Federal Student Loan Servicing: Contract Problems and Public Solutions

Eric M. Fink

Associate Professor
Elon University School of Law

and

Roland Zullo

Associate Research Scientist
Institute for Research on Labor, Employment and the Economy
University of Michigan

Table of Contents

Executive Summary ____ 3

1 — Overview of Federal Student Loan Program ____ 4

1.1 — Program History: The Rise of Direct Federal Loans ____ 4

1.2 — Program Administration: A Mixed Public-Private Model ____ 4

1.3 — Price of a Public-Private Model: Remuneration and Performance Monitoring ____ 5

2 — The Present System of Loan Servicing by Private Contractors Poorly Serves Borrowers and the Public Interest ____ 6

2.1 — Borrower Complaints Reveal Substantial Problems with Contractor Performance ____ 6

2.2 — Contract Terms: Performance-Based Payments and Allocation of Servicing Volume ____ 8

2.2.1 — Performance-Based Payment ____ 8

2.2.2 — Performance-Based Account Allocation ____ 8

2.3 — Contractual Incentives Are Poorly Aligned With Program Goals ____ 9

3 — Improving the Loan-Servicing System ____ 11

3.1 — Stricter Monitoring of Contractor Performance ____ 11

3.2 — Competition From a Public Loan-Servicing Unit ____ 12

3.2.1 — Precedent for Public Loan Servicing ____ 12

3.2.2 — Establishing a Public Student Loan-Servicing Unit ____ 13

Glossary of Acronyms ____ 15

This research was supported by a grant from the Jobs With Justice Education Fund.

Executive Summary

One consequence of the 2007–2008 financial crisis was an abrupt shift from bank-based to direct federal student loans. This momentous change required the Department of Education to rapidly establish the capacity to service loans, which was achieved by outsourcing this responsibility to four large for-profit firms and a group of smaller regional entities. Loan servicing involves routine payment processing, account management and borrower communication, as well as the non-routine yet more labor intensive role of assisting borrowers that face hardship with debt repayment.

Borrowers have expressed dissatisfaction with the present system. Complaints jumped significantly in the first two years of the loan servicing contracts and remain at historic highs. Several factors contribute to this increase, including the lackluster job market for graduates. However, upon close inspection it appears that loan servicers bear part of the blame for neglecting their responsibility to counsel borrowers with distressed loans. The Student Loan Ombudsman's Office of the Consumer Finance Protection Bureau has issued several reports that further validate this assertion. To understand why the system is underperforming, we draw attention to the public-private contract.

A question for any public-private contract is whether the incentives within are adequate to encourage contractor behavior consistent with the mission of the service. In our review of the contract terms, we conclude that the incentives to reduce operational costs far outweigh the incentives to be responsive to the needs of borrowers.

The contracts between the Department of Education and loan servicers were not for fixed amounts, but were "performance based," meaning that they were designed to reward contractors in varying amounts depending on specified metrics. Two incentive mechanisms were employed. First, using a graduated remuneration system, contractors receive a higher per monthly payment rate for current accounts and are paid incrementally less as loan accounts slide further into delinquency. This mechanism was meant to reward contractors that exerted effort to prevent loan delinquencies.

"A question for any public-private contract is whether the incentives within are adequate to encourage contractor behavior consistent with the mission of the service. In our review of the contract terms, we conclude that the incentives to reduce operational costs far outweigh the incentives to be responsive to the needs of borrowers."

The remuneration schedule places a fixed cap on the revenue that a servicer can earn from an account, thereby establishing a strong incentive to reduce costs as a way to stay solvent and achieve a profit. By comparison, the graduated payment design inflicts minor financial penalties on contractors when a loan account becomes delinquent. Using a few hypothetical (yet conservative) assumptions, we show that a profit-maximizing contractor will avoid the non-routine, labor-intensive services associated with assisting borrowers with distressed loans.

Second, contractors were periodically evaluated based on a composite measure that combines loan default volumes and rates, as well as surveys of students, higher education institutions and Federal Student Aid (FSA) personnel. Quarterly ratings are then used to determine the allocation of new loan accounts, whereby poor performing contractors receive less new business. Responsive loan servicing agents thus grow at the expense of less responsive agents.

The new account allocation system based on quarterly evaluations is also a weak incentive offset to the hard caps on per account revenue. The nature of the composite measure ensures that all contractors will receive some proportion of the new loan accounts. Moreover, because the contractors are assessed against each other, rather than against independent standards, all the contractors could perform poorly and face no punitive consequences; slightly more new accounts would be allocated to the "least of the worst" among the contractors.

This case illustrates the inherent limitations of a performance-based contract as an administrative tool. Regardless of design, contractors will strive to minimize operational commitment to any labor-intensive task, in this instance attending to the personal needs of borrowers.

There are two remedial solutions to this flawed approach. The first is to upgrade contract monitoring, which entails an expansion of the FSA within the Department of Education to oversee the performance of the loan-servicing agents. The second is to create a public loan-servicing unit that would raise standards by competing against the private loan-servicing agents. Of these two non-exclusive options, we place greater faith in the public alternative. The concept is not novel; federal agencies currently perform this role. The Department of Agriculture, for instance, successfully issues and services farm loans. A similar function can be established within a federal agency for student loans. Capacity can be built internal to the FSA, or perhaps through the Internal Revenue Service. Our discussion focuses on the advantages of the United States Postal Service, which has a history of providing financial services, manages an accessible retail network, and enjoys a favorable image among the public.

1 Overview of Federal Student Loan Program

In 2010, Congress overhauled the federal student loan program, expanding the Direct Loan (DL) program and phasing out the former bank-based program.[1] These changes were adopted in response to a near-collapse of the private student loan market in the wake of the 2007–08 financial crisis.

While the DL program ensured that students could continue to access educational opportunity, there remain significant problems with the performance of private entities that service student loans under contract with the federal government. As explained below, the source of those problems lies in the contract system itself. To remedy those problems, the federal government should take a more active role, not simply by enhancing oversight of the existing private loan servicing contractors, but by establishing a public loan servicing unit to compete with, and even potentially replace, the poorest performing private contractors. Absent a more robust competitive threat, student borrowers and the public interest will continue to be underserved.

