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The Default Rate Factor: Who is Really at Fault?

by
Joe L. McCormick

The article recognizes the fact that student loan defaults are a serious problem in student aid administration. The author attempts to place the history and current status of the issue in a context perhaps more reasonable and less simplistic than that espoused by some public officials.

In August 1985, Secretary of Education William Bennett issued a sharply worded warning about defaults in federally sponsored student loan programs (Reinhard, "ED Predicts" 1985). More recently, Deputy Under Secretary of Education Bruce Carnes decreed that "any default rate is intolerable." Projecting what he called an "alarming" five year increase in the rate and the dollar value of student loan defaults, Secretary Bennett sounded the alarm of the staggering financial implications for taxpayers and future borrowers if federal expenses for bad educational debts continue to rise. Once again, a new Secretary of Education has discovered student loan defaults as if no one before him had any idea that they were indeed a serious issue.

To the extent Secretary Bennett's remarks reflect genuine concern over a very serious problem in federal student financial aid policy, colleagues in the student loan industry welcome his concern and efforts to effectively control loan defaults. But to the extent his remarks and the policies of his department will (1) impose more rigorous and costly student loan origination and collection practices on commercial lenders, loan servicers, secondary markets, and guarantee agencies, (2) compel lenders and guarantee agencies to share an increasingly unreasonable percentage of the student loan default costs now covered by the federal government, and (3) unnecessarily deny future access to student loans in the name of default prevention, this writer must sound his own alarm and take great exception to the use of student loan defaults as the 'whipping boy' of federal student financial aid.

Secretary Bennett is by no means alone in his concern for effective resolution of student loan defaults. Consider the following recent events:

> His 1985 statement was made in the midst of a host of "default prevention" proposals in Congress, some of which have already been enacted into law as part of this past year's Higher Education Amendments of 1986 *(Congressional Record* 1986).
>
> By the end of FY 1985, the cumulative amount of matured student loans in the Guaranteed Student Loan (GSL) Program had surpassed $36.6 billion dollars, with almost 70% of this growth having occurred since 1980.

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In 1984, the Congress passed legislation directing the Internal Revenue Service, for the first time in its 70 year history, to collect defaulted student loans and other amounts owed the federal government by offsetting the tax returns of delinquent borrowers (Reinhard, "Tax Refund Withholding" 1985).

A recent survey by the National Council of Higher Education Loan Programs reported that "the reduction of student loan default rates" was the single most important concern of state guarantee agencies (National Council of Higher Education Loan Programs 1986).

Both commercial lenders and participating schools have become increasingly aware and concerned about the impact of student loan defaults on their continued involvement in the GSL program.

In summary, student loan defaults have been and are currently a serious national concern on the part of all the participants in the GSL program. It is recognized by policy maker and practitioner alike as more of a threat to the quality and integrity of our federal student aid programs than any other single issue.

Clearly, student loan defaults are a problem. They are also a fact of life in any social program that lends money to young people with no credit history, no collateral, no cosigner, and no assurance of success in their educational pursuits. There has probably never been a more critical time in the history of student loans for us to reexamine, reevaluate, and rethink what we do and why we do it in the administration of student loans. Every facet of the student loan process should be reviewed with the thought in mind: "Is what we do and why we do it Part of the Problem or Part of the Solution?" Pogo said it best: "we have met the enemy and he is us!"

Who Defaults?

When the question "Who Defaults" is initially asked, one would think as long as the student loan programs have been in existence we could answer with overwhelming empirical data. Unfortunately, there is more myth than material, more feeling than fact, and the research is hardly extensive. Some attempts have been made. What these studies have brought to light are a limited number of generally accepted facts about the defaulted borrower:

Defaulters tend to have relatively small loan balances: Davis (1985) found that the average loan balance of defaulters tended to be between $2500 and $2700. Lee (1982) found that "cumulative loan size does not appear to be closely related to the probability of default. As the cumulative loan size increases, so does the number of years in school. The future income and/or propensity to repay loans may increase with more years of education."

First year students are the most likely defaulters: A study by the New York State Higher Education Services Corporation (1984) found "a strong inverse relationship between default and . . . years spent in school. Borrowers who last borrowed as freshmen had the highest default rate, 14.2%. The default rate dropped steadily as class level rose, with seniors and graduate students having the lowest level of defaults, 2.6%." Similarly, Davis found that 54% of Pennsylvania defaulters were first-year students. This result should come as no surprise, since first year students

are more likely to drop out before completing their education or training programs. The premature termination of studies often indicates dissatisfaction with such programs and frequently correlates with low earnings and/or unemployment after leaving school.

