federal procurement. Yes, we do have personnel rules. Yes, we do have that.

Furthermore, I think earlier in your testimony you said they don't have a cost accounting system. I can't imagine a private sector company this big without a cost accounting system. And then my personal favorite line of which I am very proud of is that the—from Dr. Galloway, the 1994 congressional elections, me, I was one of the people that came in, forced many direct loan decisionmakers into adopting a risk-adverse posture. I would hope so. They are loan officers.

As a borrower, I don't like banks a lot of times. They only want to give you money if you deserve it, and they sit there, and unless you can prove you have plenty of money, they don't want to give you the loan. It's aggravating. As a parent with two students in college, quite frankly, I understand that in initial procedures with direct lending, it actually helped simplify, much like sometimes a public sector entity is needed, but then they back up after we've fixed some of that.

The truth here is that I am concerned about the ability of the government and definitely don't believe it should be expanding, and that I hope they continue to be somewhat concerned by Congress so they adopt a risk-adverse policy, and I view that as a tremendous compliment, and I want to thank you for it.

Mr. MICA. I thank the gentleman from Indiana. I don't think you were asking for a response.

Mr. Cummings.

Mr. CUMMINGS. Thank you very much, Mr. Chairman.

Mr. McNamara, a lot of times these hearings come about—I'm not always sure about how they come about—but a lot of times what happens, we read things in the newspaper or we hear it on the news, and the next thing you know we have a hearing. There's nothing wrong with that. One of the articles that I think probably had some impact here was a June 1, 1999, article, editorial rather, of Investors Business Daily. Are you familiar with that?

Mr. MCNAMARA. No, sir, I'm not.

Mr. CUMMINGS. They talk about your report extensively.

Mr. MCNAMARA. The cost study?

Mr. CUMMINGS. Yes. When you look at an editorial, a lot of times the editorial writer takes a lot of liberty, and I'm not sure whether—I mean, just based upon your testimony today, I question whether the writer is accurate. I just want to make sure we're clear.

First of all, the editorial says that your report says, "one program is costing taxpayers an extra $100 million a year." Is that accurate?

Mr. MCNAMARA. No, sir.

Mr. CUMMINGS. You never said that?

Mr. MCNAMARA. No, sir.

Mr. CUMMINGS. It also says that the Department of Education ignored your report, do you believe that to be accurate?

Mr. MCNAMARA. No, I don't believe that they have ignored it. We've had a lot of discussions with them. They also plan to adopt the methodology we use to allocate costs as they go forth to set up

their accounting system, and we've had a few meetings with them so far to get that process started.

Mr. CUMMINGS. This article was written on June 1. The actions that you just spoke of, did some of them happen before June 1, such as maybe something happened afterwards that the writer didn't know about? I'm just curious.

Mr. MCNAMARA. I would say it's both.

Mr. CUMMINGS. Could you tell us what has happened since June 1 so I can sort of update this information in my mind?

Mr. MCNAMARA. Since June 1, and I'm doing this off the top of my head.

Mr. CUMMINGS. I understand. Do the best you can.

Mr. MCNAMARA. We obtained information from the Army Materiel Command on activity-based costing. I had my staff member that did this study review that. I know he's had some discussions and had preliminary meetings with the head of the accounting and finance group in the new PBO, and she's interested in working with us as she decides on a new managerial cost accounting system. Some of that happened before the first, and some of it has happened since the first.

Mr. CUMMINGS. Quite a bit of other things happened before the first. It was only a few days ago.

Mr. MCNAMARA. Yes, sir.

Mr. CUMMINGS. Let me ask you this. Going back to the editorial, I think you said you had four recommendations?

Mr. MCNAMARA. Yes, sir.

Mr. CUMMINGS. Can you just say them again for me real quick?

Mr. MCNAMARA. To institute a cost accounting system, a managerial cost accounting, activity-based cost accounting system was one.

Mr. CUMMINGS. Some action is being taken on that based on what you just talked about?

Mr. MCNAMARA. Yes, sir.

Mr. CUMMINGS. Go ahead. Two.

Mr. MCNAMARA. The second one was to allocate employee cost to the program that benefited.

Mr. CUMMINGS. Has there been anything happening on that?

Mr. MCNAMARA. That would probably be subsumed into the first recommendation.

Mr. CUMMINGS. I'm not an accountant, but I kind of figured that. No. 3?

Mr. MCNAMARA. Was to start studies on borrower behavior.

Mr. CUMMINGS. Tell me what you have in mind by that? What does that mean?

Mr. MCNAMARA. Well, the more you know about borrower behavior, the more you know about what might happen if you change various policies, what effect it might have on defaults and various other things. I think lenders typically do this to know that if you raise interest rates, are you going to make more loans or less loans; what affect would certain collection practices have in terms of your ability to get the loans back in, that sort of thing.

Mr. CUMMINGS. Has any action been taken on that?

Mr. MCNAMARA. I'm unaware of that. The Department would be in a better position to talk about that.

Mr. CUMMINGS. No. 4.

Mr. MCNAMARA. Recommendations. I'm almost going from memory now. Let me just refer to the fourth one. The final one was to address the inefficiencies that we pointed out from previous studies that we had done or the General Accounting Office had done. Problems with the—for instance, the information systems, trying to consolidate those, eliminate the stovepipe systems that have been discussed earlier.

Mr. CUMMINGS. Some action has been taken on that?

Mr. MCNAMARA. It's currently under way. That's why the PBO was set up. Greg Woods is working on a blueprint that I'm sure he'll tell you about. Our office has been invited, and we are working with them as they design the systems to try to make sure that internal controls are designed in at the start.

Mr. CUMMINGS. Do you feel comfortable with—having spent this time doing your investigation? Do you feel satisfied that the Department is doing their part to followup on the things that you recommended generally, and from what you do know?

Mr. MCNAMARA. From what I do know, they clearly made a beginning on the first two, and that's the cost accounting. The others, you know, they've gotten started, but it's really too early to tell.

Mr. CUMMINGS. I don't have anything else.

Mr. MICA. Thank you.

We'll recognize now Mr. Ose, the gentleman from California.

Mr. OSE. Thank you, Mr. Chairman.

Mr. Butts, I want to make sure I understand the process in the direct program. The student comes in, applies to a university or higher education facility seeking financial assistance for continuing at school, for tuition, books and the like. The institution goes through its underwriting criteria, I presume, exercises some judgment on the ability of the student to repay, and makes a loan. Once the loan is made, what happens to the loan itself? You package it and sell it to Sallie Mae?

Mr. BUTTS. Once the university has given a student a financial aid package of Pell grants, loans, and so forth, we distribute the funds to the students with appropriate promissory notes and draw down the money from the Federal Government, as we do for all of our programs, and allocate it to the students' account wherever it is appropriately to go. The signed promissory note is sent to the Department of Education's contractor for servicing purposes. The servicer then enters it and sends a confirmation notice to the student that reminds the student that they have a loan. The government then assumes the responsibility for the billing and servicing. All the servicing of the student loans for direct loans is handled by private sector contractors to the Department of Education.

Mr. OSE. That's the $13 or $17 figure we keep talking about?

Mr. BUTTS. Yes, sir. That $17 figure, as I understand it, includes the profit paid to the contractors. I'm not sure that the other number includes that.

Mr. OSE. In this process, somewhere along the way, the note is sold, or is it held by the Federal Government?

Mr. BUTTS. It is held by the Federal Government. You see, the capital for these loans have been obtained for all practical purposes through the weekly auction in the private capital markets, similar

to T-bills and at, of course, very good rates for the government because it can leverage its purchasing power in the marketplace. As the loans are repaid in direct lending, then they are simply turned to the Treasury.

Mr. OSE. The actual loan is never packaged and sold?

Mr. BUTTS. Not in the direct loan program.

Mr. OSE. How about the Federal family education program, the FFELP?

Mr. BUTTS. In the FFELP program, there are, I think, some 7,000 lenders, over 300 or so very active lenders, and a variety of secondary markets including Sallie Mae, tax exempts and so forth. Those loans can be bought and sold in the marketplace. One of the advantages, we think, of the direct loan program is that the student always knows who owns their loan and who to make the payment to.