1.1 Program History: The Rise of Direct Federal Loans

The federal government's role in higher education lending originated in 1965.[2] Under the original Guaranteed Student Loan program, renamed the Federal Family Education Loan (FFEL) program in 1992, private banks made and serviced loans, backed by an array of state government and not-for-profit guarantors. Back then, the federal government's role was twofold: first, as reinsurer for the guarantors; second, the federal government provided interest rate and other subsidies "designed to ensure that private capital [would] consistently be available to make FFEL program student loans."[3]

For the federal government, the FFEL "bank-based" program was expensive. Hence, the Direct Loan (DL) program began in 1993,[4] "with the goals of streamlining the student loan delivery system and achieving cost savings."[5] With the DL program, students borrowed directly from the U.S. Department of Education (ED) rather than private banks. The FFEL and DL programs operated in tandem until the credit freeze of 2008, when major private banks vacated lending markets. To safeguard the viability of the U.S. higher education system, the federal government began assuming student loan debt.[6] The ED purchased loans written by private lenders, paying a premium of $50 over principal for each loan. The financial crisis of 2008 thus heralded the end of the bank-based system for student loans, culminating in 2010 with the termination of new lending under the FFEL program in favor of an expanded DL program.[7]

1.2 Program Administration: A Mixed Public-Private Model

The current lending system is based on a mixed public-private model. The ED oversees the program through its office of Federal Student Aid (FSA). Campus financial aid staff package student loans based on loan eligibility information derived from the Free Application for Federal Student Aid (FAFSA) submitted by prospective borrowers, and successful applicants receive funds disbursed by the ED into their campus student accounts. Capital for funding the loans is provided to the ED from the U.S. Treasury. Private entities, under contract with FSA, service the loans by communicating with borrowers, processing payments and assisting with loan restructuring. FSA also contracts with private debt collection agencies in the event of a loan default.

Once a loan has been disbursed, a loan-servicing contractor handles the account until it has been repaid (or otherwise discharged), as long as the borrower remains in a non-default status.[8] Servicers are responsible for financial reporting, managing transactions with borrowers, tracking payments to the U.S. Treasury, and maintaining system security.

Two sets of entities currently hold servicing contracts for loans under the DL program and legacy FFEL loans acquired by the federal government:

---

1 SAFRA Act, P.L. 111–152, Title II, Subtitle A, Part II – Student Loan Reform (March 30, 2010).

2 Higher Education Act of 1965, P.L. 89-329 (Nov. 8, 1965).

3 Congressional Research Service, "The SAFRA Act: Education Programs in the FY2010 Budget Reconciliation" (April 2, 2010) ("CRS SAFRA Report"), p. 6; Bureau of Consumer Financial protection, "Defining Larger Participants of the Student Loan Servicing Market" (Proposed Rule) (March 28, 2013), 78 F.R. 18902, 18904.

4 Student Loan Reform Act ("SLRA"), P.L. 103-66, Title IV, Subtitle A (Aug. 10, 1993).

5 SAFRA Act, P.L. 111–152, Title II, Subtitle A, Part II – Student Loan Reform (March 30, 2010).

6 *See* James W. Runcie, "Strengthening the Federal Student Loan Program for Borrowers," Testimony before U.S. Senate Committee on Health, Education, Labor and Pensions (HELP) (March 27, 2014).

7 Replacement of federally guaranteed private loans with federal direct loans was originally contemplated under the 1993 SLRA. However, that plan was suspended under the Higher Education Amendments of 1998, P.L. 105-244 (Oct. 7, 1998). *See* CRS SAFRA Report, p. 6.

8 Once an account has been delinquent for more than 360 days, it is deemed to be in default. The account is then supposed to be assigned to a private debt-collection firm, again under contract with FSA. Debt-collection contractors receive $0.16 for every $1.00 of debt collected; this collection fee is added to the borrower's debt obligation. Collection fees are greater ($0.18 to $0.20 per $1.00) for defaulted loans originating under the bank-based FFEL program.

1) TIVAS: Four companies – Sallie Mae[9], FedLoan Servicing/PHEAA,[10] Great Lakes Educational Loan Services, and Nelnet Loan Servicing – administer the largest share of loans. These four entities are commonly referred to as TIVAS (Title IV Additional Servicers).[11]

2) NFPs: In 2010, Congress mandated that FSA award additional loan-servicing contracts to certain not-for-profit entities (NFPs) that had previously serviced loans under the bank-based FFEL program.[12] Each NFP servicer was guaranteed an initial allocation of 100,000 loan accounts, subject to future performance-based adjustments. Until 2014, the NFPs received a premium of 10 to 32 percent over the fees paid to TIVAS for identical service responsibilities.[13] Many NFP servicers took advantage of this favored treatment by outsourcing their loan accounts to TIVAS, pocketing the difference between the premium NFP servicing fees and the lower TIVAS rates.

The Bipartisan Budget Act of 2013 eliminated this NFP subsidy, which had cost the federal government an estimated $3.1 billion.[14] Beginning in 2014, NFPs had to compete for loan accounts on the same basis and are to be paid at the same rates as the TIVAS.

The FSA Acquisitions Mission Procurement Group administers and manages contracts related to student aid programs, including contracts for loan servicing.[15] This unit is responsible for monitoring the TIVAS and NFPs to promote compliance with contractual terms and conditions, federal contracting regulations,[16] and departmental policies and procedures. The contracting officer (CO) has overall responsibility for contract administration and may appoint one or more contract specialists (CS) to carry out the technical aspects of contract monitoring.[17] Other FSA personnel, including staff from the Operations Services Group, Finance Group, Internal Control Division, and the Financial Institution Oversight Service Group, are also involved in contract oversight.

1.3 Price of a Public-Private Model: Remuneration and Performance Monitoring

There are two major FSA expenses related to the contracts with the TIVAS and NFPs: the fees paid to the TIVAS and NFPs for their services and the expense of FSA's contract monitoring staff.

The original TIVAS contracts guarantee each servicer a minimum of $5,000,000 in annual revenue. Yet the rapid growth of the DL program and the full reliance by FSA on contracted servicers resulted in payments to servicers well in excess of the guaranteed minimum. Based on figures for the number of borrowers and monthly payouts in the third quarter of 2013, the estimated monthly payments to TIVAS and NFPs were approximately $44.2 million for DL accounts and $39.8 million for FFEL accounts. Assuming that these figures do not vary significantly throughout the year, the total estimated payout to TIVAS and NFPs in 2013 was approximately $1,008 million.

On top of fees paid to servicers, FSA also incurs expenses for contractor monitoring. As of the fourth quarter of 2013, FSA employed 57 individuals in the "contracting" job classification (OPM 1102), at an average salary of $102,362.[18] Adding an additional 64 percent to account for the cost of non-cash compensation,[19] the annual cost of contract monitoring staff would exceed $9.5 million.

