



UNITED STATES DEPARTMENT OF EDUCATION
OFFICE OF INSPECTOR GENERAL

AUDIT SERVICES

December 13, 2012

FINAL ALERT MEMORANDUM

To: James W. Runcie
Chief Operating Officer
Federal Student Aid

From: Patrick J. Howard /s/
Assistant Inspector General for Audit

Subject: Debt Management Collection System 2
Control Number ED-OIG/L02M0008

The purpose of this final alert memorandum is to inform you of our concerns with issues surrounding the inability of the Debt Management Collection System 2 (DMCS2) to accept transfer of defaulted student loans from Federal Student Aid (FSA) loan servicers. Since October 2011 when DMCS2 was implemented, the Title IV Additional Servicers (TIVAS) and ACS Education Solutions, LLC (ACS) have accumulated more than \$1.1 billion in defaulted student loans that should be transferred to the U.S. Department of Education (Department) for management and collection.¹ DMCS2 has been unable to accept transfer of these loans and, as a result, the Department is not pursuing collection remedies and borrowers are unable to take steps to remove their loans from default status. On October 11, 2012, FSA's Federal Managers' Financial Integrity Act of 1982 assurance letter acknowledged some of the issues we identify in this alert memorandum, but it did not offer specific solutions. The inability of DMCS2 to accept these transfers also contributed to a material weakness in internal control over financial reporting that was identified in the audit of FSA's FY 2012 financial statements (ED-OIG/A17M0002). Based on our interaction with FSA officials to date, FSA has yet to implement effective corrective action to bring these affected loans into collection and correct the problems with DMCS2.

We became aware of these issues during our audit of FSA's award and administration of the TIVAS contracts (ED-OIG/A02L0006), which covers January 1, 2009, through

¹ The TIVAS and ACS service loans under the Federal Family Education Loan Program and the William D. Ford Federal Direct Loan Program on behalf of the Department. Xerox Corporation acquired ACS in February 2010 and changed the ACS name to Xerox Education Solutions, LLC, in April 2012.

September 30, 2011.² During the June 4–8, 2012, site visit at two of the TIVAS, Great Lakes Educational Loan Services, Inc. (Great Lakes) and Nelnet Servicing, LLC (Nelnet), we learned that some defaulted loans transferred to DMCS2 were rejected. FSA officials confirmed that this problem was also occurring with loans serviced by the other two TIVAS, Pennsylvania Higher Education Assistance Agency (PHEAA) and SLM Corporation (Sallie Mae), and by ACS.

Officials at the two TIVAS we visited stated that DMCS2 encountered problems receiving loan files for loans that previously defaulted, loans that were missing identification codes, and loans that were held by a borrower with more than one defaulted loan. FSA officials informed us that a larger problem existed with loans serviced by ACS. DMCS2 is unable to accept transfers of more than \$1 billion in loans that had redefaulted after being transferred to ACS for servicing.

Table 1 illustrates the volume and dollar amount of defaulted loans awaiting transfer to DMCS2.

Table 1: Defaulted Loans Awaiting Transfer Because of DMCS2 Problems

Servicer	Loans	Amount
Great Lakes	11,660	\$49,372,337
Nelnet	4,575	\$18,571,464
PHEAA	3,915	\$17,510,933
Sallie Mae	2,936	\$9,182,479
Subtotal	23,086	\$94,637,213
ACS	167,310	\$1,013,500,741
Total	190,396	\$1,108,137,954

Note: Great Lakes and Nelnet provided their data to the Office of Inspector General as of August 31, 2012, and September 4, 2012, respectively. PHEAA and Sallie Mae provided their data to the Department as of July 31, 2012. ACS provided its data to the Department as of September 12, 2012.

