UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF INSPECTOR GENERAL

MEMORANDUM 11/14/2005

TO: Theresa S. Shaw
Chief Operating Officer
Federal Student Aid
Lead Action Official

Sally L. Stroup
Assistant Secretary for Postsecondary Education

FROM: Helen Lew /s/
Assistant Inspector General for Audit Services

SUBJECT: Final Audit Report
Death and Total and Permanent Disability Discharges of FFEL and Direct Loan Program Loans
Control Number ED-OIG/A04E0006

Attached is the subject final audit report that covers the results of our review of FFEL and Direct Loan program loans discharged due to death during July 1, 2002, through August 27, 2004, and total and permanent disability (disability discharges) from July 1, 2002, through June 30, 2004. An electronic copy has been provided to your Audit Liaison Officers. We received your comments on the draft report non-concurring with the recommendation for finding 1, non-concurring with the finding and recommendation for finding 2, and concurring with the finding and recommendation for finding 3.

Corrective actions proposed (resolution phase) and implemented (closure phase) by your offices will be monitored and tracked through the Department's Audit Accountability and Resolution Tracking System (AARTS). ED policy requires that you develop a final corrective action plan (CAP) for our review in the automated system within 30 days of the issuance of this report. The CAP should set forth the specific action items, and targeted completion dates, necessary to implement final corrective actions on the findings and recommendations contained in this final audit report.

In accordance with the Inspector General Act of 1978, as amended, the Office of Inspector General is required to report to Congress twice a year on the audits that remain unresolved after six months from the date of issuance.

In accordance with the Freedom of Information Act (5 U.S.C. §552), reports issued by the Office of Inspector General are available to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act.

We appreciate the cooperation given us during this review. If you have any questions, please call Denise Wempe, Regional Inspector General for Audit, at (404) 562-6477.

Enclosure

Death and Total and Permanent Disability Discharges of FFEL and Direct Loan Program Loans

FINAL AUDIT REPORT

Statements that managerial practices need improvements, as well as other conclusions and recommendations in this report, represent the opinions of the Office of Inspector General. Determinations of corrective action to be taken will be made by the appropriate Department of Education officials.

ED-OIG/A04E0006
November 2005

Our mission is to promote the efficiency, effectiveness, and integrity of the Department's programs and operations.

U.S. Department of Education
Office of Inspector General
Atlanta, Georgia

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EXECUTIVE SUMMARY

The objective of our audit was to determine whether Federal Student Aid (FSA) has implemented effective policies, procedures, and internal controls over the process for discharging William D. Ford Federal Direct Loan (Direct Loan) and Federal Family Education Loan (FFEL) program loans, based on the death or total and permanent disability of the borrower. The audit period for our review of death discharges was from July 1, 2002, through August 27, 2004, and the audit period for our review of discharges based on total and permanent disability (disability discharges) was from July 1, 2002, through June 30, 2004.

We found that policies, procedures, and internal controls over the process for discharging loans based on the borrower's death were adequate. However, we identified problems with policies, procedures, and internal controls established for disability discharges. Specifically, we found that

- The regulatory three-year conditional discharge period is inadequate for determining eligibility of all borrowers. The three-year conditional discharge period begins on the date that the borrower became totally and permanently disabled as certified by a physician. In determining whether the borrower will receive the final discharge, the Department only considers the borrower's earnings from employment or receipt of a new student loan during the conditional discharge period. If the borrower's three-year conditional discharge period does not include the current date, the Department does not consider the borrower's current income and loan status when making its determination. As such, the regulations allow loans to be discharged without an adequate determination of all applicants' current disability status.

- Regulations that excuse a borrower from paying interest should be reconsidered. We found that FSA reinstated (resumed collection on) 16,457 loans previously in a conditional discharge status, totaling nearly $172.4 million. These loans were reinstated because FSA's controls, during the conditional discharge period, identified the borrowers as ineligible for disability discharges. Under current regulations, these ineligible borrowers are not required to pay the interest that accrued on the loans during the conditional discharge period. This benefit for ineligible borrowers should be reconsidered.

- FSA did not update the National Student Loan Data System (NSLDS), as required. Until April 2005, FSA did not update NSLDS to reflect borrowers' disability discharge status. Since schools cannot identify borrowers' status without this update, 17 ineligible borrowers, in conditional disability discharge status, received new student loans totaling $270,975.

We recommend that the Chief Operating Officer for FSA and the Assistant Secretary for Postsecondary Education revise Department of Education (Department) regulations to 1) allow a consideration of a borrower's current information when determining his or her eligibility for a disability discharge and 2) require borrowers who are determined to be ineligible for a discharge to pay interest for the conditional discharge period. We also recommend that FSA ensure that NSLDS reflects all borrowers' conditional disability discharge status correctly.

A draft of this report was provided to FSA and OPE for review and comment. In their joint response, FSA and OPE did not disagree with the conditions or statistics with our Finding No. 1, but did not agree with its recommendation; disagreed with our Finding No. 2; and agreed with our Finding No. 3. Where appropriate, we have incorporated into this report summaries of FSA's and OPE's comments and our responses. We provide FSA's and OPE's response to our draft report, in its entirety, as an Appendix to this report. Although we have revised our findings and recommendations slightly, for clarity, the substance of the report has not changed.

