

Identifying Colleges with Aggressive Management of Cohort Default Rates

Mark Kantrowitz

Publisher of Fastweb.com and FinAid.org

September 21, 2010

EXECUTIVE SUMMARY

Colleges can “manage” their cohort default rates by encouraging students who are experiencing financial difficulty to use deferments and forbearances, since deferments and forbearances are excluded from the numerator but not the denominator of the cohort default rate. The use of deferments and forbearances will delay a default beyond the time period that is measured by the cohort default rate.

This paper proposes two methods of identifying colleges that are aggressively managing their cohort default rates by encouraging students to use deferments and forbearances. The first method considers a college to be aggressively managing its cohort default rate when the FY2005 3-year cohort default rate is more than three times the 2-year cohort default rate. The second method considers a college to be aggressively managing its cohort default rate when the college’s deferment and forbearance rate is more than 2.5 times the college’s 2-year cohort default rate.

INTRODUCTION

A 1999 Report from the US Government Accountability Office (GAO)¹ and a 2003 Report from the Office of the Inspector General at the US Department of Education (OIG)² noted several flaws in the definition of the cohort default rate. Deferments and forbearances are included in the denominator of the cohort default rate but not the numerator, allowing colleges to improve their cohort default rates by encouraging borrowers to seek deferments and forbearances. The three-year limit on the economic hardship deferment and the five-year limit on forbearances are sufficient to push a default outside the repayment window that is evaluated by the 2-year and 3-year cohort default rates.

Similarly, in certain circumstances consolidation loans are treated as paying off the original loans in full without regard to whether the borrower subsequently defaults on the consolidation loan. The language “received for attendance at that institution” in the definition of the cohort default rate in section 462(g) of the Higher Education Act of 1965 is currently³ interpreted by the regulations at 34 CFR 668.183(b) as including borrowers who entered repayment “on any Federal Stafford loan, Federal SLS loan, Direct

¹ *Student Loans: Default Rates Need to Be Computed More Appropriately*, GAO/HEHS-99-135, July 1999.

www.gao.gov/archive/1999/he99135.pdf

² *Audit to Determine if Cohort Default Rates Provide Sufficient Information on Defaults in the Title IV Loan Programs*, Office of the Inspector General, US Department of Education, ED-OIG/A03-C0017, December 2003.

www.ed.gov/about/offices/list/oig/auditreports/a03c0017.pdf

³ 65 FR 65638 (November 1, 2000), as amended at 67 FR 67075 (November 1, 2002), 73 FR 35494 (June 23, 2008) and 74 FR 55649 (October 28, 2009)

Subsidized loan, or Direct Unsubsidized loan that they received to attend your institution, or on the portion of a loan made under the Federal Consolidation Loan Program or the Federal Direct Consolidation Loan Program (as defined in 34 CFR 685.102) that is used to repay those loans.”⁴ The regulations at 34 CFR 668.183(c)(1)(i) and (ii) include within the definition of the cohort default rate a default “on any Federal Consolidation Loan Program loan that repaid a loan that was used to include the borrower in the cohort” with similar language for Federal Direct Consolidation Loans. But if a borrower consolidates three or more times,⁵ a default on the consolidation loans obtained during the third or greater iteration will not be treated by the regulations as a default for the purpose of calculating the cohort default rate. It is also possible that the US Department of Education has not fully implemented the regulations regarding the treatment of consolidation loans in calculating the cohort default rate, so it might be sufficient to consolidate just two times to remove a pending default from the numerator. Finally, consolidating a loan resets the delinquency clock, allowing up to an additional 360 days of delinquency before the new consolidation loan will be considered to be in default.

While deferments and forbearances are intended to help avert defaults by allowing borrowers to suspend repayment during times of economic hardship, such as medical or maternity leave and temporary unemployment, they were not intended to serve as mechanisms for manipulating the cohort default rate. Using consolidation to avoid default cannot rationally be characterized as serving any purpose other than manipulation of an unintended loophole.

The OIG report demonstrated that 2-year cohort default rates decreased as deferments and forbearances increased, but that defaults in the third year did not follow the same trend, suggesting that colleges were using deferments and forbearances to manipulate their cohort default rates. The deferments and forbearances pushed the default outside the 2-year repayment window measured by the cohort default rate without appreciably affecting whether the borrowers ultimately defaulted on the loans. This motivated Congress to enact a switch from 2-year cohort default rates to 3-year cohort default rates as part of the Higher Education Opportunity Act of 2008 (P.L. 110-315) starting with the FY2009 cohort.

