
THE DEPARTMENT OF EDUCATION HAS AN
OPPORTUNITY TO IMPROVE ITS MANAGEMENT OF
THE DEFAULT AVERSION PROGRAM

FINAL AUDIT REPORT

Audit Control Number 05-80007
September 1998

Our mission is to promote the efficient
and effective use of taxpayer dollars
in support of American education



U.S. Department of Education
Office of Inspector General
Chicago, IL

NOTICE

Statements that management practices need improvement, as well as other conclusions and recommendations in this report, represent the opinions of the Office of Inspector General. Determination of corrective action to be taken will be made by appropriate Department of Education officials. This report may be released to members of the press and general public under the Freedom of Information Act.

MEMORANDUM

September 23, 1998

TO: Dr. David A. Longanecker
Assistant Secretary for Postsecondary Education

FROM: Richard J. Dowd
Regional Inspector General
for Audit - Region V

SUBJECT: The Department of Education has an Opportunity to Improve Its Management of the Default Aversion Program (Audit Control Number 05-80007)

Attached is our subject final report that covers the results of our audit of the Default Aversion Program. We incorporated the comments you provided in response to our draft audit report.

Please provide us with your final response to each open recommendation within 60 days of the date of this report indicating what corrective actions you have taken or plan, and related milestones.

In accordance with Office of Management and Budget Circular A-50, we will keep this audit report on the OIG list of unresolved audits until all open issues have been resolved. Any reports unresolved after 180 days from the date of issuance will be shown as overdue in the OIG's Semiannual Report to Congress.

Please provide the Supervisor, Post Audit Group, Financial Improvement, Receivables and Post Audit Operations, Office of the Chief Financial and Chief Information Officer and the Office of Inspector General, Planning, Analysis and Management Services with semiannual status reports on promised corrective actions until all such actions have been completed or continued follow-up is unnecessary.

In accordance with the Freedom of Information Act (Public Law 90-23), reports issued by the Office of Inspector General are available, if requested, to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act. Copies of this audit report have been provided to the offices shown on the distribution list enclosed in the report.

We appreciate the cooperation given us in the audit. If you have any questions or wish to discuss the contents of this report, please contact me at 312-886-6503. Please refer to the above audit control number in all correspondence relating to this report.

Attachment

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Executive Summary

Effective July 1, 1996, Great Lakes Higher Education Corporation (Great Lakes) and the U.S. Department of Education (ED) entered into a Default Aversion Agreement (Agreement). The Agreement implements an experimental program whereby Great Lakes agreed to support ED's efforts to reduce defaults in the Federal Family Education Loan (FFEL) Program by accepting an alternative method for payment of the costs of preclaims assistance, claim payment, and collections. The alternative payment method is designed to provide an incentive to Great Lakes to avoid defaults by borrowers and limit Great Lakes' reliance on post default collections as a method for financing operations. ED's experiment with Great Lakes significantly revised payments for default avoidance and collection fees. (See Appendix A for additional background information.) The objectives of our audit were to determine if (1) ED, Great Lakes, and student borrowers are benefitting from the new program, (2) additional improvements can be identified, and (3) the Agreement would be useful for other guaranty agencies.

While our audit disclosed that Great Lakes generally administered the new program in accordance with the Agreement, we found that ED (1) did not identify indicators of success needed to monitor the experimental program's performance, (2) lacked adequate policy guidance, (3) needs to improve communication within ED offices and with Great Lakes, and (4) lacked adequate financial reporting. As a result, we could not conclusively determine the merits of the experimental program. Our limited scope audit, however, identified four areas where ED has an opportunity to strengthen program administration and conclusively determine program merits. ED should:

1. Develop and monitor a plan to assess program performance,
2. Develop additional policy guidance,
3. Improve communication in the loan subrogation process, and
4. Require supplemental explanations on ED Form 1189.

