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Health, Education and Human Services Division

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August 25, 1995

The Honorable James M. Jeffords  
Chairman, Subcommittee on  
Education, Arts and the Humanities  
Committee on Labor and Human  
Resources  
United States Senate

Dear Mr. Chairman:

In August 1993, the Congress enacted the Student Loan Reform Act of 1993 authorizing the Federal Direct Student Loan Program (FDSLPL). In place of the many lenders and guaranty agencies in the Federal Family Education Loan Program (FFELP), schools and their students in FDSLPL deal only with the Department of Education and its loan-servicing contractors. The first FDSLPL schools (referred to as year-one schools) began making loans in July 1994 for the 1994-95 school year. As of the end of December 1994, 102 schools were participating in the program.

This letter presents information on the experience of a judgmentally selected sample of year-one schools. In May 1994--2 months before the first direct loans were made--we conducted a telephone survey of 17 schools that the Department had selected to participate in FDSLPL in year one (see enclosure 1 for our methodology). The objective of the interviews was to obtain the perceptions of officials of different types of schools--in both the schools' business and financial aid offices--regarding the adequacy of the Department's preparations for implementing FDSLPL. At your request, after participating schools had about 9 months of experience with the program, we interviewed officials at the same 17 schools to determine their schools' satisfaction with FDSLPL. This correspondence presents the results as they relate to potential trouble spots we identified in the earlier survey: the process of reconciling schools' loan records with the Department's loan-servicing contractor's records; the computer software the Department developed and provided to the schools; and the adequacy of the loan-servicing contractor's functions, such as loan origination, loan servicing, and accounting.

GAO/HEHS-95-225R Direct Student Loans

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In summary, the officials we interviewed were enthusiastic about FDSLSP, particularly about its effect on loan processing and borrower satisfaction. Eleven of the 17 schools characterized themselves as greatly satisfied with the Department's implementation and the other 6 as generally satisfied or better. This general satisfaction is confirmed by the plans of all 17 schools to maintain or increase their proportion of direct loans in year two.

At the same time, some school officials said they had serious concerns with procedures for reconciling schools' loan records against the Department's. The Department recognized it had problems with loan reconciliation and, according to a Department spokesperson, provided new software in April 1995 (after we conducted our interviews) to remedy the problem.

Problems with the Department's software (for loan reconciliation and other aspects of loan processing) occurred in several types of computer environments. On the basis of school officials' comments, software problems in adapting the Department-provided software to schools' mainframe applications appeared to be most difficult. But schools using software on stand-alone, desktop personal computers (PC) also said they experienced difficulties. However, school officials said that they had received prompt support services from the Department, its software contractor, and its loan-servicing contractor (loan servicer)<sup>1</sup> in addressing these problems.

Notwithstanding the difficulties reported with loan reconciliation and the Department's software, most school officials praised the Department's loan servicer--a notable departure from reservations expressed in our May 1994 interviews. School officials generally found the servicer helpful in identifying the source of discrepancies between the Department's and schools' data and said the Department revised its software to address several of the problems.

#### BACKGROUND

Schools participating in FDSLSP generally originate the students' loans, request and obtain loan funds from the

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<sup>1</sup>In year one, the loan-servicing function was performed by a contractor and five subcontractors.

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Department to disburse to students' accounts, and reconcile the school's loan records with those of the Department's loan servicer to ensure the Department has correct and complete information. Loan origination requires the school to provide to the Department's servicer a valid promissory note, loan origination record, and disbursement record. The servicer does not "book the loan" or record the disbursement until it receives these records. During year one, schools either originated loans directly or used the Department's servicer to originate loans on their behalf (the servicer is referred to as an alternative originator).

Schools that originate loans must use Department software or other software based on Department specifications. They may prepare promissory notes (but they have the option of having them printed by the Department's loan servicer), and they request and obtain (draw down) funds from the Department for disbursement to the borrower. Based on a borrower's loan amount and other information schools submit electronically to the servicer, the Department's software computes the gross loan disbursement amount, loan fees (deducted from the student's loan and paid to the Department), and net disbursement--the amount the school requests. Each month, schools must reconcile the cash balance in each loan account. In addition, schools use Department software to reconcile their loan records with those of the Department's servicer.

Schools using an alternative originator have a variety of arrangements available for loan origination. Generally, the Department's servicer will prepare the promissory note and initiate the drawdown of funds to the school when it determines that the necessary documents are correct and complete. The servicer sends the school a roster identifying each borrower with the amount and anticipated date of the disbursement. Schools using an alternative originator are still responsible for reporting actual disbursements and reconciling their cash balances.