However, deferments and forbearances can be used to manipulate a 3-year cohort default rate the same as for a 2-year cohort default rate. To address this problem, the US Department of Education introduced the *loan repayment rate* as a dual or inverse to the cohort default rate as part of the Gainful Employment NPRM on July 26, 2010.⁶ Rather than measure the percentage of borrowers who have defaulted on their loans, it calculates a performing assets ratio, namely the percentage of the original loan balances at repayment for which the principal balance decreased during the most recent federal fiscal year. This lumps deferments, forbearances and delinquencies in with defaults as non-performing loans. Borrowers repaying their loans under income-contingent or income-based repayment are also treated as non-performing if they are negatively amortized (i.e., making payments that are less than the interest that

⁴ Note that Parent PLUS and Grad PLUS loans are not currently included in the definition of the cohort default rate. Default rates on PLUS loans, however, are much lower than default rates on Stafford or consolidation loans.

⁵ A borrower can consolidate a consolidation loan only if the borrower is combining two or more loans or if the borrower is consolidating into the Direct loan program to obtain income-contingent repayment or public service loan forgiveness.

⁶ *Program Integrity: Gainful Employment*, Notice of Proposed Rulemaking, Federal Register 75(142):43616-43708, July 26, 2010. www2.ed.gov/legislation/FedRegister/proprule/2010-3/072610a.html

accrues).⁷ In addition, if a borrower's loans are consolidated, the loan repayment rate considers whether the principal balance of the consolidation loan (or a subsequent consolidation loan) is reduced and does not treat the consolidation loan as paying off the loans in full.⁸ Colleges that more aggressively managed their cohort default rates through deferments and forbearances tend to have lower loan repayment rates.

The OIG and GAO reports did not, however, examine the extent to which colleges were using deferments and forbearances to manipulate their cohort default rates. There are several possible approaches to identifying which colleges were aggressively managing their cohort default rates, including:

- **Ratio of cohort default rates.** This method calculates the ratio of 3-year cohort default rates to 2-year cohort default rates. It is only useful in evaluating the manipulation of cohort default rates before Congress began considering a switch to 3-year cohort default rates.⁹ If colleges were aggressively managing their default rates for 2 years but not 3 years after the borrowers entered repayment, this would be manifested in a greater than expected ratio of 3-year to 2-year cohort default rates.
- **Ratio of deferment and forbearance rates to cohort default rates.** This method calculates the ratio of deferment and forbearance rates to the 2-year cohort default rate. There is a natural progression from deferment to forbearance to delinquency to default, so one would expect deferment and forbearance rates to be proportional to default rates. Since increases in deferment and forbearance rates result in a decrease in cohort default rates, aggressive management of default rates would be manifested in a higher ratio of deferment and forbearance rates to cohort default rates, notwithstanding any naturally higher deferment, forbearance and default rates due to demographic differences.

⁷ Approximately 45% of borrowers in the income-contingent repayment plan were making a zero monthly payment in February 2009, and an additional 11% were making a non-zero payment that was less than the interest that accrues.

⁸ The draft regulatory language in the gainful employment NPRM at 34 CFR 668.7(b)(2) states that "However, a loan that is paid through a consolidation loan is not counted as paid in full for this purpose until the consolidation loan is paid in full." This language is intended to prevent the same sort of iteration problem that occurred in the definition of the cohort default rate.

⁹ After colleges became aware of the impending switch to a 3-year cohort default rate they would likely have started managing defaults during the third year of repayment. However, one could potentially substitute a ratio of 4-year cohort default rates to 2-year cohort default rates.

RATIO OF 3-YEAR TO 2-YEAR COHORT DEFAULT RATES

The 2-year cohort default rate is the percentage of borrowers entering repayment one federal fiscal year who default by the end of the following fiscal year.¹⁰ The 3-year cohort default rate is the percentage of borrowers entering repayment one federal fiscal year who default by the end of the second following fiscal year. The federal fiscal year runs from October 1 to September 30. The fiscal year a borrower enters repayment is the borrower's cohort.¹¹ For example, the FY2005 2-year cohort default rate is the percentage of borrowers entering repayment from October 1, 2004 to September 30, 2005 who default by September 30, 2006. Borrowers enter repayment on Stafford loans after the end of the six-month grace period, as per section 427(a) of the Higher Education Act of 1965.