The service fees and monitoring together amount to an estimated $1,017.5 million. This figure, however, certainly understates the full cost of these loan-servicing contracts. One unknown is the amount of additional expenses incurred by borrowers if loan servicing is inadequately performed. Service errors can results in higher interest expenses, late fees and damage to credit ratings.

---

9 Following a corporate reorganization, Sallie Mae's loan-servicing unit now operates as a separate entity, Navient Corp. *See* Sarah Mulholland, Sallie Mae Names Education Unit Navient as Lender Splits in Two (Feb. 25, 2014), http://www.bloomberg.com/news/2014-02-25/sallie-mae-names-education-unit-navient-as-lender-splits-in-two.html.

10 The Pennsylvania Higher Education Assistance Agency (PHEAA) services student loans through two units: FedLoan Servicing for federally owned loans and American Education Services (AES) for other loans. *See* FedLoan Servicing: Who Are We, http://www.myfedloan.org/about/who-are-we.shtml.

11 Originally, one company, ACS, Inc., serviced most loans under the DL (Title IV) program. FSA contracted with additional servicers in 2009, giving rise to the names TIVAS. *See* CFPB, "Defining Larger Participants of the Student Loan Servicing Market" (Proposed Rule), 78 F.R. at 18904 & n.23.

12 SAFRA Act, P.L. 111–152, Title II, Subtitle A, sec. 2212 (March 30, 2010).

13 Field, Kelly. 2013. Federal Budget Deal Bodes Ill for Nonprofit Student-Loan Servicers. The Chronicle of Higher education, December 13. *See* Part 2.2, infra, for discussion of payment terms under the TIVAS contracts.

14 Bipartisan Budget Act of 2013, P.L.113–67, sec. 502 (December 26, 2013); House Budget Committee, Summary of Bipartisan Budget Act of 2013 (December 10, 2013).

15 *See* U.S. Department of Education, FSA Acquisitions, http://www2.ed.gov/about/offices/list/om/fs_po/fsa/fsa-acquis.html.

16 48 C.F.R., Chap. 1 (Federal Acquisition Regulation) & 34 (Department of Education Acquisition Regulation).

17 *See* Department of Education Acquisition Regulation, 48 C.F.R., sec. 3401.670, 3402.101.

18 U.S. Office of Personnel Management, FedScope Employment Data Cube (December 2013). http://www.fedscope.opm.gov/. Other sources have indicated that FSA's contract monitoring staff is larger, numbering approximately 300 full-time equivalents. The larger figure presumably includes employees in other job classifications. Absent definitive information, we have used the figures for FSA staff in the "contracting" classification to provide a conservative estimate.

19 A recent study indicates that non-wage benefits "account[] for 39 percent of the cost of compensation" for federal employees. *See* Congressional Budget Office, Comparing the Compensation of Federal and Private-Sector Employees, p. 9 (January 2012). This would mean that federal employee benefits, on average, are equal to about 64 percent of salary.

2 The Present System of Loan Servicing by Private Contractors Poorly Serves Borrowers and the Public Interest

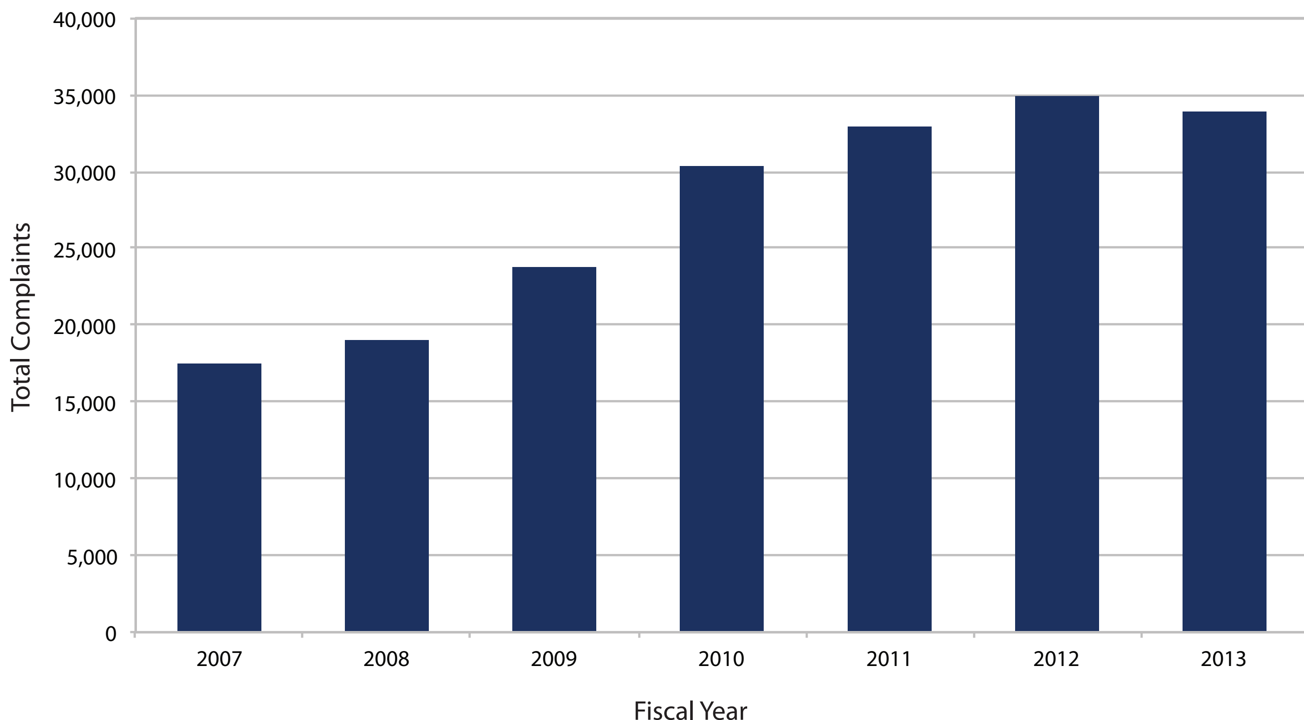
The federal student loan program advances the important social goal of enabling students to pursue higher education. One aspect of this mission is to assist student borrowers so that they do not face undue hardship in meeting their repayment obligations. In this regard, the role of loan servicing is larger than efficient payment processing; the TIVAS and NFPs have an obligation to counsel borrowers on their repayment options and to tailor repayment plans to borrower needs. For instance, depending on the circumstances, a borrower might want to minimize interest payments, extend the term of a loan, or consolidate loans. In these challenging economic times, it is critical that borrowers receive competent assistance to avoid loan delinquencies and defaults in order to protect borrower credit standing.