The problem of transferring loans from the TIVAS to DMCS2 became apparent in October 2011 when FSA migrated to the new DMCS2 system. On November 20, 2003, the Department and ACS entered into a contract to service loans, which also included the requirement to perform default management using the original Debt Management Collection System (DMCS). On June 30, 2010, ACS agreed to update DMCS to DMCS2 to include specific baseline functional system requirements, as specified in a contract modification. When the contract expires as planned on December 31, 2013, FSA will take ownership of DMCS2. Great Lakes and Nelnet officials provided us the timeline of the testing and implementation of DMCS2. Great Lakes officials stated that the Department originally planned to implement DMCS2 in October 2010 and FSA documentation states no later than January 1, 2011. That timeframe was significantly delayed. ACS did not test the transfer of defaulted loans to DMCS2 until January 2011. An FSA official stated that ACS did not test DMCS2 through the full life cycle of a defaulted loan. In March 2011, at least one TIVAS began transitioning its defaulted loan records to a new file format compatible with DMCS2. In September 2011, FSA stopped the transfer of defaulted loans between the TIVAS and DMCS in order to begin migrating files to DMCS2. On October 6, 2011, which was 9 months to a year after the planned launch date, DMCS2 went

² The objectives of our audit are to determine whether (1) FSA selected TIVAS servicing prices that are the most efficient and cost-effective for the Government and (2) FSA adequately monitored the TIVAS to determine their compliance with the contract requirements.

“live” (was placed into production) and the TIVAS started transferring defaulted loans and receiving responses from the system that some loans were rejected.

The Department’s servicing contracts require the TIVAS to transfer loans to DMCS2 when the loans reach 360 days of delinquency. If a loan cannot be transferred through no fault of the TIVAS, FSA pays the TIVAS \$0.50 per borrower per month for continued servicing. However, the TIVAS are limited in their ability to actively service defaulted loans. Although the TIVAS can accept payments on defaulted loans, they cannot perform collection activities or advise borrowers on ways to remove their loans from default status. After a loan is transferred to DMCS2, the Department or an entity acting on its behalf (such as a collection agency) may pursue collection of the loan through a number of activities. For example, the Department can request offset or withholding of the borrower’s Federal income tax refund and garnish the borrower’s wages. If a loan is not transferred, the Department cannot undertake collection activities. The inability to transfer defaulted loans also affects borrowers, as they are unable to pursue options to remedy default, such as rehabilitation, that are offered to borrowers with loans transferred to DMCS2. To rehabilitate a loan, a borrower makes 9 timely payments during 10 consecutive months on an eligible loan that has not been previously rehabilitated.

During our site visits to Great Lakes and Nelnet in June 2012 for our audit of FSA’s award and administration of the TIVAS contracts, TIVAS officials told us that defaulted loans were rejected by DMCS2 in the following instances:

1. Loans that had defaulted were initially assigned to DMCS and rehabilitated, then assigned to a servicer for normal servicing, but then defaulted again. The TIVAS officials called these “redefaulted loans” and stated that they comprise a majority of the rejected loans. They stated that these loans are rejected by DMCS2 because DMCS2 already has a record of the loan. TIVAS officials stated that neither FSA nor ACS have offered a solution to this problem.
2. Loans that were missing a guaranty agency identification code. The loan files for loans that do not have a guaranty agency assigned to them do not include this identification code. Great Lakes and Nelnet officials stated that they were instructed to transfer these types of loan files to DMCS2 with either a zero or a blank in the appropriate field. Even though Great Lakes and Nelnet followed the instructions, these loan files were rejected. Nelnet officials stated that they identified this problem in May 2011. Officials at both Great Lakes and Nelnet stated that it is still unresolved.
3. Loans held by a borrower with more than one defaulted loan. The system interprets additional loans held by the same borrower as duplicates and rejects them. FSA offered a solution to Great Lakes and Nelnet that requires resubmitting these loans to DMCS2. Great Lakes and Nelnet officials have started this process and are awaiting a response on the outcome.

In addition to problems with transfers to DMCS2, problems with transferring loans from DMCS2 to the TIVAS were identified. If a borrower rehabilitated a loan residing on DMCS2, the system could not transfer the loan to a TIVAS to resume normal repayment servicing. FSA officials acknowledged that there were loans affected by this problem.