ED submitted a written response to our draft audit report that is attached (See pages 19 and 20). ED concurred with recommendations for areas (3) and (4) above but did not concur with recommendations for areas (1) and (2). We reviewed their response and have not changed our recommendations. We paraphrased ED's comments and responded to them at the end of each area.

Audit Results

ED needs to develop and monitor a plan to assess program performance.

ED did not identify indicators of success needed to monitor the program. Instead, Great Lakes developed its own evaluation model. The results of Great Lakes' model are favorable, however, they are based on several estimates. We could not determine the reasonableness of Great Lakes' estimates due to the lack of historical data and the impact of merging the Ohio guaranty agency's portfolio. However, we reviewed the Great Lakes model for fiscal year 1997 (October through September). Based on our analysis, Great Lakes' model indicates that as long as 18.5 percent of the accounts cured through preclaims assistance do not default, ED will have a nominal cost savings.

The experimental program needs to be monitored by having an evaluation process.

ED needs to monitor the experimental program by developing an evaluation process to determine its success or failure. One way to evaluate a program is to have measurable goals and a method to collect data. To measure program goals, you must identify and select data that are mission oriented, countable, mutually exclusive, relatively uniform over time, and process definable (readily defined so that the data can be evaluated for potential improvements). Without a measurable goal(s) and a method to collect the relevant data, assessing the success or failure of the experimental program may be impossible.

The experimental program has two goals that need to be measured and monitored. One goal is to provide proper incentives for avoiding defaults. The second goal is to limit the guaranty agencies' reliance on post default collections to finance operations. ED did not instruct Great Lakes to measure these goals so Great Lakes developed its own measure. Great Lakes' measure does not specifically address the program's goals.

Great Lakes' model measures program success by estimating the cost savings to ED as a result of avoiding a default. The model does not address the impact of the Agreement's provisions to limit Great Lakes' reliance on post default collections. When Great Lakes cures an account, it estimates

ED will save the reinsurance on the average default amount reduced by the net cost of the default avoidance fee and an estimate of the Secretary's share of post default collections. Great Lakes also included a calculation that shows the effect if as many as 50 percent of the accounts recycled and ultimately defaulted.

Assuming the estimates in Great Lakes' model can be validated over time, it may prove to be a useful performance measure. In our opinion however, the model alone is not a sufficient measure to assess the success of the entire Agreement. The number of cures may be related to defaults avoided. However, there is not a one to one correlation between the number of cures and the reduction of defaults. Additional performance measures such as Great Lakes' default rate, increased collection revenue to ED, decreased operating and reinsurance costs, and continued financial health of Great Lakes should be considered to assess the success of the entire Agreement. Estimated cost savings related to cures is only one of several relevant performance measures needed to monitor the experimental program.

The lack of a plan was a conscious decision by an ED official.

An ED official stated that he made a conscious decision not to develop a plan to assess the performance of the program because he wanted to focus on changing the economic initiatives for a guarantee agency. The official also stated he did not want many rules that would hinder the development of new economic initiatives for Great Lakes. The official left the development of a plan to accomplish the program up to Great Lakes.

During the experiment, Great Lakes merged the Ohio guaranty agency portfolio with its own. The inclusion of the Ohio portfolio altered the baseline Great Lakes used to measure its performance under the program. Had ED developed and monitored a plan to assess performance, Great Lakes may not have merged the Ohio portfolio with its own without developing a separate tracking system.

RECOMMENDATIONS

We recommend that ED:

1. Develop and monitor a plan to assess program performance. The plan should:
 - a. Identify the indicators of success. Some potential indicators are (1) a reduced default rate, (2) increased collection revenue to ED, (3) decreased operating and reinsurance costs, and (4) continued financial health of Great Lakes.
 - b. Define data needs.
 - c. Establish a process to collect and evaluate data.
 - d. Establish a schedule for periodic evaluation, either monthly or quarterly.
2. Consider expanding the experimental program to other agencies if ED's analysis is consistent with Great Lakes' analysis.