#### SCHOOL OFFICIALS' SATISFACTION WITH FDSL

Our interview protocol asked school officials to rate their degree of satisfaction with FDSL. All 17 schools responded that they were satisfied: 11 said that they were greatly satisfied (the highest rating) and the other 6 were at least generally satisfied (although 3 of the 6 proposed an intermediate category between

generally satisfied and greatly satisfied). None said that they were either generally dissatisfied or greatly dissatisfied--the two lowest ratings. All 17 said their schools plan for FDSLPL loans to account for the same or a greater proportion of their new loans in year two.

One school official commented that start-up difficulties are inevitable and that the loan reconciliation portions of the FDSLPL computer systems simply were not ready at first. Another official said that his school "is far better off than it ever was under the FFEL program" even though the school encountered start-up problems. Several praised the support services provided by the Department's Direct Loan Task Force, loan servicer, and software contractor.

#### ADVANTAGES FOR STUDENTS AND SCHOOLS

Respondents described several types of benefits to students under FDSLPL. School officials we interviewed said that students gain because they receive funds promptly and, thus, do not need stopgap, emergency loans to tide them over until they receive their funds; experience less confusion regarding the status of their loans; and need not visit the financial aid office to sign their checks.

In addition, respondents said that exit counseling (school representatives meet with borrowers leaving school and discuss the students' loan repayment responsibilities and options) takes less time because FDSLPL's repayment process is simpler to explain than FFELP's. Also, because students with direct loans deal only with the Department or its loan servicer, financial aid officials need not instruct them on the financial market entities--lenders, secondary markets, and guaranty agencies--that could be involved in servicing FFELP loans.

Respondents also described a number of benefits for the schools under FDSLPL--several of which are similar to those for students. For example, schools

- receive students' funds promptly and do not have to issue emergency loans when waiting for students' checks to arrive from a lender;
- do not have to deal with numerous lenders, secondary markets, and guaranty agencies;

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- spend less time on counseling borrowers because the program is easier to explain than FFELP; and
- experience greatly reduced student traffic through financial aid offices.

Other benefits officials mentioned included reduced staffing requirements and improved cash flow. For example, one school financial aid officer cited an 86-percent reduction in student traffic through his office, which reduced the number of staff needed in the financial aid office. Another official said FDSLSP enabled her to reduce staff by two, with more reductions anticipated.

#### DIFFICULTIES WITH LOAN RECONCILIATION

The FDSLSP loan reconciliation process is crucial to ensuring the Department has complete and accurate data. But officials at 9 of the 17 schools we interviewed described problems with the reconciliation process, and 2 of the 9 said they had large numbers of unreconciled loans at the time we interviewed them.

To reconcile loans, each month schools electronically submit to the Department's servicer a file of all their student loan disbursements that have not been previously reconciled. The servicer matches schools' loan records with its record of each school's fund drawdowns from the Department and disbursements to borrowers. The schools provide the servicer with information explaining unreconciled loans, which helps the servicer reconcile loans.

The respondents' most frequently cited causes of reconciliation problems were as follows:

- Flaws in the Department's software for reconciling loans and revisions to remedy those flaws--Officials from several schools mentioned problems related to flaws in the Department's software that impaired the reconciliation process. To remedy these flaws, the Department modified its software, in turn necessitating changes in schools' software adaptations. One of the schools, whose system--including reconciliation--had been running smoothly until the software was revised in February 1995, had been unable to reconcile its loan accounts as of the date of our interview.

- Difficulty making changes in loans--Officials of three schools attributed their schools' reconciliation problems to the difficulty of making loan changes to correct errors or respond to borrowers' requests. For example, one school official said that because the Department's communications software handles loans in batches, it is impossible to recall individual loans to make needed changes. Rather, the school must issue a new loan.

The Advisory Committee on Student Financial Assistance also raised this issue.<sup>2</sup> An Advisory Committee representative said that schools delayed submitting loans to the servicer to avoid having to reissue them if changes became necessary. This practice, according to the representative, contributed to loan reconciliation delays.

- Confusion regarding the reconciliation process--According to a Department official, some of the loan reconciliation difficulties reflect schools' misunderstanding of the reconciliation process. In particular, some schools did not know that the servicer does not record a disbursement to the borrower until the servicer has acknowledged the loan's origination records and promissory note after a record edit. One school official said that the Department's instructions on reconciliation had been inadequate or unclear, and another said that training materials on reconciliation were incomplete. Similarly, during our interviews in May 1994, several school officials expressed apprehension about the cash management and reconciliation functions mainly because Department training materials had not given as much attention to these topics as to other aspects of the program.