Mr. OSE. Because the institution continues to hold it, and it is serviced by the private contractor.

Mr. BUTTS. Because the government owns the loan, and it's being serviced by one entity.

Mr. OSE. Now, you would have the direct loans, so you would not be involved in the guarantee, because if the Federal Government isn't paid, they just write it off or declare them dead.

Mr. BUTTS. At one point we were involved with the guaranteed loan program, and we dealt with every lender and secondary market in the country as a national university and dealt with—it was a very complicated process for us, which is why we changed. We think direct loans provide better service to our students; other institutions think otherwise. Clearly the marketplace is now making both programs competitive, but we think that the fact that the student in direct lending knows who owns their loan, and that doesn't change, may change repayment plans wherever possible, and has access to income-contingent repayment plans are clear advantages for the students.

Mr. OSE. Mr. Chairman, I thank you for the 5 minutes. I know we have a vote, so I yield back.

Mr. MICA. I want to thank all of our panelists: Mr. Berthoud from the National Taxpayers Union. Mr. Butts, we're waiting to hear back from the University of Michigan's reconciliation of accounts from 1995–1996. Dr. Galloway, we wish you many further studies and contracts. Mr. McNamara, thank you. We appreciate the new Inspector General's willingness to go forward today, even though she's not in place, but we wanted to get this matter before the subcommittee in a timely fashion.

I might say, too, this is not the result of a GAO study ordered by Congress. This is a study, as I understand, that the Department authorized, and the audit results speak for themselves, but we do need your interpretation and appreciate your cooperation.

We will hear from the second panel and the Department of Education in—I think we have four votes or so. We're going to have to recess the hearing until about 12:35. It will be just under an hour, which will give folks an opportunity to catch a quick bite.

I apologize to our next two witnesses, but there will be a series of votes, and we can't conduct business in the interim. I thank this

panel. You're excused. This meeting of the subcommittee is in recess.

[Whereupon at 11:45 a.m., the subcommittee recessed to reconvene at 12:35 the same day.]

Mr. MICA. I would like to call this meeting of the subcommittee back to order.

We have our second panel before us: Dr. Marshall S. Smith, Acting Deputy Secretary, Department of Education; Mr. Greg Woods, Chief Operating Officer, Office of Student Financial Assistance Programs under the Department of Education.

Gentlemen, this is an investigation and oversight subcommittee. Would you please stand and be sworn?

[Witnesses sworn.]

Mr. MICA. The witnesses answered in the affirmative.

If you have lengthy statements, we'll make them part of the record by unanimous consent. Otherwise, you're recognized.

The first witness is Dr. Marshall Smith, Acting Deputy Secretary, Department of Education.

Welcome, and you're recognized, sir.

STATEMENTS OF MARSHALL S. SMITH, ACTING DEPUTY SECRETARY, DEPARTMENT OF EDUCATION; AND GREG WOODS, CHIEF OPERATING OFFICER, OFFICE OF STUDENT FINANCIAL ASSISTANCE PROGRAMS, DEPARTMENT OF EDUCATION

Mr. SMITH. Thank you, Mr. Chairman, Mrs. Mink.

The Department of Education administers two Stafford student loan programs. Under the FFEL, Federal family education loan program, the Federal Government subsidizes private lenders to make student loans and then guarantees those loans against defaults.

Under the direct loan program, we fund student loans with Federal capital and hire private companies under performance-based contracts to deliver and service the loans.

This year, the FFEL program will provide an estimated $20.4 billion in new loans for approximately 3.5 million students; and the direct loan program will provide $10.6 billion in loans to 1.9 million students.

Before the direct loan program was founded in 1994, students and schools were often confused by an array of different paperwork, procedures and schedules in the FFEL program. Only 68 percent of schools expressed satisfaction with the program. Federal subsidies for FFEL lenders and guarantee agencies were too costly for taxpayers, and the program had not received a clean audit opinion at least since the Department of Education was founded in 1980.

The direct loan program reduced paperwork, created a single loan account with one point of contact for each student and allowed the graduates greater flexibility in repaying the loans, including the new income contingent repayment plan. In 3 years, over 1,200 schools chose to leave the FFEL program and join direct lending. The direct loan program now originates as many loans as the largest 15 FFEL lenders together. It holds one-third of one of the largest financial markets in the world.

A new and strong competitor, the direct loan program helped inspire FFEL lenders to help improve their services. As a senior FFEL executive said last year, "Direct Loans have introduced some ways of doing business and some delivery mechanisms that made the private industry wake up a little bit. It's been good for the industry, particularly for students and schools."

Competition does help, primarily to improve service in the FFEL program. Satisfaction with both student loan programs among schools increased from 68 percent in 1994–1995 to 81 percent in 1997–1998.

Students are also satisfied. A 1998 survey found that 94 percent of all student borrowers were satisfied with their loan program.

With the help of Congress and our partners, the Department strengthened the financial management of the loan programs. The national cohort default rate has been reduced from 22.4 percent 5 years ago to a record low 9.6 percent. At the same time, annual collections have increased by two-fifths, from 6.6 percent of outstanding defaults in fiscal year 1993 to 9.2 percent in fiscal year 1998.

The National Student Loan Data System has helped prevent ineligible students from receiving as much as $400 million in grants and loans this year. These and other improvements helped the Department receive an unqualified opinion from its auditors on its fiscal 1997 financial statement.

The subcommittee heard this morning from the Department of Education's Office of the Inspector General, which recently completed a study of direct loans and FFEL costs. We welcome the findings of the study, which I hope will help us reduce administrative costs and improve our internal accounting. However, I'm concerned that some have misunderstood the study and wrongly concluded that the direct loan program is more expensive for taxpayers than the FFEL program.

The report does not compare the total cost to the taxpayer of these programs. It's that simple. Instead, the Inspector General's report compares documented direct loan administrative costs with estimates of what it might cost a large FFEL lender to manage the same loans. It does not report actual administrative costs in the FFEL program. More importantly, it does not combine the Federal administrative costs with the Federal subsidy costs.

The overall Federal subsidy includes default costs, interest subsidies and other expenses that are the large majority of Federal expenses in operating the FFEL program. Adding the subsidy costs to the Federal administrative costs would present a clearer picture of the total cost to taxpayers.

The table on page 8 of my written testimony does this. That table shows that using current economic assumptions, both by the CBO and by the administration, the direct loan program is substantially less expensive for taxpayers than the FFEL program. In this analysis, each FFEL loan is nearly twice as expensive for taxpayers as a comparable direct loan, according to either the administration or the CBO's estimate. As a result, direct loans are estimated to save taxpayers over $700 million this fiscal year compared to the cost of all direct loans if they were FFEL loans.

In summary, the student loan programs have come a long way since the direct loan program was established in 1994. Major im-

provements to the program include healthy competition between the two student loan programs, creating marketplace incentives to improve service and increase customer service satisfaction. Now schools can move to the program that they believe will best serve their students.

We now have lower interest rates for students who have saved $4.7 billion—since 1994.

Finally, there have been over $5 billion in savings—$5 billion in savings for taxpayers since 1994 due to reduced subsides for FFEL financial institutions and the lower Federal costs for direct loans than for FFEL loans. That's $5 billion.

In addition, taxpayers have saved additional billions in reduced default costs.

Now the loan programs are poised for further improvements. The new performance-based organization established by Congress has greater management flexibility, accountability for results, and incentives for high performance.

We supported this law and have been pleased to implement it quickly and enthusiastically. The first Chief Operating Officer for Student Aid, Greg Woods, has hit the ground running. He has the right experience, including being the CEO of a software company and 5 years at the Reinventing Government initiative, to make the PBO a success.

After Mr. Woods describes his plans for improving the administration of student aid, I'd be happy to answer any questions you may have. Thank you, Mr. Chairman.

Mr. MICA. Thank you.

[The prepared statement of Mr. Smith follows:]

U.S. DEPARTMENT OF EDUCATION

Statement by

Marshall S. Smith
Deputy Secretary (A)

on

The Federal Direct Student Loan Program

June 17, 1999

Committee on Government Reform
Subcommittee on Criminal Justice, Drug Policy, and Human Resources

Mr. Chairman and Members of the Subcommittee:

I welcome the opportunity to speak with you today about the Federal Direct Student Loan program, which I regard as a cornerstone for the federal government's efforts to reform its student loan programs to improve customer satisfaction, strengthen financial management, and reduce costs for both students and taxpayers.