BACKGROUND

Section 437(a) of the Higher Education Act of 1965, as amended (HEA), requires the Department to discharge a borrower's FFEL Program loan if he or she "dies or becomes permanently and totally disabled (as determined in accordance with regulations of the Secretary)." This provision also applies to the Direct Loan Program under Section 455(a)(1) of the HEA.

In 1998 and 1999, we conducted an audit to determine the nature and extent of the Department's controls to ensure that FFEL Program loans were discharged for reasons authorized by the HEA and the Department's regulations. Our audit report identified control weaknesses in the Department's system for determining borrower eligibility for death and disability discharges, and we concluded that the Department improperly discharged FFEL Program loans.[1]

During the two-and-a-half-year period examined in the audit, the Department discharged loans totaling over $508 million: over $216 million for borrowers who died and over $292 million for borrowers claiming total and permanent disability. We found that 708 (or 2 percent) of the borrowers who received death discharges, totaling over $3.8 million, were earning wages after the discharge, and we found that 9,798 (or 23 percent) of the borrowers who received disability discharges, totaling over $73 million, were earning wages after the discharge.

In response to the findings in our audit report, the Department revised its regulations for death and disability discharges, to improve the process for evaluating applications for discharge. The Department's revised regulations were proposed in a Notice of Proposed Rulemaking on August 2, 2000 (65 FR 47634) and published as Final Regulations on November 1, 2000 (65 FR 65678).

- Death Discharges. Under the Department's previous regulations, a FFEL Program lender was able to grant a death discharge based on a death certificate or other proof of death, acceptable under applicable state law. The Department's revised regulations restrict the evidence on which a death discharge may be granted. Specifically,

  > A discharge of a loan based on the death of the borrower (or student in the case of a PLUS loan) must be based on an original or certified copy of the death certificate. Under exceptional circumstances and on a case-by-case basis, the chief executive officer of the guaranty agency may approve a discharge based upon other reliable documentation supporting the discharge request. (34 C.F.R. § 682.402(b)(2))

- Disability Discharges. Under the Department's previous regulations, a FFEL Program lender was responsible for reviewing and making the determination on a borrower's

[1] *Improving the Process for Forgiving Student Loans*, issued June 7, 1999 (ACN A06-80001).

application for a disability discharge. If the lender determined that the borrower was totally and permanently disabled, the borrower's loan was discharged.

Under the revised regulations, the FFEL Program lender and guaranty agency make determinations on whether the application supports the conclusion that the borrower meets the criteria for a total and permanent disability discharge. If they determine that the application supports that conclusion, the loan is assigned to the Department and the application and supporting documentation are forwarded to FSA's Conditional Disability Discharge Unit (CDD). If the CDD, on behalf of the Secretary, makes—

> . . . an initial determination that the borrower is totally and permanently disabled . . . the loan is conditionally discharged for up to three years from the date that the borrower became totally and permanently disabled, as certified by a physician. The Secretary suspends collection activity on the loan from the date of the initial determination of total and permanent disability until the end of the conditional period. If the borrower satisfies the criteria for a total and permanent disability discharge during and at the end of the conditional discharge period, the balance of the loan is discharged at the end of the conditional discharge period and any payments received after the date the borrower became totally and permanently disabled . . . are returned to the sender.
>
> (ii) A borrower satisfies the criteria for a discharge of a loan based on a total and permanent disability if, during and at the end of the three-year [conditional discharge period]—
>
> (A) The borrower's annual earnings from employment do not exceed 100 percent of the poverty line for a family of two, as determined in accordance with the Community Service Block Grant Act; and
>
> (B) The borrower does not receive a new loan under the Perkins, FFEL, or Direct Loan programs, except for a FFEL or Direct Consolidation loan that does not include any loans that are in a conditional discharge status. (34 C.F.R. § 682.402(c)(1))

The Department also made similar changes to the regulations for death and disability discharges in the Direct Loan Program, in 34 C.F.R. §§ 685.212 and 685.213. The CDD processes disability discharges for both FFEL and Direct Loan Program loans.

An FSA contractor, Affiliated Computer Services (ACS), performs CDD operations. From July 1, 2002, through June 30, 2004, the CDD processed 45,657 disability discharge applications.

AUDIT RESULTS

We found that FSA's policies, procedures, and controls over the death discharge process were adequate. However, we identified problems with FSA's policies, procedures, and internal controls for disability discharges. Specifically, we found that 1) the regulatory three-year conditional discharge period is inadequate for determining eligibility of all borrowers; 2) regulations that excuse a borrower from paying interest should be reconsidered; and 3) FSA did not update borrowers' outstanding principal balance in NSLDS, as required.

Finding No. 1 – The Regulatory Three-year Conditional Discharge Period is Inadequate for Determining Eligibility of All Borrowers

Under 34 C.F.R. §§ 682.402(c)(1)(ii) and 685.213(c), a borrower is eligible for a disability discharge if, during and at the end of the three-year conditional discharge period, 1) his or her annual earnings from employment did not exceed allowable limits, and 2) he or she did not receive additional Title IV loans. Because a determination of a borrower's eligibility under this method does not always consider the borrower's current condition, it does not ensure that only totally and permanently disabled borrowers receive disability discharges.

The application that a borrower submits for a disability discharge includes a section that is completed by the borrower's physician. In this section, the physician certifies that the borrower's condition meets the Department's definition of total and permanent disability. The physician also provides the date that "the borrower became unable to work and earn money in any capacity." During the discharge process, this date is considered to be the borrower's disability date. The borrower's three-year conditional discharge period begins on this disability date.