Difficulties with reconciliation were identified by officials at loan-originating schools as well as at schools that use the Department's servicer as an alternative originator to draw down funds on their

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<sup>2</sup>The congressionally established Advisory Committee acts, in part, as an independent source of advice and counsel to the Congress and the Secretary of Education on student financial aid policy.

behalf. One proprietary school<sup>3</sup> that used the alternative originator this year has received Department permission to originate loans next year. An official at the school said that the alternative originator provided the funds well in advance of the disbursement date listed on the roster, which can cause the school to incur interest charges if it holds the funds for more than 3 days. On the other hand, one private school that originates loans and has limited staff in its financial aid office said it was seriously considering using an alternative originator for some of its loan origination activities, such as reviewing loan origination records and promissory notes and initiating the transfer of funds in year two, to avoid the cash management difficulties experienced in year one.

Officials at two proprietary schools said their schools chose to use private firms for functions the school would normally perform to process student loans. Both schools said this arrangement is working very well and they were not aware of any problems in reconciling their loans. Because this arrangement appeared to work so well, we interviewed a spokesperson for the private firm working for one of the schools. Though she had learned the reconciliation process without attending the Department's training, using only the Department's manual, she said reconciliation posed no problems to speak of. According to the spokesperson, payments that the servicer made to schools prematurely were no longer a problem, and in any case, the school had leeway to disburse funds early to avoid incurring interest charges. Like several school officials we interviewed, she praised the Department's loan servicer and software contractor.

#### COMPUTER SOFTWARE MODIFICATIONS

School officials said there were a number of problems with the Department's computer software. Problems ranged from needing to adapt the software to the school's computer environment to large amounts of time required for transferring data between the school and the servicer.

Schools used several types of computer arrangements to process their direct loans. The Department had to accommodate three major categories of computer

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<sup>3</sup>Proprietary schools are for-profit trade and technical schools.

environments in developing software for FDSLSP: schools that run Department software stand-alone on a PC; schools that use a mainframe computer or computer network in combination with Department software to process or communicate the loan data to the Department's servicer; and schools that adapt the software to their own mainframe computer and communicate data to and from the servicer without using Department software. Officials at 6 of the 17 schools said they used only the Department's software; 5 used the Department software to link their mainframe computer with the loan servicer; 1 used the Department software to link its network with the loan servicer; and 1 adapted the entire program, including the communications package, to its own mainframe. In addition, two used PC software other than the Department's, and two contracted with private firms (also using the Department's communications package) to support their entire direct loan operations.

Officials at all 17 schools said they initially had difficulties. However, they said the Department's support services to overcome software difficulties were generally prompt and helpful. Examples of some of the problems follow.

According to an official at a school with a single stand-alone mainframe computer, the Department's software specifications proved difficult to apply. However, the official said that her appeal for assistance was answered within the week by a team that included representatives from the Department and its software and loan-servicing contractors. She said the software program is now running well.

Officials at schools combining the PC software with their own mainframe systems also said they had difficulties. Officials at two of the five schools told us that PC limitations made up- and downloading data very slow. A second difficulty--reported by an official at another of the five schools--was in the design of the interface between the school's mainframe and the PC.

In addition to difficulties related to their particular computer environments, school officials were also concerned about two generic software design problems. First, officials from four schools said that the Department's communications software made it difficult to enter loan changes. For example, one official said the computer was "losing" change records and another said some changes resulted in loan cancellation. And second,



the Department's data system is organized by loan, but some school officials said they prefer data systems organized by borrower. Because the Department's system is organized by loan, a school official explained, her school has to call up separate records if a borrower has, for example, both a subsidized and an unsubsidized loan. She said that this was a time-consuming inconvenience.

LOAN RECONCILIATION

The problems with loan reconciliation have also received attention in studies by the Advisory Committee and the Department of Education's Office of Inspector General (OIG) contractor that conducted the fiscal year 1994 financial audit of FDSLPL.<sup>4</sup> Each made recommendations directed at reconciliation problems.

An Advisory Committee spokesperson attributed reconciliation difficulties at least in part to schools' delayed submission of loans to the servicer to avoid having to reissue loans when borrowers request changes and to the servicer's resulting backlog in loan processing. The spokesperson said that the Department could minimize servicing delays by changing FDSLPL regulations to encourage timely submission of loan information to the servicer and by permitting schools to change loan amounts after submitting loan origination records to the servicer. According to a Department official, the software now accommodates loan changes (see p. 11).