As you know, prior to 1994, all of the Department of Education's Stafford student loans were made through the Federal Family Education Loan (FFEL) program. The FFEL program encourages private lenders to make loans to students by subsidizing lenders and guaranteeing student loans against default. In fiscal year 1994, the FFEL program provided $20.7 billion in new loans to 4.0 million students. This year, the FFEL program will provide a similar amount of new loans: $20.4 billion to 3.5 million students.

Established five years ago, the Direct Loan program funds student loans with federal capital and is administered by private companies under performance-based contracts that are awarded competitively. The Direct Loan program is roughly half the size of the FFEL program and will provide $10.6 billion in new loans this year to help 1.9 million students afford a postsecondary education.

Today, I will discuss (1) the impetus for the Direct Loan program in 1993 and the challenges it has faced, (2) how the competition between the two loan programs has benefited students, schools, and taxpayers, and (3) the federal costs of FFEL and direct loans and the recent study on this subject by the Department of Education's Inspector General.

THE ORIGIN OF DIRECT LOANS

In 1993, the FFEL program was in need of serious reform. Different lenders often had different paperwork, procedures, and schedules, causing confusion and increasing the administrative burdens placed on students and schools. For the most part, loans were processed on paper forms. Perhaps as a result, only 68 percent of schools expressed satisfaction with the FFEL program in a survey by Macro International conducted in 1994-95 (the first year for which data are available).

There was a longstanding need for the Department and our partners to strengthen the financial management of the FFEL program. A series of reports by the General Accounting Office documented its weaknesses and labeled it a "high risk" to taxpayers. The most recent cohort default rate, for students entered repayment during fiscal year 1990, was 22.4 percent. And the program had not received a clean audit opinion at least since the Department of Education was founded in 1980.

Federal subsidies for FFEL lenders and guaranty agencies were high, creating a large and unnecessary expense for taxpayers. Lenders and guaranty agencies faced rules that

created financial disincentives to prevent loan defaults or spend federal dollars most prudently.

The Direct Loan program began a new approach. It reduced paperwork for students applying for loans. Graduates found greater flexibility in repaying their loans, including the income-contingent repayment option that allowed them to repay their loans as a share of their income. And direct loan borrowers had just one loan account with a single point of contact regardless of the number of loans they have borrowed, unlike some FFEL borrowers who were required to make payments to several different lenders.

Direct lending offered schools a single set of procedures, faster and more reliable delivery of funds, less paperwork, electronic loan processing, and an emphasis on customer service. Within three years, roughly one-quarter of all schools — over 1,200 of them — chose to leave the FFEL program and join direct lending.

In only five years, the Direct Loan program has become the largest single source of new student loans, originating as many loans as the largest 15 FFEL lenders together. It now holds one-third of one of the largest financial markets in the world.

In part because of its rapid expansion, the Direct Loan program — like many start-up ventures — experienced some growing pains. Federal constraints on procurement and personnel and the difficulty of planning investments through the cumbersome and sometimes contentious annual budget process contributed to this challenge.

A 1997 transition between private-sector contractors disrupted and delayed the origination of new loans. The transition also caused difficulties in consolidating loans, leading the Department to suspend accepting applications for direct consolidation loans for three months while it re-engineered the consolidation process.

However, the Direct Loan program's origination and consolidation operations under the new contractor have been running smoothly since late 1997. Our contractor processes

99 percent of loan origination records within 12 hours. The consolidation loan program is another success story: between July 1998 and January 1999, when a lower interest rate was temporarily available on direct consolidation loans, our contractor's weekly volume increased as much as tenfold. In those seven months, our contractor consolidated the loans of about 200,000 borrowers, usually faster than the expected 60 days. In calendar year 1998, the Direct Loan program consolidated $2.9 billion in student loans, nearly as many as the $3.1 billion consolidated by all FFEL lenders put together.

THE BENEFITS OF COMPETITION

A new and strong competitor, the Direct Loan program helped inspire FFEL lenders to improve their service. Improvements to the FFEL program over the past five years include simpler and faster loan processing, new income-sensitive repayment options, a common manual of loan policies, and improved entrance and exit counseling to help borrowers understand their obligations and avoid default.

As a senior FFEL executive told *Student Lending Update* in 1998, "[Direct Loans] have introduced some ways of doing business and some delivery mechanisms that made the private enterprise wake up a little bit. To be perfectly honest, as a private enterprise we thought we were doing almost an A-plus job. When we stepped back a little bit, we saw some of the things the Department of Education was doing and we realized we weren't. . . It's been relatively good for the industry, particularly for the recipients in terms of students and schools."

And in a 1999 assessment of the Direct Loan program, Macro International stated, "Virtually no one disputes that the operation of an alternative loan program has produced a competition that inspired innovation and service — to the benefit of all borrowers and schools."

Due primarily to improved service in the FFEL program, satisfaction with both student loan programs among schools increased from 68 percent in 1994-95 to 81 percent in 1997-98.

While I am pleased by this increase, the satisfaction of direct loan schools remains too low. Satisfaction among direct loan schools dropped in academic year 1996-97, probably because of the service disruptions caused by a transition between contractors, and had not yet fully recovered by last year. The new performance-based organization has embraced this challenge and my colleague, Greg Woods, will speak to those efforts in a few minutes.

School Satisfaction by Program and Year
Academic Years 1994-95 to 1997-98

Academic Year	All Schools	Direct Loan Schools	FFEL Schools
1994-95	68 %	91 %	68 %
1995-96	80	83	79
1996-97	78	64	83
1997-98	81	71	84

Source: Macro International, *Survey of Institutions Participating in the Federal Direct Loan and Federal Family Education Loan Programs: Academic Year 1997-98*, Appendix A, page 8.

Students and parents borrowing from both programs are generally satisfied with their loan experience. A 1998 Macro survey of borrowers in school found that 96 percent of direct loan borrowers and 93 percent of FFEL borrowers were satisfied with their loan program. And a 1999 Macro survey found that, among borrowers in repayment, 87 percent of direct loan borrowers and 91 percent of FFEL borrowers were satisfied. Of course, the Department is also looking at ways to improve satisfaction among these customers.

The Department is committed to continuing to evaluate ourselves against customer satisfaction. In fact, we plan to establish customer satisfaction as one of the performance-based organization's three core performance measures (along with employee satisfaction and reduced unit costs). We are now studying how best to collect satisfaction data.

With the help of Congress and our partners, the Department has also strengthened the financial management of the loan programs. The national cohort default rate has been reduced from 22.4 percent five years ago to a record-low 9.6 percent. At the same time, collections on defaulted loans have more than doubled, from $1 billion in fiscal 1993 to $2.2 billion in fiscal 1998. As a percentage of outstanding defaults, annual collections have increased by two-fifths, from 6.6 percent in fiscal 1993 to 9.2 percent fiscal 1998.

By improving the quality of data in the National Student Loan Data System, we have prevented the disbursement of as much as $400 million in grants and loans to ineligible students in academic year 1998-99. These and other improvements to the loan programs helped the Department receive an unqualified opinion from its auditors on its fiscal 1997 financial statement.

Federal subsidies for banks and guaranty agencies have been pared down, reducing costs to taxpayers and allowing Congress and the President to further reduce interest rates for students. As a result of the reforms of the past five years, taxpayers have saved $1.6 billion in payments to FFEL financial institutions while students have saved $4.7 billion on their loans.

In summary, there was little competition in the FFEL program in 1993. The Direct Loan program gave students and schools a choice, injecting healthy competition into the marketplace. Today, we have two leaner, more competitive, customer-focused, technology-based programs. That's good news for students, families, schools, and taxpayers.

FEDERAL COST OF STUDENT LOANS

The Direct Loan program is substantially less expensive for taxpayers than the FFEL program. Each FFEL loan is nearly twice as expensive for taxpayers as a comparable direct loan, under current economic assumptions. As a result, Direct Loans will "save" taxpayers $700 million this year, compared to the federal cost if all direct loans had been made through the FFEL program.