Auditee Comments

ED does not believe that the program has had sufficient time to generate measurable results that can be extrapolated to the industry. The baseline needed for performance measures was altered when Great Lakes merged the Ohio portfolio with its own. Great Lakes has created a conservative assessment plan, in consultation with ED. Preliminary assessments by Great Lakes suggest that the program may be (emphasis added) effective at reducing defaults without adversely affecting the guarantors' revenue as a result of the reduced collections retention.

Auditor's Response

While we agree that the program may be effective, we could not make a conclusive determination based on Great Lakes' assessment model. Great Lakes' assessment model is not sufficient to cover the Agreement's goals. Identifying indicators for desired outcomes will clearly communicate the desired outcomes to Great Lakes without dictating the methods Great Lakes uses to achieve the outcomes. Also, data may not be available if indicators and related data collection procedures are not identified. We believe that in over two years since the

program's effective date on July 1, 1996, enough time has elapsed to expect to see at least preliminary results.

ED should develop additional policy guidance.

The Agreement does not adequately define the (1) number of times or under what circumstances ED will pay the \$60 default avoidance fee, (2) applicable cost principles for determining the actual costs of post default collections, and (3) need to maintain a baseline for performance measures when merging portfolios. ED and Great Lakes could benefit from written policy guidance to manage the experimental program.

ED needs to further define the policies for the default avoidance fee.

The Agreement requires ED to pay the \$60 default avoidance fee if the lender does not file a claim during the 180 days following the receipt of the preclaims assistance request. However, this requirement does not prevent Great Lakes from billing ED multiple times for the same borrower. Great Lakes is billing ED for the \$60 fee each time it receives a lender request for preclaims assistance and cures the account. ED has no written policies limiting the number of times it will pay the \$60 fee and only a limited policy regarding under what circumstances it will pay.

Great Lakes' internal policy limits the circumstances under which it will request payment for the default avoidance fee. Great Lakes does not request payment if the following conditions occur:

1. The loan lost its guaranty,
2. The cure amount is less than \$60,
3. A deferment, forbearance, or payment cured the loan before Great Lakes received the Request for Collection Assistance,
4. Non-sufficient funds or bounced checks,
5. Loan defaulted after running cure report,
6. Bankruptcy or loans that will default as a result of bankruptcy,
7. Death of the borrower,
8. Invalid cure, which includes loans that are usually not serviced by Great Lakes and have been cured in error or improper documentation such as deferment rejection by the servicer, and
9. Other, which may include any other unforeseeable problems.

Allowing Great Lakes to bill ED for the \$60 default avoidance fee multiple times during a year increases costs to ED. However, in some cases, ED may derive some benefit from paying the additional fee. We reviewed a non-statistical sample consisting of 49 borrowers judgmentally selected from two months of fiscal year 1997 (November 1996 and August 1997) billing reports. We researched these borrowers' accounts to determine the nature of the preclaims actions Great Lakes took to prevent the default and whether there were multiple payments of the \$60 default avoidance fee in one fiscal year. Fifteen of the 49 (31%) borrowers went into delinquency and were cured more than once in fiscal year 1997. Great Lakes received a fee more than once in the fiscal year for these 15 borrowers. Most of these borrowers had two cures during the fiscal year and Great Lakes performed additional work to cure the accounts. The additional cure fees would have been higher if Great Lakes had not implemented its own internal policy limiting the circumstances under which it would request payment.

We believe that allowing Great Lakes to bill the default avoidance fee multiple times as a result of granting forbearances puts ED at risk. Great Lakes could grant a borrower repeated forbearances and bill ED repeatedly for preventing a default. In August 1997, Great Lakes cured 11,865 accounts, of which 2,506 (21%) were cured with a forbearance.

ED has no policy regarding applicable cost principles.