Since it takes 360 days of non-payment before a borrower is considered to be in default,¹² the 2-year cohort default rate effectively provides a one-year window (370 days) during which the default can occur and the 3-year cohort default rate provides a two-year window (735 days) during which the default can occur. Since the window during which the default can occur is effectively double ($735 / 370 = 1.986$), one would expect the 3-year cohort default rate to be no more than twice the 2-year cohort default rate.

If the 3-year cohort default rate is more than double the 2-year cohort default rate, it may be a sign that the college was actively managing defaults for the two years after borrowers entered repayment, but not attempting to minimize defaults in the third year. (If the 3-year cohort default rate is less than double the 2-year cohort default rate, it is still possible that the college was managing default rates by encouraging students to use deferments and forbearances but not targeting the counseling to just the first two years in repayment. But when the 3-year cohort default rate is more than double the 2-year cohort default rate, it is a clearer sign of aggressive default rate management.)

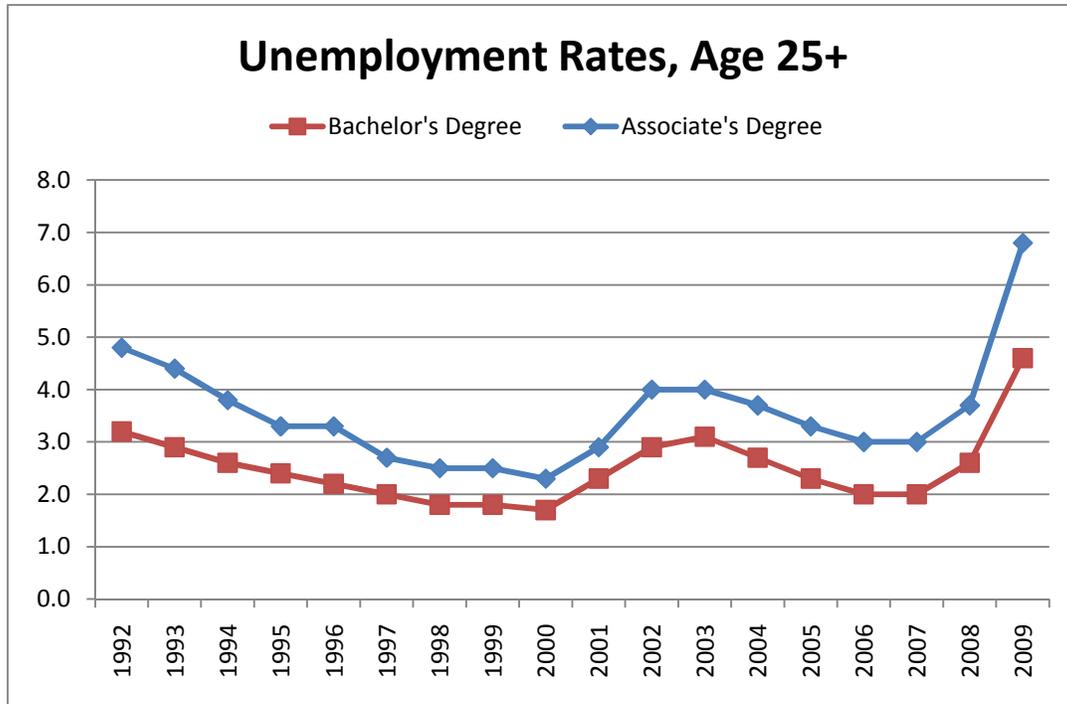
However, since the 3-year cohort default rate adds a year of follow-up beyond the 2-year cohort default rate, it is possible that the 3-year cohort default rate could be more than double the 2-year cohort default rate if conditions have changed significantly during the third year. For example, unemployment rates could have increased, average interest rates at graduation could have increased and graduation rates could have decreased.

¹⁰ Note that the cohort default rate is based on the percentage of borrowers as opposed to the percentage of loans or the percentage of dollar loan amounts.

¹¹ A borrower can be included in more than one cohort if the borrower's loans enter repayment in different years. Examples include a borrower returning to school and obtaining more loans for additional education, or a borrower consolidating his or her loans in a subsequent year following the year in which the borrower entered repayment on the unconsolidated Stafford loans.