Federal costs are categorized differently between the two loan programs and, therefore, it is easy to misunderstand the relative costs to taxpayers. Both loan programs incur administrative costs and "subsidy costs," which include interest subsidies, default costs, and other expenses.

However, Direct Loan administrative costs paid for by the federal government include all expenses for originating and servicing loans and maintaining loan data. Federal administrative funds for the FFEL program, in contrast, mainly pay for transmitting and receiving payments from FFEL financial institutions and for maintaining data. The costs of originating and servicing FFEL loans are paid by lenders and are not considered federal administrative costs (although taxpayers help pay for these costs indirectly through subsidies to lenders and guaranty agencies).

Because of these additional responsibilities, the federal government spends more to administer the Direct Loan program than to administer the FFEL program. However, the Direct Loan program is still less expensive for taxpayers because of the large difference in subsidy costs between the two programs.

Both the Administration and the Congressional Budget Office (CBO) estimate that subsidy costs are much higher in the FFEL program than in the Direct Loan program. The Administration estimates that the federal government will pay $13.32 in subsidy costs for every $100 loaned through the FFEL program this year over the life of those loans, compared to only $0.39 for every $100 of direct loans. The CBO estimates these

subsidy cost figures to be $16.32 and $1.52, respectively.[1] (These subsidy cost estimates will vary over time with economic assumptions, as do many other estimated federal costs.)

The following table demonstrates that, despite its lower federal administrative costs, the FFEL program costs taxpayers nearly twice as much as the Direct Loan program per $100 in loans, under current economic assumptions.

Total Estimated Federal Costs Over the Life of the Loan, Per $100 in Loans Loans Made in Fiscal Year 1999

	FFEL Program	Direct Loan Program
Federal Administrative Costs	$ 1.94	$7.82
Net Federal Subsidy Costs	$13.32	$0.39
Total Federal Costs	$15.26	$8.21

Source: U.S. Department of Education calculations.

The Subcommittee will hear today from the authors of a recent study — begun by Macro International and completed by the Department's Inspector General — of Direct Loan and FFEL costs. The report estimated that the Department paid $17 per loan to administer the Direct Loan program, $4 more than it might cost a large private lender manage a similar loan portfolio. We welcome the findings of this study, which I hope will help us reduce direct loan administrative costs and improve our internal accounting as we modernize the student aid systems.

However, I am concerned that some have misunderstood the study and wrongly concluded that the Direct Loan program is more expensive for taxpayers than the FFEL program. It is important to understand that the report does not indicate the total cost to

[1] Congressional Budget Office, *Baseline Projections for the Student Aid Programs*, March 1999.

the taxpayer of these programs. It examines administrative costs and subsidy costs separately and does not calculate a comparison of the total costs of the programs to taxpayers.

Nor does the Inspector General's report compare actual administrative costs between the two programs. It compares documented Direct Loan costs with estimates of what it might cost a large FFEL lender to manage the same loans, but it does not report actual administrative costs in the FFEL program or consider federal costs in running the FFEL program.

Nonetheless, the report's conclusion that the Department can reduce its Direct Loan administrative costs is well taken. The report set the bar high: the FFEL operations it considered are mature and among the most efficient in the FFEL industry. Moreover, private sector companies are generally more nimble and less constrained in managing personnel and procuring services.

However, reducing administrative costs is one of the statutory priorities of the new performance-based organization. Although we believe that our management costs are comparable to the more efficient private operations, we also believe that there is room for improvement. We accept the challenge and look forward to meeting it.

CONCLUSION

The student loan programs have come a long way since the Direct Loan program was established in 1994. Major improvements to the program include:

- Competition between the Direct Loan and FFEL programs, which has introduced market incentives to improve service and increase customer satisfaction;

- Lower interest rates for students, who have saved $4.7 billion since 1994, and more flexible repayment options to help them manage their debt; and

- Substantial savings for taxpayers, estimated at $5.2 billion since 1994, through lower subsidies for FFEL financial institutions and the lower federal costs on direct loans (compared to if those loans had been made through the FFEL program).

Now, the loan programs are poised for further improvements. Last fall, Congress passed legislation establishing the federal government's first performance-based organization (PBO) to administer the student aid programs with greater management flexibility, accountability for results, and incentives for high performance. The Administration supported this law and prepared to implement it many months before its passage by preparing to reorganize our offices and beginning a search for the first Chief Operating Officer (COO) for Student Financial Assistance.

We found that COO in Greg Woods, and he has hit the ground running. I believe Mr. Woods has the right mix of experience, including eight years as CEO of a software company and five years at the Reinventing Government initiative, to make the PBO a success. He is now working under a performance agreement with Secretary Riley, which describes his objectives and performance measures. I believe that the PBO has the potential to dramatically improve the operation of all of our student financial aid programs.

I will let Mr. Woods speak to his plans for improving the administration of student loans. After he concludes, I would be happy to answer any questions you may have.

Mr. MICA. I'd like to recognize Mr. Greg Woods, Chief Operating Officer, Office of Student Financial Assistance Programs.

Mr. WOODS. Mr. Chairman, committee members, thank you very much.

I'll focus on the improvements we're making in the PBO in the overall delivery of student financial assistance; and, with your permission, I will submit a written record.

Mr. MICA. Without objection, that will be made part of the record. Thank you.

Mr. WOODS. I'll summarize it briefly here.

Six months ago, I became the first Chief Operating Officer of the government's first performance-based organization. Congress created that performance-based organization to focus on the operational aspects of student aid, as distinguished from its policymaking functions, the whole idea to make the thing run more like a business.

That's my background. I'd been a success in business, and I bring that point of view to this job.

My specific mandates in the legislation are to improve customer service and to reduce cost and, as a way of doing both, to integrate and streamline the computer systems. I view my ultimate customer here as the student who needs financial help to get an education, but the aid is delivered in the system. That system includes partnerships with schools and the financial community.

The overall cost of getting aid to the student includes everything that our delivery partners and we spend on that entire process. That means my job, as I view it, is to do whatever I can to make both these programs, the direct loan program and the FFEL program, efficient and effective, to make them both excellent values for the student and the taxpayers and to make them both excellent investments for America.

The natural competition between the two programs I view is a good thing and a powerful tool to that end. The Secretary has already spoken to the advantages that competition has introduced into this arena and that competition continues. On the other hand, OSFA and these commercial lenders are partners with a common goal. That is, we're helping to put America through school. So we're trying to constantly collaborate with these partners to improve service and cut costs in the entire system.

Our overall goal in the PBO is service that equals the best in business. To get to that level of performance, we're in the process of changing absolutely everything that goes on in this organization. We're reorganizing the Office of Student Financial Assistance along the lines of private sector corporations to focus in channels on the people that we deal with, a channel for students, a channel for schools, and a channel for our financial partners.

We're instituting a financial management system to get the kind of cost data that the IG referred to as necessary to do proper cost estimates and to manage this business day in and day out.

We have a Customer Service Task Force that's been in consultation with our partners listening to students, listening to partners, listening to our own employees; and, next month, we'll publish a report with about 200 ideas on ways to improve service delivery in our organization.

We have a new acquisition strategy. We are in the process of renegotiating all of our contracts for our computer systems into performance contracts with goals that would tie to my own as the Chief Operating Officer of the organization.

With the help of the schools community, technical centers like Highway One and financial powerhouses like the Bank of America, we've been preparing a Modernization Blueprint that will go after the reengineering of our stovepipe computer systems. And in September, I'll deliver to the Congress a 5-year performance plan that will have an aggressive set of goals for improving service and lowering cost. In fact, everything we're doing goes back to the PBO mandates from Congress to improve service to the students and to cut costs, whether they be FFEL or direct loan costs.

Thank you very much. I would be happy to assist the Secretary now in answering any questions that you might have.

Mr. MICA. Thank you.

[The prepared statement of Mr. Woods follows:]

U.S. DEPARTMENT OF EDUCATION

Statement by

Greg Woods
Chief Operating Officer
Office of Student Financial Assistance Programs

on

The Federal Direct Student Loan Program

June 17, 1999

Committee on Government Reform
Subcommittee on Criminal Justice, Drug Policy and Human Resources

Mr. Chairman and Members of the Subcommittee:

Thank you for this opportunity to appear here today to explain the actions the Office of Student Financial Assistance (OSFA) is taking to improve the administration of the federal student loan programs.