The Agreement allows Great Lakes to retain from collections on defaulted loans its actual costs of post default collections. Great Lakes is billing ED for all the direct costs of the Collection Support units and for costs allocated for facilities management, general administration, system support, systems development, special projects, word processing, and records maintenance in accordance with Attachment 1 to the Agreement. However, Great Lakes did not have the actual costs certified annually by a supplemental schedule to the A-133 audit as required by the Agreement.

The Agreement does not identify the cost principles to be followed in determining Great Lakes' actual costs. The Office of Management and Budget (OMB) Circular A-122 establishes the cost principles for non-profit organizations. Great Lakes has designed its own policy. Our audit disclosed that Great

Lakes billed ED for costs that would reasonably be associated with collection costs. However, we did not test for compliance with OMB Circular A-122.

We believe that not having a policy in place regarding the applicable cost principles for determining the actual costs of post default collections puts ED at risk. Great Lakes created two new non-profit corporations; Great Lakes Higher Education Guaranty Corporation (GLHEGC) and Great Lakes Higher Education Servicing Corporation (GLHESC). GLHESC created and operates a wholly owned, for-profit subsidiary, Great Lakes Educational Loan Services, Inc. (GLELSI). To the extent that shared costs may not be equitably allocated among the various corporations, there is a risk that reserve funds could be used to finance non-guaranty activities. The absence of a policy regarding applicable cost principles increases the opportunity for abuse.

There is a need to maintain a baseline for performance measures.

After Great Lakes and ED entered into the Agreement, Great Lakes merged the Ohio guaranty agency portfolio with its own portfolio without providing for separate tracking. The Ohio merger altered the baseline used by Great Lakes to measure its performance under the experimental program. ED told Great Lakes to track the merged portfolio for Northstar separately when Great Lakes subsequently merged with Northstar. If ED expands the experimental program to other guaranty agencies, the other agencies will need to maintain a baseline to accurately measure their performance for preventing defaults.

The lack of guidance in these areas has affected the operation and evaluation of the default aversion program at Great Lakes and will likely cause inconsistencies if the program is expanded to other agencies. The inconsistencies could include the number of times and under what circumstances they bill ED for the \$60 default avoidance fee, how they bill for actual costs of post default collections, and how they measure performance. These inconsistencies may also result in increased costs to ED and a lack of standardized performance measures that accurately reflect the success of the experimental program.

The experimental program for default aversion and move toward fee for service is new. Therefore, ED did not have policies in place regarding the (1) number of times or under

what circumstances it will pay the \$60 fee, (2) applicable cost principles for determining the actual costs of post default collections, and (3) need to maintain a baseline for performance measures when merging portfolios. The implementation of any new program raises issues that were not anticipated.

RECOMMENDATIONS

ED needs to:

1. Implement policy guidance regarding:
 - a. The number of times or under what circumstances it will pay the \$60 default avoidance fee to the agency,
 - b. The applicable cost principles for determining the actual costs of post default collections (OMB Circular A-122, “Cost Principles for Non-Profit Organizations”), and
 - c. The need to maintain a baseline for performance measures when merging portfolios.
2. Enforce the existing requirement in the Agreement for an annual certification of actual costs of post default collections in a supplemental schedule to the A-133 audit.

Auditee Comments

ED does not believe that additional policy guidance is necessary or desirable. Great Lakes is encouraged to test various approaches to default reduction. ED intentionally did not develop extensive policy guidance for administering the program. Part of the experimental program was to test new approaches to regulating guaranty agencies. ED does not believe that Great Lakes views the program simply as a way to increase its Federal reserve funds. ED does agree that more policy guidance must be developed before the program is expanded to other guaranty agencies.

Auditor’s Response

ED believes that additional policy guidance will hamper Great Lakes’ flexibility in achieving the program’s goals. However, we are not recommending extensive policy guidance but rather minimal guidance to limit ED’s risk exposure. Minimal guidance would limit ED’s risk exposure for multiple fee payments, cost allocation, and facilitate assessment of the program results.