¹² Section 435(l) of the Higher Education Act of 1965 and the regulations at 34 CFR 682.200(b) define a federal education loan that is paid in monthly installments to be in default if the loan is more than 270 days delinquent. The regulations at 34 CFR 682.511(e)(1) require FFELP lenders to file a default claim within 90 days. Most lenders delay the filing of the default claim until the end of the 90-day claim period to maximize the accrual of interest, since accrued but unpaid interest is paid by the guarantee agency as part of the default claim. It is possible to cure a default by making a payment within the 90-day claim period before the lender files the default claim with the guarantee agency. Thus it usually takes $270 + 90 = 360$ days of delinquency before a FFELP is considered to be in default. The regulations at 34 CFR 668.183(c) define a default as 360 days delinquent for a loan in the Direct Loan program.

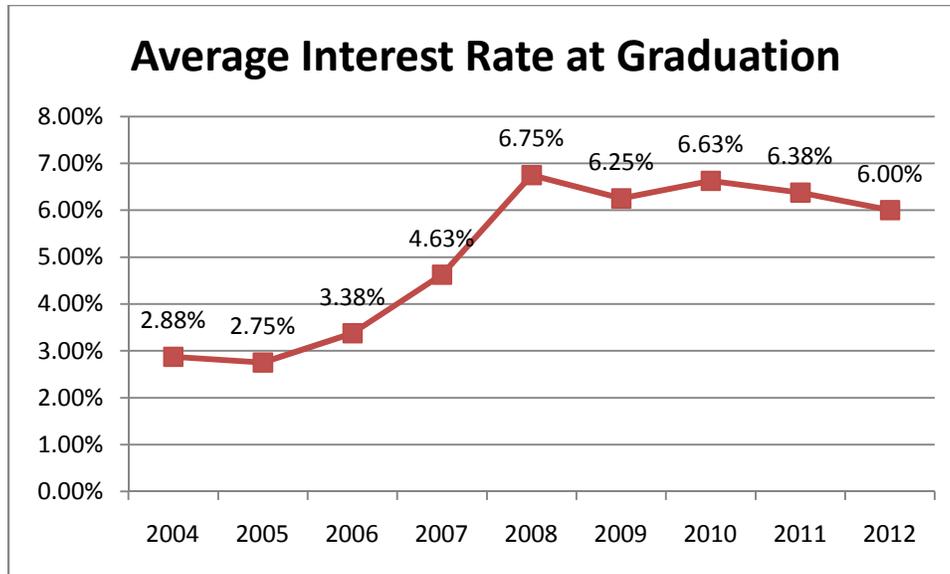
The following chart shows seasonally-unadjusted unemployment rates for college graduates based on Bureau of Labor Statistics (BLS) data, demonstrating that the recent increase in unemployment rates started in 2008.¹³ The increase was about 2% for Bachelor's degree recipients and 3% for Associate's degree recipients, more than enough to account for the recent increases in default rates.



The US Department of Education does not currently track average interest rates at graduation. However, the annual rates on Stafford loans decreased steadily from 2000-2001 to 2004-2005, corresponding to reductions in the Federal Funds Rate after 9/11, and increased in 2005-2006. The switch from variable rates to fixed rates yielded a big jump in interest rates in 2006-2007. With each successive graduating class more of their loans would have been at the higher fixed rates, yielding a big increase in the average interest rate at graduation. However, Congress passed a phased-in interest rate reduction for subsidized Stafford loans for undergraduate students starting in 2008-2009 as part of the College Cost Reduction and Access Act of 2007, which would tend to slightly reduce the average interest rate at graduation. Loan limits also increased in 2007-2008 and 2008-2009. If one makes reasonable assumptions about the borrowing patterns,¹⁴ it is possible to model the overall direction of trends in average interest rates at graduation as illustrated in the following chart. This chart demonstrates that average interest rate at graduation rose in 2006 and 2007 and peaked in 2008, but has decreased only gradually since then.

¹³ www.bls.gov/cps

¹⁴ This chart assumes that students graduate in four years after borrowing to the limit on Stafford loans, with subsidized Stafford loans at half of the subsidized Stafford loan limit and the rest unsubsidized, that half of the students get the dependent student loan limits and half get the independent student loan limits, and that all students consolidate their loans soon after graduation.