2.1 Borrower Complaints Reveal Substantial Problems with Contractor Performance

Evidence suggests that student borrowers have not been well-served by the current system. FSA and other sources have identified persistent problems with the performance of TIVAS and NFPs, the extent and nature of which indicate serious structural shortcomings and conflicts of interests in the present contractual arrangement.

The FSA Ombudsman Group fields complaints and attempts to resolve disputes related to federal student loans. The volume of complaints (both in absolute and proportionate terms) has increased markedly since 2009, when FSA first contracted with the TIVAS.[20] As Figure 1 below illustrates, the rate of increase was greatest in the first two years of the new contract system.[21] While the number of complaints fell slightly in FY 2013 compared to the previous year, the ongoing level of complaints remains significantly higher than before the advent of the current system.[22]

Figure 1



20 *See* FSA, Annual Report 2013, p. 73; FSA, Annual Report 2010, p. 55.

21 *See* FSA, Annual Report 2010, p. 55 (noting increase in complaint volume over previous year of 25 percent FY 2009 and 28 percent for FY 2010, compared to only 9 percent for FY 2008).

22 *See* FSA, Annual Report 2013, p. 73; FSA, Annual Report 2010, p. 55.

Moreover, a substantial portion of the increase is attributable to complaints about the TIVAS and NFPs. Disputes with servicers, which accounted for just over nine percent of all complaints in 2009, grew to more than 20 percent of all complaints in 2012.[23] The most common subjects of borrower complaints in the most recent reporting period (FY 2013) were,

- Disputes about account balances, interest accrual or application of payments;
- Requests for assistance with repayment plans;
- Requests for loan cancellation or discharge;
- Disputes or inquiries about the default status of loans;
- Disputes or concerns about credit reporting.[24]

Further evidence of borrower dissatisfaction comes from the Consumer Finance Protection Bureau (CFPB) – Student Loan Ombudsman's Office, which has reported widespread complaints directed at loan servicers. Grievances include problems with adjustment of repayment terms for borrowers experiencing financial hardship, processing and application of payments, difficulty accessing payment histories and payoff information, confusion arising when loan accounts are transferred from one servicer to another, and questionable debt collection practices.[25] There have also been problems with improper treatment of military personnel, for whom the DL program provides special protections and allowances.[26]

Many complaints concern the application of loan repayments. In particular, borrowers making payments greater than the minimum amount due have reported uncertainty as to how the additional amounts were allocated. One motive for making extra payments is to reduce outstanding principle balances and lower accrued interest over the life of the loan. The magnitude of the reduction, however, can depend on how a servicer allocates the additional payments. For instance, dividing a prepayment equally among all outstanding loans, regardless of interest rate, will be less advantageous to the borrower than applying the full amount to the loan with the highest interest rate.[27]

Servicers, however, may be allocating prepayments based on a method that is sub-optimal for borrowers. For instance, the allocation of a prepayment across all active loans might match the revenue maximizing objectives of the TIVAS and NFPs, even though such practices impose an interest cost for the borrower. The lack of transparency sows distrust. In an investigation of unfair and deceptive student loan-servicing practices, the FDIC concluded that Sallie Mae "[i]nadequately disclos[ed] its payment allocation methodologies to borrowers while allocating borrowers' payments across multiple loans in a manner that maximizes late fees."[28]

While the CFPB Ombudsman's report addresses the private student loan market,[29] it is significant that the majority of all complaints received by that office in 2013 concerned two servicers, Sallie Mae and AES/PHEAA, which are also two of the TIVAS under the DL program.[30] Sallie Mae accounted for the most complaints, 49 percent of the total, followed by AES/PHEAA, with 11 percent of the total.[31]

A question is whether these problems are induced by structural flaws and conflicts of interest inherent in the public-private system. To answer the question one must examine the contract language.

---

23 FSA, Annual Report 2012, p. 70. The 2013 FSA Annual Report does not provide a similar breakdown of borrower complaint types. In its 2012 Annual Report, FSA suggested that "Borrowers faced with difficulty repaying their student loans appear to be choosing to dispute the amount owed – the way interest was calculated or the addition of collection costs and other fees – as an initial step in managing their debt." Id.

24 FSA, Annual Report 2013, p. 74. Despite the slight decline in the total number of complaints received in FY 2013, the number of complaints about credit reporting increased during the same period. As a result, credit reporting issues rose from 10th to fifth place on the list of most commonly reported problems.

25 Annual Report of the CFPB Student Loan Ombudsman, p. 7 (Oct. 16, 2013).

26 Id. Depending upon factors such as length and type of service, military personnel can be eligible for a range of options for reducing debt payment. Provisions can include loan forgiveness, principal reduction and an interest rate cap. Military families have complained that loan servicers have not provided adequate information and assistance for these benefits. Hollister Petraeus and Rohit Chopra, "The Next Front? Student Loan Servicing and the Cost to Our Men and Women in Uniform." Consumer Financial Protection Bureau (Oct. 18, 2012).

The federal government recently settled claims against Sallie Mae (the largest servicer under both the DL and FFEL programs) over its treatment of servicemembers. *See* Justice Department Reaches $60 Million Settlement with Sallie Mae to Resolve Allegations of Charging Military Servicemembers Excessive Rates on Student Loans (May 13, 2014) http://www.justice.gov/opa/pr/2014/May/14-ag-502.html; FDIC Announces Settlement with Sallie Mae for Unfair and Deceptive Practices and Violations of the Servicemembers Civil Relief Act (May 13, 2014) http://www.fdic.gov/news/news/press/2014/pr14033.html.

27 CFPB Student Loan Ombudsman, 2013 Annual Report, p. 10–11.

28 FDIC Announces Settlement with Sallie Mae for Unfair and Deceptive Practices and Violations of the Servicemembers Civil Relief Act (May 13, 2014) http://www.fdic.gov/news/news/press/2014/pr14033.html.

29 Under a new regulation adopted at the end of last year, the CFPB will now also oversee "larger participants of the student loan servicing market." CFPB, Final Rule, Defining Larger Participants in the Student Loan Servicing Market, 78 FR 73383, 73384 (Dec. 6, 2013) (defining the loan-servicing market to encompass both federal and private student loans, and "larger participants" as those with loan-servicing account volumes exceeding one million). This category includes all of the TIVAS plus the largest NFPs. Id. at 73396.

30 As previously noted, PHEAA services federal loans through its FedLoan Servicing unit and non-federal loans through its AES unit.

31 *See* CFPB Student Loan Ombudsman, 2013 Annual Report, p. 7.

