Testimony of
James W. Runcie
Chief Operating Officer
Federal Student Aid
U.S. Department of Education

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Hearing on
"Examining the Mismanagement of the Student Loan Rehabilitation Process"

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Thank you Madam Chairwoman, Ranking Member Hinojosa and Members of the Subcommittee for inviting me to testify before the Subcommittee as you examine the rehabilitation of defaulted student loans.

My name is James Runcie and I am the Chief Operating Officer of the Department of Education's Federal Student Aid office. Our organization is responsible for administering the Federal student financial assistance programs that annually enable millions of students across this country to pursue higher education.

While managing loans in default and loan rehabilitation is a significant and important part of our work at Federal Student Aid, it is only one part of a successful public-private partnership encompassing over 1,300 government employees and more than 10,000 employees of private contractors. Together we administer the Federal student aid programs by, among other things, conducting outreach to high school students and to other college-bound students and their families, processing more than 20 million financial aid applications each year, determining student aid eligibility, disbursing billions of dollars in grants and loans, servicing the accounts of millions of student loan borrowers, performing oversight of program participants and, what we are here to discuss today, collecting on defaulted student loans.

<u>Background</u>

To place Federal Student Aid's responsibilities and current scope of operations in the proper context for this hearing, I would like to review with the Committee how we got to where we are today.

Since 1994, there were two primary Federal student loan programs in this country – the Federal Family Education Loan (FFEL) program, through which private lenders using private capital made federally guaranteed loans to students; and the Direct Loan program, through which the Department of Education made loans directly to students. Prior to the economic downturn beginning in 2007, the Direct Loan program's share of $64 billion Federal student loan annual disbursements was approximately 20 percent with FFEL program loans comprising the remaining 80 percent. At the time, Direct Loans accounted for approximately 21 percent of the $509 billion outstanding student loan portfolio.

Starting in 2007, the decline in the financial markets affected student lending by restricting the availability of capital for private lenders to make FFEL loans. Many schools, reacting to the economic and financial landscape, began moving from the FFEL program to the Direct Loan program. As the number of schools moving to the Direct Loan program increased, Federal Student Aid took steps to assume responsibility for additional Direct Loan volume.

Beginning in 2008, we increased our stand-by loan origination capacity to handle the projected volumes of new Direct Loans. We also augmented our Direct Loan servicing capacity with the awarding of loan servicing contracts to four contractors. Understanding that there would continue to be large increases in the number of borrowers, we also began updated the FSA default management system.

As you are aware, the Student Aid and Fiscal Responsibility Act (SAFRA), enacted in 2010, ended the origination of new loans in the FFEL program and thus made all new Federal student loans available only through the Direct Loan program beginning in July 2010. FSA successfully implemented the transition to full direct lending and in FY 2013 the Department disbursed approximately $100 billion dollars in Direct Loans to approximately 10.6 million student and parent borrowers. This is an increase of almost 700 percent in just five years.

Today, Federal Student Aid originates 100 percent of the over 100 billion dollars in new Federal student loans. Federal Student Aid manages a Federal student loan portfolio of FFEL and Direct Loans of approximately one trillion dollars for more than 40 million borrowers. We have successfully managed substantial growth in the Title IV Federal financial aid programs and continue to serve our customers—students and families—by providing information, tools and resources they need to pursue postsecondary education. In FY 2013, Federal Student Aid successfully delivered $138 billion in Federal grants, loans and work study aid to more than 14 million eligible students and their families.

Challenges Associated with Loan Rehabilitations and DMCS

Going from approximately 20 percent to 100 percent of the Federal student loan originations and the accompanying servicing and default management have not been without some challenges. Beginning in 2012, we started working with the Department's Inspector General (IG) to address these issues. These challenges are discussed in the General Accountability Office's (GAO) report, *Federal Student Loans: Better Oversight Could Improve Defaulted Loan Rehabilitation*. Addressing these challenges has been a major focus of Federal Student Aid management and we are proud of our success in overcoming the initial hurdles noted in the GAO report. We have also instituted significant regulatory, contractual, and process improvements since 2012 that make loan rehabilitation easier for borrowers and for collection agencies and loan servicers to implement. That said, we are aware of and concerned with the delays and disruptions to the loan rehabilitation process that occurred on in 2011 and 2012 and I take full responsibility. We have worked hard to ensure that this situation does not happen again. Accordingly, I share the concerns raised by GAO and appreciate its thoughtful suggestions.

This matter should not detract from the incredible accomplishments of the Federal Student Aid workforce who manage a $138 billion student aid program that serves more than 14 million students and families attending over 6,000 institutions of higher education.

In late 2011 FSA implemented the new Default Management and Collection System (DMCS). As with all transitions, we faced a number of challenges, particularly during its initial months of operation in late 2011 and early 2012. The new DMCS replaced a legacy system that was nearly 30 years old, technologically and functionally limited, and subject to a number of security issues and audit findings. This legacy system was operated under a larger contract that expires on June 30, 2014 and provides other services to Federal Student Aid.

Beginning in 2010, we began negotiations with the contractor to prepare for the wind-down and close-out of the contract. As part of those negotiations, the contractor agreed to develop, implement, and document a new debt management and collection system at no additional contract cost to the government. This allowed Federal Student Aid to cancel a planned Debt Recovery System development contract, thereby saving in excess of $10 million in budgeted development costs.

The new DMCS system was designed to be more secure, more robust, and less costly than the legacy system. A pilot version of the new system was launched for 5,000 newly defaulted borrowers in February 2011. Following testing and a pilot conversion in early September of more than 150,000 additional borrowers, all three million defaulted borrowers on the legacy system were transferred to the new DMCS beginning in September 2011; the new system went live in October of that same year.