In many cases, borrowers' disability dates occurred more than three years before their applications for disability discharge were submitted. We compared borrowers' disability dates to the earliest possible date of application (July 1, 2002) for the 4,844 borrowers who received disability discharges between July 1, 2002, and June 30, 2004. As Table 1.1 shows, about 54 percent of the applications for borrowers who received disability discharges were received more than three years after the disability date. As a result, for the discharges that FSA approved from July 1, 2002, through June 30, 2004, about 54 percent were based on a three-year period that did not include current income data.

Table 1.1—Discharged Borrowers With Applications Filed More Than Three Years After The Reported Disability Date

		Percentage of the 4,844
More Than 3, less than 6 Years	1,322	27.29%
From 6 to 10 Years	743	15.34%
10 Years or More	528	10.90%
Total	2,593	53.53%

We were unable to review income data for each of the 2,593 discharged borrowers included in Table 1.1, because we did not have access to the borrowers' earnings records. As such, we could not identify all borrowers who would have been ineligible for a disability discharge if the discharge were based on their current earnings from employment. However, current income information was available for the limited number of these borrowers who had submitted a subsequent Free Application for Federal Student Aid (FAFSA). We found that 121 of the 2,593 borrowers completed a FAFSA after their reported date of disability, and we reviewed their FAFSAs for award years 2003 through 2005. Of the 121 borrowers, 10 reported income over the allowable regulatory limits.

When making a determination on a borrower's eligibility for a disability discharge, FSA only considers whether the borrower earned income over the allowable limit or received a new Title IV loan during the three-year conditional discharge period, the three years after the borrower's disability date. If the date of a disqualifying event occurs after the end of the three-year conditional disability discharge period, that information is not a basis to deny a borrower's disability discharge. As a result, a borrower who is not currently disabled may receive a disability discharge, even when FSA has knowledge of the borrower's current disqualifying income or loan information.

By requiring borrowers to complete Internal Revenue Service (IRS) Form 4506-T (Request for Transcript of Tax Return), FSA may gain access to IRS information about borrowers' current earnings from employment. Recent loan data information for borrowers is available to FSA through NSLDS. However, neither of these sources of information is considered when determining the borrower's eligibility, if the borrower's date of disability is more than three years before the application date.

As we noted in the Background section, Section 437(a) of the HEA requires the Department to discharge a borrower's FFEL or Direct Loan Program loan if he or she "dies or becomes permanently and totally disabled (as determined in accordance with regulations of the Secretary)." The use of the three-year conditional discharge period, as established in the Department's regulations, is ineffective for making this determination because it does not always allow the Department to examine a borrower's current earnings and loan information.

RECOMMENDATION

We recommend that the Chief Operating Officer for FSA and the Assistant Secretary for Postsecondary Education

1.1 Revise the Department's regulations to ensure that current income and Title IV loan information is considered when determining whether a borrower is totally and permanently disabled. One way of doing this would be to re-define the three-year conditional discharge period, to start the three-year period on the date the borrower submits his or her application, rather than the date the borrower became disabled.

FSA and OPE Response:

FSA and OPE did not disagree with the conditions and statistics in the finding. However, they disagreed with our recommendations. FSA's and OPE's joint response stated

> The current regulations implement the Department's response to an earlier OIG study that concluded that a one-time "snapshot" approach to determining eligibility for a discharge was inadequate. Current regulations, to which the OIG agreed despite the strenuous objections of the student loan community require monitoring borrower eligibility over a significant time period (three years) before granting a final discharge.
>
> The OIG does not define "current earnings." It is, therefore, unclear whether revising the regulations to provide for a three-year conditional period that begins on the date of the borrower's application for total and permanent disability discharge will address the concern that borrowers appear to be ineligible "based on their current earnings." Even if the three-year conditional period were prospective from the date of application, it would not include the borrower's "current" income because the conditional discharge would still be based on the three previous year's [sic] incomes. A borrower could still receive a discharge and then have income that exceeds the current regulatory income threshold. The report and finding should be revised to clarify this issue and whether the OIG believes this will eliminate the problem it has identified.

The response asked that OIG acknowledge amendments to the HEA proposed by H.R. 609 (Report No. 109-231), which would base the Department's determination of a borrower's eligibility for a total and permanent disability discharge on medical determinations by the Department of Veterans Affairs (VA) o r the Social Security Administration (SSA). OPE and FSA stated that, if adopted, this amendment could render our recommendation moot and that they "plan to make no regulatory changes in this area before the Congress completes action to amend and extend the Higher Education Act."

OIG Comments:

Though the prior regulations were developed to address the control weaknesses identified in our earlier report, the results of this audit indicate the need to revisit the regulations again. When the regulations were last revised, neither the Department nor our office anticipated that the applicant pool would be dominated by applications based on disabilities that arose more than three years prior to the application date.

In revising the regulations, the Department should ensure that the discharge is based on verified income and Title IV loan information that is reasonably contemporaneous with the discharge determinations. Starting the conditional discharge period on the application date and utilizing the current practice of verifying annual income during the conditional discharge period through the use of IRS Form 4506-T would be a reasonable approach.

