REPORT OF

THE

STATE AUDITOR

Colorado Student Loan Program
Defaulted Student Loans

Performance Review
March 1999

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March 12, 1999

Members of the Legislative Audit Committee:

This report contains the results of the performance review of Defaulted Student Loans at the Colorado Student Loan Program, including our findings, conclusions, and recommendations, and the responses of the Colorado Student Loan Program. This review was conducted pursuant to Section 2-3-103, C.R.S.

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Authority, Purpose, and Scope

This performance review was conducted under the authority of Section 2-3-103, C.R.S. The report discusses our review of defaulted student loans and the Colorado Student Loan Program's controls and activities related to the collection of those loans. The review was conducted in accordance with generally accepted government auditing standards. We gathered information through interviews, data analysis, and document reviews. Audit work was performed between January and March 1999.

Overview

The Colorado Student Loan Program (CSLP) was created as a division of the Department of Higher Education (DOHE) by an act of the Colorado General Assembly in June of 1979. The CSLP director is appointed by the executive director of the Colorado Commission on Higher Education. As of Fiscal Year-End 1998, CSLP had 235 FTE, including 39 nonclassified positions. The program is funded by federal funds and other revenues (e.g., guarantee fees, loan servicing fees, account collections, and interest on investments).

CSLP assists students with expenses incurred for higher education. The program's mission is to "provide students access to postsecondary education by ensuring the availability, effective delivery and responsible management of educational financing; and to provide quality service to all program participants." CSLP represents a partnership between lenders, schools, and the U.S. Department of Education. The program administers the Federal Family Education Loan Program and guarantees the loans made to students and parents in accordance with federal regulations established in the Higher Education Act of 1965. When a student loan is made, CSLP insures the lender against the financial loss from default, disability, death, or bankruptcy. Defaulted loans are those loans that a private lender tried to collect on for a period of either six months or one year (depending on the terms of the loan) where the borrower failed to make payments. If both CSLP and the private lender are unsuccessful in getting the borrower to begin making payments on the loan, CSLP must then pay the insurance claim (default claim) to the private lender. In the past several years, the federal government has become increasingly punitive in its treatment of defaulted borrowers.

For further information on this report, contact the Office of the State Auditor at 303-866-2051.

Defaulted Student Loans

Federal regulations are specific with regard to how guaranty agencies, including CSLP, collect on defaulted student loans. Under revised regulations effective in January 1998, defaulted borrowers face significantly higher penalties for default, including the assessment of collection charges of up to 25 percent of the outstanding balance of principal and interest on each borrower payment. There is currently no limit on the amount of collection charges that can accrue. Each payment made is first applied to collection charges, then to interest, and finally, if any amount remains, to principal. For many defaulted borrowers, application of payment in this manner increases the length of time and total dollars taken to pay off the outstanding debt. Although CSLP is collecting loans in accordance with federal regulations, we found several areas in which some of the program's practices could be improved.

CSLP Needs to Have a More Integrated Information System for Tracking Loans

About 3,000 of CSLP's defaulted loans are tracked in a database separate from the rest of the program's 75,000 defaulted loans. The 3,000 loans are consolidation loans, deemed at one time to require separate treatment. The consolidation loans database was overlooked in 1998, when an important notification regarding collection charges was mailed to borrowers. The lack of an integrated database also caused a problem in the application of collection charges. We reviewed a sample of 21 consolidation database files that did not have collection charges applied. We found that 17 of the 21 files should have had collection charges applied. In February 1999 CSLP retroactively reapplied borrowers' payments, resulting in account balances increasing by $375 on average. CSLP did not notify borrowers of the reapplication of their payments and the increases in their balances. **We believe that CSLP should immediately notify all borrowers of the 1998 changes in collection costs. In addition, CSLP should notify borrowers whose payments were reapplied to collection charges of the period of time for which those payments were reapplied and the outstanding balance on their loans. Finally, CSLP should continue its efforts to upgrade database systems.**

CSLP Could Be More Aggressive in Trying to Get Loans out of Default

Getting a loan out of defaulted status is the only means by which a borrower can avoid being assessed the 25 percent collection charge. There are currently only four methods by which a borrower can get a loan out of default status: 1) lump sum payment, 2) consolidation, 3) rehabilitation, and 4) compromise. The revised federal regulations make rehabilitation and consolidation more advantageous to borrowers by offering borrowers lower collection charges. On rehabilitations and consolidations, borrowers are assessed only 18.5 percent collection charges as opposed to 25 percent. CSLP began sweeping its accounts in 1993 to identify borrowers whose accounts appear to be eligible for rehabilitation and to notify borrowers of their eligibility. However, during our audit we

found that, in 4 of the 15 cases we reviewed CSLP did not notify the borrower in a timely manner. In three of the four cases, borrowers had met the requirements to rehabilitate prior to January 1, 1998. For these three cases, the earliest discussion of rehabilitation was in September 1998 after these borrowers had made at least nine payments and CSLP had applied 20 percent of each payment to collection charges. If these borrowers had been notified of the benefits of rehabilitation prior to the effective date of the new regulation, they may have been able to avoid paying collection charges of 25 percent of the outstanding principal and interest due on a loan. **We recommend that CSLP be more aggressive in its efforts to notify eligible borrowers of the benefits of rehabilitation or consolidation.**

All Accounts Should Be Monitored for Eligibility to Rehabilitate

Currently CSLP has approximately $139 million in accounts assigned to outside collection agencies and $9.9 million in accounts assigned to outside legal groups. CSLP does not bring accounts assigned to either group back in-house for collection activities or to rehabilitate a loan. For accounts assigned to outside legal groups, neither CSLP nor the legal groups notify borrowers of the benefits of rehabilitation. CSLP is currently considering a pilot program to evaluate accounts assigned to outside legal groups and determine whether it is cost-beneficial to establish procedures for getting these borrowers into voluntary repayment and rehabilitating their loans.

We also found that the current payment structure used to pay outside collection agencies has some built-in incentives for agencies to keep borrowers in default repayment rather than rehabilitating or consolidating their loans. Collection agencies are paid lower commission rates for consolidations and rehabilitations than for payments received from borrowers. Although we found no evidence that outside collection agencies are keeping borrowers in default repayment as opposed to rehabilitation or consolidation, we believe that additional protection is needed to limit the incentives built into the payment structure and to ensure that all students are offered the same opportunity to rehabilitate their loans. **We recommend that the Student Loan Program implement measures to ensure that borrowers whose accounts are assigned to outside legal groups and collection agencies are offered the same opportunities to rehabilitate their loans out of default as borrowers whose accounts are being serviced by CSLP. We believe these measures should include: 1) testing methods in a pilot study for notifying borrowers who are paying through wage garnishment of the benefits of entering into voluntary repayment, and 2) a contractual requirement or other internal method of requiring collection agencies to notify borrowers when they become eligible to rehabilitate or consolidate their loans.**

CSLP Could Offer More Incentives to Paying Students

Currently all students with defaulted loans guaranteed by CSLP are assessed collection charges of 25 percent on the outstanding balance of principal and interest due. During our audit we found that some states are allowing borrowers who enter into repayment agreements within 60 days of their loan

defaulting to avoid collection charges as long as the borrower does not violate the terms of the agreement. In addition, we found that although federal regulations allow guaranty agencies to assess collection charges using a flat rate, regulations do not require it. Assessing charges at a flat rate, regardless of payment history, does not offer any incentive for borrowers who are paying consistently to continue repaying their loans. Further, assessing charges in this manner does not take into account the actual collection costs on a particular borrower's account. **We believe that CSLP could offer more incentives for getting borrowers to enter repayment, including: 1) waiving collection charges for those borrowers who enter into a repayment agreement within 60 days of their loan defaulting, and 2) adopting an approach for assessing collection charges in which borrowers who pay consistently are charged lower collection fees than those who are not making routine payments.**

CSLP Should Continue to Evaluate its Costs of Collection

Currently CSLP reports that its actual costs of collection are about 29.5 percent of the dollars it collects on defaulted loans. CSLP may be able to lower these costs. We found that indirect costs comprise approximately 31 percent of total collection costs. This appears high. Further, CSLP pays outside collection agencies a maximum of 15 percent to collect on defaulted loans, but its own costs of collection are 29.5 percent. CSLP should evaluate its costs against those of private sector collection agencies. In addition, the formula used by CSLP to arrive at the 29.5 percent cost rate appears to be somewhat inconsistent in its treatment of dollars collected and may result in a higher cost rate than necessary. **We believe that CSLP should continue to evaluate its costs of collection. In addition, we believe that CSLP should begin using a methodology for calculating its collection cost rate that treats all types of dollars collected consistently.**

Summary of Agency Responses

The Colorado Student Loan Program agrees or partially agrees with eight recommendations and disagrees with one recommendation in this report. The full text of each response is located within the report body.