Great Lakes officials identified a related problem that DMCS2 did not always permit a TIVAS to recall a loan transferred to DMCS2 if the TIVAS subsequently received documentation proving that the loan is not in default, such as when a borrower is deceased or received a loan deferment. These borrowers may have been adversely affected by collection activities, such as income tax withholding and administrative wage garnishment, because their loans were transferred to DMCS2 and could not be recalled.

Recommendations

We recommend that the Chief Operating Officer for FSA:

- 1.1 Identify each problem related to DMCS2 loan transfers, the source of each problem, and the entire population of loans adversely affected.
- 1.2 Establish milestone dates for resolving the cause of each identified problem related to DMCS2 loan transfers.
- 1.3 Establish temporary workarounds as necessary for all identified DMCS2 problems until permanent solutions are implemented.
- 1.4 Determine whether DMCS2 can become a fully operational system that will meet all of the baseline functional system requirements. If the system will not meet all of the functional requirements, develop a plan to address the deficiencies or determine whether to obtain a replacement debt management system.
- 1.5 Identify and pursue all available contractual remedies with ACS for ineffective DMCS2 functionality.

FSA Comments

We provided a draft of this alert memorandum to FSA for comment. In its response dated November 14, 2012, FSA agreed that the issues we raised are significant. FSA stated it has addressed each recommendation. By the end of December 2012, FSA expects corrective actions to be implemented that will address the three instances of defaulted loans being rejected by DMCS2 that are noted in this alert memorandum. For Recommendation 1.1, FSA stated it identified each problem related to DMCS2 loan transfers and each population of affected borrowers. FSA will monitor to ensure that corrective actions address the population of affected borrowers. In response to Recommendation 1.2, FSA stated it established and will monitor milestone dates for the resolution of the root causes of the DMCS2 problems. FSA stated that for Recommendation 1.3, it deployed “borrower relief” initiatives for affected individuals, which included manual workarounds. For Recommendation 1.4, FSA stated that as of October 31, 2012, more than 90 percent of “key system functionality is fully or partially validated and in production” and that it would address any unresolved issues with ACS or a new contractor following the expiration of the ACS contract. For Recommendation 1.5, FSA stated it has “pursued and will continue to pursue appropriate remedial contract actions” with ACS.

In addition, FSA provided comments on the body of the draft alert memorandum regarding statements it found to be inaccurate or incomplete. Specifically, FSA commented on the dates of

its testing and implementation of DMCS2, credit bureau reporting, and eligibility for loan rehabilitation. FSA also stated that it resolved the problems with transferring and recalling loans from DMCS2 to the TIVAS in spring 2012 and June 2012, respectively.

We included FSA's comments in their entirety as an attachment to this memorandum.

OIG Response

We considered FSA's comments to be responsive to our recommendations. However, FSA described many of its corrective actions as still in progress or the subject of future activity. FSA also did not provide documentation to support the actions it stated have been completed. Therefore, to ensure proper tracking and completion of corrective action, we have not modified our recommendations.

We made minor revisions in response to FSA's comments on the body of the memorandum. Specifically, we agreed with FSA's correction that the TIVAS can report a borrower's default status to credit bureaus, and we modified our memorandum accordingly. We also clarified that borrowers can rehabilitate a loan only once. However, we did not modify the report in response to FSA comments that the testing and implementation dates of DMCS2 noted in the alert memorandum were incorrect. The documentation and testimonial information we obtained support the dates listed in this memorandum. Finally, because FSA did not provide evidence that it resolved the problems related to transferring and recalling loans from DMCS2 to the TIVAS in spring 2012 and June 2012, we did not revise our final memorandum.

Corrective actions proposed (resolution phase) and implemented (closure phase) by your office will be monitored and tracked through the Department's Audit Accountability and Resolution Tracking System.