Regarding legislative proposal, H.R. 609,

- There is no assurance that the proposed amendment to discharge requirements will be included in the legislation when it is enacted;
- It does not appear that the proposed amendment would apply to all borrowers, just to those who receive determinations by the VA or SSA; and
- The Department itself, when it was developing the final regulations issued on November 1, 2000, considered using SSA determinations but found that "there is no documentation currently issued by SSA that would effectively establish that a borrower is totally and permanently disabled under the title IV standard" (65 FR 65683).

Although we did not change our recommendation, we have revised the example in the recommendation, for clarity. We disagree with FSA's and OPE's intent to delay amending the regulations. Due to the requirements in Sections 482 and 492 of the HEA, the earliest that any of the regulatory changes can be implemented is July 1, 2007, and then only if the Department initiates and completes negotiated rule-making and publishes final regulations by November 1, 2006. If the Department waits for Congress to complete re-authorization it may not be able to meet the November 1, 2006, deadline, and effective corrective action would then be delayed until July 1, 2008, at the earliest. While a brief delay may be appropriate to determine if changes to the discharge regulations can be combined with post-reauthorization rule-making, the Department should proceed with preparations to amend the discharge regulations by November 1, 2006, in the event Congress does not complete reauthorization soon.

Finding No. 2 – Regulations That Excuse a Borrower From Paying Interest Should Be Reconsidered

If a borrower's loans are placed in a conditional discharge status but the borrower is later determined to be ineligible for a final discharge, the borrower's loans are reinstated (FSA resumes collection on the loans). The regulations provide that a borrower is not required to pay interest that accrued on his or her loans during the conditional discharge.

We found that a substantial portion of applicants who receive a conditional discharge either do not pursue their applications or do not qualify for a final discharge. Although we did not quantify the amount of unpaid interest, we found that 36 percent (16,457 of 45,657) of the loans to borrowers who applied for a disability discharge from July 1, 2002, through June 30, 2004, were reinstated. These borrowers had loan balances totaling nearly $172.4 million.

Under 34 C.F.R. § 682.402(c)(16)

> If, at any time during the three-year conditional discharge period, the borrower does not continue to meet the eligibility requirements for a total and permanent disability discharge, the Secretary resumes collection activity on the loan. The Secretary does not require the borrower to pay any interest that accrued on the loan from the date of the initial determination . . . through the end of the conditional discharge period.

Similar requirements are provided for Direct Loans in 34 C.F.R. § 685.213(a)(3).

In the preamble to the final rule, the Department stated

> [B]orrowers suffer no negative consequences during the conditional discharge period. No collection activity or adverse credit reporting occurs during the conditional discharge period. If a borrower's situation changes during this period, we believe the borrower should be expected to repay the student loan. However, even if collection activity resumes on the loan, the borrower is not obligated to pay any interest that accrued during the conditional discharge period. (64 FR 65681)

The CDD reinstates loans from a conditional discharge for three reasons:

1. <u>No income verification form</u>. After a year of the conditional discharge period has passed, the borrower is required to provide a signed Request for Transcript of Tax Return (Form 4506-T). This is an IRS form that allows FSA to review the borrower's annual earnings from employment and to verify the borrower's eligibility for a disability discharge. If the borrower does not respond to FSA's request, FSA makes three additional, monthly requests for return of the form. If the borrower does not respond within two weeks of the final notice, FSA reinstates the borrower's loans. (FSA performs skip tracing if it becomes apparent that the borrower's address is unknown.)[2]

[2] We did not survey borrowers to identify the reasons they failed to return the income verification form. However, we examined the Department's records for a random sample of 75 of the 1,552 borrowers with discharge claims processed by the CDD during the month of June 2004, where the borrowers' loans were reinstated because they failed to return the income verification form. We found that 46 of the borrowers contacted FSA before or after their loan reinstatement to find out what FSA needed to discharge the loan; 20 borrowers did not respond to the reinstatement; 8 borrowers provided the income verification forms late, after FSA had already reinstated their loans; and 1 borrower had income over the poverty guidelines.

2. Additional loans in NSLDS. To qualify for a disability discharge, a borrower may not receive a new loan, after his or her disability date, under the Perkins, FFEL, or Direct Loan program, except for a FFEL or Direct consolidation loan that does not include any loans that are in a conditional discharge status. (34 C.F.R. §§ 682.402(c)(1)(ii)(B) and 685.213(c)(2)) FSA reviews NSLDS when the borrower begins a conditional discharge period and quarterly, thereafter, to ensure that borrowers meet this requirement. If a borrower does not meet this requirement, the borrower's loans are reinstated.

3. Income in excess of poverty guidelines. FSA uses the authorizations that borrowers provide on IRS Form 4506-T to review IRS data on the borrowers' annual earnings from employment. If a borrower's earnings exceed the poverty guidelines described in 34 C.F.R. §§ 682.402(c)(1)(ii)(A) and 685.213(c)(1), the borrower's loans are reinstated.

Table 2.1 provides the number of borrowers, the number of loans, and the loan amounts attributable to each reason for reinstatement:

Table 2.1—Reinstated Loan By Reason For Reinstatement

			Loan Amount (rounded in millions)
No Income Verification Form	**14,650**	**32,400**	**$152.5**
Additional Loans in NSLDS	**1,745**	**4,676**	**$19.0**
Income in Excess of Poverty Guidelines	**62**	**148**	**$0.9**
Total	**16,457**	**37,224**	**$172.4**

The 16,457 borrowers who were found to be ineligible for a disability discharge were not required to pay the interest that accrued on their loans during the conditional discharge. Interest did not accrue for up to a year and three months on $153.4 million, for borrowers who failed to return the income verification form or who received income in excess of poverty guidelines. Interest did not accrue for up to three months or more on $19 million, for borrowers who received additional loans after their disability date, depending upon the speed with which NSLDS was updated with the borrower's new loan information.

