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Federal Student Loan Servicing Accountability and Incentives in Contracts

- **Student loan servicers play a critical and underappreciated role in federal student loan programs.**
- **The federal government contracts out to servicers an array of many of the most critical functions related to student loan repayment, including account management, payment processing, and the provision of information about payment plans and solutions for distressed borrowers**
- **In fact, most borrowers' interactions with federal student loan repayment are almost exclusively with their servicer**
- **We aim to improve upon the scarce research literature about federal student loan servicers by exploring the complicated set of measures that determine how servicers are compensated for servicing each debtor and awarded portfolios for future business**
- **The coverage and construction of these measures influence servicers' behaviors by creating strong incentives that coincide to varying degrees with the goals of the government, public, student loan borrowers, and the servicers themselves**
- **Understanding accountability and incentives in current and past contracts is critical as the U.S. Department of Education reforms servicer contracts and responsibilities through its Next Gen Federal Student Aid initiative**

About 43 million debtors collectively owe more than $1.4 trillion in outstanding federal student loan debt in the United States as of 2019, an amount that is nearly three times the amount from 12 years earlier (U.S. Department of Education, 2019). Delinquency rates on student loan debt have nearly doubled during the past decade nationally, and default rates on federal loan programs recently reached their highest level in more than 15 years (Lee et al., 2014; U.S. Department of Education, n.d.). Default and delinquency are costly for debtors, but also for the public; federal student loan debt is guaranteed, such that the public absorbs the costs of default. Student loan servicers (hereafter referred to as servicers) play a critical and underappreciated role in federal student loan programs; the federal government contracts out to servicers many of the most critical functions related to students' loan repayments, including account management, payment processing, and the provision of information about payment plans and solutions for distressed borrowers. In fact, most borrowers' interactions with federal student loan repayment are almost exclusively with their servicer.

In response to growing concerns about servicer practices and efficiency, the U.S. Department of Education (ED) has frequently adjusted the regulatory context for servicers in recent years and has considered numerous drastic programmatic changes, including controversially proposing to move to a single servicer. Servicer oversight is ever more salient as practices by servicers of federally supported student loan debt have increasingly come under fire. For example, high-profile lawsuits have been brought against some of the largest loan servicers: Navient and the Pennsylvania Higher Education Assistance Agency (PHEEA), including by the Consumer Financial Protection Bureau (CFPB) and state attorneys general (e.g., Consumer Finance Protection Bureau, 2017; Cowley, 2017; Hillian, 2019; New York Attorney General, 2019). In addition to lawsuits, consumer complaints about student loan servicing have been prominently highlighted in media reports (e.g., Cowley, 2020; Friedman, 2019; Ortiz, 2019; Rosato, 2017).

The ED has acknowledged limited oversight among its current contracts, asserting that "today's loan servicing environment does not require maximum accountability. The legacy servicing contracts do not contain adequate incentives to reward servicers when they manage borrowers' accounts successfully, and they do not allow for the appropriate consequences to be applied to loan servicers that fail to meet contract requirements" (U.S. Department of Education, 2020). At the end of 2017, the ED announced the Next

Gen Federal Student Aid initiative, which intends to alter the nature of how students and their families interact with the federal student aid system. A prominent aspect of this initiative is to reform servicer practices, contracts, and relationships, with its first set of contracts announced in June 2020. Understanding accountability and incentives in current and past contracts is critical as the ED reforms servicer contracts and responsibilities through its Next Gen initiative.

In this paper, we aim to improve upon the scarce research literature about federal student loan servicers. The ED and federal agencies use a variety of accountability mechanisms to provide oversight to servicers, including performance and compliance monitoring, audits, and multiple avenues through which borrowers can lodge complaints. In this paper, we focus on a complicated set of implicit accountability measures that determine how servicers are compensated for servicing each debtor and awarded portfolios for future business. The coverage and construction of these 3 measures influence servicers' behaviors by creating strong incentives that coincide to varying degrees with the goals of the government, program administrators, public, student loan borrowers, and the servicers themselves. We also add to the general knowledge of public sector contracting by empirically exploring whether the goals of servicers, borrowers, and the government conflict through this underexplored area.

First, we describe the federal student loan servicing market from 2009 through 2019, a market that has undergone a drastic transformation as student loan borrowing increased substantially, the federal student loan program underwent a large structural change, and the government altered its process for awarding student loan servicing contracts. Next, we examine the implications of the ways that economic incentives in servicing contracts guide servicer behavior, using the lens of performance-based contract theory. The first incentive relates to a perborrower fee paid to servicers with penalties based on delinquency and loan status, which follows a linear contract model (e.g., Heinrich and Choi, 2007). The second incentive derives from how ED semiannually allocates new loans based on the servicers' quarterly performance from the two quarters prior, akin to a multitournament contract (e.g., Gibbons and Roberts, 2013; Holmstrom, 1982). To assess performance as part of this second measure, the ED uses a formula that is currently composed of three components with varying degrees of measurability: default prevention, borrower satisfaction, and federal personnel satisfaction. We examine performance on these metrics over time in relation to national student loan market trends and the relationship of the measures to each other, across servicers, and over time. While connecting servicer goals to public goals can improve performance, these goals may also be in competition with each other. We find repayment measures and borrower satisfaction empirically conflict with each other, which gives rise to concerns that increasing success in one may come at the expense of the other. Further, 4 we simulate performance outcomes for servicers under different reweighting schemes that reflect different goal prioritization.

Finally, we consider the extent to which consumer complaints registered against servicers are about terms and fees, handling payments, interactions with servicers and marketing, or account maintenance and information. We code over 16,000 complaints made about federal student loan servicers to the Consumer Finance Protection Bureau (CFPB) from 2016 to 2019 and find that, over the time period, the share of complaints about interactions with servicers and terms and fees have dropped by about half, while the share of complaints related to maintenance and information has doubled