2.2 Contract Terms: Performance-Based Payments and Allocation of Servicing Volume

To some extent, the terms of the loan-servicing contracts reflect the exigencies surrounding the rapid expansion of the government's student loan portfolio resulting from the acquisition of outstanding FFEL debt and the shift to an exclusive DL program. The original contract asked for services of "indefinite delivery, indefinite quantity," which gave FSA flexibility to adjust the nature and volume of loan services over the life of the contracts.

Despite the urgency of the moment for loan-servicing capacity and the open-ended terms for indefinite delivery-indefinite quantity, the contracts did include provisions that were designed to encourage efficient and responsive loan servicer behavior. Two key "performance-based"[32] mechanisms are discussed below: (1) the payment schedule, and (2) the rules for allocating new loan accounts.

2.2.1 Performance-Based Payment

Under their contracts with FSA, the TIVAS and NFPs are reimbursed based on status of the loan accounts they service (see Table 1 below). Payments are highest, $1.90 per month, for accounts in current repayment or a grace period.[33] As accounts fall further into delinquency, the monthly payment is incrementally reduced, from $1.62 to as low as $0.50 per month. For loans in deferment (postponement based on certain circumstances such as military service) or forbearance (suspended or reduced repayment based on financial hardship) the rate is $1.74 per month.

Table 1: Common Pricing Schedule

Borrower Status	*Monthly Unit Price*
In School	$1.05
Grace Period or Current Repayment	$1.90
Deferment or Forbearance	$1.73
31–90 Days Delinquent	$1.62
91–150 Days Delinquent	$1.50
151–270 Days Delinquent	$1.37
270+ Days Delinquent	$0.50

By design, this rate schedule is intended to give servicers an incentive to keep loan repayments current and to work with borrowers who experience financial difficulties that might lead to delinquency or default.[34] At the same time, the fixed payment rates force the TIVAS and NFPs to be efficient by placing a ceiling on operational expenses.

2.2.2 Performance-Based Account Allocation

The method for allocating new loan accounts is the second mechanism by which the contracts attempt to encourage loan servicers to fulfill program goals. Under this approach, FSA evaluates servicers based on five performance metrics:

1. **Defaulted Loan Volume**. Measured as a percentage of the servicer's portfolio;
2. **Defaulted Borrowers**. Measured as a percentage of all borrowers in the servicer's portfolio;
3. **Borrower Satisfaction**. Measured by surveys of borrowers;
4. **School Satisfaction**. Measured by surveys of post-secondary schools;
5. **FSA Satisfaction**. Measured by surveys of FSA personnel.[35]

---

32 The term "performance-based" refers to incentives in the contract system that rewards desirable outcomes or punishes undesirable outcomes.

33 Accounts can enter a grace period up to six months after a borrower is no longer enrolled in at least half-time study.

34 Once an account is more than 360 days delinquent, it is supposed to be reassigned to a private collection agency. However, these reassignments do not always occur promptly, thus enabling loan servicers to continue earning fees (at the $.50/month rate for delinquencies of 270 days or more) on accounts beyond the 360-day default limit. *See* Memorandum from Patrick J. Howard, OIG, to James W. Runcie, FSA, Subject: Debt Management Collection System, p. 2 (December 13, 2012).

35 *See* Contract, Attachment A-4. Rohit Chopra, Explainer: Scoring Student Loan Servicers (Sept. 23, 2013) http://www.consumerfinance.gov/blog/scoring-student-loan-servicers/.

FSA conducts quarterly performance assessments, ranking each servicer on the five performance metrics. In each category, the lowest-ranking servicer receives a score of "1" while the highest-ranking receives a score equal to the total number of servicers. The five performance metrics are weighted equally. Quarterly results are averaged to yield annual performance rankings. New loan accounts are then allocated among servicers based on their relative annual performance scores, as illustrated in Table 2.

Table 2: Performance Measures

SERVICER	*(1)*	*(2)*	*(3)*	*(4)*	*(5)*	*Sum*
Nelnet	4	4	3	2	2	15
FedLoan Svcg.	2	2	2	3	4	13
Great Lakes	1	1	4	4	3	13
Sallie Mae	3	3	1	1	1	9

Based on Chopra, Scoring Student Loan Servicers.

In this example, the aggregate of all scores is 50. New loan volume would thus be allocated as indicated in Table 3.

Table 3

SERVICER	ALLOCATION
Nelnet	15/50 = 30%
FedLoan Svcg.	13/50 = 26%
Great Lakes	13/50 = 26%
Sallie Mae	9/50 = 18%

2.3 Contractual Incentives Are Poorly Aligned With Program Goals

Problems with government outsourcing can often be traced to the incentives created by contract terms. It is a safe bet that contractors will endeavor to reap the greatest net profit by maximizing the revenue they receive while minimizing operational costs. These two components to profit, revenue maximization and cost minimization, are in constant tension. A question for any public-private contract is whether the structured incentives balance these components in alignment with the social goals of the program.

Contractors making operational decisions consider potential revenues against the expenses necessary to receive those revenues. For loan servicing, if the added costs of providing responsive loan servicing are below the anticipated increase in revenue, then one can assume that rational TIVAS or NFPs seeking to maximize profit or net revenue would choose to adopt a high-quality, responsive loan-servicing model. If, on the other hand, the costs of creating a responsive loan-servicing system exceed the anticipated revenue gain, contractors would choose to forgo the expense, and service quality will suffer.

Service quality is primarily a function of human capital (i.e. skill) and effort. A highly skilled and conscientious workforce, spending the time necessary to communicate with borrowers and help them navigate loan repayment options appropriate to their particular circumstances (e.g. hardship deferrals, income-based repayment, loan restructuring) will provide better service than a lower skilled workforce limiting their activities to routine payment-processing tasks. The high-quality model, in which loan-servicing agents are responsive to borrowers, will thus entail higher labor expenses, in terms of both time and compensation, than the low-quality model.

As described, the performance-based contracts governing the relationship between FSA and the TIVAS and NFPs attempt to create incentives for responsible loan-servicing practices by means of a graduated fee schedule and competition for new loan accounts (and thus new revenue opportunities). Under these terms, servicers stand to lose revenue when student borrowers fall behind on payments, when loans enter default, or when borrowers, post-secondary schools and FSA staff give a servicer comparably poor evaluations.

Are these contractual provisions sufficient to encourage TIVAS and NFPs to take preventative measures that keep borrowers current? How effective are these mechanisms compared against the incentives inherent in all employment relations to drive down labor costs? To explore these questions, the weight of the two competing types of incentives – to reach for greater revenues and to minimize operational costs – must be compared.

