Student Aid Policy Analysis

Analysis of Preliminary FY2009 2-Year Cohort Default Rates

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INCREASE IN COHORT DEFAULT RATES

According to a May 20, 2011 announcement by the US Department of Education, the preliminary draft FY2009 2-year cohort default rate is 8.9%, up from 7.0% for FY2008 and 6.7% for FY2007.[1] Official default rates won't be published until September, after colleges have had a chance to correct errors in the data, but national aggregate statistics generally do not demonstrate much movement from draft to final publication. This is the highest 2-year cohort default rate since 1997, but still well below the 22.4% peak in 1990[2] that lead to passage of stricter controls on college eligibility for federal student aid as part of the Higher Education Amendments of 1992.

The following table shows the cohort default rates disaggregated by type of college and by loan program.

Type of College	FY2009 Overall	FY2009 FFELP	FY2009 DL
Total	8.9%	9.6%	5.8%
Public	7.3%	8.1%	5.1%
< 2-Year	9.9%	10.0%	7.4%
2-3 Year	12.1%	12.3%	10.9%
4-Year	5.2%	5.8%	4.1%
Non-Profit	4.7%	4.7%	4.5%
< 2-Year	14.8%	13.2%	15.6%
2-3 Year	10.1%	10.2%	9.4%
4-Year	4.6%	4.6%	4.1%
For-Profit	15.2%	15.7%	10.8%
< 2-Year	14.0%	15.3%	11.3%
2-3 Year	15.0%	15.5%	10.9%
4-Year	15.6%	15.8%	9.8%

As in previous years, the US Department of Education has truncated the default rates instead of rounding them to the nearest 0.1%.

The Direct Loan (DL) program had lower default rates than the FFEL program in all sectors except non-profit less-than-2-year colleges. That anomaly may be due to the small number of non-profit less-than-2-year colleges participating in the Direct Loan and FFEL programs at the time.

[1] http://ifap.ed.gov/eannouncements/052011CDR2009announcement.html
[2] http://www2.ed.gov/offices/OSFAP/defaultmanagement/defaultrates.html

DL accounted for 21.9% of borrowers in repayment and 14.3% of borrowers in default, down from 23.2% and 15.2% in FY2008.

BORROWERS IN REPAYMENT

The number of borrowers in repayment in FY2009 increased by 8.6% as compared with FY2008. (DL increased 2.2% and FFELP increased 11.1%.) The number of borrowers in repayment increased 5.3% at public colleges, 9.2% at non-profit colleges and 14.3% at for-profit colleges and 8.6% overall.

Of the borrowers in repayment, 49.4% were at public colleges, 22.6% were at non-profit colleges and 27.7% were at for-profit colleges. This compares with 50.9%, 22.5% and 26.3% in FY2008.

BORROWERS IN DEFAULT

The number of borrowers in default in FY2009 increased by 37.2% as compared with FY2008. (DL increased 28.7% and FFELP increased 38.8%.) The number of borrowers in default increased 26.9% at public colleges, 29.3% at non-profit colleges and 49.6% at for-profit colleges and 37.2% overall.

Of the borrowers in default, 40.4% were at public colleges, 12.1% were at non-profit colleges and 47.4% were at for-profit colleges. This compares with 43.7%, 12.8% and 43.4% in FY2008.

DEFAULT RATE INCREASES CONCENTRATED AT COLLEGES SERVING LOW-INCOME STUDENTS

Above-average increases in default rates occurred at public < 2-year (3.2%), public 2-year (2.0%), for-profit 2-year (2.4%) and for-profit 4-year (4.7%) colleges. The increase in default rates at for-profit 4-year colleges, from 10.9% in FY2008 to 15.6% in FY2009, was significantly higher than expected.