As the government's first Performance-Based Organization, OSFA's mandate is to improve services and reduce costs in the administration of all the student aid programs authorized under Title IV of the Higher Education Act of 1965. Our responsibility to the taxpayer is especially important in the two student loan programs, Direct Loans and Federal

Family Education Loans (FFEL), which provide roughly four-fifths of the Title IV aid distributed to students each year. In Fiscal Year 1999, about one-third of total student loan volume—$10.6 billion—will be made through the Direct Loan program and about two-thirds—$20.4 billion—will be made by private lenders and guaranteed by the Federal government under the FFEL Program. Our operational plans assume these relative proportions will remain stable over the next several years.

As the Deputy Secretary has explained in his testimony, the creation of the Direct Loan program introduced meaningful competition into the student loan industry that has resulted in improved services to students and schools under both the Direct Loan and FFEL programs. It has also led to lower costs for students and taxpayers. I am committed to the effective and efficient operation of both, in keeping with our mandate to improve services and reduce costs of administering Title IV programs. We have undertaken several major initiatives in our transition to a performance-based organization that will support this goal. These include our Customer Service Task Force, a systems modernization blueprint, realigning our functions and business processes through a major reorganization, and developing with our stakeholders a five-year performance plan as called for in our legislation.

Customer Service Task Force

First, our Customer Service Task Force is nearing completion of its report that will present concrete recommendations on ways to dramatically improve service to students and our service delivery partners—schools, lenders, and guaranty agencies. The Task Force, made up of over 50 front-line employees, has been active since February, gathering information directly

from students, borrowers, and our service delivery partners. They have researched operational problems and come up with creative solutions that will help OSFA deliver services equal to what consumers have grown to expect from the best in business. I have committed to pursue the recommendations included in the final report by dedicating resources and personnel to critical tasks that our customers and partners have helped us identify.

Many of the preliminary Task Force recommendations are designed to improve the quality of service in both the Direct and FFEL programs. Some of these, which will require close collaboration with guaranty agency and lender partners, are:

- Improving early aid awareness and debt management counseling to ensure borrowers understand their aid options, their repayment obligations, and how best to manage their debts.
- Providing borrowers, including those borrowers who hold both Direct Loans and FFELs, access to all loan information via the web or a 1-800 number.
- Use of PINS and digital signatures to enable transactions to be done electronically.

Modernization Blueprint

Second, we are developing a Modernization Blueprint to guide the re-engineering of our information systems to provide program managers, employees, customers, and delivery system partners immediate access to reliable, up-to-date information. Currently, the delivery and management of Title IV assistance is carried out under 14 separate systems and 8 separate contractors.

This tangled hairball of systems evolved over the past 30 years in parallel with the addition of new programs and administrative requirements by Congress. These systems have served most of our basic needs adequately, delivering funds to intended beneficiaries as Congress intended. But they have become increasingly difficult to use and to change, thus limiting our ability to improve services to students, schools, and our financial partners.

Our Modernization Blueprint explains how OSFA will modernize its systems and the sequence for doing so. Its foundation was the work done previously under Project EASI (Easy Access for Students and Institutions), with the involvement of students, schools, and our financial partners in the FFEL program. The first public working draft was released last month. At the end of each month between now and October, we will release updates reflecting community input and additional work by our contractor, Computer Sciences Corporation. We are actively seeking ideas for improvement from financial partners and representatives from both Direct Loan and FFEL schools.

By using the latest technology now in use in the financial industry—middleware, intranet, and "wrappers" that go around existing legacy systems —our systems will be able to talk to each other, and users will be able to extract the information they need. This will benefit students, who need to know the status of their loans and other assistance. It will benefit schools and financial institutions, who need to monitor their transactions with OSFA, track students moving from school to school, and monitor their own performance relative to OSFA performance benchmarks. It will also enable us to institute dramatically improved financial management processes that monitor the flow of funds across all programs and closely track the performance of the

Department's growing portfolio of direct and guaranteed loans, now valued at more than $150 billion. Some new system applications will be in place by next year. Under the Blueprint, all key systems will be re-engineered by the end of fiscal year 2002.

Reorganization

Third, OSFA will undergo a major reorganization, adopting a model used by the best in business. In the private sector, the most successful businesses organize along customer lines to allow for continual customer feedback and tailoring of services to meet their needs. In OSFA's current organization, no top managers have been clearly designated to serve the needs of our distinct customer groups – students, postsecondary schools, and financial institutions.

Under OSFA's new structure, we will have three general managers running basic operations and determining what improvements are needed to keep pace with changing expectations. A General Manager for Students will be charged with improving student and borrower awareness of financial aid options, ensuring the smooth and efficient processing of student transactions. A General Manager for Schools will provide assistance to schools to ensure they can meet program eligibility requirements, and will oversee ongoing financial and other transactions with schools. A General Manager for Financial Institutions will work with lenders and guaranty agencies, providing technical assistance, processing financial transactions, and collaborating on better ways to support the needs of students and schools.

OSFA's Chief Information Officer will provide technical support to the general managers in the development of new system applications. A Chief Financial Officer within OSFA will implement an integrated financial management system and monitor OSFA's financial

performance. One of my highest priorities is creating a modern financial management system, by investing in high-end software and systems now used by industry to manage our costs, measure performance, and assess risk. We will begin implementing these dramatic changes throughout our organization soon, with substantial input from employees and the union.

Five-Year Performance Plan

Fourth, OSFA will complete development of its five-year performance plan by the end of this fiscal year. The plan will focus on achieving measurable results in three key areas: increased customer satisfaction, increased employee satisfaction, and reduced unit costs. This "balanced scorecard" approach has been used by many successful private sector corporations. The plan will be informed by the work of the Customer Service Task Force, the Modernization Blueprint, and our reorganization design effort. It will also reflect the analysis we have begun to determine the unit costs for our current operations, and strategies for reducing those unit costs over time. We will seek input on the plan from employees, program stakeholders, and Congress before it becomes final.

Cost Reduction

The concept of "unit costs" is essential for measuring OSFA's success in meeting its statutory goal to reduce costs. The Direct Loan and FFEL portfolios are expected to grow dramatically over the next five years. While Direct Loans are expected to continue to account for roughly one-third of the loan volume over that time period, the addition of new cohorts of students in this young program will increase the overall portfolio by more than 84 percent

between FY 1998 and FY 2000, reaching $60 billion and over 6 million borrowers by the end of FY 2000.

The Direct Loan portfolio will more than double by FY 2004. The more mature FFEL portfolio will grow by about 26 percent during the same period to over $150 billion. These loan volume projections are based on analysis of historical data and are roughly consistent with those developed by the Congressional Budget Office.

Servicing the rapidly expanding Direct Loan portfolio represents OSFA's single largest administrative cost. The combination of two key factors will result in significantly greater costs for Direct Loan administration in the coming years: (1) the increased volume of new loans; and (2) the maturing of Direct Loan portfolio as more loans enter repayment and the number of hard-to-service delinquent loans increases. Consequently, even with significant reductions in our unit costs for administering Direct Loans, as well as FFEL and our other Title IV programs, total costs to administer these programs are expected to rise.

Significant reductions in our unit costs cannot be achieved without major restructuring of our systems and contracts. Along with our Modernization Blueprint, we are developing a new acquisition strategy that will radically change how we contract for services. Few of OSFA's current contracts are performance-based, and those that are could be improved upon. Most of our contracts dictate how contractors must perform particular processes. This approach has stifled innovation and failed to provide contractors with appropriate incentives to get the right result at the lowest cost. We will renegotiate or restructure all of our existing contracts to make

them performance-based, and we will align contractor performance measures with the PBO's. Potential cost savings to the taxpayer will be a major consideration in the sequencing of contract changes.