RECOMMENDATION LOCATOR
Agency Addressed: Colorado Student Loan Program

Rec. No.	Page No.	Recommendation Summary	Agency Response	Implementation Date
1	17	CSLP should immediately notify all borrowers whose loans defaulted prior to January 1, 1998, of the changes in federal regulation. These borrowers should be given an appropriate amount of time to find a means of paying off, or substantially paying down, their loan balances.	Agree	March 31, 1999
2	19	The Colorado Student Loan Program should notify all borrowers whose payments were retroactively reapplied. This notification should include a statement of the period of time for which payments were reapplied, the current balance outstanding on their loan, and the reason payments were reapplied.	Agree	March 31, 1999
3	21	The Colorado Student Loan Program should implement additional quality control measures to timely detect problems in maintaining its defaulted loan accounts. These measures should include additional levels of review to help ensure that programming errors affecting borrowers' accounts do not occur in the future.	Partially Agree	November 1998
4	21	The Colorado Student Loan Program should continue in its efforts to upgrade the mainframe system. As part of this upgrade, all defaulted loans should be accounted for in an integrated system.	Agree	June 30, 2000

RECOMMENDATION LOCATOR
Agency Addressed: Colorado Student Loan Program

Rec. No.	Page No.	Recommendation Summary	Agency Response	Implementation Date
5	24	The Colorado Student Loan Program should be more aggressive in getting eligible borrowers to enter rehabilitation or consolidation plans by notifying borrowers when they have met the requirements.	Disagree	--
6	27	The Colorado Student Loan Program should implement measures to ensure that borrowers whose accounts have been assigned to outside collection agencies or legal groups will be offered the same opportunity to rehabilitate their loans out of default as borrowers whose accounts are serviced by CSLP.	Partially Agree	May 1, 1999
7	32	The Colorado Student Loan Program should work to develop incentives, including waiving collection charges for individual borrowers who enter into repayment within 60 days of default, and developing an approach that assesses lower collection charges to borrowers making consistent payments.	Partially Agree	May 1, 1999
8	37	The Colorado Student Loan Program should continue to evaluate its costs of collecting on defaulted loans. This analysis should include an evaluation of the indirect costs applied to default loan collections.	Agree	On or Before January 1, 2000
9	38	The Colorado Student Loan Program should begin using a methodology for calculating its collection cost rate that treats all types of collections consistently.	Partially Agree	On or Before January 1, 2000

Description of the Colorado Student Loan Program

Overview

The Colorado Student Loan Program (CSLP) was created by an act of the Colorado Legislature in June of 1979. Section 23-3.1-104, C.R.S., describes the powers and duties of CSLP, including the power to promulgate rules and regulations for administration of the student loan program. CSLP is a division of the Department of Higher Education (DOHE), and CSLP's director is appointed by the executive director of the Colorado Commission on Higher Education. As of Fiscal Year-End 1998, CSLP had 235 FTE, including 39 nonclassified positions. The program is funded by federal funds and cash funds exempt. CSLP receives most of its revenues through guarantee fees, loan servicing fees, account collections, and interest on investments. For Fiscal Year 1998, CSLP had total revenues of $21.7 million, including $9.7 million in federal funds and nearly $12 million in cash funds exempt. The projected fund balance for Fiscal Year 1999 is $45.5 million, with $31.8 million reserved in the Federal Reserve Fund and $9.3 million reserved in the Federal Recall Fund. These reserve funds are required by the U.S. Department of Education to be maintained by guaranty agencies for payment of lender default claims and payment of federal drawdowns resulting from the Balanced Budget Act of 1997 and the Reauthorization of the Higher Education Act in1998. The remaining fund balance of $4.4 million is available for use by CSLP for loan servicing activities, development of new loan servicing programs, supporting loan guarantee operations, improving services to students, and contingent liabilities.

CSLP assists students with the expenses incurred for higher education. The program's mission is to "provide students access to postsecondary education by ensuring the availability, effective delivery and responsible management of educational financing; and to provide quality service to all program participants." CSLP represents a partnership between lenders, schools, and the U.S. Department of Education. The capital for student loans is provided by approximately 34 private lenders, including banks, savings and loan associations, credit unions, pension funds, insurance companies, and secondary markets. The Student Loan Program administers the Federal Family Education Loan Program and guarantees the loans made to students and parents in accordance with federal regulations established in the Higher Education Act of 1965. When a student loan is made, CSLP insures the lender against the financial loss from default, disability, death, or bankruptcy. CSLP not only performs

loan servicing functions for lenders, but also assists with loan application processing and origination, provides training to program participants, performs program reviews of schools and lenders, assists borrowers through default prevention activities, and pursues collection of defaulted loans.

For Fiscal Year 1997, CSLP reported that it guaranteed over 84,000 new loans totaling about $242 million. These loans are made to both residents and non-residents of Colorado who are attending both in-state and out-of-state schools. In addition, one student may receive multiple loans that are guaranteed by CSLP. CSLP expects to guarantee over $305 million in loans in Fiscal Year 1999. For 1998, CSLP reported that it collected $26 million on defaulted student loans.

Defaulted Student Loans

This review focused on the activities at CSLP related to the collection of defaulted student loans. Defaulted loans are those loans that a private lender tried to collect on for a period of either six months or one year (depending on the terms of the loan) where the borrower failed to make payments. Once a private lender has been unable to collect on a student loan, that lender contacts CSLP to help them to try and get the borrower into repayment before the loan defaults. If both CSLP and the private lender are unsuccessful in getting the borrower to begin making payments on the loan, CSLP must then pay the insurance claim (default claim) to the private lender. Once the Student Loan Program pays the private lender the amount of principal and interest outstanding on the loan, that loan is considered to be in default. Upon payment of a default claim, the U.S. Department of Education then pays CSLP a percentage of the amount paid to the lender under the terms of the reinsurance agreement between CSLP and the Department. The percentage paid to CSLP is based on the year in which the loan was disbursed to the student and ranges from 95 to 100 percent of the amount of the claim paid to the lender. In 1998, CSLP paid nearly $45.1 million in default claims. Of this amount, CSLP was reimbursed by the U.S. Department of Education for nearly $44.6 million, resulting in a reinsurance loss on default claims of over $470,000, which CSLP pays for with cash funds exempt such as interest earned on investments and guarantee fees.

According to data provided by CSLP staff, as of the first calendar quarter of 1999, CSLP's portfolio of defaulted loans includes nearly 36,000 individual borrowers. The average amount in default for each of these borrowers is about $7,200.

Penalties for Default Are Becoming More Severe

On January 1, 1998, Part 682 of Title 34 of the Code of Federal Regulations (CFR) governing student loans was revised. The revisions brought some major changes to

the way CSLP collects on defaulted student loans. Although CSLP and other guaranty agencies have always been allowed to assess and recover collection costs from borrowers in default, this revision substantially changed the way those costs are recovered. In the past several years, the federal government has become increasingly punitive in its treatment of defaulted borrowers. For example, in the early years of the program, each payment made by a defaulted borrower was first applied to principal and then to interest, therefore helping to minimize the amount of interest accruing on the loan balance. In 1993 the regulations were revised so that each payment made by a borrower had to be applied first to interest outstanding, and if any amount remained, the payment was then applied to principal, and when all principal and interest were paid off, the guaranty agencies would attempt to recover any outstanding collection costs. At that time, the regulation allowed guaranty agencies to choose whether to apply payments to interest or collection charges first. In order to treat borrowers most favorably, CSLP chose to first apply all payments to interest.

The most recent revision to the federal regulations became effective January 1, 1998. This revision, among other things, changed the methods for how payments on defaulted loans are to be applied as well as how collection charges are to be calculated. According to 34 CFR 682.404(f), an appropriate amount of every payment made on a defaulted loan must first be applied to collection charges. In Colorado, the collection costs are assessed at an annual rate of 25 percent of all outstanding principal and interest. As a result, CSLP must first apply 20 percent (an effective rate of 25 percent per annum) of every payment made on a defaulted loan to collection charges, then apply the payment to interest and, finally, apply any remaining amount to principal. As a result of these changes, on January 1, 1998, the outstanding balance of each defaulted loan may have increased by as much as 25 percent. Along with that increase, the length of time and total amount taken to pay off the outstanding debt increased significantly for many defaulted borrowers.