DIFFERENCES IN DEFAULT RATES CONCENTRATED AT 4-YEAR COLLEGES

Most of the difference in default rates according to control of institution is at the 4-year institutions, where public colleges have a 5.2% 2-year default rate in FY2009, non-profit colleges have a 4.6% default rate and for-profit colleges have a 15.6% default rate (7.4% overall average default rate). If we calculate a combined default rate for 2-year and less-than-2-year institutions, the default rates are 12.1% at public colleges, 11.2% at non-profit colleges and 14.7% at for-profit colleges (13.2% overall average default rate). For-profit colleges account for 48.0% of the defaults at 2-year and less-than-2-year institutions combined, but they also account for 43.2% of the borrowers entering repayment. The default rate at for-profit colleges is about a fifth higher than at 2-year and less-than-2-year public institutions, compared with three times higher at 4-year colleges. It is therefore likely that the higher default rate at 2-year and less-than-2-year for-profit institutions may have more to do with a greater percentage of students borrowing and students graduating with higher debt than with other factors.

For-profit colleges account for 93.1% of the defaults at less-than-2-year institutions, but that's probably because they account for 91.8% of the borrowers entering repayment from such colleges. With 2-year colleges the percentages are 39.8% and 34.7%. With 4-year colleges the percentages are 47.0% and 22.2%. Overall the percentages are 47.4% and 27.8%. So the disproportionate share of defaults at for-profit colleges is again due primarily to 4-year colleges.

PREDICTING FY2009 3-YEAR COHORT DEFAULT RATES

The US Department of Education did not release preliminary 3-year cohort default rates for FY2009 because the third year of the 3-year period is not yet complete. As illustrated by the following table, the 3-year cohort default rates in FY2008 are 60% higher than the 2-year cohort default rates for public colleges, 69% higher for non-profit colleges and 93% higher for for-profit colleges.

Type of College	FY2008 2-Year	FY2008 3-Year	Increase
Total	7.0%	12.3%	75.1%
Public	6.1%	9.7%	60.2%
< 2-Year	6.6%	13.0%	95.0%
2-3 Year	10.1%	16.3%	60.6%
4-Year	4.5%	7.1%	59.5%
Non-Profit	4.0%	6.8%	69.0%
< 2-Year	14.2%	23.0%	62.3%
2-3 Year	8.0%	14.7%	83.2%
4-Year	3.9%	6.5%	68.6%
For-Profit	11.6%	22.3%	92.7%
< 2-Year	12.2%	24.2%	98.8%
2-3 Year	12.6%	24.8%	97.2%
4-Year	10.9%	20.5%	88.3%

If we assume that the FY2009 3-year cohort default rates will demonstrate similar increases, then the 3-year cohort default rates will be as follows:

Type of College	Predicted FY2009 3-Year
Total	15.6%
Public	11.7%
< 2-Year	19.3%
2-3 Year	19.4%
4-Year	8.3%
Non-Profit	7.9%
< 2-Year	24.0%
2-3 Year	18.5%
4-Year	7.8%
For-Profit	29.3%
< 2-Year	27.8%
2-3 Year	29.6%
4-Year	29.4%

This suggests that all levels of for-profit colleges are at high risk of violating the 30% 3-year cohort default rate threshold when the 3-year cohort default rates are effective for sanctions in 2014.

FY2009 OR FY2010 COHORTS MAY REPRESENT HIGH WATER MARK

However, the FY2009 cohort started at the height of the recession and either FY2009 or FY2010 may represent the high water mark. The following table shows recent unemployment rates by educational

attainment for individuals age 25+, not seasonally adjusted. This demonstrates that the FY2009 cohort entered repayment at the height of unemployment rates during the economic downturn. Unemployment rates have started improving and will likely be lower by September 2011.

Date	High School Graduate, No College	Associate's Degree Recipient	Bachelor's Degree Recipient
September 2006	3.8%	2.8%	2.1%
September 2007	4.1%	2.9%	2.0%
September 2008	5.8%	3.8%	2.6%
September 2009	10.0%	7.0%	5.0%
September 2010	9.3%	7.5%	4.5%

Still, with averages hovering just below the threshold, there may be a significant number of for-profit colleges that fail to maintain eligibility for federal student aid when the 3-year cohort default rates become effective for sanctions.