As noted in GAO's report, we encountered a number of significant issues following the full implementation of the new system including many issues related to data integrity deficiencies of the 30-year old legacy system. As a result, certain key functionalities such as payment processing, correspondence production and account transfer capabilities either took much longer than expected or failed to work properly at the higher post-transfer volumes.

Federal Student Aid immediately took steps to assess the problems and to restore key functions. Our efforts prioritized restoring borrower services, such as loan rehabilitation and refund processing, and minimizing disruptions to collection activities. Wherever possible, we limited the impact on borrowers as we worked through the system issues. For example, during the period when loan rehabilitations were delayed, we established borrower relief initiatives through which we manually cleared credit histories and re-established Title IV student aid eligibility for over 8,000 borrowers who were eligible for loan rehabilitation.

We also levied appropriate and necessary contractual sanctions against the contractor for poor performance including the issuance of a cure notice and the imposition of significant financial penalties. After the system was developed, but while the contractor was unable to perform all of the required functions, Federal Student Aid withheld over $50 million in contract payments until the contractor could demonstrate adequate performance. As a result, Federal Student Aid did not ultimately pay approximately $11 million (of the $50 million) of contractor costs. Additional actions may occur in the broader negotiations at the contract's end, on June 30, 2014. Late last year, we ended our relationship with the original contractor and awarded a new contract for the management of DMCS.

Functionality Restored

The DMCS's loan rehabilitation functions were fully restored in April 2012 and the backlog of borrowers whose loan rehabilitation was delayed was resolved by January 2013. Over 525,000 borrowers have rehabilitated defaulted student loans with a value of more than $9 billion dollars since functionality was restored, including a record $5.6 billion in FY 2013.

The Department of Education has achieved record overall collection totals in both FY 2012 and FY 2013. Collections on defaulted loans have grown from approximately $3.4 billion in FY 2011 to $3.7 billion in FY 2012 to $8.5 billion in FY 2013. DMCS now has the capacity to support the Department's collection activities including providing an effective and efficient loan rehabilitation process. In addition, the new system is more secure, has fewer manual workarounds, and boasts many enhanced features such as web access for borrowers and weekly rather than monthly loan rehabilitation processing. Despite the system's initial issues, I believe that the new DMCS system represents an important upgrade in services to better support defaulted student loan borrowers and to protect the taxpayer investment in student loans.

Moving Forward

We have worked closely with GAO over the last two years. We appreciate its insights and concur with the report's three recommendations. In fact, we have already begun to address their suggestions:

- We are developing additional metrics for use in overseeing loan rehabilitations. We are working with both private collection agencies (PCAs) and our loan servicing contractors to develop statistics to identify and resolve process issues affecting loan rehabilitations quickly.

- We have established a contract monitoring plan for DMCS that tracks explicit deliverables related to key risk areas. In addition, the new DMCS contract requires that the vendor use Lifecycle Management Methodology (LMM) in managing any development activity. The LMM process includes the production and ongoing monitoring of detailed risk logs and mitigation strategies for all projects. Lastly, Federal Student Aid has procured an independent verification and validation (IV&V) service for DMCS to ensure that all appropriate processes and controls are in place. While these steps will significantly reduce any risks, we will continue to review our monitoring and oversight processes and plans to determine whether additional actions are needed.

- We have also strengthened our procedure for reviewing telephone calls by our collection agencies, giving particular and regular attention to loan rehabilitation calls. We have revised the monitoring procedures to improve the documentation of corrective actions by pCAs). We have also developed a database to track errors discovered in PCA reviews and to identify those PCAs with a pattern of errors. The database will also document PCA corrective actions.

- We are considering improvements such as more extensive trending and data analysis to inform our oversight of collection agency activities. The corrective actions tracked in the new database will also contain each error identified in each review, allowing Federal Student Aid staff to analyze PCA performance to identify and address problem areas and poor performers. While these steps will significantly improve the call review process, we will assess their impact to determine whether additional actions are needed.

The Department has also revised its guidance on how Direct Loan debt collectors calculate the "reasonable and affordable" payment in the loan rehabilitation process. Borrowers are required to make nine "reasonable and affordable" payments before their loans can be rehabilitated and their credit histories cleared. We directed the Direct Loan collection agencies to calculate those payments as no more than 15 percent of their discretionary income. The Department extended this directive to FFEL debt collection agencies in regulations (effective July 1, 2014).

In an effort to be completely transparent with taxpayers, we self-reported a material weakness associated with the DMCS system conversion in the Department's FY 2012 Annual Financial Report and FSA's FY 2012 Annual Report. This material weakness was an aggregation of the control deficiencies, some relating to the rehabilitation process. The Department's IG agreed with our self-assessment and reported a material weakness in its audit of the Department's and FSA's FY 2012 financial statements. During FY 2013, FSA aggressively addressed these control deficiencies and made significant progress in fixing them. As a result, the Department eliminated that material weakness in FY 2013, and the Department and Federal Student Aid once again have no material weaknesses on their financial statement audits.

The new DMCS has now been operating for two years. We are processing record numbers of collections in all categories and defaulted borrowers have better service and more options than at any time in the history of our programs. We have learned from these system transition problems and are incorporating those lessons into management improvements across the organization.

At an organizational level, our priority remains service to our customers through the effective and efficient delivery of Federal financial aid, prudent management of our outstanding loan portfolio, and proper oversight of our programs. This will further our students' educational pursuits, safeguard taxpayer dollars, and ensure the viability of these programs.

I want to thank the Subcommittee for providing me the opportunity to discuss this very important issue and I look forward to answering any questions you may have this afternoon.