ED should improve communication in the loan subrogation process.

Great Lakes was not able to meet the timelines in the Agreement for the defaulted loan subrogation to ED. Subrogation of the defaulted loan portfolio is a major step in the Agreement to reduce the costs incurred by guaranty agencies and move toward a system based on a fee for service.

In the Agreement, Great Lakes agreed to subrogate to ED the defaulted loans, beginning September 1, 1996, on which it paid a default claim to a lender at least 2-years ago and on which it has received no payments from the borrower. Great Lakes also agreed to promptly negotiate with ED to agree to a schedule by December 1, 1996, for subrogating all remaining defaulted loans held by Great Lakes.

Great Lakes experienced a delay subrogating loans to ED.

A Great Lakes official informed us that Great Lakes was not able to subrogate as many defaulted loans as it would like. First, E-Systems (an ED contractor) was unable to accept them because it had a backlog due to other agencies subrogating large volumes and changes in the edit criteria. Second, IRS offset, bankruptcy, and disability requirements reduced the number of loans eligible for subrogation. Third, a Dear Colleague Letter limited subrogation of accounts with certain default dates. Therefore, Great Lakes needed permission from ED to subrogate accounts with default dates up to September 30, 1995. In January 1998, ED gave Great Lakes permission to subrogate accounts with default dates up to September 30, 1996.

When Great Lakes first attempted to subrogate a large number of accounts E-Systems returned them because it could not handle the volume. This caused additional work for Great Lakes, since it had to reload the loan information on its system and start working the account again. The approximate six month period from the time Great Lakes sent the loans to E-Systems until it reloaded the loans onto its system caused many problems with the borrowers. This six-month delay could affect the collectability of some loans. The subrogation delays also affect ED's efforts to reduce the costs incurred by guaranty agencies in the FFEL Program and move toward a system based on a fee for service.

After the initial delay, E-Systems informed Great Lakes it would only accept tapes of 5,000 accounts per tape on a

gradual basis so it could handle the volume. From fiscal years 1995 through 1997, Great Lakes subrogated 101,720 accounts totaling \$514,474,380 to E-Systems which has accepted 89,337 accounts totaling \$332,864,883. Before E-Systems accepts the subrogated accounts it performs edit checks. The 12,383 accounts not yet accepted are in the edit check process. In addition, as of April 1, 1998, Great Lakes had approximately 28,375 accounts to subrogate.

Unforeseen events, such as the closing of the Ohio and Northstar guaranty agencies, caused some of the delay problems. ED officials indicated they did not anticipate the large default loan volumes subrogated by these agencies when they entered into the Agreement with Great Lakes. However, we believe the lack of communication within ED offices and with Great Lakes caused some of the delay problems. Better communication could have disclosed the changes in the edit criteria and the need for ED approval to subrogate certain defaulted loans. The increased communication would have made the subrogation process more timely.

RECOMMENDATION

If ED expands the experimental program to other guaranty agencies, ED should improve its communication within ED offices and with Great Lakes (or other guaranty agencies) to ensure they carry the subrogation process out in a timely manner.

Auditee Comments

ED concurred with the recommendation and stated it is working with Great Lakes and E-Systems to resolve the difficulties that have prevented the subrogation of the Great Lakes defaulted loans.

ED should require supplemental explanations on ED Form 1189.

The current ED Form 1189 does not facilitate accurate reporting of default avoidance fees and actual post default collection costs. According to Title 34 Code of Federal Regulations (CFR) 682.414(b), guaranty agencies are required to accurately complete and submit reports to the Secretary. ED provides standardized forms for guaranty agency reporting. The current ED Form 1189 is not designed to capture data relevant to the experimental program. ED officials opted not to change the ED Form 1189 during the experimental program

because of time and money issues and the need for OMB approval.