As with most loans, the borrower's balance changes daily to reflect accruing interest as well as any payments made on the total balance. As the total balance of principal and interest changes (downward with payments that are adequate to cover collection charges, outstanding interest, and a portion of principal; and upward with an absence of payments or payments that are too small to cover collection charges, outstanding interest, and a portion of principal), the collection charges are recalculated daily to equal 25 percent of the total outstanding balance of principal and interest on a given day. Therefore, borrowers who make payments that are inadequate to cover collection charges, outstanding interest, and also reduce principal will not only see their interest balances continue to increase, but will also be assessed greater collection charges. Under federal regulation there is currently no limit on the amount of collection charges that can accumulate.

CSLP and lenders work with borrowers to help them avert default through temporary postponement of payments (for reasons such as poor health, inability to obtain employment, etc.) and/or reduced payments. For some loans, these efforts to prevent a student from defaulting extend for periods of up to one year. Although CSLP and lenders make a concentrated effort to prevent students from defaulting on their loans, ultimately, default is the responsibility of the borrower. Once a loan defaults, taxpayers often pay the price of that default. The main goal behind the revision to the regulations governing student loans was to place the responsibility and cost of defaulted loans on those citizens who defaulted rather than on taxpayers. By forcing guaranty agencies to recover the cost of collection up-front, the federal government greatly reduced the amount of federal dollars lost on each defaulted student loan.

Defaulted Student Loans

Background

The Colorado Student Loan Program (CSLP) is 1 of 36 guaranty agencies nationwide. These 36 agencies operate in cooperation with the federal government as guarantors for student loans. The federal government and, more specifically, the U.S. Department of Education, acts as the reinsurer for all student loans. As a result, when a student loan defaults and a guaranty agency pays a default claim to the private lender of that loan, the U.S. Department of Education reimburses the guaranty agency. The amount of the reimbursement depends on the guaranty agency's federal reinsurance default (trigger) rate. Agencies with trigger rates of more than 5 percent will not receive the maximum reimbursement rate for default claims paid. A trigger rate of 5 percent indicates that the guaranty agency paid claims of 5 percent of its total loans that were in repayment at the end of the previous fiscal year. For Fiscal Year 1997 Colorado's trigger rate was 2.86 percent, well below the 5 percent threshold. The maximum reimbursement rates are as follows:

- 95 percent of each default claim paid if the loan was made after October 1, 1998

- 98 percent of each default claim paid if the loan was made between October 1, 1993 and October 1, 1998

- 100 percent if the loan was made prior to October 1, 1993

In addition, CSLP's Cumulative Net Default Rate has decreased over the past three years from 9.18 percent to 7.95 percent, indicating that the total amount paid for defaults is decreasing. The Cumulative Net Default Rate is the total amount of default claims paid by a guaranty agency as a percentage of total loans guaranteed.

As discussed in the Description chapter, the federal regulations governing student loans have become increasingly more severe with respect to the treatment of borrowers who default on these loans. Revised regulations require guaranty agencies to assess up to 25 percent in collection charges to borrowers' accounts and recover those charges from each borrower payment before applying the payment to either principal or interest. Under the current regulations, defaulted borrowers face many penalties for default, including:

- Interest outstanding at the time of default is capitalized and included in the new principal amount of the defaulted loan.

- Guaranty agencies must accrue interest on the defaulted loans. Loans we reviewed had average annual percentage rates of 9 percent simple interest. This rate is required to be the greater of the rate stated in the original promissory note, or the rate provided for by state law in a judgment case.

- Guaranty agencies must assess collection charges at a rate not to exceed 25 percent of the outstanding balance of principal and interest at any given time. There is currently no limit in federal regulation on the amount of collection charges that can accrue over time, as long as those charges do not exceed 25 percent of the balance of principal and interest.

- Guaranty agencies must first apply a percentage of each payment to satisfy collection charges, then apply the remainder to interest, and finally to principal, greatly extending the length of time to pay off the loan.

- Collection charges can be applied to all defaulted borrowers at the same rate, regardless of a borrower's repayment status or of the actual cost of collecting a particular loan.

As a result of the more restrictive federal regulations, guaranty agencies have less flexibility in assessing and recovering collection costs from borrowers. Borrowers now face balances that are up to 25 percent higher, and for those borrowers on a payment plan, the balance will take substantially longer to pay off.

CSLP Practices Could Be Improved

Federal regulations are specific with regard to how guaranty agencies, including CSLP, collect on defaulted student loans. Although CSLP is collecting loans in accordance with federal regulations, we found several areas in which some of the program's practices could be improved, including:

- **CSLP needs to have a more integrated information system for tracking loans.** About 3,000 of CSLP's defaulted loans are tracked in a separate database from the rest of CSLP's 75,000 defaulted loans. This separate database was overlooked in the past when an important notification was mailed to all other borrowers and also when collection charges were applied, resulting in some defaulted borrowers' receiving inconsistent treatment.

- **CSLP could be more aggressive in trying to get loans out of default.** Getting a loan out of defaulted status is the only means by which a borrower can avoid being assessed the 25 percent collection charges.

- **CSLP could offer more incentives to those borrowers who are consistently paying on their defaulted loans.** This could include: 1) waiving collection charges for those borrowers who enter into a satisfactory repayment agreement within 60 days of their loan defaulting, and 2) adopting an approach for assessing collection charges in which borrowers who are consistently making timely payments are charged lower collection fees than those who are not making routine payments.

- **CSLP should continue to evaluate its costs of collection.** Currently CSLP reports that its actual costs of collection are about 29 percent of the dollars it collects on defaulted loans. Although this is within the range of other, similar guaranty agencies, CSLP should strive to lower these costs. Also, the formula used by CSLP to arrive at the 29 percent cost rate appears to be somewhat inconsistent in its treatment of dollars collected and may result in a higher cost rate than necessary.

All Defaulted Loans Should Be Accounted for in an Integrated Information System

CSLP currently uses two separate information systems to account for its defaulted student loans. CSLP uses an Access database to account for its defaulted consolidation loans and uses a mainframe system to account for all other defaulted loans. When consolidation first became available to student borrowers in 1986, CSLP staff believed that the terms and conditions of consolidation loans made them less susceptible to default. For example, most consolidation loans have repayment periods of 30 years with very low interest and, as a result, very low payments. Because CSLP staff did not believe that consolidated loans were at risk for defaulting, they chose not to spend the resources necessary to upgrade the mainframe computer system to handle consolidation loan tracking.

After some time, CSLP staff found that borrowers were in fact defaulting on their consolidation loans, and the tracking of those loans became significantly more complex. Because CSLP is in the process of transitioning to a new information system for tracking all loans, they decided not to update the current mainframe and continued tracking the consolidation loans on a separate database. Tracking this

group of loans on a separate system has caused some problems for the program, including: 1) an important notification was not sent to all borrowers, and 2) the consolidations database is not maintained appropriately.

Due Diligence Was Met for the Consolidated Loans

For all of its defaulted loans, CSLP is required by federal regulation to perform certain due diligence activities with respect to collecting on those loans. These activities include:

- Sending written notice within the first 30 days after a default claim is paid stating that the loan is in default; the amount of principal, interest and any other charges owing on the loan; the rate of interest; and opportunities available to the borrower to get the loan out of default.

- Attempting to collect on the loan, including at least one contact by telephone, from 60 to 180 days after a default claim is paid.

- Referring the account at the end of the 180-day period to an outside collection agency to perform collection activities on the account. As of February 1999, CSLP reported that it had 45,979 claims with a total value of nearly $139 million assigned to outside collection agencies.

- Referring accounts for civil suit if CSLP determines that collection efforts are not working and also if the borrower has sufficient assets available to satisfy the outstanding balance as well as the legal costs. CSLP uses both internal and external litigation groups to seek judgments in these cases. As of February 1999, CSLP staff reported that there were 3,319 claims with a total value of over $9.9 million assigned to an external legal group.

According to CSLP staff, in February 1999 there were about 3,000 consolidated loans in default and being tracked in the separate database. During our audit we chose a sample of 15 of these loans to determine whether CSLP met the due diligence requirements. We found that in all cases sampled, CSLP met the minimum due diligence requirements set forth in federal regulation for these cases.

Important Notification Was Not Sent to Borrowers in the Consolidation Database

Although CSLP met the notification requirements that relate to its due diligence activities, not all borrowers received other important notifications. Although notification was not required by federal regulations, CSLP management decided to

send a letter to some defaulted borrowers to notify them of the change in federal regulation prior to its implementation on January 1, 1998. On December 8, 1997, program managers sent letters to borrowers who had been making payments and had not yet been assessed any collection charges. This population of borrowers was chosen because management believed that borrowers making payments would be the most impacted by the change in federal regulation. This letter informed borrowers that effective January 1, 1998, the balance outstanding on their defaulted student loans may increase. The notice also said that a portion of each payment made after January 1 would be applied toward collection costs, and the only way to avoid payment of these collection charges would be to pay the total balance in full prior to January 1, 1998.