Defaulters tend to come from the ranks of younger students: Davis correlated the high incidence of default among first-year students, in part, to the relative youth of such borrowers. Younger students are often less mature, less worldly, and therefore less likely to exercise appropriate judgment when making educational and credit decisions.

Defaulters are more frequently low income borrowers: Ehlenfeldt and Springfield (1984), in a study of approximately 4,000 Virginia defaulters, found that over 77 percent were from families that, at the time their loans were originated, had total incomes of $20,000 or less. Those from families with incomes of $20,001 to $40,000 comprised approximately 20 percent of the state's defaulters, while students from families with incomes above $40,000 accounted for less than 3 percent of those who had failed to repay their educational debts. Low income students tend to be educationally, socially, and economically disadvantaged, so they are less likely to succeed in school. Upon leaving school, they are more likely to experience unemployment and/or low wages. Also, low income students are less likely to come from households in which credit experience is the norm.

Defaulters are more likely to have attended trade and technical schools and community colleges than universities and graduate schools: Lee (1984) reported a gross national default rate of 18.61 percent for two-year public colleges, 17.54 percent for proprietary institutions, and 10.28 percent for public four-year colleges. New York found that "people who last borrowed for attendance at vocational schools had a proportion of defaulters (17.2%) two times as great as borrowers who had attended two-year schools (8.6%). At four year colleges and graduate schools, the percentages of delinquent defaulters dropped lower still, to 4.8% and 2.7%." However, default rates among different school types may be less a function of such schools' policies and practices as a result of the characteristics (socioeconomic status, unemployment and/or income level after graduation, etc.) of borrowers who attend various institutions. Boyd and Martin (1985), for example, found the highest levels of unemployment among former GSL borrowers to be within the ranks of former proprietary school students, while the lowest unemployment levels came from students with postgraduate degrees. As Boyd and Martin concluded, "Evidently, higher degrees not only mean higher incomes but more regular forms of employment as well."

We also learned what came as no surprise to anyone . . . High risk students (low income, minority, low achievers) are more likely to default on a student loan than the traditional middle income, white, highly motivated student! This is no less true today than when the GSL Program was established in 1965. But at least in 1965 we had, as a nation, determined, and most appropriately so, *that such students were worth the risk!*

These were the very students that federal financial assistance was designed to rescue, to aid. When President Lyndon B. Johnson signed the Higher Education Act in 1965, he spoke of what it meant to the nation, its people, and its future. Because of all that went into the HEA, particularly the student aid provisions, he said "any high school senior in this great land of ours can apply to any college or university in any of the fifty states and not be turned away because his family is poor" (Johnson 1965). Students from "large families and poor families," he said, would be able to

learn how to be "mechanics and welders and operators of heavy machinery, and they will have jobs that are more enduring and more profitable than some . . . who go out to lead in our classrooms."

We must face our dilemma forcefully, honestly, and pragmatically. Defaults can be prevented, loans can be paid back in full, but we must first recognize an old ancient proverb: if you make enough loans to enough people over a long enough period of time, there will be some Defaults!!

Who is the Fault in "Defaults"?

In the thirty year history of the federal student loan programs, there has been a tremendous amount of debate over this question. From a purely legal and moral perspective, the student borrower is at "Fault". He or she borrowed the money and promised to pay it back, regardless of what the future might or might not hold for him/her.

From a policy perspective, there is the "Fault" of the federal government for not providing the necessary program administration, incentives, and funds to effectively control student loan defaults. There has also grown to be an unmistakable 'imbalance' of loan vs. gift aid available to needy students. This has occurred during the past five years due to a real dollar decline in the funding of Pell and other federal grant programs (Gillespie and Quincy 1984). In order to not deny access to needy students, schools have had to rely increasingly on loans, not grants, to meet students' financial needs. The total amount of debt burden a student can reasonably be expected to carry is becoming more and more a major concern (Hansen 1987).

Lenders, schools, and guarantee agencies are all at "Fault" for aggressively promoting the student loan program to encourage more borrowing in order to maximize yield, increase enrollments, and increase loan access. Now that we have entered a new era of balanced budgets, fiscal constraints, and more restricted growth in federal student aid programs, we are again hearing such phrases as "limited access," "credit worthiness," and the "raising of standards." New economic realities simply do not allow massive federal investments in the future of all its citizens. Former Secretary of Health, Education, and Welfare John Gardner once stated: "the society which exalts philosophy because philosophy is an exalted profession and scorns plumbing because plumbing is a humble profession will someday find that neither its philosophies nor its toilets will hold water."