Improvements to Benefit Both Loan Programs

Administration of the Direct Loan program over the last several years has helped the Department understand where improvements are needed in systems and processes that benefit both the direct and guaranteed loan programs. For example:

- The Department's Direct Loan portfolio is currently serviced by AFSA Data Corporation , a Department subcontractor that is also a major servicer of FFEL loans for private lenders. The Department has required its contractor to follow the same regulatory "due diligence" procedures that all FFEL lenders must follow. These procedures require all loans—regardless of borrower characteristics—to be serviced in accordance with detailed procedural steps prescribed by regulation more than a decade ago. Since then, significant advances have been made in other loan sectors, where business performance is measured by bottom-line financial results. These advances use state-of-the-art technology and rely on risk analysis systems to tailor default prevention strategies based on specific borrower needs and payment experience. To improve service and reduce costs, the Department is now discussing—both with its contractor and with FFEL participants—changes to the current requirements that could reduce unnecessary administrative costs and ultimately lower the default costs taxpayers now bear.

- Until recently, the Department has measured its success on default prevention by the reduction in the statutorily-defined "cohort default rate." This rate was created to eliminate high default schools from the loan program and measure the number of borrowers that default within the first two years of the repayment period. Other federal credit programs and the financial services industry track default activity over the life of the loans and use this to measure the effectiveness of their default prevention strategies. Using historical data from the National Student Loan Data System, OSFA is now instituting a life-of-the-loan default measurement system to analyze default activity by school, guaranty agency, lender, and the Department's own direct loan servicer. This will help us understand variations in default patterns and devise new strategies with our Title IV partners to lower overall default costs.

- For years, rigid interpretation of statutory prohibitions against "inducements" kept FFEL participants from providing important services to schools and students that could help reduce defaults or make aid administration simpler for school and students. Through the Direct Loan program, the Department recognized the importance of helping schools provide high quality entrance and exit counseling, and simplifying administrative processes for financial aid officers and students. As a result, the Department has revised its interpretation and now allows, and encourages, FFEL participants to provide similar services.

- Many Direct Loan borrowers have outstanding FFEL loans too, and they face the inconvenience of having to track and manage these loans separately. Direct Loan schools have to verify enrollment status of students transferring to and from FFEL schools. The FFEL community has begun to respond to similar problems in FFEL through collaborative

efforts such as ELM Resources Incorporated, which allows students to access information from multiple lenders, and the Student Loan Clearinghouse, which provides student enrollment information to schools, lenders, and guarantors. In recent months, OSFA has begun to explore with the FFEL industry ways to make these information exchange services available to Direct Loan schools and students. OSFA's Modernization Blueprint envisions the seamless exchange of information (in accordance with privacy requirements) among students, schools, lenders, guarantors, and OSFA, regardless of the loan source.

- Until this year, both loan programs required students to sign a new promissory note each year in which they borrowed. This was inconvenient for students and costly to administer. The Administration supported a Higher Education Act Amendment authorizing a multi-year promissory note that would improve services and reduce costs in both programs. OSFA is now working with the FFEL community to implement a standard master promissory note for both loan programs.

- OSFA understands the need for accurate, up-to-date data to manage both loan portfolios. The development of the National Student Loan Data System, as called for in statute, has been a major achievement that has resulted in significant savings to taxpayers, preventing the award of over $1 billion in loans and grants to ineligible students. Nonetheless, OSFA also recognizes the need to work with our partners to further enhance the reliability NSLDS, to ensure it has accurate information on which to base management decisions.

Conclusion

In sum, OSFA views itself as both a leader and a partner working with the FFEL loan industry to improve how we serve students, schools, and taxpayers. While the two programs will continue to compete to provide the best services, the two can also benefit from collaboration in areas of mutual interest. Through the Customer Service Task Force, the Modernization Blueprint, our upcoming reorganization, and the development of our five-year performance plan, OSFA is charting a course designed to improve the effectiveness and efficiency of both student loan programs.

Mr. MICA. I have questions for both of you. We'll try to cover this pretty quickly here.

First of all, we've seen the audit, the report, and there are a number of criticisms. There were some items that we had a report—was it Mr. McNamara who cited that corrections are being instituted, some corrections he was aware of, some he was not? Specifically, what has brought this hearing to such a peak are questions about disability and people having their payment waived and then coming back on the system and being reeligible. Could you tell us, first of all, what's being done to correct that?

Mr. WOODS. Absolutely. One thing I'd like to make sure is understood here, this is an example of the Department identifying a problem and trying to get after it on its own. The study that the IG did here was at the request of the Department. The Department was concerned about fraud and other disability programs and was concerned about trends in the rise in its disability claims and asked the IG to look into it.

The results of the study confirmed those fears, as you've indicated, in the worst way. We have things in process already with our partners here.

Note that this problem exists within the FFEL program primarily. That's where the difficulties have been found because more of the loans in the FFEL program are into the repayment status. And we're working with the guaranty agencies on new procedures here, looking again at commercial practices.

We can require certified certificates. That's something we haven't done. It's common practice in the insurance industry.

We can require doctors' identification numbers and phone numbers. We can go into training programs with the guarantors and their people who are reviewing these applications for disability so that they're better informed about what to look for.

The other thing I'd like to state here is that we, in fact, believe we can go after and recover this money. Where we find that there were mistakes made in processing, we can reinstitute these loans and collect on them.

Mr. MICA. Well, Dr. Smith, in the record, page 8, I believe it is—there's a chart. It says, new loans after disability discharge, and it shows 1994–1995 pretty much stable and then 1995 just shoots off the charts. It's my understanding that the Department changed the regulations in 1995 to make it easier for students who have gotten loans forgiven to get new loans. Has that policy been changed back or are we still operating under the policy that had this sort of shoot off the charts?

Mr. SMITH. At this moment we're still operating under the policy. The regulation will be under review. It is now under review. All these regulations have to go through something called negotiated rulemaking. It's the congressional intent for all of our regulations. So we have to bring people together in order to change things, and we intend to look at that. I intend to talk with the Secretary soon about this, and we'll be moving.

Mr. MICA. We just heard reports coming out in a month after this hearing or so with a lot of suggestions, but to get things done and—you know, we have to focus on the big enchiladas here. Certainly, this is the biggest area, we have identified the program.

Your audit which—I congratulate you for taking that step, but now our job in oversight is making certain that there's a change in action and a change in policy. So we're going to have to followup on this, and we need a change in the policy.

We've also satisfied the PBO with I'm told more than 1,000 folks; is that correct?

Mr. WOODS. The staffing level——

Mr. MICA. Tell me what our staffing level is. We've ramped that up pretty dramatically, and our administrative costs I guess have risen 200 percent in 6 or 7 years.

Mr. WOODS. I'd be delighted to address that.

Actually, the staffing level in the PBO is relatively stable at 1,200 people. These people were involved in the loan——

Mr. MICA. That's a third of the Department of Education.

Mr. WOODS. It's a third of the Department of Education—a quarter.

Mr. MICA. I'm sorry, 25 percent approximately; and when did they come on?

Mr. WOODS. This staff?

Mr. MICA. Yes.

Mr. WOODS. The staff was increased over the past few years with the direct loan program, but that staffing increase number I don't have for you here today. It's nothing like the kind of percent that's shown on this chart. The indication in the chart is that we've dramatically increased the cost without an increase in workload, and I'd like to dispel that idea. That's just not the case at all.

What we've been doing in the direct loan program for several years now is issuing on the order of $10 billion a year in loans. So each year a loan is put out, that adds to the workload. It doesn't go away after the first year.

Now we're actually entering a period of time where as the loans go into servicing, the workload increases. The servicing is a much more expensive proposition than simply issuing them. They're not being serviced to that extent while they're in school. So our workload has actually increased dramatically over this time.

Mr. MICA. We're told that one of the biggest problems with the PBO is that there's no chief information systems officer. Is that still the case?

Mr. WOODS. We have an excellent man who's been leading the information systems work there for some time. We've been able to add a couple of experts, for example, in privacy and security to support that. And, of course, this is my background. I'm certainly fully qualified to carry that work out and make decisions in that area. So compared to where we were 6 months ago, we're probably dramatically stronger.

Mr. MICA. Two other areas, there's been great concern expressed about both in this panel and in the public arena, and that's payments for students who claim to be dead and are very much alive and then the problem with our foreign student loans. Could you address both of those for me?

Mr. WOODS. The death and disability claims is what we referred to earlier and the changes we're making there with death certificates and training and those improvements as well as the policy issue you addressed to the Secretary.