An error was made by CSLP staff when these notifications went out. None of the borrowers in the database of consolidated loans were sent notice of the changes in federal regulation, resulting in about 1,500 borrowers (who had been making payments) not being notified. In both systems combined, about 14,000 borrowers were not notified prior to the implementation of the revised regulation and, therefore, were not provided with the same opportunity to avoid collection charges as the 1,935 borrowers who did receive the notification letter.

According to information provided by CSLP staff, 98 of the 1,935 borrowers notified found a way to pay off the balance of their loans and avoid collection charges. In other words, within 30 days of notification, about 5 percent of those notified found a way to pay off the balance of their loan and completely avoid the 25 percent collection charges. If CSLP had notified the remaining 14,000 borrowers and received the same response rate, approximately 700 borrowers may have found a way to pay off the balance of their loans. The response rate could have been even greater if CSLP had given borrowers more than 30 days' notice.

One of the defaulted borrowers in the consolidation database found out about the change in federal regulation by accident when he called to inquire why a payment check he sent had not cleared his bank. This borrower found out that as a result of collection charges being applied to his payments, the $11,000 in payments made over the previous 14 months had only reduced his total balance by $5,500. According to this borrower, had he been notified of the impact of this change in regulation, he would have found some other means of paying off his loan in order to avoid collection charges.

Other Guaranty Agencies Notified All Borrowers of the Change in Regulation

As part of this audit we interviewed six guaranty agencies throughout the nation that had similar performance records to the Colorado Student Loan Program. During these interviews we found that five out of six agencies we spoke with made an effort to notify all borrowers in default of the changes in federal regulations, and gave the borrowers at least 60 days' notice to pay off or pay down their loan balances and avoid the collection charges that would begin accruing after January 1, 1998. Staff at one of the agencies we spoke with stated that "we felt it was our ethical responsibility to notify our borrowers of this change in regulation because of the large impact it would have on their loan balances, and the increased length of time it would take to pay off the loan." This guaranty agency not only used letters to notify borrowers of these changes but also used press releases in all of the major newspapers in that state. According to this guaranty agency, they received a large response, and many borrowers took the opportunity to pay off their loan balances before the revised regulation went into effect.

CSLP staff recognize that they made an error in not notifying borrowers in the consolidation database at the same time they notified the 1,935 borrowers in the mainframe system. In an effort to try to address this situation, CSLP is planning on sending letters to borrowers who were not notified during the first round of notifications and allowing those borrowers to make a lump sum payment within a defined grace period. If payment in full is received within this grace period, borrowers will be able to avoid some or all collection charges. However, at the time of our audit, CSLP had not determined whether notification would be sent to all borrowers not initially notified (approximately 14,000) or whether only those borrowers in the consolidation database would be notified (approximately 1,500). CSLP had also not determined the length of the grace period that would be given to borrowers during this notification.

As a result of the inconsistent notifications of the change in federal regulations, we believe that CSLP should notify not only borrowers with consolidated loans but also notify all defaulted borrowers, whether they are making payments or not. By doing this, CSLP ensures that they are treating all borrowers equitably, and CSLP may also get some borrowers to pay off their loan balances that otherwise are not paying consistently.

Recommendation No. 1:

Colorado Student Loan Program should immediately notify all borrowers whose loans defaulted prior to January 1, 1998, of the changes in federal regulation. These borrowers should be given an appropriate amount of time to find a means of paying off, or substantially paying down, their loan balances. The notice sent to borrowers should include the following:

a. A description of how the change in regulation affects their loan balances, payments made, and the length of time taken to pay off their loan.

b. An offer that if payment is received within a determined grace period, CSLP will agree to waive some or all collection charges that have accrued.

c. A statement that tells borrowers that if full payment is not received within the specified grace period, collection charges will be assessed on the outstanding balance of principal and interest (at the current rate of 25 percent, given our comments in Recommendation Nos. 8 and 9) and will continue to be assessed until the loan is paid in full.

Colorado Student Loan Program's Response:

Agree. The principal effect of the change was on the application of borrower payments, requiring that a portion be applied first to collection charges, then to interest, and finally to principal. For this reason, CSLP determined it was obliged to inform only those defaulted borrowers who were making payments. As the audit report notes, however, not all such borrowers were informed of the change. To ensure the equitable treatment of all defaulters, those who are paying and those who are not, CSLP accepts the recommendation to send all its defaulted borrowers a letter informing them of the changes in federal default collection rules. The letter will include an explanation of the benefits of consolidation and rehabilitation, and will offer a possible reduction of collection charges for balances paid in full by June 1, 1999.

With the exception of collection charges canceled within the first 60 days after default for payment in full, or at the time of consolidation or rehabilitation, federal program regulations permit full or partial cancellation of collection charges only on a case-by-case basis at the time of a lump-sum settlement to satisfy the debt. A policy of blanket amnesty on collection charges is not considered possible within existing federal regulation.

The Consolidation Database Is Not Always Maintained Appropriately

During our review we found some problems related to the maintenance of the consolidations database, including:

- Collection charges are not applied to all accounts consistently.
- Collection charges are applied to some accounts that cannot legally accrue collection charges.

According to CSLP staff, both of these problems are related to consolidation loans not being included in the mainframe system with all other defaulted loans.

Collection Charges Not Applied Consistently

During our review we found that CSLP had not assessed collection charges on all eligible payments received after January 1, 1998. We reviewed a sample of 21 files from the consolidation database that did not have collection charges applied to all borrower payments made after January 1, 1998. We found that 17 of the 21 files did not have collection charges assessed or collected from eligible payments. According to CSLP staff, these 17 files are part of a population of 139 accounts that were erroneously excluded from collection charges being applied. Our audit revealed that a programming error in the consolidation database resulted in these charges not being applied appropriately. According to CSLP staff, they found this programming error in January 1999, and in February staff retroactively reapplied all payments on any of the 139 accounts that were not yet paid in full. In other words, all payments made on these accounts were reapplied, with 20 percent of these payments going toward collection charges. This resulted in the outstanding balance on the loans increasing for these borrowers. According to CSLP staff, they had no choice but to reapply these payments because the federal regulations stated that, beginning January 1, 1998, all payments made must be applied first to collection charges.

We reviewed the accounts affected by the reapplication of payments and found that, on average, about $1,400 in borrower payments were reapplied and the balance of principal, interest, and collection charges on the affected accounts increased by an average of about $375. On some accounts as much as $6,600 in payments made between January 1998 and February 1999 were reapplied. We also found that the balance of principal, interest, and collection charges increased by as much as $1,800 on these accounts. Because of the significant impact this programming error had on these borrowers' accounts, we believe it is critical for CSLP to inform these borrowers that their account balances may have changed.

Because this error was not corrected until February of 1999, CSLP also had to correct the 1098 tax forms sent to borrowers to show them how much interest was paid on their student loans in 1998 for tax purposes. The only notification sent to borrowers of the reapplication of borrower payments was a letter stating that they would be receiving a revised interest statement for 1998.

Borrowers have not been notified of the effect this programming error had on their loan balances. Therefore, some borrowers who called in at the end of 1998 for their loan balances will be surprised to find out that, next time they call, their balances may be up to $1,800 higher, including collection charges. Because the retroactive application of these payments significantly affects the balance outstanding on borrowers' loans, we believe that CSLP should notify borrowers of the changes to the balance and the reapplication of payments.

Recommendation No. 2:

The Colorado Student Loan Program should notify all borrowers whose payments were retroactively reapplied. This notification should include a statement of:

a. The period of time for which payments were reapplied.

b. The current balance outstanding on their loan.

c. The reason payments were reapplied.

Colorado Student Loan Program's Response:

Agree. Due to a programming omission, CSLP did not notify 139 borrowers whose collection charges had been retroactively applied to their payments. CSLP will send those borrowers a letter that will include a statement of the period of time for which payments were reapplied, the current balance outstanding on their loan, and the reason payments were reapplied.

Collection Charges Were Applied to Accounts in Error

Once a defaulted loan has gone through a legal proceeding and a judgment has been obtained, no further collection charges can be assessed on the balance due. A judgment represents the total amount due from the borrower and includes legal and attorney fees as part of that total.