The time has come to admit the obvious: we are all at "Fault" for defaults and in a real sense no one is at "Fault." There are and there will be defaults in any student loan program that serves needy students. The challenge for us is to continue to improve what we are now doing to more effectively control the defaults that we now have and will have in the future. If we truly believe in providing educational opportunity for all those we serve, then we must resist efforts to close the 'front' door of educational opportunity in misguided efforts to close the 'back' door of defaults. It is high time we took the "fault" out of "defaults" and put in its place a strong commitment to the future of the young people we serve . . . a strong commitment to improving the student loan programs we administer in order to preserve, not limit access to postsecondary educational opportunity.

Some Possible New Perspectives

If we can accept that fact that there are defaults without condemning the loan program and "throwing the baby out with the bath water," then we can more effectively address the question of solutions. As unpopular and politically unwise as it may appear on the surface, we must look at the question of acceptable tolerances in the default rate. Contrary to what others may think, there are acceptable tolerances

for default rates in the GSL program. It is important for us to develop realistic definitions and to educate Congress and the American public as to what is acceptable.

What levels of student loan default should Americans expect to bear? Why not 15 percent? While this may seem abnormally high, it still means that 85 percent of all dollars borrowed by students are being repaid — not a bad success rate for a program that lends money to young people who are without credit histories, lacking in collateral, unassisted by cosigners, and lack the assurance of success in their educational pursuits.

Another possible solution, no more popular than the first, is to provide substantial increases in grant funding for high risk needy students. Ideally, student loans should be the last thing awarded the student in his financial aid package after his eligibility for scholarships, grants, and work programs has been exhausted. No other solutions would do more to curb potential defaults than dramatic increases in grant aid. In the long run it is probably cheaper for society to provide grant aid to young and needy students than to pay their tab for defaulted loans. We must renew our efforts to seek and secure well balanced student financial aid programs at both the federal and state levels. Let's spend a little less on our military and technological hardware and a little more on the human resources that will one day be needed to manage that hardware. Political realities must be overcome and new priorities won in the never ending battle of the budget.

Finally, there is a solution that is somewhat independent of the Congress and the Department of Education. It is this solution that may ultimately determine the future of student loans in this country. Simply stated, this solution calls on all sectors of the student loan industry — schools, lenders, secondary markets, and guarantors — to take bold, new initiatives (not yet identified and/or agreed to) in establishing a better understanding of student loan defaults and in working together to more effectively prevent and control them.

A first step in his effort should most definitely be the sponsorship of an extensive national research effort to document the multifaceted nature of the student loan default problem in this country. What we now know about defaults is simply not enough. Who really is the defaulted borrower? What were the most significant factors surrounding his default? What other socioeconomic indicators were related to the actual default? In addition, loan servicing and collection practices should be studied as well as the various activities of schools and lenders.

The answers may not be pleasant. Some of us will no doubt find their policy implications threatening to the way we currently do business. But we must do the research, analyze the data, and replace the myth with a methodology that works.

Next we must expand and embrace self-regulation. If student loan defaults threaten the entire student loan industry, then we must exercise the appropriate accountability to all the publics we serve: students, taxpayers, policymakers, etc. Schools, lenders, and guarantors who experience serious default problems must take the necessary steps to effectively "clean house." Concerned associations like the National Association of Trade and Technical Schools, the National Council of Higher Education Loan Programs, the National Association of Student Financial Aid Administrators, and the Consumer Bankers Association must encourage reasonable, but firm, expectations of program administration on the part of their members. Peer pressure can be an effective tool in combating defaults, especially when it is one of the few remaining alternatives to sweeping government regulation.

Finally, we can improve what we are already doing. Schools, lenders, and guarantors should reexamine their current policies and procedures in light of changes which could help prevent defaults in the future. Improved student consumer information is

just one example of a possible area of needed improvement. In addition, schools must become more concerned about outcomes: the success of the student at the end of the program of education or training. It is not enough for the student to have the ability to benefit from the education, he must also have a reasonable chance to succeed in the pursuit of his educational goals. Support services such as tutoring and counseling programs must be available if the "high risk" student is to have any reasonable chance to succeed.

In closing, it should be pointed out that short-term solutions to a long-range problem simply will not effectively address the question of student loan defaults. We cannot afford, no matter how politically tempting, to quick-fix, budget-cutting solutions that continue to plague the GSL program. It is imperative that we address the issue of defaults openly, candidly, and in the context of what will most effectively solve the default problem and assure access to student loans in the future. This is what we must all truly be about. We have made a promise to the young people of this great nation. Their future and the future of our society demands that we keep it.

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