Mr. MICA. Specifically, though, are you now requiring the death certificate?

Mr. WOODS. Yes. We're——

Mr. MICA. Is that in place?

Mr. WOODS. We have notified the guarantors that we intend to do this.

Mr. MICA. But it's not in place?

Mr. WOODS. No, sir. They are already looking at changing their policies. Where we stand with each of the guarantors I couldn't tell you today. I would be happy to answer that detailed question for the record.

Mr. MICA. Is that a policy question that Dr. Smith would have to address that becomes——

Mr. WOODS. We don't believe that change is a regulatory change, so we believe we can proceed administratively to deal with this. The community is very eager to work with us on this.

Mr. MICA. But it's still not in place. It's a request at this point?

Mr. WOODS. That would be accurate.

Mr. MICA. Dr. Smith, did you want to respond?

Mr. SMITH. Well, it's just that Mr. Woods has to work with a variety of guaranty agencies out there and explain to them exactly what they need to do and they need to look it over and see how quickly they can put their changes into practice. I think that's the delay in this process. It's not as though they're going to get a choice. They will have to carry out the policy.

Mr. MICA. That would be a variety, I guess, of participants.

What about the direct loan program where you can make a decision. Has that been made?

Mr. WOODS. That decision has been made.

Mr. MICA. And is taking place?

Mr. WOODS. Yes, sir.

Mr. MICA. The other item was the foreign student problem.

Mr. WOODS. Right. The foreign schools issue I don't believe is a schools issue per se. Several years back, the Department undertook a review and went through a recertification on schools and a number of schools dropped out of the program—in fact, over 400. We have about 450 foreign schools currently involved in the direct loan program. The cases that were found seemed to be cases that were involved with students, and 18 cases is what we're talking about here. Eighteen cases of fraud identified where students are being pursued for that, a relatively small number.

The other point I'd make about the foreign schools program is that the overall default rate, which has been much at issue here this morning and this afternoon, that default rate is 5.5 percent, which is better than the national average. So while we're concerned about fraud any time we find it, I just want that to be in perspective.

We also think we've instituted some practices here that will improve the performance going forward. We're notifying schools, for example, when loans are issued to students who are alleged to be enrolled there. That will get the schools involved as a checkpoint on whether that student is actually there and eligible for funding.

Mr. MICA. Dr. Smith, did you want to respond?

Mr. SMITH. No, that's fine.

Mr. MICA. You said that one of the things you wanted to do was study borrower behavior. Could you elaborate a little bit more on that?

Mr. WOODS. My private sector experience was that it's very important to be focused on the customer and to think in terms of what the private sector talks about as customer segmentation. Different parts of the population have obvious different needs. Small business is different than big business, seniors different than juniors.

In our case, students in 4-year, 2-year and proprietary schools have different needs and, as we find, much different default rates among those institutions. We think that by understanding behaviors in these customer segments and the needs of those populations, we can intervene earlier, and thereby reduce the cost in terms of default and produce a better situation for that borrower in terms of services. That's what we are interested in.

Mr. MICA. One other quick question before I get to the ranking member, I did not ask you. I asked you about the number of employees with the PBO. Do we have any way of assessing the contract employees or employees that are involved through contract?

Mr. WOODS. We certainly could get you an accurate number if you'd like. I believe that number, at a peak during the year, might run to 3,000 employees if you totaled it up for all the peak periods.

The reason I say peak is because our business is cyclical. When we're consolidating loans, we ramp up in that area. We don't maintain that staff level. As soon as we don't need the people, these part-time people under contract are reduced.

The same thing with our student eligibility application. We ramp up and tail off in order to minimize the cost. So that's the way we're managing that contract work force.

There was conversation here about the practice of involving the private sector, using private sector firms to handle the loan programs. The truth is that this organization is well on the path to contracting out these service functions and processing functions. We have experts for phone service, experts for computer processing, experts for transforming paper into electronic images, and contractors who ramp up and down to meet the particular business cyclical needs.

Mr. MICA. Let me yield now to Mrs. Mink, if I may.

Mrs. MINK. Thank you very much, Mr. Chairman.

I served on the Education and Workforce Committee when it was known as the Education and Labor Committee, and as I recall, the initiation of the whole idea of direct loans, it was something that was generated by Congressman Robert Andrews and supported by the chairman, William D. Ford of Michigan. Those were the two individuals most responsible for the initiation and creation of this program.

After a number of discussions and debates and meetings with the administration, the administration came on board and supported the program. Is my memory correct on that?

Mr. SMITH. I think that's right, Mrs. Mink. I believe that a direct loan program existed in the prior Congress as well, a small direct loan program. Congressman Petri as well as, I believe, Congressman Andrews and, of course, the chairman were all involved in

that. And then I believe there was discussion early in Mr. Clinton's administration, and there was a decision to move with a larger program rather than just the pilot.

Mrs. MINK. Yes. What I wanted to note with reference to this history is that—to dispute or dismiss the assumption that this was a grab on the part of the Federal Government for the administration, supervision and management of a program. Rather, as I recall, it was an initiation by the Congress at a time when everyone was looking for ways in which to reduce the deficit and balance the budget. And because of the high interest that the private sector banks and financial institutions were charging for the management of this program, there was this idea that maybe the Federal Government, even though you realize you have to put on more manpower and personnel and create a whole new system, that it could be done with a cost savings.

Now, in your statement, Dr. Smith, you say substantial savings have occurred for the taxpayers. Can you elaborate on that?

The testimony we heard this morning seemed not to conclude that that has, in fact, occurred; and since that was the genesis of this whole idea, I'm very anxious to really get to the bottom as to whether we, in fact, have enjoyed any savings.

Mr. SMITH. Mrs. Mink, we estimate and the Congressional Budget Office estimates that the savings have been considerable. As I mentioned, we can estimate them at about $700 million this year if all of the direct lending students were, in fact, in the FFEL program.

Now, there have been a lot of other savings as well to the taxpayers and to the students, and they've come about in two ways. One is the way I just mentioned. That is, that the direct lending program, because it doesn't have to pay huge subsidies to private lenders, turns out to be a cost saver under most economic assumptions.

As you recall, the IG said he wasn't sure. There are certain economic assumptions one can make about the interest rates and so on where it might not be a cost saver but, by and large, and certainly over the last 6 years, the life of this program, it has clearly been a cost saver. We estimate that the cost savings to the taxpayer have been roughly $5 billion since 1994.

We can supply more detail on that if you'd like, but it is from a couple of things. One is from the direct lending program having one-third of the business. The other is the reduction in some of the subsidies that have gone to the private sector. The private sector, as you know, continues to make a reasonable profit on this, a fair profit.

Mrs. MINK. What is the percentage surcharge now on the loans that the private sector charges the student or the program?

Mr. SMITH. The interest rates?

Mrs. MINK. Yes. The surcharge for managing the program.

Mr. SMITH. To the Federal Government? We do it in terms of subsidies. The private sector gets an origination form of fee, which is about 4 percent. They also then charge interest rates to the students, and they get to keep whatever profits on those interest rates. In effect, they have to give some money back.

By and large, what you have is a system where the Federal Government guarantees the private sector payments and then pays them a reasonable subsidy in order to provide loans for students. It has worked reasonably well over the last 4 or 5 years.

I think here is where the other real savings comes in. There's competition between the two programs, which I believe resulted in savings to students and much better service to students and has gotten the two sectors competitive. The private sector, the FFEL program, for example, has become quite competitive in the reduction of some of the origination fees and in some of the other costs to students. So I think we've got a very healthy, competitive system now that has saved students a large amount of money and saved taxpayers a large amount of money.

Adding them together, it's almost $10 billion over the last 6 years.

Mrs. MINK. About a third of the loans currently expected are about one-third in the direct loan and the balance in the private sector; is that correct?

Mr. SMITH. That's correct.

Mrs. MINK. That's a balance you expect to maintain over the long haul?

Mr. SMITH. That's certainly what we expect to maintain over the foreseeable future, that's right. And it is, as I said, a competitive market; and we're working to maintain that.

Mrs. MINK. The direct loan program was initiated when? When was the first loan issued?

Mr. SMITH. I believe in 1994.