Tension between the incentives is evident in the contract terms. The payment schedule (Table 1) provides a fixed monthly payment to the TIVAS and NFPs based on loan account status, which imposes hard cost-containment pressures on the TIVAS and NFPs. And as mentioned, the most direct and effective way to lower costs is by hiring less skilled employees and then instructing them to minimize the time spent assisting borrowers. On the other hand, the payment schedule remunerates the TIVAS and NFPs on a graduated scale featuring higher rewards when loan accounts avoid delinquency. To the extent that the TIVAS and NFPs can reduce loan account delinquency rates through superior service, TIVAS and NFPs receive greater immediate revenue and a larger share of future loan account volume.

So which incentive prevails, cost containment or responsive service? The volume and nature of borrower complaints indicates that cost minimization is the dominant profit-maximizing strategy. A hypothetical scenario using the graduated payment schedule illustrates why this is likely the case.

> "So which incentive prevails, cost containment or responsive service? The volume and nature of borrower complaints indicates that cost minimization is the dominant profit-maximizing strategy."

The graduated payment schedule is designed to reward TIVAS and NFPs that work to keep accounts current and to penalize them when accounts become delinquent. But the penalty for allowing an account to slide into delinquency is small: the difference in monthly payment for a current account ($1.90 per month) versus an account 31 to 60 days delinquent ($1.62 per month); a mere $0.28; even at the lowest payment rate of $0.50 for loans more than 270 days delinquent, the marginal loss to the loan servicer is only $1.40 per month.

On the other side of the ledger, consider the expense of the intervention.[36] Assume that the contractor's average labor cost for a loan-servicing professional is $20.00/hour, and that it takes an average of 30 minutes for her to contact a borrower and arrange for a loan restructure or other appropriate repayment alternative. If an account is 31–60 days delinquent, and a single 30-minute call is sufficient to bring and keep that account current, the intervention would cost the contractor $10. For this expense, the contractor gains an extra $0.28 per month in revenue. Under these simple assumptions, it would take more than 35 months for the servicer to recoup the cost of intervention.[37]

However, intervention is not always necessary or effective. The TIVAS and NFPs are aware that some borrowers will bring their accounts current without any intervention. Similarly, despite the best efforts by a TIVAS and NFP, some delinquent accounts will remain delinquent. If a loan-servicing agent cannot distinguish self-correcting and uncorrectable delinquent accounts from accounts that would benefit from intervention, the return due to the intervention declines dramatically.

Continuing the hypothetical, assume that half of all delinquent accounts self-correct and that half of all interventions into delinquent account will fail. This would mean that intervention by the TIVAS or NFP is both necessary and effective for only 25 percent of delinquent loans. Under these assumptions, the payout for a proactive loan-servicing agent is reduced by a factor of four. It would take 140 months (longer than the standard 10-year repayment term under the DL program[38]) of current and uninterrupted loan payments to recoup the cost of a single, 30-minute intervention on an account 31–60 days delinquent.[39]
The hypothetical illustrates the weak incentives in the graduated payment schedule. Incremental reductions in monthly revenue for delinquent accounts are almost certainly insufficient to offset incremental expenses of monitoring at-risk loans and providing proactive assistance to borrowers with delinquent loans.

The rules for distributing new accounts are the other mechanism designed to motivate responsive service. TIVAS and NFPs are periodically assessed, and superior performing TIVAS and NFPs are rewarded with a larger share of new accounts. This "managed competition" design relies on objective (the percentage of loan volume and individual borrowers in default) and subjective (stakeholder satisfaction surveys) performance measures. Accepting these measures as valid, the issue is whether the lure of future account volume is a sufficient incentive for TIVAS or NFPs to invest in quality service.

---

36 For this, we have to rely on unverified assumptions. Despite our requests, we were unable to obtain information on student loan servicers' labor and other operating costs. Absent more precise figures, we can only provide estimates based on what we believe to be conservative assumptions.

37 ($20 * 0.5 hours)/$0.28=35.7. For an account more than 270 days delinquent, on which the rate reduction is $1.40, it would still take more than seven months to recoup the cost of a single 30-minute phone call. ($20 * 0.5 hours)/$1.40 = 7.1.

38 *See* FSA's summary of repayment plan options at http://www2.ed.gov/offices/OSFAP/DirectLoan/RepayCalc/dlindex2.html.

39 In effect, a 50 percent self-correction rate cuts the expected payoff for each intervention by half, and a 50 percent efficacy rate reduces the expected payoff by another half. ($20 * 0.5 hours)/($0.28 * 0.5 * 0.5) = 142.9.

Early on, the power of this mechanism was diluted by the privileged status of NFPs. Until 2014, NFPs were guaranteed allocations of new accounts, which greatly reduced the volume of new accounts for distribution to the TIVAS.

The NFPs no longer enjoy this advantage. However, there remains a feature of the allocation scheme that blunts the power of this mechanism. Specifically, the allocation formula (Tables 2 and 3) distributes new accounts based on the relative performance of TIVAS and NFPs. There are no minimum benchmarks to be met to remain in good standing. The five-item performance measure nearly guarantees some share of new accounts for even the very worst TIVAS and NFPs. While the worst performers will receive fewer accounts, they may (as previously discussed) conclude that reduced operating expenses offset the forgone additional revenue, resulting in greater net revenue. Without a threat of replacement, the roster of TIVAS and NFPs could all pursue a low-cost service model with little risk.

Incentives to pursue a low-cost service model, by comparison, are strong. The TIVAS and NFPs only realize a profit when their average monthly per account reimbursements exceed their average monthly per-account expenses. The TIVAS and NFPs therefore have little choice; the hard cap on account reimbursement rates (Table 1) drives them to limit operating costs.

Expense reduction thus stands out as the dominant structural incentive; the graduated payment system and new loan account allocation scheme are weak offsets to the rewards for minimizing costs. TIVAS or NFPs can aggressively cut operating expenses, provide abysmal service, and risk only marginal losses in current and prospective revenues.[40] Pressure to be cost-conscious far outweighs the consequences for borrower neglect.

3 Improving the Loan-Servicing System

In this closing section we discuss two non-mutually exclusive ideas for improving FSA loan servicing. The first is to upgrade contractor monitoring. The second is to augment competitive pressure on the TIVAS and NFPs by establishing a public loan-servicing unit that would compete for loan accounts.

3.1 Stricter Monitoring of Contractor Performance

One commonly offered solution to poor contractor performance is stricter monitoring. The problem with this solution is that monitoring is time-intensive and administratively expensive.