During our review we found several accounts that were assessed collection charges, even though they should not accrue these charges. For example, our review of 15 accounts in the consolidation database revealed that 3 accounts with judgments are currently being assessed additional collection charges. The collection charges included in the outstanding balances on these three accounts range from $6,000 to nearly $12,000. According to CSLP staff, there are fewer than 10 accounts for which a judgment has occurred and collection costs are being accrued in error. In the event that this does occur, CSLP staff will manually correct the account so that only the amount of the judgment is collected and charges that accrued erroneously are written off.

According to staff, this error is also the result of a programming error made in the consolidation database, and once the consolidation loans are incorporated into the new loan tracking system in Fiscal Year 2000, this will no longer be a problem.

During our review several problems we identified were directly attributed to the consolidation loans being tracked on a system that is not integrated with the mainframe system for tracking loans. The initial problem with notification of the new federal regulation not being sent to consolidated borrowers in default was attributed to the loans being accounted for separately. In addition, problems with payments being applied inconsistently and to collection charges inappropriately are also the result of programming errors in this separate database. Although CSLP staff did ultimately identify these errors and correct them, CSLP should implement quality control measures that will prevent these types of errors from occurring in the future. CSLP staff recognize these problems with tracking loans in a system that is not integrated with its other systems for tracking loans. CSLP is currently in the process of developing a new loan tracking system and plans to include all loans on this integrated system when it is implemented in Fiscal Year 2000. We encourage CSLP to continue its efforts to upgrade its information system, and also believe that CSLP should implement additional measures of review to ensure that programming mistakes such as those described above do not occur in the future.

Recommendation No. 3:

The Colorado Student Loan Program should implement additional quality control measures to timely detect problems in maintaining its defaulted loan accounts. These measures should include additional levels of review to help ensure that programming errors affecting borrowers' accounts do not occur in the future.

Colorado Student Loan Program's Response:

Partially agree. Pending implementation in 2000 of a new computer system which will enable integrated management of all defaulted loans, additional quality control reviews of the consolidated loan database have been instituted to ensure that programming changes do not adversely affect borrowers.

Recommendation No. 4:

The Colorado Student Loan Program should continue in its efforts to upgrade the mainframe system. As part of this upgrade, all defaulted loans should be accounted for in an integrated system. Also, while the transition to the new system is taking place, CSLP staff should ensure that consolidation loans are included in all important notification processes and that the consolidation database is maintained appropriately.

Colorado Student Loan Program's Response:

Agree. The new guaranty system is an agency priority and is expected to be completed during the second quarter 2000. As noted in the response to Recommendation Number 3, quality control procedures have been instituted to ensure that the consolidation database is maintained accurately and that all consolidation borrowers are included in borrower notifications.

Methods for Getting Loans out of Default Could Be Improved

Once a borrower has failed to make payments to the original lender for a period of six months (or one year depending on when the loan originated), the loan goes into default and the guaranty agency must pay the default claim on the loan (principal and outstanding interest) to the original holder of the loan. After the default claim is paid, the loan is in default. Federal regulations state that all guaranty agencies must assess and collect the costs of collection from defaulted borrowers until the loans are no

longer in default. Currently there are four methods for getting a loan out of default status:

- **Lump Sum Payment -** The borrower finds a way to pay off the loan in full.

- **Consolidation -** After making three consecutive, timely, appropriate, and voluntary payments, a borrower can consolidate one or more of the loan(s) out of default by getting a lender to refinance the loan. Consolidation creates a new loan, but does not clear the borrower's credit record completely of the defaulted loan(s). Consolidation also makes borrowers eligible to receive other financial aid. Most borrowers who choose to consolidate their loan(s) are doing so because they need to have the defaulted loan show as paid in full on their credit report and cannot wait 12 months to rehabilitate the loan(s) and have their credit record cleared of the default.

- **Rehabilitation** - After making 12 consecutive, timely, appropriate, and voluntary payments, a borrower can choose to rehabilitate the loan(s) by getting a lender to refinance the loan. Rehabilitated loans clear the borrower's credit record of the defaulted loan reported by the guaranty agency.

- **Compromise -** If at some point CSLP believes that its chances of collection of a loan would be improved by accepting payment in full for a lesser amount than is due, CSLP has the authority to compromise a portion of the collection charges, principal, or interest. If CSLP and the borrower can come to an agreement on a settlement amount, CSLP accepts payment according to the terms of that agreement, and the debt is considered to be fully satisfied.

When notification is sent to borrowers that their loans are in default, CSLP also notifies borrowers of their options for getting those loans out of default. However, CSLP cannot at any time force a borrower to choose any of the options available for getting loans out of default status.

Until the revised federal regulations became effective in January 1998, guaranty agencies had much more flexibility in assessing and collecting the cost of collection from the borrowers. As mentioned in the Description chapter, the costs of collection were either not assessed or were assessed at the end of the loan repayment once all interest and principal had already been paid off. According to CSLP staff, in many cases, collection charges were never recovered because once borrowers paid all principal and interest outstanding on the loan, they would stop making payments and CSLP would write off the remaining collection charges.

The Revised Regulation Makes Rehabilitation and Consolidation More Advantageous

Until the implementation of the revised federal regulation, the options of rehabilitation and consolidation were not beneficial to the borrowers. When a borrower consolidates or rehabilitates a defaulted student loan, 18.5 percent of the outstanding balance of principal and interest is assessed for collection charges and is included in the new principal balance of the refinanced loan. Therefore, before collection charges began to be assessed at the rate of 25 percent, a borrower was better off to enter into a repayment plan and pay off the loan through CSLP rather than through rehabilitation. However, since January 1998, it is better for borrowers who cannot pay their balances in full to either consolidate or rehabilitate their loans. By choosing to rehabilitate or consolidate, borrowers will only pay 18.5 percent in collection charges, whereas if borrowers continue to make monthly payments to CSLP, they will be paying 25 percent in collection charges.

Four of the six guaranty agencies we interviewed have active programs for getting borrowers to either consolidate or rehabilitate their loans, including sending notification to a borrower once the requirements for consolidation or rehabilitation have been met. One state uses a series of letters to notify defaulted borrowers that they meet the requirements to apply for rehabilitation. The first letter in the series is sent after they have made six consecutive payments. The second letter is sent when borrowers have made 10 consecutive payments and includes an application for rehabilitation. Finally, when borrowers have made 12 consecutive payments, another reminder is sent with another application for rehabilitation.

CSLP began doing sweeps of its default accounts in 1993 to identify those accounts that qualify for either rehabilitation or consolidation. However, in our review of 15 loans, we found four accounts that were eligible for rehabilitation, but were not notified about this possibility in a timely manner. For three of these accounts, the borrowers had met the requirements to rehabilitate their loans prior to January 1, 1998. The earliest notation in the files that rehabilitation was started in these cases was September 1998, after the borrower had already made at least nine payments and 20 percent had been applied to collection charges from each payment. One of these accounts was just recently rehabilitated in February 1999, after making 13 months of payments on which the borrower was assessed collection charges. Because these borrowers were eligible for rehabilitation prior to January 1, 1998, they could have avoided paying any collection charges at the rate of 25 percent. The fourth borrower became eligible for rehabilitation in March 1998. However, this borrower was not notified that he had met the requirements until November 1998. According to CSLP staff, this borrower's account slipped through their system of account sweeps and notification due to a change in staff.

Because it is now better for borrowers to enter into repayment or consolidation of their loans, we believe that CSLP staff should be more proactive in notifying borrowers, not only in the beginning when their loan defaults but also when they have met the payment requirements for rehabilitating their loans. By doing this, CSLP will be acting in the best interest of its borrowers as well as increasing the number of student loans that are taken out of default status. We commend CSLP staff for the efforts they have made in attempting to identify borrowers who are eligible for rehabilitation and encourage CSLP to continue these efforts by notifying all borrowers of the benefits of rehabilitation at the time they meet the requirements to rehabilitate.

Recommendation No. 5:

The Colorado Student Loan Program should be more aggressive in getting eligible borrowers to enter rehabilitation or consolidation plans by notifying borrowers when they have met the requirements. These options reduce the amount of collection charges assessed to the borrower as well as allow CSLP to increase collections and get the loans out of default status.

Colorado Student Loan Program's Response:

Disagree. Our efforts in this regard are already very aggressive. We currently sweep all defaulted accounts on a monthly basis to determine which are qualified for consolidation or rehabilitation and notify eligible borrowers by letter. We have also put procedures and controls in place to ensure that these sweeps are complete and thorough on all accounts, including those at outside collection agencies. Our success in this regard is reflected in the significant increase in consolidation and rehabilitation volume over the past year. Our projections through the end of this fiscal year indicate a 33 percent increase in rehabilitation volume and a 13 percent increase in consolidation volume over last year.