During the experimental program, Great Lakes is using the supplemental preclaims assistance (SPA) line of the current ED Form 1189 to report the net amount of cure fees and adjustments for actual collection costs. ED users were not aware that Great Lakes changed the data it is reporting on the SPA line. For example, when discussing the ED Form 1189 reporting issue with ED officials from Accounting and Financial Management Service, FFEL Program, they informed us they were unaware of the new experimental program at Great Lakes. The officials noted that Great Lakes' SPA amount went from about \$1.5 million in 1996 to about \$6.5 million in 1997 but did not know why.

RECOMMENDATION

We recommend that ED require Great Lakes to add footnotes or an attachment to the ED Form 1189 to explain the details behind the amount reported on the SPA line. If ED expands the experimental program to other guaranty agencies, we recommend that it modify the ED Form 1189 to properly account for the alternative method for reimbursement of preclaims assistance and actual collection costs.

Auditee Comments

ED concurred with the recommendation and agreed to promptly implement it.

Summary

We could not conclusively determine the merits of the experimental program. However, Great Lakes' assessment model indicates that the experimental program appears to have merit. Our limited scope audit identified areas where ED has an opportunity to strengthen program administration and conclusively determine program merits.

ED needs to develop and monitor a plan to assess program performance. The program needs to be monitored by having an evaluation process. ED needs to develop additional policy guidance and improve its communication within ED and with Great Lakes. ED should also require supplemental explanations on ED Form 1189. Improvements in these areas will facilitate the full implementation of the Agreement.

If the evaluation indicates the program is working as intended, it should be gradually expanded to a few additional guaranty agencies and evaluated to rule out the possibility that some unique characteristic of Great Lakes is responsible for the results. If the program is successful during the expanded test, necessary legislative and/or regulatory changes should be sought to expand the program to all guaranty agencies.

Background

Description of Great Lakes

Great Lakes Higher Education Corporation (Great Lakes) is a nonprofit Wisconsin corporation that was established in 1967 for the purpose of guaranteeing student loans for Wisconsin residents. Since then, Great Lakes has administered the FFEL Program under several agreements with ED.

Great Lakes was reorganized as of September 30, 1996. Pursuant to an internal restructuring resolution, Great Lakes created two new Wisconsin nonstock, nonprofit corporations; Great Lakes Higher Education Guaranty Corporation (GLHEGC) and Great Lakes Higher Education Servicing Corporation (GLHESC).

Under an Assignment and Assumption Agreement between Great Lakes, GLHEGC and GLHESC, the net assets and personnel related to the activities traditionally conducted by the Great Lakes Guaranty Division were assigned to GLHEGC and the net assets and personnel related to activities traditionally conducted by Great Lakes' Servicing Division were assigned to GLHESC.

Great Lakes has retained certain controls over GLHEGC and GLHESC through its rights as the sole corporate member of each corporation. It also continues to provide certain support functions for GLHESC and GLHEGC such as information systems, facilities management, and accounting services. GLHESC also created and operates a wholly owned, for-profit subsidiary, Great Lakes Educational Loan Services, Inc. (GLELSI), which is responsible for all alternative student loan servicing activities. GLELSI was intended to be responsible for all loan servicing activities for loans under the William D. Ford Federal Direct Loan Program, until cancellation of the contract between E-Systems and ED in 1997.

**Description of Default
Aversion Program**

Effective July 1, 1996, Great Lakes began participating in an experimental program with ED whereby Great Lakes agreed to support ED's efforts to reduce defaults in the FFEL Program by accepting an alternative method for payment of the costs of preclaims assistance, claim payment, and collections. The alternative payment method is designed to provide an incentive to Great Lakes to avoid defaults by borrowers and limit Great Lakes' reliance on post default collections as a method for financing guaranty agency operations.