Mrs. MINK. Now, has there been, since the initiation of the direct loan programs, any experience with collections and defaults and determinations of waivers and discharges of debt and so forth with respect to the direct loan program?

Mr. SMITH. Well, there's been some but not very much to make a real generalization.

Mrs. MINK. It hasn't been in existence that long to experience——

Mr. SMITH. That's right. In fact, the numbers are very low right now. The percentages are low. I wouldn't count on that as being something that will hold up in the future. We see no reason that this will behave any differently than the FFEL program.

Mrs. MINK. The reason for my question, the reports that generated the call of these hearings with respect to the discharges for disability and the erroneous notion of students being dead and having their debt discharged emanate not from the direct loan program but from the existing private sector loan program.

Mr. SMITH. I believe that's true. It's probably true for 98 to 99 percent of the cases, if not 100 percent.

Mrs. MINK. So the management of the private sector loans to which this problem is attributed is a responsibility of the private sector? Or is it the responsibility of the Federal Government to institute control so that it doesn't occur?

Mr. SMITH. I believe it's a shared responsibility. These are fiscal——

Mrs. MINK. Who recommends the waiver of the collection? Is that the private sector that recommends it or is it the Federal Government that recommends it?

Mr. WOODS. The process would have the private sector agency processing the paperwork. As the chairman indicated earlier, there are regulations that the Department issues that cover this practice and then——

Mrs. MINK. Who makes the final decision?

Mr. WOODS. At that instant in time on the piece of paper, the private organization would make that determination, but we have required certain things of them. Once they've gone through that, they're perfectly within their rights to make that call.

Mrs. MINK. If they sign off and say this is discharged because of disability, in the end it's the taxpayer that loses because it's unable to collect.

Mr. WOODS. That's correct.

Mrs. MINK. What is the process then that the Federal Government has set up to look at these discharges to make sure they're all valid? Is there someone in the Department that does that?

Mr. WOODS. We have not had a review function specifically focused on this issue. We have an active review program that looks at the overall practice, makes site visits, program reviews for these guarantors. And naturally those reviews in the future, any one of them that we make, would focus on this issue. But we haven't got a medical examiner or a medical reviewer at the Department level for this function.

Mrs. MINK. Can you say with some assurance that, with respect to the new program, the direct loan, that you have this in hand and that these sorts of misdeterminations would not occur under the government-managed program?

Mr. WOODS. I wouldn't want to assure you that there would be zero, but I know we can reduce this number dramatically by instituting the kind of practices that are followed in other Federal agencies and in other retirement programs in making these determinations. Those are available to us, and we'll be able to institute those.

Mrs. MINK. Mr. Chairman, I'm at the end of my questioning; I just simply want to say that I'm very much reassured by the testimony of the two witnesses from the Department that the direct loan program is being well administered. The questions that we raised have now been brought to their attention, and I have confidence that they'll be able to correct it. I say this not as an early supporter of the direct loan program. I have to make a public confession that I had great misgivings about the creation of this huge bureaucracy to manage a program that I considered so vital. At that point in our early deliberations, it seemed to me that it was an undertaking that was going to challenge our witnesses and our abilities.

But I'm pleased to hear today that it's progressing along, and I commend the Department for initiating the audit to look at yourselves and come up with safeguards to make sure that this program will continue to be managed well and that the taxpayers' dollars will indeed be saved by it.

Thank you, Mr. Chairman.

Mr. MICA. Thank you. I appreciate the comments of the gentlelady and the ranking member.

I wish I could be as confident in the bureaucracy we've created to oversee this program. Quite frankly, I do have some concerns, as I said even during their testimony, that they had commented that corrections are on the way. I think I've sat and heard that before and then some of the mechanisms and resources that we've provided for them, including PBO, which have been put in place at great expense, still have not produced the results we hoped for.

We now have 24 percent of the entire Department of Education, as far as personnel, involved in the program, and costs are escalating for administration, so I have some concerns. Not to mention that we have some great loopholes in forgiveness of payments for people who are ineligible and, in fact, by their own report and these are not insignificant amounts.

Again those corrections are not in place. Some policy changes are not in place, and we need those in place. Some of the administrative corrections are not in place by their own general audit. We still have some serious personnel deficits and problems that need to be addressed to make this whole program work. I have additional questions regarding the differential between the administrative costs that have been presented, not by me but by the audit, and I think we'll have some very specific questions in writing so that we can get a written response.

Additionally, I have specific questions which I didn't get to about loan consolidation costs.

In closing, maybe I could just ask a quick question. The information that our subcommittee obtained said that loan consolidation costs of the direct loan program greatly exceed those of the guaranteed loan program. For example, I guess you have indicated that the direct loan consolidations in 1998 cost $12.9 million for 107,000 loans or $121 per consolidation. In 1999 you reported $21.8 million for 194,000 consolidations equaling a little bit less than cost, bigger volume, $112 per consolidation.

However, we're told that these figures may, in the private sector, be about half the amount, far less than the consolidation loans that are done by you. In fact, I guess the consolidation problem got so bad, and this has been testified to, that in August 1997, the Department had to close down the direct loan consolidation program. What's being done to correct this situation? And, in fact, is it still costing almost twice as much for loan consolidation by the Department?

Mr. SMITH. Mr. Chairman, we're going to have to check your figures. The $110 figure is actually the maximum figure, the underperformance-based contract. They're expected to hit a target of, I believe it's 65 days, or whatever the industry standard is. If they come in earlier than that with a consolidated loan that is faster for the student, they get an increase in that payment. If they come in later, they can deduct it from their amount of money.

The average amount of money here is $70 per loan. For a regular loan, we charge—it costs us, in terms of paying the consolidator, considerably less for certain other kinds of loans. So there's a real mixture of loans, and I believe what—the figure you're using is actually the figure for the maximum amount that could be paid rath-

er than the amount that on average is actually paid. But we will get you those figures.

I also believe that the numbers for 1998 were not quite right, but we'll also get you those.

Mr. MICA. Again, we're using figures that have been supplied by the Department or figures that have been taken from the audit studies. So we have some very specific, lengthy questions. And I know that you have a limited time schedule; and you've been most patient, Dr. Smith. We appreciate your testimony today.

Mrs. Mink, why don't we, by unanimous consent, submit the balance of the questions to the Department for response in writing?

Mrs. MINK. Fine with me.

Mr. MICA. And we'll leave the record open for 30 days to give you extra time to respond.

Again, I think we've raised some important issues here. It's not our job just to be bad guys. Mrs. Mink practices in trying to be one of the nicest Members in Congress, and she's a wonderful ranking member, but we have a responsibility to conduct oversight of these programs. Your audit helped trigger some of the reports about continuing problems, and they certainly need to be addressed by our panel. Working with you we hope we can get this program in order and make it work efficiently and take whatever legislative steps are necessary. We hope that we'll get response from the policy and operational end.

There being no further business to come before the subcommittee at this time, this meeting is adjourned. Thank you.

[Whereupon, at 1:20 p.m., the subcommittee was adjourned.]

[The prepared statement of Hon. Dennis J. Kucinich follows:]

Rep. Dennis J. Kucinich
Opening Statement
Hearing on "Student Loans"
House Government Reform Committee, June 17, 1999

Mr. Chairman, the oversight of our nation's student loan programs is a complex task, but one that has major implications for the ability of *all* students to have the opportunity for a college education. I have been pleased to see real competition emerge in this market since 1993, as the US Department of Education makes Direct Loans available to students at very competitive interest rates, while financial institutions make guaranteed student loans accessible to others. It is important that Congress take whatever action is necessary to maintain and refine this system.

When we evaluate the cost effectiveness of these alternative programs, it is important that we go beyond a single year and look at cost savings over the life of the loan. We need to take into account the revenue streams that the federal government obtains, for example, and look beyond a simple annual calculation of administrative costs. Our review should be guided by consideration of what is best for our student population, and this means that any benefits accorded to one part of the system -- such as discounts in origination fees -- should be available to students who make use of the other part of the system. This is a matter of basic fairness.

I look forward to hearing from our panelists today. In particular, we need to learn more about the benefits of competition and what the federal government is doing to expand and upgrade its systems of distributing Direct Loans and collecting student payments.

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