The Department's regulations should be changed to require borrowers who do not receive a final discharge to pay the interest that accrued during the conditional discharge period due to the substantial percentage of borrowers who either do not qualify for final discharge or fail to pursue their applications. The intent of Section 437(a) of the HEA is to discharge a borrower's FFEL or Direct Loan Program loan if the borrower becomes permanently and totally disabled. However, the decision to excuse interest provides a benefit to *ineligible* borrowers and to borrowers who fail to pursue their applications.

RECOMMENDATION

We recommend that the Chief Operating Officer for FSA and the Assistant Secretary for Postsecondary Education

2.1 Revise the Department's regulations to ensure that, if a borrower's loans are reinstated from a conditional discharge status, the borrower is required to pay any interest that accrued on his or her loans through the end of the conditional discharge.

FSA and OPE Response:

FSA and OPE comment that our report "incorrectly states that the Secretary pays interest benefits on behalf of borrowers during the 'conditional discharge period.'" Their response points out that the Department does not pay interest benefits to lenders during the conditional discharge period.

FSA and OPE do not agree that, when reinstated from a conditional discharge status, borrowers should be required to pay interest that would otherwise have accrued. FSA and OPE state

> Such a retroactive assessment of accrued interest has the potential to discourage and ultimately penalize a borrower for applying for a discharge based on total and permanent disability. Moreover, it may result in the capitalization of the accrued interest, thus increasing the amount of the borrower's debt. A retroactive assessment of as much as three years of accrued interest may also precipitate a default when the borrower returns to repayment. The OIG does not address in any way the possible negative consequences resulting from this change in treatment of borrowers or the OIG's recommendations for dealing with them.

FSA and OPE stated that they "plan to make no regulatory changes in this area before the Congress completes action to amend and extend the Higher Education Act."

OIG Comments:

Our draft report did not state that the Secretary pays interest on behalf of borrowers during the 'conditional discharge period.'" However, we have revised our finding, for clarity, by removing the terms "interest benefits" and "interest waivers."

We do not agree with FSA's and OPE's rationale for excusing borrowers from paying interest, for the following reasons:

- We believe it is likely that most ineligible borrowers will be identified within the first year of the conditional discharge period, by the time the Department first verifies the borrower's earnings from employment and receipt of new Title IV loans. As such, in most cases, accrued interest should not be an unreasonable burden.

- It is unlikely that the possibility of repaying accrued interest would be enough of a disincentive to discourage eligible borrowers from applying for discharges. The only apparent disincentive would be for ineligible borrowers, who would be able to anticipate that their loans will be returned to repayment. Since such a large percentage of loans are being reinstated, a disincentive for ineligible borrowers would be appropriate and useful.

- Of the borrowers whose loans are reinstated, approximately 89 percent were ineligible because they failed to return an annual income verification form (see Table 2.1). This raises the question of the legitimacy of the borrowers' initial applications and of compliance by the borrowers with rules for reporting increased earnings, under 34 C.F.R. § 682.402(c)(14)(iv). Borrowers should not be excused from paying interest as the result of their non-compliance with discharge requirements.

- FFEL or Direct Loan Program loan borrowers are not excused from paying accrued interest if, after applying for other types of loan discharges or for teacher loan forgiveness, they are found to be ineligible and their loans are returned to repayment.

- A disabled borrower who is reinstated in error is not precluded from re-applying and receiving a discharge.

- If a borrower becomes unable to make payments on his or her loan as the result of accrued interest, there are other, more appropriate, methods to help the borrower avoid default. The borrower may request a deferment, a forbearance, income contingent repayment, or income sensitive repayment.

We disagree with FSA's and OPE's intent to delay amending the regulations, for the reasons we stated in response to the comments in Finding No. 1. We did not change our recommendation.

Finding No. 3 – FSA Did Not Update NSLDS, As Required

Until April 2005, the CDD did not update NSLDS to identify loans in a conditional discharge status. Schools could not identify borrowers in a conditional discharge status until CDD began updating NSLDS. As a result, from July 1, 2002, through June 30, 2004, 17 borrowers in conditional disability discharge status received new student loans totaling $270,975.

Under 34 C.F.R. §§ 682.201(a)(7) and 685.200(a)(1)(iv)(C), a borrower in a conditional discharge must meet certain criteria before he or she is eligible to receive a new Title IV loan: 1) a physician must certify that the borrower is able to engage in substantial gainful activity; 2) the borrower must sign statements that neither the loans conditionally discharged nor the new loans the borrower will receive may be discharged on the basis of a current impairment, unless that impairment substantially deteriorates; and 3) the borrower must sign a statement acknowledging that collection will resume on any loans in a conditional discharge period.

For many borrowers in a conditional discharge, schools are required to review data in NSLDS before disbursing Title IV funds. Under 34 C.F.R. § 668.19(a)(4), when a student transfers from one school to another, schools must review data in NSLDS:

> Before an institution may disburse Title IV, HEA program funds to a student who previously attended another eligible institution, the institution must use information it obtains from the Secretary, through the National Student Loan Data System (NSLDS) or its successor system, to determine . . . [t]he outstanding principal balance of loans made to the student under each of the title IV, HEA loan programs . . . .