In December 2011, the Office of Inspector General (OIG) released an Ernst & Young consulting report, "Title IV Additional Servicers Capacity Assessment."[41] In a memorandum to FSA summarizing the Ernst & Young report, OIG Auditor Patrick Howard discusses the tasks involved in monitoring contactor performance:

> The Contract Monitoring Directive, Section VII.H, states that the COR [contracting officer's representative] must ensure that invoices reflect the agreed-on price for completed and accepted work. To accomplish this, the CORs verify that the invoice subtotals are accurate and equal the total. In addition, the Contract Monitoring Directive, Section VII.L, states that detailed record-keeping is necessary to keep an up-to-date history of the life of a project despite changes in staff. Detailed record-keeping of activities, such as math verifying invoices and accepting deliverables, provides a mechanism for analysis by future reviewers and auditors. In addition, the COR appointment memorandum lists the COR's responsibilities and is signed by the COR, CO, and TIVAS. It states that the COR is required to monitor and ensure that the contractor meets the technical requirements of the contract by inspecting and testing deliverables and evaluating reports.[42]

Invoice verification, detailed record-keeping and inspecting and testing deliverables and evaluating reports are not tasks that can easily be delegated to third parties. In all likelihood, FSA officials must perform these tasks. Stricter monitoring escalates the cost of maintaining a contract system, but without that expense, FSA risks major billing inaccuracies. Once again, citing the Ernst and Young report, the memo states:

> Because the CORs did not sufficiently validate the accuracy of invoices that we sampled, there is a heightened risk of improper payments for the $337,363,472 paid to the TIVAS during our audit period.[43]

---

40 One test is to examine operational profit with regard to performance. If inattentive TIVAS and NFPs earn higher profits than their responsive counterparts, it would indicate that the system rationalizes the low-cost strategy.

41 ED-OIG/S15L0001.

42 Patrick J. Howard, OIG, to James W. Runcie, FSA, Federal Student Aid Paid Private Collection Agencies Based on Estimates. Memorandum (May 15, 2013), p. 8.

43 Patrick J. Howard, OIG, to James W. Runcie, FSA, Federal Student Aid Paid Private Collection Agencies Based on Estimates. Memorandum (May 15, 2013), p. 9.

FSA has taken steps to improve the oversight of TIVAS and NFPs. In response to borrower complaints, FSA established the Servicer Monitoring Group in October 2012. Moreover, under recently adopted regulations, the CFPB will now oversee the TIVAS and larger NFPs. A more robust approach to monitoring should improve contractor responsiveness and billing accuracies, but in doing so FSA will certainly incur greater administrative costs. All principal-agent relationships face this dilemma.

3.2 Competition From a Public Loan-Servicing Unit

A second, less expensive option is to increase the competitive pressure on TIVAS and NFPs by establishing a public loan-servicing unit. The public agent can compete on the same basis as private providers, preserving and enhancing the "managed competition" model.

"Adding a public loan-servicing unit, with the potential to replace existing contractors, should motivate TIVAS and NFPs to be more attentive to borrowers."

Once a suitable public agent is found, an initial set of accounts can be allocated to the public agent from a randomly drawn cohort of accounts held by existing TIVAS and NFPs. Afterward, the capacity for the public servicing agent to grow will depend on the same performance metrics used to assess and allocate accounts among the TIVAS and NFPs. If the public agent does well, capacity can grow incrementally to absorb accounts from the poorer performing TIVAS and NFPs.

The goal is for the public servicing agent to serve as a credible threat that induces responsible behavior by TIVAS and NFPs. In time, the public loan-servicing unit may even replace the worst performing TIVAS and NFPs. As discussed, competitive pressure for the TIVAS and NFPs to be responsive to borrowers is weak compared to the contrary cost-containment incentives inherent in the remuneration schedule. Adding a public loan-servicing unit, with the potential to replace existing contractors, should motivate TIVAS and NFPs to be more attentive to borrowers.

Furthermore, the present system lacks "public" standards for satisfactory performance, which a new public unit will provide. Currently, the TIVAS and NFPs are judged solely on their relative performance compared to one another. A public loan-servicing unit, with a mandate to prioritize attentive and responsible service over revenue maximization, can set baseline quality standards against which to gauge the performance of private TIVAS and NFPs.

3.2.1 Precedent for Public Loan Servicing

The idea of a federal loan-servicing unit is not novel. The United States Department of Agriculture issues and services direct loans to farmers through the Farm Service Agency.[44] Like the former situation with student loans, federal assistance to farmers can come as either direct loans or guarantees to support commercial lending. Direct loans are reserved for farms that are considered risky by commercial lenders, such as in the case of new farms, or to support historically disadvantaged borrowers or regions.[45]

Farm loans are quite different from student loans. The average farm loan is around $75,000 compared with an average student loan of around $20,000.[46] Farm loans frequently deal with seasonal cash flow shortages and are thus short-term as opposed to longer term student loans. By financing businesses, farm loans are easier to collateralize than student loans. Differences between the two loan types make it inappropriate to use the Farm Service Agency's performance to project the success of a public student loan-servicing unit.

Nonetheless, the experience of the Farm Service Agency stands as an example of a federal agency directly servicing loans. Data for October 2013 indicate that for farm operating loans, delinquencies amounted to 13.72 percent of total loan accounts and 6.25 percent of total loan dollars. That a larger proportion of smaller loans were delinquent reflects the fact that the Farm Service Agency issues relatively risky farm loans to smaller start-up enterprises. The analogous figures for longer term farm ownership loans are 7.47 percent and 1.85 percent, respectively.

The point is not to imply that a public student loan-servicing unit will have similar outcomes. Instead, as an example of a federal agency directly engaged in loan servicing, the Farm Service Agency proves there is nothing inherent to the loan-servicing function that calls for private-sector expertise. It is by historic accident that student loans are currently serviced by private contractors.

---

44 To avoid confusion, we will refer to the Farm Service Agency by its full name, and reserve the acronym "FSA" for the Education Department's office of Federal Student Aid.

45 For a description, *see* Charles Dodson and Steven Koenig, Evaluating the Relative Effectiveness of the Farm Service Agency's Farm Loan Program, U.S. Dept. of Agriculture (August 2006).

46 Farm loan statistics based on October 2013 figures provided by the Farm Service Agency. Student loan statistics are based on the third quarter, 2013 National Student Loan Data System.

3.2.2 Establishing a Public Student Loan-Servicing Unit

An important consideration in establishing a public loan-servicing unit is choosing an appropriate federal agency to assume this function. One option is to add this role to FSA's existing responsibilities under the student loan program. Alternatively, this role can be assigned to a different federal agency, in the interest of transparency and efficiency. Under that second option, three possible candidates would be the Treasury Department, the Internal Revenue Service and the U.S. Postal Service.