This alert memorandum issued by the Office of Inspector General will be made available to members of the press and the general public to the extent information contained in the memorandum is not subject to exemptions in the Freedom of Information Act (5 U.S.C. § 552).

We conducted our work in accordance with the Office of Inspector General quality standards for alert memorandums.

For further information, please contact Daniel P. Schultz, Regional Inspector General for Audit at (646) 428-3888.

cc: David A. Bergeron, Acting Assistant Secretary, Office of Postsecondary Education
Philip H. Rosenfelt, Acting General Counsel, Office of the General Counsel
Janie Funkhouser, Audit Liaison Officer, Office of Postsecondary Education
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ATTACHMENT



NOV 14 2012

TO: Daniel P. Schultz
Regional Inspector General for Audit
Office of Inspector General

FROM: James W. Runcie *JWR*
Chief Operating Officer

SUBJECT: Draft Alert Memorandum— "Debt Management Collection System 2"
Control Number ED-OIG/L02-M0008

Thank you for providing us with an opportunity to respond to the Office of Inspector General's (OIG) concerns expressed in the draft alert memorandum. Federal Student Aid's (FSA) management shares these concerns and is committed to resolving outstanding problems with the new Debt Management and Collection System (DMCS2) as quickly as possible while limiting negative consequences for borrowers and federal taxpayers.

The draft alert memorandum states that loan servicers under the Common Services for Borrowers (CSB) and Title IV Additional Servicers (TIVAS) contracts cannot transfer some new defaulted loans to DMCS2. (Under the CSB contract, Xerox—formerly ACS Education Solutions—services non-defaulted loans through the ACES system and operates DMCS2.) We agree this issue reflects a significant problem, although it is important to note that servicers are able to transfer the overwhelming majority of new defaulted loans to DMCS2 without delay. Since DMCS2 was implemented, Department servicers have successfully transferred over 2.4 million defaulted loans totaling more than \$10.6 billion. FSA management is closely monitoring the remaining transfer-related issues and has worked closely with Xerox to identify the underlying problems and develop effective corrective action plans.

Your memorandum also identified three areas where problems were preventing servicers from transferring loans to DMCS2: (1) loans assigned to the servicer as a result of rehabilitation that subsequently re-defaulted; (2) loans missing a guaranty agency identification code; and (3) borrowers with more than one defaulted loan. These items are closely correlated in the system and corrections are expected to be implemented by the end of December 2012.

We have devoted extensive resources to manage the challenges associated with this system implementation, and have in fact taken many of the steps your memorandum suggests to resolve the problems with DMCS2. As a result, FSA is working closely with Xerox on a detailed plan to address the remaining issues. We have also implemented plans to reduce or eliminate possible negative consequences to taxpayers and to those student loan borrowers who might be affected.

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Before proceeding with our responses to each of your specific recommendations, we do want to correct or clarify some statements in the draft alert memorandum that are inaccurate or incomplete. For example, the memorandum's discussion of the overall implementation plan and schedule for DMCS2 includes some incorrect information. DMCS2 was implemented in phases, with a pilot module loaded with a relatively small population of new debts originally scheduled to come up in January 2011 and full implementation scheduled for June 2011. During the course of the implementation, these dates shifted to February 2011 and September/October 2011, respectively. During the pilot phase, transfers of new defaults from servicers to DMCS2 were successfully tested. Problems with this process developed after full conversion and implementation in September/October 2011; the majority of these problems were resolved by spring 2012, when most normal transfer activity resumed. FSA has closely monitored ongoing issues throughout the implementation process, with senior management actively involved in weekly and sometimes daily status meetings with Xerox to identify and prioritize issues, allocate resources, and spur progress.

While the inability of the servicers to transfer a subset of loans to DMCS2 is clearly a problem, the list of potential negative consequences included in your memorandum is not completely accurate. Defaulted borrowers do not need to be transferred to DMCS2 to have their credit report updated; the current servicer reports borrowers to credit bureaus as defaulted when they become 270 days delinquent and continues to do so until the loan is transferred to DMCS2. In addition, borrowers may only rehabilitate their loans once; as a result, re-defaulted borrowers would be ineligible to rehabilitate their loans.