It should be noted that all defaulted borrowers might not qualify for these programs. For example, rehabilitation is a one-time opportunity; rehabilitated loans that have re-defaulted are not eligible for another rehabilitation. In any case, lenders are under no obligation to repurchase or consolidate loans. Because of borrowers' past payment history, lenders may, in fact, be reluctant to accept the risk involved in an inordinate volume of rehabilitations and consolidations. The contingent liability of a re-default could present a real risk to both lenders and taxpayers.

Auditor's Addendum

Our review revealed that CSLP's process for sweeping accounts is not working effectively to notify borrowers in a timely way that they meet the requirements to rehabilitate. As noted above, 4 of the 15 accounts we reviewed were eligible to rehabilitate their loans but were not notified of their eligibility until eight months or longer after they qualified. As a result of these findings, we believe that CSLP should take additional measures to ensure that their process for sweeping borrowers' accounts results in timely notification of qualifying borrowers.

All Accounts Should Be Monitored for Eligibility to Rehabilitate

As mentioned earlier, there are currently nearly $139 million in accounts assigned to outside collection agencies and over $9.9 million in accounts assigned to external legal groups. Once accounts are assigned to outside collection agencies and legal groups, CSLP staff no longer have responsibility for performing due diligence activities on those accounts, and typically, accounts are left with the outside agency until the loan is paid in full. Of the 15 accounts we reviewed, eight borrowers made 12 consecutive monthly payments prior to January 1, 1998. CSLP assigned four of these accounts to a legal group prior to the borrower's entering into repayment. However, the four accounts assigned to legal groups are not currently eligible for rehabilitation because payments are being made through wage garnishment and are not considered voluntary.

Accounts Assigned to Legal Groups

Once an account is assigned to the legal group, (internal or external), CSLP does not attempt to bring that account back in house for collections activities. As mentioned earlier, borrowers with accounts assigned to internal or external legal groups are often making payments through wage garnishment, and as a result, their payments do not qualify for rehabilitation because they are not considered voluntary. However, once a good payment relationship is established, a borrower can request that wage garnishment be stopped and that borrower can continue making payments voluntarily in order to qualify for rehabilitation. CSLP does not currently have a means for reviewing accounts assigned to legal groups and determining if accounts would be good candidates for rehabilitation. Furthermore, neither CSLP nor the legal groups currently attempt to get borrowers to begin repaying voluntarily or notify consistently paying borrowers of the requirements and benefits of rehabilitation. CSLP is

considering piloting a program to determine if it is cost-beneficial to begin evaluating legal files for rehabilitation and getting those borrowers into voluntary repayment so that they can become eligible to rehabilitate their loans. Currently CSLP pays its external legal group lower commission rates on rehabilitations and consolidations (11 percent) than it pays for a borrower's repaying through wage garnishment (20 percent). This indicates that it is less costly to get these borrowers into a rehabilitation program or consolidation program as early as possible.

Accounts Assigned to Outside Collection Agencies

According to CSLP staff, once an account is sent to an outside collection agency, CSLP does not bring that account back in house for any action, including rehabilitation and consolidation. Collection agencies have the authority to rehabilitate loans. According to CSLP staff, outside collection agencies typically like to collect lump sum payments as opposed to incremental payments on accounts. As a result, CSLP staff stated that collection agencies are active in promoting the consolidation program for getting loans out of default because the agencies can obtain full payment with low overhead cost after receiving only three months of adequate payments. In fact, CSLP staff estimate that nearly $2 is collected from consolidations for every $1 collected in borrower payments. However, the current method for paying outside collection agencies for their services inherently offers some incentives for collection agencies to keep borrowers who pay consistently in repayment as opposed to consolidation or rehabilitation. CSLP currently pays collection agencies on a commission basis. Collection agencies receive a percentage of all dollars collected on default loans. Therefore, collection agencies can make more money when their collections are higher. Two primary incentives are built into this payment structure:

1) Collection agencies are currently paid commission rates of 15 percent on borrower payments collected, whereas on consolidations and rehabilitations commission rates are only between 10 and 11.5 percent.

2) The amount of collection charges assessed on borrower payments is higher (25 percent annually of the outstanding balance of principal and interest) than those assessed on rehabilitations and consolidations (18.5 percent of the outstanding balance).

Therefore, borrowers who are repaying their loans rather than consolidating or rehabilitating provide more income to collection agencies. On borrowers in repayment, collection agencies could conceivably retain their higher commission rate of 15 percent on a 25 percent collection charge as well as continuously accrue interest. In contrast, on a rehabilitation or consolidation, collection agencies would earn only a 10 to11.5 percent commission rate on collection charges of 18.5 percent.

Although we did not find any instances in which a collection agency had not attempted to rehabilitate a qualifying account, the incentives built into the payment structure for outside collectors do put accounts at outside collection agencies at risk. As a result, we believe that it is important for CSLP to include in collection agency contracts a clause requiring collection agencies to notify borrowers of when they have met the requirements for rehabilitation and consolidation. Such a clause would help to assure both borrowers with defaulted loans, and CSLP staff, that accounts assigned to outside collections are given equal opportunity to rehabilitate their loans. In addition, such a clause would limit the incentives for collection agencies to allow borrowers to remain in repayment in order to earn higher commission rates.

The federal regulation is specific with respect to when borrowers become eligible to apply for rehabilitation of their loans and get those loans out of default status. In addition to the benefits of lower collection charges, rehabilitation clears the borrowers' credit reports of the guaranty agency's claim and reduces costs to the guaranty agency of: 1) performing due diligence activities, 2) paying outside collectors (i.e., 11 percent as opposed to 15 percent of the amount collected), and 3) paying legal fees for accounts assigned to litigation (i.e., 11 percent as opposed to 20 percent of the balance collected).

Considering the benefits of rehabilitation to not only the borrower but also the guaranty agency, we believe that CSLP should ensure that borrowers whose accounts are handled by outside collections agencies, as well as either internal or external legal groups, be notified of the benefits of rehabilitation once they have met the requirements.

Recommendation No. 6:

The Colorado Student Loan Program should implement measures to ensure that borrowers whose accounts have been assigned to outside collection agencies or legal groups will be offered the same opportunity to rehabilitate their loans out of default as borrowers whose accounts are serviced by CSLP. These measures should include:

a. Testing methods in a pilot study for notifying borrowers who are paying through wage garnishment of the benefits of entering into voluntary repayment so that they can become eligible to rehabilitate their loans.

b. A contractual requirement or other internal method of requiring collection agencies to notify borrowers who have met the requirements for rehabilitation and consolidation.

Colorado Student Loan Program's Response:

Partially agree. Borrowers whose accounts are at outside collection agencies (OCAs) do have the same opportunity to consolidate or rehabilitate their loans out of default as borrowers whose accounts are managed at CSLP, and are encouraged by OCAs to do so. In FY1998, 57 percent of the dollars collected by OCAs on CSLP's behalf came from consolidations or rehabilitations. We project that will increase to 65 percent for FY1999. Amendments to present and future contracts with OCAs to specify notification requirements regarding borrowers' rehabilitation and consolidation eligibility would be difficult to contractually enforce. To more effectively comply with the intent of the audit report's recommendation, CSLP will include all borrowers, whether their accounts are at CSLP or at OCAs, in its monthly sweeps to determine their eligibility for rehabilitation or consolidation. CSLP will then directly notify by letter all eligible borrowers of their rehabilitation and/or consolidation options.

It would not be practical or productive to review garnishment accounts to determine if the borrower would be a good candidate for rehabilitation or consolidation, since these borrowers have become subject to garnishment precisely because of their demonstrated inability or unwillingness to make and keep a payment arrangement. They are working and yet for over 180 days after default have failed to make and keep a payment arrangement. They have already had numerous prior opportunities to enter into the consolidation or rehabilitation programs. Establishing objective criteria for the suggested pilot study to determine which of these borrowers is a likely candidate for consolidation or rehabilitation would be nearly impossible, and subjective evaluations could be construed as discriminatory. However, borrowers in garnishment may request the opportunity to make consistent, voluntary, qualifying payments in order to qualify for consolidation or rehabilitation.

Auditor's Addendum

See Auditor's Addendum for Recommendation Number 5 concerning the effectiveness of CSLP's process for sweeping borrowers' accounts.