The OIG financial audit said the schools' delay in submitting loan data to the servicer was a transmission and start-up problem. In addition, an auditor who worked on the audit identified several discrepancies in loan data. For example, schools and the servicer were using different procedures for rounding the amount recorded in their accounts, and the resulting discrepancies led to reconciliation failures. The auditor said that the Department has resolved this problem. Also, keypunching

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<sup>4</sup>Advisory Committee on Student Financial Assistance, Implementation of the Federal Direct Student Loan Program and Modifications to the Federal Family Education Loan Program (Aug. 1994); and Office of Inspector General, Financial Statement Audit: U.S. Department of Education Federal Direct Student Loan Program for the Year Ended September 30, 1994, Audit Control Number 17-48320 (Mar. 1995).

errors at the servicer were causing discrepancies. This is the type of discrepancy the reconciliation process is designed to identify and illustrates that the process is working properly. Finally, some schools were inadvertently transmitting only partial loan data to the servicer, which would show up as an error in loan reconciliation. According to an OIG spokesperson, efforts to reconcile these kinds of users' records from fiscal year 1994 persisted into January 1995. The audit report recommended that to remedy identified weaknesses in schools' processing and reconciling loans, the Department's training should include increased emphasis on loan reconciliation.

THE DEPARTMENT'S RESPONSE TO SCHOOLS' CONCERNS

According to a Department spokesperson, the Department is addressing schools' concerns regarding loan reconciliation as well as the software that runs it. She said these issues should not be a problem in year two. The official acknowledged that reconciliation did not receive much emphasis in year-one training. But year-two training will specify that schools must submit each transaction separately rather than the net result of various transactions and that the servicer will include in its reconciliation only those loans for which it has recorded and acknowledged to the school the adequacy of the loan origination record, promissory note, and disbursement.

The Department has developed a process for schools to use to ensure the servicer has acknowledged the adequacy of the required documents. However, the Department official also said that reconciliation difficulties were related to the rounding logic in the servicer's software, which has been changed to conform to the Department's PC software and became operational in April 1995.

In addition, according to the Department official, schools' concerns about the reconciliation process were based, in part, on a misunderstanding of how the reconciliation process was to function, and special year-two training will focus on reconciliation and cash management. Because a certain number of loans will be at different places in the loan process at any time, discrepancies will exist between the schools' and servicer's disbursement data and will need to be reconciled. In addition, a reconciliation guide was distributed to all year-one and year-two schools in June.

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It provides a step-by-step explanation of the reconciliation process.

The official also said the Department has improved the software program for year two to make it more "borrower-based." For example, year-two software will provide a "copy screen" on the school's computer monitor that will allow various descriptive and demographic data pertaining to a borrower to be transferred from one loan record to another when a school issues a second loan--for example, an unsubsidized loan issued after a subsidized loan. Thus, school officials will not have to enter this information more than once. While school officials will have better access to a borrower's total financial aid records, schools will still not be able to call up all of a borrower's outstanding student loan records on a single computer screen in year two. The Department hopes to incorporate that feature in its software revisions for year three.

Through another software modification, year-two software is permitting schools to enter changes in loan amounts. As a result, schools will not have to reissue loans to correct mistakes or to accommodate changes in the loan amounts requested by students.

#### LOAN SERVICER'S SUPPORT

Despite the schools' frustrations with reconciling their loan records and with certain aspects of the Department's software, school officials' comments about the Department's loan servicer were almost universally favorable. Most school officials said they were having no problems with the servicer and described the servicer with such words as "excellent," "very cooperative," and "helpful in working out problems." They said that the servicer's staff were either immediately available or returned calls promptly. For example, officials of several schools spoke positively of the support they had received from the loan servicer and the software contractor in addressing computer problems; and others spoke of the servicer's willingness to work out identified data problems over the phone.

These comments were in marked contrast to school officials' apprehensions about loan-servicing arrangements before the start of year one. In our earlier survey, officials at six schools told us they were concerned because FDSLPS was new and they had relatively little contact with the loan servicer.

Notwithstanding the general satisfaction with the servicer's performance in year one, two officials expressed concern in our March 1995 survey that the servicer might not be as accessible in year two because many more schools are scheduled to participate.

CONCLUSIONS

In summary, school officials we interviewed were satisfied with FDSL P even though most had some difficulties implementing the program. Officials were uniformly positive in their comments about the responsiveness of the Department and its software and loan-servicing contractors, whose support services they said had been prompt and helpful. Year-one implementation problems were related mainly to the process of reconciling schools' loan records with the Department's and to software modifications and adaptations the Department made in response to loan reconciliation and other start-up problems. Notwithstanding the difficulties school officials reported, they saw FDSL P's advantages to students and schools as outweighing those difficulties and planned to maintain or increase their participation in year two.