Assuming that unemployment rates for college graduates start decreasing soon, cohort default rates should start decreasing in FY2009 or FY2010.

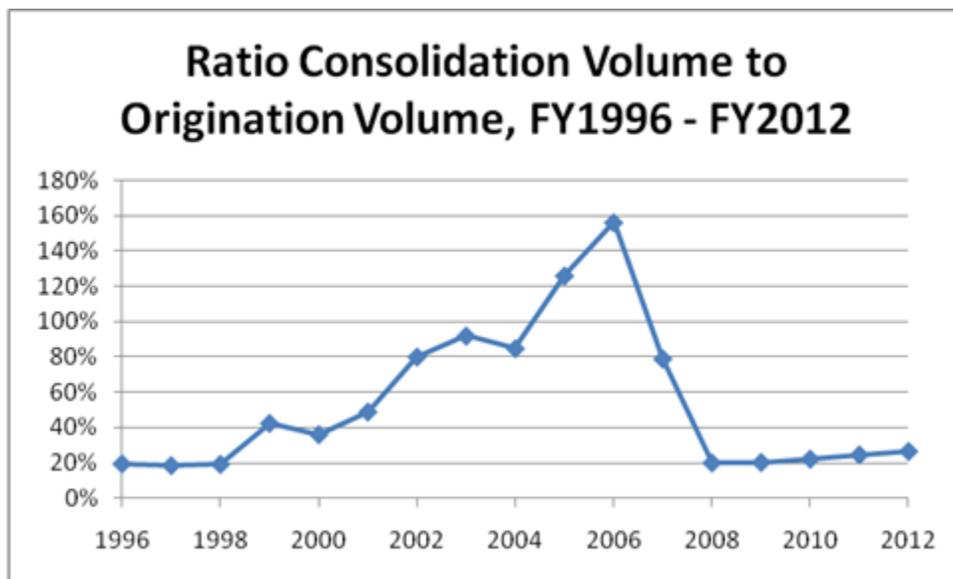
An additional complication is the impact of the early repayment status loophole. The early repayment status loophole¹⁵ allowed borrowers to consolidate their federal loans while they were still in school by temporarily putting the loans into repayment. This caused a spike in consolidation loan volume in FY2005, as illustrated by the ratio of consolidation volume to origination volume in following chart, because borrowers could use consolidation to lock in rates as low as 2.875% on variable rate Stafford loan. In the aftermath of 9/11, interest rates on variable rate federal education loans had reached successive historic lows, driven by cuts to the Federal Funds Rate. Consolidation loan volume exceeded new origination volume in FY2005 because borrowers could consolidate their loans while they were still in school and because interest rates were expected to start increasing for the first time since 9/11, as they did on July 1, 2005, adding a bit of urgency to the need to consolidate.¹⁶ Congress subsequently repealed the loophole as part of the Higher Education Reconciliation Act of 2005 (P.L. 109-171) effective July 1, 2006. This legislation also switched all new federal education loans to fixed rates starting on July 1, 2006.

The early repayment status loophole shifted some borrowers from a later cohort to an earlier cohort, since the loans were in repayment, even if only for a microsecond. (Some of these borrowers were also included in later cohorts because they would borrow additional federal student loans during their remaining in-school years.) This reduced the cohort default rates for the earlier cohorts because the borrowers would be in an in-school deferment with no opportunity to default after exploiting the loophole. Moreover, the lower interest rate on these loans made it easier for these borrowers to repay their loans, reducing the likelihood of default. The borrowers who took advantage of the loophole also

¹⁵ Anne-Marie Chaker, *A Novel Way to Tackle Student Loans*, Wall Street Journal, May 12, 2005. online.wsj.com/article/SB111585599594131196.html

¹⁶ Consolidation loan volume continued to increase in FY2006 in part because some of the 2004-2005 consolidation loans were recorded in FY2006. So long as the consolidation loan application was substantially complete before midnight June 30, 2005 the borrower could lock in the 2.875% interest rate, even if the lender was unable to complete the process until FY2006 due to a big backlog of consolidation loan applications.

demonstrated a greater degree of financial sophistication and alertness than the borrowers who were oblivious to the loophole. Thus one could argue that the borrowers remaining in the later cohorts were, on average, more likely to default. In any event, interference from the early repayment status loophole means that the cohort default rates for FY2005, FY2006, FY2007 and FY2008 are not necessarily comparable on a longitudinal basis.