In May 2002, the Department issued Dear Colleague Letter GEN-02-03, which provides operational guidance for reflecting a loan's conditional discharge status in NSLDS:

> Upon assignment of a loan to the Department, the guaranty agency will report the loan to NSLDS by using a "DI" or "DS" [disability] code with a $0 balance . . . . The [CDD], after its initial determination of eligibility, will reenter in the NSLDS system the outstanding balance last reported on the loan or otherwise prevent deletion of the outstanding balance on the loan in the NSLDS system. (Dear Colleague Letter GEN-02-03, Attachment 3, Section (III)(B))

The Dear Colleague Letter further explains that a loan with a "DI" or "DS" disability code, a positive outstanding principal balance, and a date of loan status on or after July 1, 2002, denotes a loan in the conditional discharge period. The loan remains in the conditional discharge status until

1. A final discharge is granted, which is reflected by setting the outstanding balance on the loan to zero; or

2. The borrower loses eligibility for a final discharge and the loan is placed back into repayment, which is reflected by reporting the loan with its previous NSLDS Loan Status Code.

FSA's program manager for the disability discharge process said that FSA was aware of its failure to update NSLDS and that there was a task order to modify NSLDS, to allow the CDD to adjust the outstanding balances in NSLDS. In a discussion with FSA's Director of Borrower Services, we learned that the task order had been completed April 8, 2005, and that FSA is in the process of running tests to ensure the data is correct.

We reviewed documentation and verified that FSA initiated the upgrade/modification to NSLDS. According to FSA's Director of Borrower Services, the request for the modification was made during the original Conditional Discharge Loan Servicing contract, but NSLDS was unable to support the changes to its system at that time. When the original contract expired on December

31, 2003, and became part of the Common Services for Borrowers contract, FSA was able to begin the required modifications to its NSLDS system.

Because FSA did not update borrowers' outstanding principal balances in NSLDS before April 2005, borrowers in a conditional disability discharge status appeared to be eligible for new loans. As a result, 17 borrowers in a conditional disability discharge status received new student loans totaling $270,975. Although the conditionally discharged loans for these 17 borrowers were reinstated based on the CDD's NSLDS quarterly checks, these NSLDS checks did not prevent borrowers from initially receiving the new loans. Schools were unable to correctly certify borrowers' eligibility based on information in NSLDS.

RECOMMENDATIONS

We recommend that the Chief Operating Officer for FSA

3.1 Review NSLDS to ensure that the records for all borrowers in a conditional disability discharge status from July 1, 2002, through April 8, 2005, were properly updated with the correct outstanding principal balance.

3.2 Continue to update the outstanding principal balance for borrowers in a conditional disability discharge status so that FSA complies with existing guidance in Dear Colleague Letter GEN-02-03, Attachment 3, Section (III)(B).

FSA and OPE Response:

FSA and OPE concur with our recommendations. Their response stated that the Conditional Disability Discharge Tracking System (CDDTS) has been reporting to NSLDS on a monthly basis since April 8, 2005. The most recent submittal, on August 2, 2005, included all loan information in the CDDTS portfolio, including the correct outstanding principal balance as of the end of July 2005. FSA has confirmed that ACS is continuing to update the outstanding principal balances for borrowers in the CDDTS.

OIG Comments:

We reviewed documentation and verified that FSA initiated the upgrade/modification to NSLDS and that FSA's most recent submittal to NSLDS, on August 2, 2005, included all loan information in the CDDTS portfolio, including the correct outstanding principal balance as of the end of July 2005. FSA appears to have taken appropriate steps to respond to our recommendations

OTHER MATTERS

When making an initial determination that a borrower is totally and permanently disabled, and is eligible for conditional discharge, the CDD contacts the physician who certified the application, if the certification is incomplete or unclear. A CDD nurse told us that physicians are contacted for approximately half of the disability discharge applications the CDD receives. According to CDD staff, on three occasions in 2003, when physicians were contacted by fax for follow-up information, the physicians stated that they had never signed the physician certification.

To ensure that borrowers are not perpetrating this type of fraud, we suggest that the Chief Operating Officer for FSA implement a procedure, during the quality control review process, to verify on a sample basis that physicians certifying borrowers' applications actually examined the borrowers.

FSA and OPE Response:

FSA's and OPE's response stated that FSA's contractor, ACS, follows up with physicians for approximately 70 percent of loan discharge applications received. This follow-up provides the physician with an opportunity to indicate whether he or she believes the borrower forged his/her signature or engaged in some other form of fraud. The response states, "FSA believes this provides an on-going statistically representative monthly sample with which to monitor borrower fraud."

OIG Comments:

We acknowledge in our report that doctors are contacted frequently; however, the FSA contractor selects the doctors judgmentally. Whether doctors are contacted for approximately half of applications (as the CDD nurse told us) or 70 percent (according to the FSA and OPE response), a statistical sampling is not used, so the results of the contacts are not representative and cannot be projected to the universe of applications.

We have not changed our suggestion.

OBJECTIVE, SCOPE, AND METHODOLOGY

The audit objective was to determine whether FSA has implemented effective policies, procedures, and internal controls over the process for discharging Direct Loan and FFEL program loans based on death or total and permanent disability. Audit coverage for our review of disability discharges included the period July 1, 2002, through June 30, 2004, and audit coverage for our review of death discharges included the period July 1, 2002, through August 27, 2004.