AGENCY COMMENTS ON OUR EVALUATION

The Department of Education's Office of Postsecondary Education generally agreed with the results of our findings. It suggested several technical changes, which we incorporated in this letter, as appropriate.

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We did our review from April 1995 through July 1995 in accordance with generally accepted government auditing standards.

We are sending copies of this letter to Congressman Edolphus Towns, the Secretary of Education, appropriate congressional committees, and other interested parties.

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Please call me at (202) 512-7014 if you or your staff have any questions regarding this letter. Major contributors include Joseph J. Eglin, Jr., Assistant Director; Charles M. Novak; and Susie Anschell.

Sincerely yours,

*Cornelia M. Blanchette*

Cornelia M. Blanchette  
Associate Director, Education  
and Employment Issues

Enclosures - 2

SCOPE AND METHODOLOGY

In March 1995, to obtain information on year-one schools' experience with FDSLSP, we conducted telephone interviews with financial aid officials at the same 17 schools we had contacted in May 1994, 2 months before the program began. In a few cases, when suggested by the financial aid officials, we spoke also with business office or computer staff for additional information. We also interviewed the financial aid processing contractor for one of the schools that chose to use a private firm to help process its loans.

The schools we contacted were a judgmental sample drawn from various types of institutions (4-year public, 2-year public, private, and proprietary) and from schools with various size loan volumes. To select schools, we stratified the list of year-one schools by type of school and ranked each stratum by loan volume. We selected approximately the fifth highest and fifth lowest in each stratum, modifying our selections as necessary to achieve geographic representation.

Our sample included schools that, in May 1994, were planning to self-originate loans or to use the Department's loan servicer as an alternative originator that would draw down funds for their loans. A list of the schools by type and method of loan origination is in enclosure 2. We recognize that all schools participating in FDSLSP in year one asked to be in the program's first year of operation. Hence, when rating their satisfaction with FDSLSP, they may have been more favorably biased toward the program than a more typical random sample might be.

Our March 1995 interviews consisted of open-ended questions that followed the outline used in our May 1994 survey but emphasized those areas we had identified in the earlier interviews as potentially troublesome. In both interviews, we asked respondents to rate their satisfaction with the Department's implementation of FDSLSP using one of four responses: greatly satisfied, generally satisfied, generally dissatisfied, greatly dissatisfied. The topics we focused on in the second interview were the schools' (1) experiences in using the FDSLSP software provided by the Department, including its technical aspects and the Department's approval of alternative software applications; (2) views on the adequacy of the Department's training, training materials, and other communications, and of the support services provided by the Department and its loan servicer and software contractor; (3) difficulties in obtaining funds from the Department for disbursement to borrowers; (4) difficulties with the loan reconciliation process; and (5) other experiences with the Department's loan servicer. We also asked a few questions to

identify perceived advantages and disadvantages of FDSLSP relative to FFELP and to learn respondents' intentions for year two--that is, whether they planned to remain in FDSLSP and if so, whether direct loans would be a larger or smaller share of student loans originated at their school. As a point of reference, we obtained data describing schools' computer environments (that is, PC only, PC/mainframe combination, PC/network combination, or mainframe alone), their loan origination method (that is, self-origination or used alternative originator), and the proportion of their new loans being issued under FDSLSP.

We also contacted two organizations that had recently reported on certain aspects of FDSLSP implementation: the Advisory Committee on Student Financial Assistance and the contractor that conducted the fiscal year 1994 FDSLSP financial audit for the Department's OIG. We reviewed their reports and discussed their results with representatives responsible for their preparation.

YEAR-ONE FDSLPL SCHOOLS INTERVIEWED

Type of school	How schools originate loans	State in which school is located	Anticipated year-one loan volume (millions) <sup>a</sup>
Public/4-year	Self-origination	WA	\$34.3
Public/4-year	Self-origination	CO	31.3
Public 4-year	Self-origination	NJ	24.0
Public/4-year	Self-origination	CA	18.1
Public/4-year	Self-origination	FL	1.4
Public/2-year	Self-origination	TX	0.9
Public/2-year	Alternative originator	NM	0.3
Private	Self-origination	IL	9.5
Private	Self-origination	RI	8.3
Private	Self-origination	PA	4.9
Private	Self-origination	NY	1.2
Private	Self-origination	MA	0.6
Proprietary	Alternative originator	FL	5.8
Proprietary	Alternative originator	CA	0.7
Proprietary	Alternative originator	NE	0.5
Proprietary	Alternative originator	TX	0.3
Proprietary	Alternative originator	NC	0.1

<sup>a</sup>FFELP loan volume for fiscal year 1991 multiplied by the percentage of loans the schools committed to FDSLPL for year one.

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