One can adjust for the potential impact of unemployment rates, graduation rates and interest rates – and perhaps even the early repayment status loophole – on the ratio of 3-year to 2-year cohort default rates by using a threshold greater than 2.0. For example, a ratio higher than 3.0 clearly indicates an increase in the default rates that is not explained by the 3-year cohort default rate’s larger window or by changes in unemployment rates, graduation rates and interest rates.

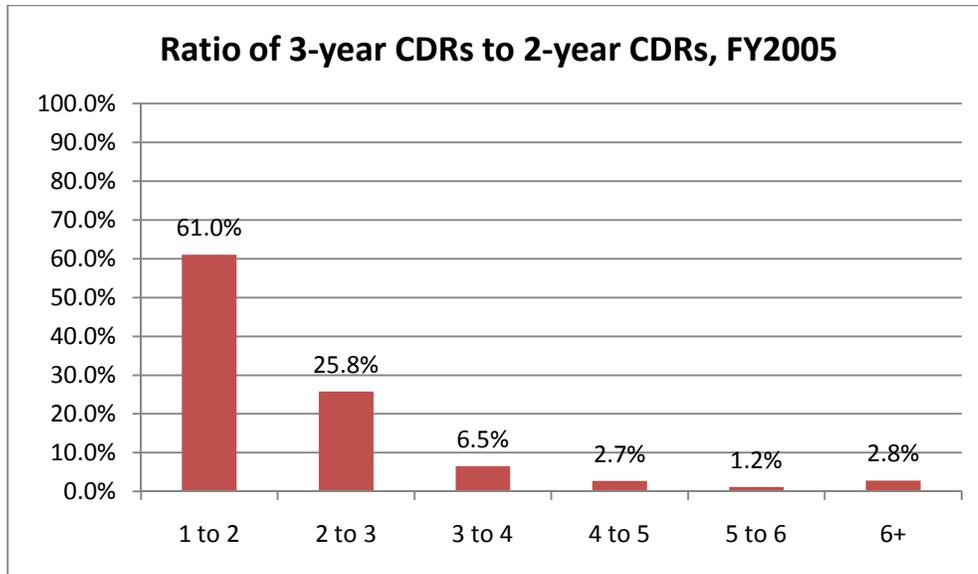
The US Department of Education published 2-year and 3-year cohort default rates for individual colleges by OPE ID for FY2005, FY2006 and FY2007 on December 14, 2009.¹⁷ One can calculate the ratio of 3-year to 2-year cohort default rates for each of these years. However, the FY2005 cohort is the best one to use because it entirely predates the proposal to switch from 2-year to 3-year cohort default rates^{18 19} and as such occurred before any colleges might have considered attempting to reduce defaults in the third year. Also, the FY2005 2-year and 3-year cohort default rates predate the onset of the recession that began in December 2007 and ended in June 2009, before the increase in unemployment rates.

The following chart shows the distribution of colleges according to the ratio of 3-year cohort default rates to 2-year cohort default rates for the FY2005 cohorts. Institutions with ratios of less than 1.0 were excluded as anomalous, since the 3-year cohort default rate cannot be lower than the 2-year cohort default rate.

¹⁷ federalstudentaid.ed.gov/datacenter/library/TrialYearCDR.xls

¹⁸ Doug Lederman, *Default Rates Projected to Soar*, Inside Higher Ed, January 21, 2008. www.insidehighered.com/news/2008/01/21/defaults

¹⁹ Kelly Field, *For-Profit Colleges Fight Proposal on Default Rates*, Chronicle of Higher Education 54(22), February 8, 2008. chronicle.com/article/For-Profit-Colleges-Fight/25979



There are 526 colleges with ratios greater than or equal to 3.0 in FY2005, representing 13.2% of all colleges. Slightly more than half of these colleges are for-profit institutions, as demonstrated by the following table.

FY2005 CDR Ratio \geq 3.0			Percentage of
Institution Type	# Colleges	Distribution	Institution Type
Public 4-Year	32	6.1%	5.0%
Public 2-Year	64	12.2%	7.5%
Non-Profit 4-Year	130	24.7%	11.3%
Non-Profit 2-Year	12	2.3%	11.2%
For-Profit	288	54.8%	23.1%
Overall	526	100.0%	13.2%

The following table is similar, but restricts the number of borrowers in repayment to 30 or more. There are exceptions in the definition of the cohort default rate for colleges with less than 30 borrowers entering repayment.