More Incentives Should Be Offered to Paying Students

Currently CSLP assesses collection charges at an annual rate of 25 percent of the outstanding principal and interest due on a loan. When payments are made toward the balance of the loan, 20 percent of each payment is first applied to collection costs. For example, if a borrower has principal of $10,000 outstanding, and one month of accrued interest ($74) outstanding, total collection costs assessed on the account would be $2,519. As mentioned previously, the revision of the regulations governing student loans in January 1998 substantially changed the manner in which borrower payments are applied to defaulted loan balances. As a result of this change, it takes borrowers substantially longer to pay off the balance of the loan. The chart below shows how a borrower payment would be applied in the example given above with outstanding principal and interest of $10,074 and collection charges of $2,519.

Application of Borrower Payments
Previous Version of the Code of Federal Regulations
vs.
Revision to Code of Federal Regulations Effective January 1, 1998

	Previous Regulation (Payment is Sufficient to Satisfy Accrued Interest)	**Regulation Effective January 1, 1998** (Payment is Sufficient to Satisfy Accrued Interest)	**Regulation Effective January 1, 1998** (Payment **Not Sufficient** to Satisfy Accrued Interest)
Beginning Principal Balance Outstanding:	$10,000	$10,000	$10,000
Payment Amount:	$150	$150	$75
Applied to:			
Collection Charges:	$0	$30	$15
Interest:	$74	$74	$60
Principal:	$76	$46	$0
Principal Balance Remaining:	$9,924	$9,954	$10,000
Interest Outstanding After Payment:	$0	$0	$14
Interest Accrued in the Month Following the Payment:	$73.41	$73.63	$73.97
Ending Principal and Interest Balance:	**$9,997.41**	**$10,027.63**	**$10,087.97**

Source: Office of the State Auditor Analysis.

Until all outstanding interest is paid off, borrower payments will not be applied to principal. As a result of payments being applied first to collection charges, the principal balance on the loan is not decreased as rapidly, which results in more interest being charged to the borrower over the period of the loan. In the example above, the interest amount will continue to grow at a rate of $75 per month for as long as the payments are too small to cover collection charges, interest outstanding, and a portion of the principal.

As the table demonstrates, the current regulation is considerably more punitive than the previous regulation. Borrowers who are making consistent payments will not see

their loan balances decreasing as rapidly as they would have under the previous regulation. Although Colorado is operating within the federal regulations, we believe that the CSLP could offer additional incentives to consistently paying borrowers including: 1) waiving collection charges for those borrowers who enter into a repayment agreement within 60 days of their loan defaulting, and 2) adopting a method for assessing collection charges in which borrowers who are consistently making payments are charged lower collection fees than those who are not making payments consistently.

Some Guaranty Agencies Offer Incentives to Borrowers Who Enter Into Repayment Agreements

According to 34 CFR 682.410(b)(5)(ii)(D), when a guaranty agency pays a default claim, that agency must notify the borrower of the payment of that claim and give the borrower 60 days to either pay the loan in full or enter into a satisfactory repayment agreement with the agency. During this 60 days, the regulation prohibits guaranty agencies from assessing any collection charges on accounts.

Of the six guaranty agencies we interviewed, three will not assess collection charges to borrowers who enter into repayment within the 60-day time frame. These guaranty agencies will not assess collection charges on any payments made under that repayment agreement as long as the borrower does not violate the terms of the agreement at any time. Once the borrower misses a payment under the repayment terms, the agencies will then begin assessing collection charges, and will continue to assess those charges until the loan is paid in full or otherwise taken out of default.

CSLP's current policy is to assess collection charges on any accounts that are not paid in full within 60 days from the date the default claim is paid. Although both methods appear to be allowed under the terms of the current federal regulations, by offering borrowers the option of entering into repayment without any collection charges, CSLP would be increasing a borrower's incentives to enter into repayment immediately and continue repaying his or her loan. Other guaranty agencies also believe this is an effective tool for encouraging repayment.

Collection Charges Could Be Assessed In Accordance With Payment History

Although the U.S. Department of Education does allow guaranty agencies to assess collection charges at a flat rate to all borrowers in their portfolio, this method for applying collection charges is not mandated. According to a letter from the U.S. Department of Education to a defaulted borrower, the Department was originally

considering establishing a uniform collection cost rate to be applied to all borrowers throughout the country. However, comments received in response to this original proposal stated that "the assessment of a uniform rate may not be the fairest approach to assessing collection costs." As a result of these comments, the U.S. Department of Education did not establish a uniform rate; however, the Department does still allow guaranty agencies to apply collection charges using a flat rate.

The application of collection charges to all borrowers based on the same rate does not offer an incentive to borrowers who are making consistent payments to continue making those payments. In fact, one borrower stated that the application of collection charges in this manner is a disincentive to pay, because it takes so much longer for the borrower to pay off the loan.

As a result of the revised federal regulation, guaranty agencies do not have any choice but to assess collection charges on defaulted loans. However, guaranty agencies do have some flexibility in the methods used to assess these charges. One approach that could be considered would be an aging schedule approach. Using this approach, CSLP could use its information system to group accounts into various categories such as borrowers making payments every month versus those not making payments for periods of 60 days, 90 days, and longer than 90 days. Those borrowers making monthly payments could be assessed collection costs at a lower rate than those in the other categories of payment status. This type of approach assesses charges that more clearly reflect the actual costs of collecting on particular accounts, since there are fewer collection activities on accounts with consistent payment records.

We believe that a combined approach is needed. Borrowers who enter into repayment within 60 days of default could not be assessed collection charges on payments made under that repayment agreement. Also, an approach that lowers collection charges for borrowers who are paying consistently could offer greater incentives for borrowers to continue repaying their defaulted loans. In addition, since CSLP has not yet completed its new system for tracking loans, CSLP should investigate whether the system will be able to perform this type of function automatically, and if not, CSLP should investigate the costs of having this function added to its new system.

Recommendation No. 7:

The Colorado Student Loan Program should work to develop incentives to get borrowers into repayment agreements. These incentives could include:

a. Waiving collection charges for individual borrowers who enter into repayment agreements within 60 days of payment of the default claim, and maintaining that waiver for as long as the borrower remains in compliance with the repayment agreement.

b. Developing an approach to assessing collection charges in which borrowers who are making consistent payments on their loans are assessed lower collection charges than borrowers who make payments less consistently. This method could include using an aging schedule approach for grouping accounts into various brackets by payment history and assessing collection charges accordingly.

Colorado Student Loan Program's Response:

Partially agree. CSLP currently offers all the incentives for payment-in-full, compromise, rehabilitation, and consolidation that are permitted under federal law and regulation. CSLP's counsel has determined that federal regulations require imposition of collection charges on all defaulted borrowers who have not paid their loans in full within 60 days of their default. Since the interests of borrowers and taxpayers are best served by: 1) payment in full, 2) compromise settlement (which guarantors are prohibited by regulation from initiating), or 3) by rehabilitating or consolidating loans out of default as soon as possible, these are the focus of CSLP's default collection efforts. These options allow borrowers to avoid all future collection charges. A tiered approach to collection fees would benefit only those relatively few borrowers who might be paying consistently but do not qualify or choose to rehabilitate or consolidate. They can be helped in other ways. Moreover, the necessary programming changes for a tiered-fee system would add to the cost of collections for all borrowers, and be subject to frequent revision to reflect changing federal regulations.

CSLP proposes instead the following alternative means of assisting consistent payers who may not qualify for rehabilitation or consolidation through the Federal Family Education Loan (FFEL) Program which CSLP administers. Those borrowers whose payments are consistent, but substandard due to economic hardship, may not qualify for rehabilitation or consolidation through the FFEL Program. However, to assist these borrowers and achieve the intent of the audit report's recommendation, CSLP will facilitate consolidation of their loans through the Federal Direct Consolidation Loan Program, which discharges the default, restores eligibility for federal student assistance, and permits income-contingent repayment on the new Consolidation Loan.

Collection Cost Rate Should Be Reviewed

According to 34 CFR 682.410(b)(2), guaranty agencies are required to charge a borrower an amount equal to reasonable costs incurred by the agency in collecting a loan on which the agency has paid a default claim. Reasonable costs can include all attorneys' fees, collection agency charges, internal collection costs, and court costs. The costs charged must be the lesser of the actual costs incurred by the agency as calculated in 34 CFR 30.60, or the amount the same borrower would be charged by the U.S. Department of Education (currently 25 percent).

The Student Loan Program hired a consultant to review its costs and allocate an appropriate percentage of the indirect costs of its divisions to the cost of collecting on defaulted loans. With both indirect costs and the direct costs of collecting on defaulted loans, CSLP found that its costs of collection are 29.5 percent.