Following the example of the farm loan program, under which the Farm Service Agency both originates and services loans, the Department of Education could directly service loans it originates through FSA. That arrangement would have the advantage of leveraging FSA's expertise and existing resources as the agency already responsible for administering and overseeing the federal student loan program.

Alternatively, it may be preferable to separate the public loan-servicing function from other program administration and oversight functions, by assigning the loan-servicing function to a different federal agency. Doing so would place the public unit on more of an even footing with the private TIVAS and NFPs with regard to performance evaluation, oversight and accountability. It could also take advantage of the resources and experience of other agencies whose operations lend themselves to the loan-servicing role.

"Locating a public student loan-servicing unit within the USPS makes sense given its accessibility to student borrowers, its experience and resources for handling large numbers of consumer transactions, and its history of providing diverse services in the interest of national economic stability."

One candidate in this regard is the U.S. Treasury Department. It is the Treasury Department that provides the capital from which FSA makes loans available and to which servicers remit payments received from borrowers. Having Treasury itself service those loans could yield efficiencies by reducing the intermediating transactions between student borrowers and the Treasury as ultimate creditor.

Another candidate is the Internal Revenue Service, which already collects and processes payments from millions of Americans. Assigning the loan-servicing function to the IRS would take advantage of its existing resources and capacity, which would likely yield administrative efficiencies over establishing an entirely new infrastructure within FSA. In addition, for student borrowers who are employed, the IRS could collect loan payments through payroll withholding, as it does for income and payroll taxes. That option may be especially well-suited to borrowers who are availing themselves of the income-based repayment option.

A third candidate is the U.S. Postal Service (USPS). Locating a public student loan-servicing unit within the USPS makes sense given its accessibility to student borrowers, its experience and resources for handling large numbers of consumer transactions, and its history of providing diverse services in the interest of national economic stability.

Founded in 1775, with the mission of providing a national communication network to unify the states, spur commerce and advance democracy, the post office has always served as an important institution for national growth. In keeping with its broad charter to promote economic growth and facilitate democracy, the USPS has filled many roles beyond postal delivery.

For instance, to facilitate public discourse, educate voters and grow a free press, newspaper delivery was subsidized. Depending on the distance, sending a newspaper could be free or very low cost, especially when compared to the weight of a letter. To further support democratic participation, free mail privileges (a.k.a. franking) were granted to Congress, political officials and postmasters to encourage constituent communication.

The USPS has played a vital role in economic growth, particularly the creation of a national transportation infrastructure. Shipping mail by contract using horse-drawn coaches, trains, steamships, and eventually, airplanes, the postal service stabilized and supported each of these industries. Beginning in 1896, the postal service offered rural delivery to areas with road access, encouraging states to build roads and bridges. To ease citizen travel and further the movement of persons, the USPS began processing passport applications in 1972.

The USPS continues to promote economic growth by subsidizing commercial mail delivery. The practice of "worksharing" offers volume discounts for customers that presort, pre-barcode and drop-ship mail pieces. First class mail discounts were introduced in 1979, and parcel post discounts followed in 1991. It is estimated that over 80 percent of mail volume is now discounted.

In January 2014, the USPS Office of the Inspector General (USPS-OIG) proposed expanding the USPS into non-banking financial services.[47] The proposal points out that the USPS has a history of offering financial services dating back to 1911, when post offices served as savings depositories for low-income citizens and immigrants.[48] Following that spirit, the proposal is to use the USPS to assist people, especially in poor regions, who are underserved by existing financial institutions. For example, one suggestion is for the USPS to offer short-term credit to low-income citizens at interest rates well below the predatory rates of payday lenders.

Student loan servicing appears to overlap neatly with this recent USPS proposal, as well as fit within the historic public mandate of the USPS. Consistent with the intent behind the USPS white paper, responsive loan servicing improves education affordability and reduces debt burden upon graduation. Few policy directives are more promising for the economy and civil society than expanding access to post-secondary education.

The USPS is especially well-positioned to serve as public student loan-servicing agency. The USPS manages a vast network of retail offices, with many located on college and university campuses. Unlike the TIVAS and NFPs, the USPS could offer face-to-face counsel to borrowers. The USPS enjoys higher trust levels among the public than banks[49] and has personnel and infrastructure to assist borrowers with financial transactions.

In sum, adding loan servicing to USPS operations potentially brings more responsive loan servicing for student borrowers. Further study is required to map the extent that the existing USPS infrastructure can be leveraged for this role. Nonetheless, student loan servicing appears on its face to be consistent with the historic mission of the USPS to grow the economy and enhance civil society. This timely idea should be central to any contemporary USPS proposal to expand into non-banking financial areas.

---

47 U.S. Postal Service Office of Inspector General, Providing Non-Bank Financial Services for the Underserved (January 27, 2014). The Postmaster General has distanced himself from the Inspector General's report, *see* Kevin Wack, Architect of Postal Banking Proposal Speaks Out, American Banker (Mar. 28, 2014). We believe that having the Postal Service perform the public student loan-servicing function would be viable either in connection with or separate from a postal banking program.

48 Id., Appendix A.

49 Id., p. 6–7.

Glossary of Acronyms

ACS	ACS Education Solutions, LLC
CDR	Cohort Default Rate
CO	Contracting Officer
Contract Monitoring	U.S. Department of Education Directive OCFO [Office of the Chief Directive Financial Officer]: 2-108, Contract Monitoring for Program Officials
COR	Contracting Officer's Representative: title of someone within the Program Management Services Group within FSA
CPCS	Competitive Performance and Continuous Surveillance
Department	U.S. Department of Education
Direct Loan	William D. Ford Federal Direct Loan
DMCS	Debt Management Collection System
DMCS2	Debt Management and Collection System 2
FAR	Federal Acquisition Regulation
FFEL	Federal Family Education Loan
FSA	Federal Student Aid
Great Lakes	Great Lakes Educational Loan Services, Inc.
Nelnet	Nelnet Servicing, LLC
NFPs	Not-for-Profit Entities
NSLDS	National Student Loan Data System
OIG	Office of Inspector General
PBO	Performance-Based Organization
PCAs	Private Collection Agencies
PHEAA	Pennsylvania Higher Education Assistance Agency
Sallie Mae	SLM Corporation
SF 30	Standard Form 30, "Amendment of Solicitation/Modification of Contract"
Title IV	Title IV of the Higher Education Act of 1965, as amended
TIVAS	Title IV Additional Servicers: private contractors servicing student debt