The alternative method was to be implemented under the following guidelines: (1) ED and Great Lakes agreed to test the program from July 1, 1996 to December 31, 1996, unless modified or terminated [later extended through June 30, 1998]; (2) ED agreed to pay Great Lakes \$60 per default claim avoided because of Great Lakes' efforts; (3) ED and Great Lakes agreed to consider a default claim avoided if Great Lakes received a preclaims assistance request from a lender after the loan has been delinquent for 90 days and a default claim was not paid on the loan during the 180 days following receipt of the preclaims assistance request; (4) ED agreed to allow Great Lakes to retain from collections its actual costs of post default collections, calculated in accordance with Attachment 1 to the Agreement and certified annually by a supplemental schedule to the annual compliance audit; (5) Great Lakes agreed not to retain a percentage of post default collections, except for the actual costs as discussed in #4 above, and not to bill ED for SPA.

Beginning September 1, 1996, Great Lakes agreed to assign to ED the defaulted loans on which it paid a default claim at least two years ago and on which no payments have been received from the borrower. Great Lakes also agreed to set up a schedule by December 1, 1996, for subrogating all remaining defaulted loans.

Great Lakes agreed to return to ED \$5 million in Federal reserve funds maintained under 34 CFR 682.410(a)(1) as a first step toward converting the guaranty agency financing system from one based on the accumulation of reserve funds to a system based on a fee for service competitively based working capital cost reimbursement methodology. Subsequent to the

Agreement, Great Lakes returned the \$5 million in reserve funds to ED.

Federal Regulations

Title 34 of the CFR, Part 668 and 682, govern the administration of the FFEL Program. In addition, the FFEL Program is subject to the provisions contained in Title IV of the Higher Education Amendments of 1992 (Public Law 102-325). The current regulations do not specifically address the default aversion program. However, the Agreement does provide requirements agreed to by Great Lakes and ED for the administration of the experimental program.

Purpose, Objectives, Scope, and Methodology

Purpose, Objectives, and Scope

The purpose of our audit was to determine if ED's Agreement with Great Lakes is working as intended. The audit covered the period October 1, 1995 through April 17, 1998.

The specific objectives were as follows: (1) determine if the Agreement has benefitted ED, Great Lakes, and student borrowers, (2) determine if additional improvements can be identified, and (3) assess whether the Agreement would be useful for other guaranty agencies. Our specific objectives included reviewing and evaluating management controls, the accounting for the program, and adherence to provisions in the Agreement.

Methodology

To achieve the purpose and specific objectives, we interviewed key ED officials and Great Lakes management, reviewed written policies and procedures, documents and accounting records, and student financial assistance files pertaining to preclaims assistance. Our review of student files consisted of reviewing 49 borrowers judgmentally selected from two months of fiscal year 1997 (November 1996 and August 1997) billing reports. The universe for fiscal year 1997 was 108,985 cures.

We sampled 49 borrowers to determine what ED is paying for when Great Lakes avoids a default and if ED has paid Great Lakes multiple times for avoiding a default for individual borrowers. We reviewed the histories of 21 borrowers from the August 1997 preclaims supplemental allowance billing report for the sample. We judgmentally selected three borrowers from each of the following reasons for the default avoidance (cure): deferment, forbearance, low delinquency, miscellaneous cure, monetary update, paid in full, and payment posting. In addition, we reviewed the histories of an additional 28 borrowers from the November 1996 preclaims supplemental allowance billing report. We judgmentally selected 4 borrowers from each of the previous reasons for the default avoidance (cure).

We performed field work at the Guarantor and Lender Oversight Service, Washington, D.C. and Great Lakes in

Madison, Wisconsin from February 9, 1998 through April 17, 1998. We performed our audit in accordance with government auditing standards appropriate to the limited scope of audit described above.

Statement on Management Controls

Purpose of Assessment

As part of our review we assessed the system of management controls including policies, procedures, and practices applicable to ED's administration of the experimental program. We performed our assessment to determine the level of control risk for determining the nature, extent, and timing of our substantive tests to accomplish the audit objectives.