Of the other guaranty agencies we spoke with, two had actual collection costs lower than the U.S. Department of Education rate of 25 percent. One agency reported actual costs of 21 percent and the other reported costs of 22 percent. Actual costs of the other four agencies we interviewed ranged from 25 to 32 percent. Colorado's collection costs are within the range of costs reported by similar guaranty agencies. However, CSLP staff recognize that it does not benefit the guaranty agency to have collection costs that are higher than the federally allowed recovery rate of 25 percent. As a result, CSLP staff are setting up a task force to evaluate collection costs and determine ways to lower the costs of collection.

Our review of the consultant's report and methodology for applying indirect costs to defaulted loans collection did not reveal any problems with the allocation methodology. However, we would recommend that the task force set up by CSLP carefully review the indirect costs included in its cost rate calculation. Indirect costs for 1998 represent 31 percent of all costs associated with default collections. The divisions contributing the majority of expenses to the indirect cost pool include three data processing divisions, the Records Center, and the Accounting Division. Combined, these divisions represent 78 percent of all indirect costs. Interviews with other guaranty agencies revealed that the agencies included indirect costs ranging from 10 percent to 30 percent of the costs allocated to default collections. Although CSLP's indirect costs are not far beyond the range reported by other guaranty agencies, indirect costs of 31 percent are somewhat high and should be examined.

Although CSLP pays outside collection agencies a maximum of 15 percent to collect on defaulted student loans, CSLP assesses borrowers collection charges of 25 percent on default loans. For 1998 CSLP estimated that its actual cost of collecting on default loans was about 29.5 percent. Because of the large difference between what

CSLP pays to outside collection agencies and what CSLP's actual costs of collection are (15 percent versus 29.5 percent), we believe that CSLP should evaluate its costs against those of private sector collection agencies.

Formula for Calculating the Collection Cost Rate Treats Collections Inconsistently

The U.S. Department of Education allows guaranty agencies to retain a portion of the dollars they collect on each defaulted student loan. For those loans on which borrowers are making payments, guaranty agencies are allowed to retain 24 percent of all dollars collected, including principal, interest, and collection charges. On loans that are rehabilitated or consolidated, the guaranty agency is allowed to collect 18.5 percent of the outstanding balance of principal and interest at the time the loan is refinanced. All dollars remaining are reverted to the U.S. Department of Education.

The basic formula for calculating the collection cost rate is as follows:

$$\textbf{Collection Cost Rate} = \frac{\textbf{Total Costs of Collection}}{\textbf{Total Dollars Collected}}$$

Although federal regulations governing the calculation of collection charges are fairly specific with respect to the types of costs that guaranty agencies can include in the costs of collection on default loans, the regulation is much more vague with respect to what types of dollars collected should be included in the formula to arrive at the cost rate.

Prior to implementation of the revised Code of Federal Regulations, CSLP considered several formulas for calculating the collection cost rate. Although the costs assigned to collection of default loans remained constant in each formula, the types and amounts of dollars included in collections changed. Two of the formulas considered by CSLP are as follows:

$$\textbf{1) Cost Rate} = \frac{\textbf{Total Costs of Collection}}{\textbf{Gross Borrower Payments + Retention on Consolidations and Rehabilitations + Interest on Repurchases}}$$

$$\textbf{2) Cost Rate} = \frac{\textbf{Total Costs of Collection}}{\textbf{Total Gross Collections}}$$

CSLP ultimately chose to use the first formula shown for calculating its collection cost rate. By choosing this formula, CSLP excluded over $8.1 million in dollars that were collected but not retained on rehabilitations and consolidations. CSLP included the following types and amounts of collections in its calculation:

Collections:

Retention on Consolidations of Defaulted Loans	$ 1,916,308
Retention on Rehabilitations	$ 566,674
All Other Gross Collections	$15,351,728
Interest on Repurchases	$ 474,642
TOTAL	$18,309,352

Those dollars classified as "Retention on Consolidations of Defaulted Loans" and "Retention on Rehabilitations" represent only the amount that CSLP gets to retain for the costs of collection when a defaulted loan is consolidated or rehabilitated (18.5 percent). However, "All Other Gross Collections" represents 100 percent of all borrower payments received in 1998 rather than merely the retention amount of 24 percent that the Department of Education allows CSLP to keep. As a result, the treatment of payments received from borrowers and payments received from a third party, such as a lender who refinanced a loan, is inconsistent for the purposes of calculating the collection cost rate.

If CSLP treated all types of collections consistently and included total dollars collected on rehabilitations and consolidations rather than only the amount retained, the cost rate would be significantly lower. In 1998 the total amount collected would have been $26.4 million rather than $18.3 million and would result in a cost rate of 20 percent as opposed to 29.5 percent.

CSLP staff stated that they tried to obtain guidance from the U.S. Department of Education on what collections should be included in calculating the cost rate. However, the Department did not provide any guidance, and as a result, CSLP chose to use previously provided guidance relating to the percentage of various collections that can be retained by guaranty agencies. The guidance chosen was a letter from the Department stating that guaranty agencies can keep 24 percent of all collections received through borrower payments; the remainder of collections made through borrower payments is reverted to the U.S. Department of Education. In this letter, the Department also stated that guaranty agencies could not keep any dollars received through third-party payments (such as payments made by the lender who consolidates or rehabilitates a loan). However, the letter does state that guaranty agencies are allowed to assess and retain 18.5 percent for collection charges on all consolidated and rehabilitated loans. This amount is rolled into the new principal balance of the refinanced loan. Therefore, guaranty agencies collect a total of 118.5 percent of the

total outstanding balance of principal and interest from the lender who financed the consolidation or rehabilitation. On all consolidation and rehabilitation loans, the U.S. Department of Education receives 100 percent of the principal and interest balance outstanding on the loan and the guaranty agency retains 18.5 percent.

However, because CSLP gets to retain only a portion of all dollars collected, whether through borrower payments (24 percent) or through third-party payments (18.5 percent), the above-mentioned guidance does not appear to justify CSLP's treating the two types of collections differently. In other words, the above reasoning does not support CSLP's calculating total collections based on including 100 percent of dollars collected through borrower payments and only including 18.5 percent for payments received through consolidation or rehabilitation. For consistency purposes, we believe that CSLP should count all dollars collected (regardless of the source of those collections). This methodology would be consistent with methodology number two shown above and is one of the original methods considered by CSLP. This method is also consistent with that used by three other guaranty agencies we were able to interview with respect to how they calculated their actual cost rate. These agencies include gross collections, regardless of the source of those collections.

The methodology that includes total collections, as opposed to merely the amount retained on some types of payments, treats collections most consistently and also most accurately represents total dollars collected as payment for defaulted student loans. Because this methodology is more consistent, and is also the method of choice for similar guaranty agencies, we believe that CSLP should adopt this method for calculating its collection cost rate in the future.

We applaud CSLP in its efforts to set up a task force composed of lender and school representatives as well as internal staff to review the costs associated with collecting on defaulted student loans and encourage CSLP to continue to look for ways of lowering costs.

Recommendation No. 8:

The Colorado Student Loan Program should continue to evaluate its costs of collecting on defaulted loans. This evaluation should include an analysis of the indirect costs applied to defaulted loan collections and identify methods for reducing overall collection costs.

Colorado Student Loan Program's Response:

Agree. Federal regulations already require us to evaluate collection costs and charges each year. CSLP has created a task force of lender and school representatives, drawn from the agency's Advisory Committee, to assist us in determining our costs of post-default collection, keeping those costs as low as possible, and charging the lowest possible collection fees to defaulted borrowers. Nonetheless, we feel that the collection charges we assess are: 1) in compliance with federal regulations; 2) an accurate reflection of our actual costs of collection; 3) within the range of industry standards; 4) effective, as intended by Congress and the U.S. Department of Education, as an incentive to borrowers to get their loans out of default; 5) necessary to protect the interests of taxpayers who bear the principal liability for defaults and for shortfalls in recovering collection costs; and 6) at the same time, neither excessive nor usurious in their intent or application.

Recommendation No. 9:

The Colorado Student Loan Program should begin using a methodology for calculating its collection cost rate that treats all types of collections consistently. We believe this method should include gross collections from both borrower payments and payments made through consolidation and rehabilitation.

Colorado Student Loan Program's Response:

Partially agree. In conjunction with a task force including school and lender representatives drawn from CSLP's Advisory Committee, CSLP will evaluate various methodologies for calculating collection costs and present recommendations to the U.S. Department of Education, which oversees guarantor operations, for their consideration. Evaluation of these costs should include consideration of the amount necessary to make federal taxpayers whole with regard to their cost in paying and collecting on default claims.

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