To determine FSA's controls over the discharge processes, we

- Interviewed officials responsible for oversight of the death and total and permanent disability discharge processes.
- Reviewed current policies and procedures relating to the loan discharge process.

To evaluate the disability discharge processes, we

- Visited the guaranty agency USA Funds,[3] Indianapolis, IN; the Direct Loan Servicing Center, Utica, NY; the Atlanta Debt Collection office; and the Conditional Disability Discharge Unit (CDD), Utica, NY.
- Interviewed officials responsible for processing disability discharges.
- Reviewed and tested current policies and procedures relating to the disability discharge process.
- Reviewed file documentation for a random sample of 69 of the 38,965 disability discharge claims contained in NSLDS that were processed by the CDD from July 1, 2002, through May 5, 2004, to determine whether the CDD discharged only eligible applicants.
- Reviewed file documentation for a random sample of 75 of the 1,552 discharge claims processed by the CDD during the month of June 2004 where the loans were reinstated because of no response to income verification requests.

To perform our analyses, we

- Identified, in the Conditional Disability Discharge Tracking System (CDDTS), borrowers who had loans reinstated due to the NSLDS quarterly check and reviewed data in NSLDS for those borrowers to determine who received new loans while in a conditional discharge status.
- Identified the 4,844 borrowers who received discharges and
  - Determined which borrowers applied more than three years after their date of disability, and
  - Determined which borrowers applied for new loans after a discharge and reviewed the income amount they reported on the FAFSAs they completed after the discharge.
- Reviewed the Internal Revenue Service website to verify IRS income record retention policies applicable to the conditional discharge process.

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[3] USA Funds had the highest concentration of FFEL loan discharges for all guaranty agencies. We also met with officials at Sallie Mae, which is USA Funds' contractor for its discharge processing.

To evaluate the death discharge processes, we

- Visited the guaranty agency USA Funds, the Direct Loan Servicing Center, and the Atlanta Debt Collection office.
- Interviewed officials responsible for processing death discharges.
- Reviewed and tested current policies and procedures relating to the death discharge process.
- Reviewed file documentation for a random sample of 65 of the 8,372 death claims contained in NSLDS that were processed from July 1, 2002, through May 5, 2004, at USA Funds, 50 of the 266 death claims processed at the DLSC during the month of February 2004, and 50 of the 304 death claims processed at the Atlanta Debt Collection Center during the week ending August 27, 2004.[4]

During the audit, we relied on computer-processed data contained in the CDDTS. We tested selected data from the CDDTS by reviewing support documentation corroborating 100 percent of a listed population identified in the CDDTS Monthly Management Report. We also reviewed data from USA Funds, Atlanta Debt Collection, DLSC, and CDD borrower files and used this data to verify the accuracy of the CDDTS and NSLDS data. Based on these tests and assessments, we concluded that the CDDTS and NSLDS data were sufficiently reliable for our use in meeting the audit objective.

We performed audit work from June 2004 through September 2004 at FSA Headquarters, in Washington, DC, and at the sites described above, in Indianapolis, IN; Utica, NY; and Atlanta, GA. Subsequent audit work was performed through April 2005. An exit conference was held with FSA officials on July 15, 2005. The audit was performed in accordance with generally accepted government auditing standards appropriate to the scope of the review described above.

[4] Each week, the Atlanta Debt Collection office sends death claim documentation to Greenville, Texas, to be warehoused; therefore at any time, it has a week's worth of documentation on hand. We were able to review documentation for the week ending August 27, 2004, before the Atlanta Debt Collection office sent that documentation for warehousing.

Appendix A - Written Response to the Draft Report

UNITED STATES DEPARTMENT OF EDUCATION

WASHINGTON, D.C. 20202-

SEP - 1 2005

TO: Denise M. Wempe
Regional Inspector General for Audit
Office of the Inspector General

FROM: Theresa S. Shaw
Chief Operating Officer
Federal Student Aid

Sally L. Stroup S.L.S.
Assistant Secretary for Postsecondary Education

SUBJECT: Draft Audit Report
Death and Total and Permanent Disability Discharges of FFEL and Direct Loan Program Loans
ED-OIG/A04-E0006

Thank you for providing the Department with an opportunity to comment on the Office of Inspector General's (OIG) Draft Audit Report dated July 21, 2005. The Department's response to the findings and recommendations follow.

Finding No. 1 - The Regulatory Three-year Conditional Discharge Period is Inadequate for Determining Eligibility of All Borrowers.

Recommendation 1.1 – The Chief Operating Officer (COO) for Federal Student Aid (FSA) and the Assistant Secretary for Postsecondary Education (OPE) should revise regulations to ensure that current information is considered when determining whether a borrower is totally and permanently disabled.

The Federal Family Education Loan (FFEL) and Direct Loan Program regulations stipulate that, in order for a borrower to establish eligibility for a loan discharge based on total and permanent disability, the borrower's earnings cannot exceed allowable limits and the borrower cannot receive additional Title IV loans during a three-year conditional discharge period. This three-year conditional discharge period begins on the date the borrower became permanently and totally disabled as certified by a physician. The OIG states that approximately 54 percent of the borrowers who applied for a discharge based on total and permanent disability applied more than three years after the reported disability date resulting in an immediate discharge based on outdated information. The

OIG recommends that the Department revise FFEL and Direct Loan Program regulations to re-define the three-year conditional discharge period as prospective from the date of application to ensure that "current" earnings are considered when determining whether a borrower is totally and permanently disabled. Such an approach would preclude a borrower who is not currently disabled from receiving a disability discharge.