To make the assessment, we identified and classified the significant management controls into the following categories:

- " Program implementation
- " Program monitoring
- " Program evaluation

Because of inherent limitations, a study and evaluation made for the limited purpose described above would not necessarily disclose all material weaknesses in the management controls. However, our assessment disclosed significant management control weaknesses which adversely affected ED's ability to administer the experimental program. Our limited scope audit identified weaknesses in controls needed to: (1) Develop and monitor a plan to assess the performance of the experimental program, (2) Develop additional policy guidance, (3) Improve communication in the loan subrogation process, and (4) Require supplemental explanations on ED Form 1189. These weaknesses and their effects are fully disclosed in Audit Results section of this report.

MEMORANDUM

U.S. DEPARTMENT OF EDUCATION
*Student Financial Assistance Programs
Guarantor and Lender and Oversight Service
Office of the Director*



DATE: September 8, 1998

TO: Richard J. Dowd
Regional Inspector General
for Audit - Region V

FROM: Larry Oxendine
Director, Guarantor and Lender
Oversight Service, SFAP

SUBJECT: Draft Report -- ACN A0580007

Dr. David Longancecker has asked me to responded to the draft report.

Although the Great Lakes experience with the demonstration program thus far has been very favorable, we do not believe that the program has had sufficient time to generate measurable results that can be extrapolated to the industry. This is especially relevant in light of the merger of the Ohio portfolio into the demonstration program without first establishing a baseline. The inclusion of the Ohio portfolio was done without the Department's knowledge. Once it was discovered we asked Great Lakes officials to create a baseline from which to measure performance before merging any additional portfolios into the demonstration program.

The following are our responses to each of the recommendations in the draft report. For ease of review, we have repeated the recommendation before each response.

1. Recommendation: Develop and monitor a plan to assess program performance.

Response:

An assessment plan has been created by Great Lakes, in consultation with the Department, which is used to continuously measures the performance of the demonstration program. In developing the assessment, we asked Great Lakes to be conservative in any estimates used in assessing the program's effectiveness. We recognize that an independent assessment must be made at the appropriate time if we wish to expand the program to other guaranty agencies or make legislative recommendations based upon the program's performance. Preliminary assessments by Great Lakes suggest that the demonstration program may

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be effective at reducing defaults without adversely affecting the guarantors' revenue as a result of the reduced collections retention. In addition, the demonstration program eliminates the perverse incentive that allows guaranty agencies to benefit greater economically from collecting defaults than from preventing them.

2. Recommendation: Develop addition policy guidance.

Response:

We do not agree with the recommendation. We do not believe additional policy guidance is necessary or desirable. As discussed in the draft report, the Default Aversion Agreement between Great Lakes and the Department authorized the implementation of a demonstration program designed to reduce defaults. Great Lakes is encouraged to test various approaches to default reduction. We intentionally did not develop extensive policy guidance for how the program is to be administered. In addition, part of the experiment was to test new approaches to regulating the guaranty agencies; e.g., instead of imposing prescriptive requirements, create economic or other incentives designed to encourage desirable outcomes. As indicated by the voluntary return of \$5 million of its Federal reserve funds, its evident that Great Lakes do not view the demonstration program simply as a way to increase the size of its Federal reserve. Even under the most conservative estimate, the demonstration program has saved the Department much more in reinsurance than it has cost. We do agree, however, that more policy guidance must be developed before the program is expanded to other guaranty agencies. The experience gained as a result of the Great Lakes demonstration will be valuable in developing that guidance.

3. Recommendation: Improve communication in the loan subrogation process.

Response:

We agree with the recommendation and are working with Great Lakes and our contractor, E-Systems, to resolve the difficulties that have prevented the subrogation of the Great Lakes defaulted loans.

Recommendation: Require supplemental explanations on ED Form 1189.

Response:

We agree with the recommendation and will promptly implement it.

cc: Linda Paulsen, AFMS
Patrick J. Howard, OIG

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Director, PAMS	1
Regional Inspectors General for Audit	1 each