FY2005 CDR Ratio \geq 3.0			Percentage of
Institution Type	# Colleges	Distribution	Institution Type
Public 4-Year	21	4.7%	3.3%
Public 2-Year	54	12.0%	6.3%
Non-Profit 4-Year	118	26.2%	10.3%
Non-Profit 2-Year	10	2.2%	9.3%
For-Profit	247	54.9%	19.8%
Overall	450	100.0%	11.3%

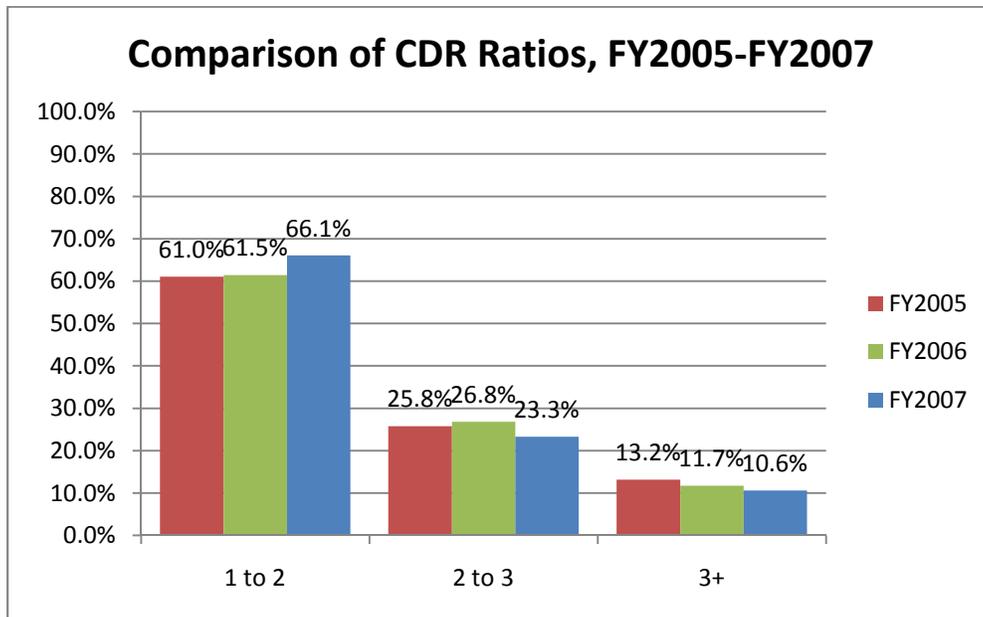
The distribution of defaults by state in FY2005 paralleled the distribution of enrollments by state, with the exception of Louisiana, presumably due to the impact of Hurricane Katrina in August 2005.

The following table shows the percentage of colleges with a 3-year cohort default rate to 2-year cohort default rate ratio of 3.0 or greater in FY2005 that also had a 2-year cohort default rate under 10%. This

suggests that not only were colleges manipulating cohort default rates to retain eligibility for federal student aid, but also to comply with the preferred threshold for regulatory waivers to the two-disbursements rule and the 30-day delay for first-year first-time borrowers. Also, some education lenders would lend only to students at institutions that maintained a 2-year cohort default rate less than 10.0%.

CDR Ratio \geq 3.0 Institution Type	% Colleges with 2-year CDR < 10%
Public 4-Year	87.5%
Public 2-Year	100.0%
Non-Profit 4-Year	99.2%
Non-Profit 2-Year	100.0%
For-Profit	99.0%
Overall	98.5%

The following chart compares the changes in the ratios of 3-year cohort default rates to 2-year cohort default rates from FY2005 to FY2007. The decrease in the percentage of colleges with a ratio of 3.0 or greater is perhaps an indication that more colleges began trying to reduce default rates in the third year of repayment.



Very few of the colleges were medical schools. Most medical school graduates defer repaying their student loans during the residency and internship, which typically last for three years. Thus one would not expect to see high ratios of 3-year cohort default rates to 2-year cohort default rates. A high ratio would be more likely when comparing 4-year or 5-year cohort default rates at medical schools to 2-year cohort default rates.