Your memorandum notes that DMCS2 is unable to send borrowers eligible for rehabilitation to loan servicers. While this problem did exist after implementation, it was resolved in spring 2012. Borrowers eligible for rehabilitation are now transferred on an ongoing basis. Lastly, the memorandum notes that DMCS2 did not always permit a TIVAS to recall a loan transferred to DMCS2 if the TIVAS subsequently receives documentation proving that the loan is not in default. While this problem did exist after implementation, it was resolved in June 2012.

Our response to each of the recommendations follows:

Recommendation 1.1: Identify each problem related to DMCS2 loan transfers, the source of each problem, and the entire population of loans adversely affected.

Response to Recommendation 1.1: FSA has addressed this recommendation. As part of the ongoing management of the DMCS2 project, each problem related to DMCS2 loan transfers was identified and analyzed. As noted above, we have been aware of this problem for some time, and have shared the specifics with OIG as part of the financial statement audit. The population of affected borrowers has been identified and is monitored on an ongoing basis to ensure corrective actions address the full population.

Recommendation 1.2: Establish milestone dates for resolving the cause of each identified DMCS2 problem related to DMCS2 loan transfers.

Response to Recommendation 1.2: FSA has addressed this recommendation. As part of the ongoing management of the DMCS2 project, milestone dates were established and monitored for each root cause. As noted above, two of the root causes were corrected earlier this year. The solution for the third has been identified and is in development; FSA management is working closely with Xerox to monitor progress against the planned timeline.

Recommendation 1.3: Establish temporary workarounds as necessary for all identified DMCS2 problems until permanent solutions are implemented.

Response to Recommendation 1.3: To the extent possible, FSA has addressed this recommendation. Throughout the DMCS2 implementation process, FSA has developed and deployed "borrower relief" initiatives to help individuals adversely affected by the challenges of the system transition. Examples include manual workarounds to process refunds, acknowledge loan rehabilitations, clarify credit bureau or Title IV eligibility reporting status, and process hearing requests related to administrative wage garnishment. While most key system processes are now functioning, we will continue to examine ways to limit adverse impacts on borrowers until the implementation is complete.

Recommendation 1.4: Determine whether DMCS2 can become a fully operational system that will meet all of the baseline functional system requirements. If the system will not meet all of the functional requirements, develop a plan to address the deficiencies or determine whether to obtain a replacement debt management system.

Response to Recommendation 1.4: FSA has addressed this recommendation. The ongoing management of DMCS2 is focused on ensuring that all baseline requirements and identified enhancements are implemented and validated. As of October 31, 2012, over 90 percent of key system functionality is fully or partially validated and in production. In addition, as part of a larger transition plan developed in preparation for the expiration of the CSB contract at the end of December 2013, FSA management is in the process of reviewing DMCS2 performance, documentation, and capacity. Any issues identified in this review will either be addressed by the current vendor or reflected in requirements for the upcoming acquisition for a new vendor to take over the system after the end of FSA's agreement with Xerox.

Recommendation 1.5: Identify and pursue all available contractual remedies with ACS for ineffective DMCS2 functionality.

Response to Recommendation 1.5: FSA has addressed this recommendation. Beginning in late 2011, we have pursued and will continue to pursue appropriate remedial contract actions. For example, on February 24, 2012, Xerox was issued a cure notice related to their performance on DMCS2. In addition, compensation for work

related to default management under the CSB agreement has been withheld for an extended period of time and will continue to be withheld until such time that system functionality issues have been resolved to an acceptable level. Additional remedies may be applied in the context of broader negotiations regarding the conclusion of the CSB agreement, which expires at the end of 2013.

Thank you again for the opportunity to comment on your draft memorandum.

cc: Pat Howard, Assistant Inspector General for Audit
Kenneth Smith, Director, Student Financial Assistance Advisory Team