The current regulations implement the Department's response to an earlier OIG study that concluded that a one-time "snapshot" approach to determining eligibility for a discharge was inadequate. Current regulations, to which the OIG agreed despite the strenuous objections of the student loan community, require monitoring borrower eligibility over a significant time period (three years) before granting a final discharge.

The OIG does not define "current earnings." It is, therefore, unclear whether revising the regulations to provide for a three-year conditional period that begins on the date of the borrower's application for total and permanent disability discharge will address the concern that borrowers appear to be ineligible "based on their current earnings." Even if the three-year conditional period is prospective from the date of application, it would not include the borrower's "current" income because the conditional discharge would still be based on the three previous year's incomes. A borrower could still receive a discharge and then have income that exceeds the current regulatory income threshold. The report and finding should be revised to clarify this issue and whether the OIG believes this will eliminate the problem it has identified.

The final report should acknowledge that legislative proposals currently before the Congress, if adopted, could render the recommendations for regulatory change moot. Under the proposals contained in H.R. 609, a borrower's eligibility for a total and permanent disability discharge could be based on a medical determination made under the standards of the Department of Veterans Affairs or the Social Security Administration. Under this proposal, the Secretary would be prohibited from requiring any further documentation from a borrower in support of the borrower's eligibility for the discharge.

We plan to make no regulatory changes in this area before the Congress completes action to amend and extend the Higher Education Act.

Finding No. 2 - Regulations that Provide Interest Benefits to Ineligible Borrowers Should be Reconsidered.

Recommendation 2.1 – The COO for FSA and the Assistant Secretary for OPE should revise regulations to ensure that, if a borrower's loans are reinstated from a conditional discharge status, the borrower is required to pay any interest that accrued on his or her loans through the end of the conditional discharge period.

The OIG incorrectly states that the Secretary pays interest benefits on behalf of borrowers during the "conditional discharge period." Under the regulations, if the loan holder makes a preliminary determination that the borrower's medical condition supports the borrower's eligibility for the discharge, the borrower's loans must be assigned to the Secretary. The Secretary then reexamines the borrower's eligibility and monitors the borrower's status over the three-year conditional discharge period. No payments are due from the borrower during this period. The Secretary does not pay interest benefits or subsidy payments to a lender during this period.

The OIG recommends that all borrowers who fail to maintain eligibility for discharge during all or part of the three-year conditional period be held responsible for interest that would have otherwise accrued. The OIG believes that any portion of the conditional period for which the borrower is not billed for interest prior to the borrower's disqualification represents an ineligible receipt of benefits. However, the OIG acknowledges that the current regulations do not require a borrower to repay such interest.

We disagree. Such a retroactive assessment of accrued interest has the potential to discourage and ultimately penalize a borrower for applying for a discharge based on total and permanent disability. Moreover, it may result in the capitalization of the accrued interest, thus increasing the amount of the borrower's debt. A retroactive assessment of as much as three years of accrued interest may also precipitate a default when the borrower returns to repayment. The OIG does not address in any way the possible negative consequences resulting from this change in treatment of borrowers or the OIG's recommendations for dealing with them.

For these reasons, we plan to make no regulatory changes in this area before the Congress completes action to amend and extend the Higher Education Act.

Finding No. 3 - FSA Did Not Update NSLDS, as Required.

Recommendation 3.1 – The COO of FSA should review NSLDS to ensure that the records for all borrowers in conditional disability discharge status from July 1, 2002 through April 8, 2005 were properly updated with the correct outstanding principal balance.

The Department concurs with the OIG's recommendation. The first Conditional Disability Discharge Tracking System (CDDTS) submission to NSLDS was on April 8, 2005 and included all loan information in the CDDTS portfolio, including the correct outstanding principal balance as of the end of March 2005. Since then, CDDTS has been reporting to NSLDS on a monthly basis. The most recent submittal was on August 2, 2005 and included all loan information in the CDDTS portfolio, including the correct outstanding principal balance as of the end of July 2005.

Recommendation 3.2 – The COO of FSA should continue to update the outstanding principal balance for borrowers in conditional disability discharge status so that FSA complies with the existing guidance in Dear Colleague Letter GEN-02-03, Attachment 3, Section (III)(B).

FSA has confirmed that Affiliated Computer Services (ACS) is continuing to update the outstanding principal balances for borrowers in the CDDTS in compliance with FSA's existing guidelines described in Dear Colleague Letter GEN-02-03, Attachment 3, Section (III)(B).

Other Matters – To ensure that borrowers are not submitting fraudulent physician certifications, we suggest that the COO for FSA implement a procedure, during the quality control review process, to verify on a sample basis that physicians certifying the borrowers' applications actually examine the borrowers.

FSA's contractor, ACS, often follows up with physicians during the medical evaluation that comprises the initial determination of disability. This follow-up provides the physician with an opportunity to indicate whether he or she believes the borrower forged his/her signature or engaged in some other form of fraud. ACS reports that it performs follow-up with the physician for approximately 70 percent of loan discharge applications received. FSA believes this provides an on-going statistically representative monthly sample with which to monitor borrower fraud.

Should you have questions concerning our response to the Draft Audit Report, please contact Denise Leifeste at 202-377-3293.

cc: Helen Lew
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