RATIO OF DEFERMENT AND FORBEARANCE RATES TO COHORT DEFAULT RATES

There is no *a priori* reason to expect deferment and forbearance rates to differ among colleges, other than differences in the graduation rates and participation in the FFEL program versus the Direct Loan program. Borrowers who drop out often do not undergo exit counseling and so are less likely to use deferments and forbearances to avoid defaulting on their federal student loans. Borrowers in the FFEL program are more likely to use deferments and forbearances because FFEL program lenders were more aggressive in encouraging borrowers to use these options as an alternative to default.²⁰ Aside from these differences, one would expect deferment and forbearance rates to be proportional to cohort default rates.

Encouraging borrowers to obtain a deferment or forbearance, however, usually reduces the cohort default rate by pushing the default outside the window that is tracked by the cohort default rate. If a college's cohort default rate is low because the college is aggressively managing their cohort default rate by encouraging their student borrowers to pursue deferments and forbearances, then the deferment and forbearance rate would be higher than average. Thus the ratio of the deferment and forbearance rate to the cohort default rate might be a good indication of the degree to which a college is aggressively managing its cohort default rate through deferments and forbearances.

Unfortunately, the US Department of Education has not published institutional deferment and forbearance rates on a cohort or overall basis. Based on national averages²¹ and a handful of colleges for which deferment and forbearance rates are known, it seems likely that colleges that are managing their cohort default rates through deferments and forbearances will have a deferment and forbearance rate that is at least 2.5 times the 2-year cohort default rate.²² This threshold could be refined if the US Department of Education were to release deferment and forbearance rates for all colleges. Assuming that some colleges are managing their default rates through deferments and forbearances and some are not, then a histogram of the ratios might demonstrate a two-humped distribution.

²⁰ If the borrower uses a deferment or forbearance, the lender gets an additional year (or more) of interest even if the borrower ultimately defaults since accrued but unpaid interest is included as part of a default claim. It is therefore in a FFEL program lender's best financial interest to encourage borrowers who are experiencing financial difficulty to pursue all options before defaulting on the loans.

²¹ Since many colleges manage their default rates, the national averages will include a baseline level of default rate management. Thus this technique will identify colleges that are more aggressively managing their default rates, and not all colleges that are managing their default rates.

²² This threshold is approximate. More data is necessary to develop a threshold that is statistically significant.

RECOMMENDATIONS

There are several steps the US Department of Education can take to better inform the public about the difficulty borrowers experience in repaying their loans and the extent to which colleges manipulate their cohort default rates. This will provide a better context in which to evaluate cohort default rates.

- The US Department of Education should publish delinquency, deferment and forbearance rates for each cohort and for all borrowers nationally and disaggregated by institution type, by institution control and degree program and by specific college.
- The US Department of Education should publish statistics concerning the number and percentage of borrowers in each repayment plan nationally and disaggregated by institution type, by institution control and degree program and by specific college.
- The statistics concerning the income-contingent and income-based repayment plans should specify the number and percentage of borrowers who are making a zero monthly payment and the number and percentage of borrowers who are negatively amortized.
- The US Department of Education should publish annual recovery rates for defaulted loans nationally and disaggregated by institution type, by institution control and degree program and by specific college. The recovery rates should report both the percentage of dollars and the percentage of defaulted borrowers, as well as the average and mean amount recovered.
- Each of these reports should also be disaggregated by whether the student did or did not complete the educational program.
- In addition to reporting cohort default rates, which are based on the number of borrowers defaulting on their education loans, the US Department of Education should report the number of loans and the dollar balance outstanding on the defaulted loans for each cohort.
- The US Department of Education should report actual lifetime default rates based on the number of borrowers, number of loans and principal balance of loans in default for each of the last 20 cohorts.
- The US Department of Education should publish annually the percentage of all student loan debt outstanding that is in default (by dollars, by number of loans and by number of borrowers), overall and disaggregated by institution type, by institution control and degree program and by specific college.
- The cohort default rate should be modified to include PLUS loans.

The amount of data currently reported regarding defaults is rather limited. For example, the education appendix to the President's budget reports default claims and net default collections for the FFEL program, but only net default collections for the Direct Loan program because there is no claim process for defaulted loans in the Direct Loan program. Yet it would still be beneficial to report the dollar total of all new defaults in the Direct Loan program each year.