For-profit colleges may find it challenging to maintain eligible cohort default rates while complying with the new gainful employment requirements. The loan repayment rate calculations depend on borrowers being in active repayment instead of a deferment or forbearance. Shifting default management efforts from deferments and forbearances to the various repayment options may lead to an increase in default rates even if these efforts are carefully targeted at high risk borrowers. Accordingly, it seems likely that for-profit colleges will need to also adopt other methods of reducing default rates, such as:

- try-before-you-buy policies (essentially aiming to shake out students who are unlikely to complete their education before they borrow),
- more selective admissions policies (e.g., no longer accepting students who pass ability-to-benefit tests instead of having a high school diploma or GED, adopting their own admissions tests or requiring high school GPA or standardized test scores above minimum thresholds),
- developing statistical analyses that predict intent to repay debt,
- customized support to at-risk populations (e.g., providing on-campus childcare facilities for students who are single parents),
- improvements in educational quality,
- cutting college costs (to the extent that it reduces debt at graduation) and
- encouraging graduates to move to where the jobs are instead of staying in impoverished neighborhoods.

(In addition, the predicted average 3-year cohort default rates for 2-year and less-than-2-year public and non-profit colleges are close enough to the threshold that many may be at risk of losing eligibility for federal student aid. Accordingly, it seems likely that many of these colleges may decide to opt out of the federal student loan programs while their default rates are still at eligible levels in order to preserve eligibility for the federal Pell Grant program, especially if borrowers represent a relatively small percentage of their student population.)

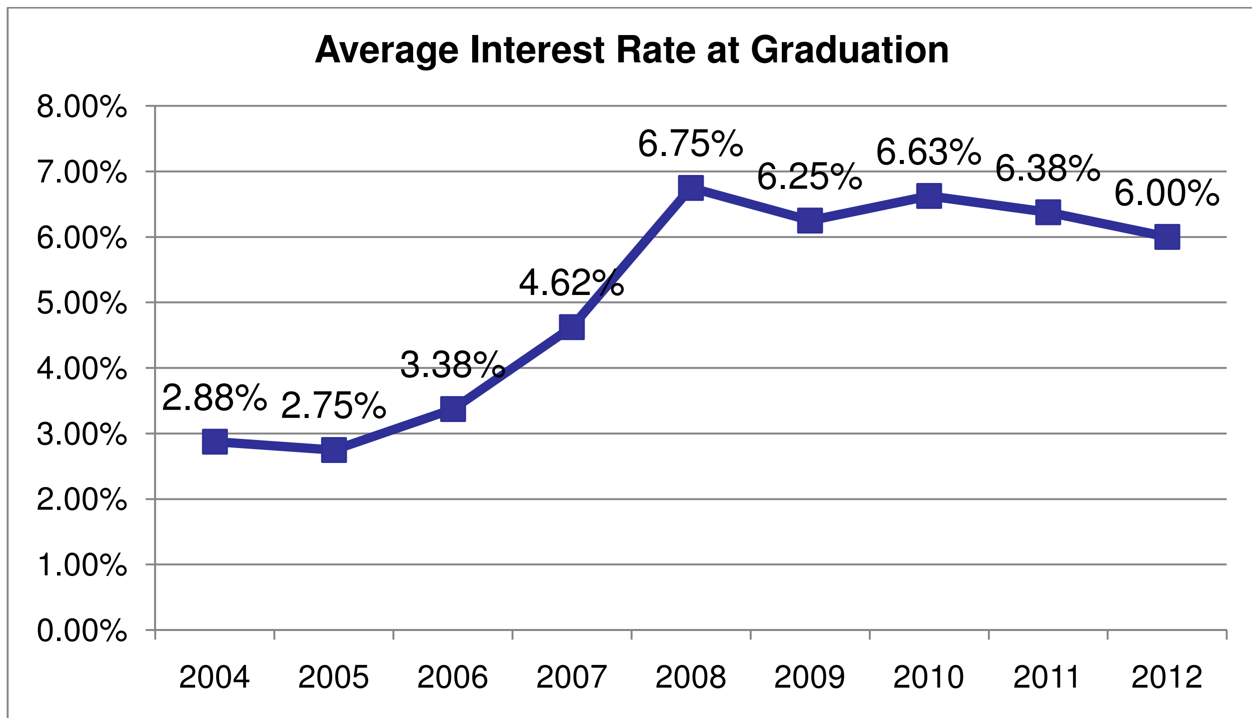
Note that with all new federal education loans made through the Direct Loan program starting on July 1, 2010, the number of loans entering repayment will start shifting significantly to the Direct Loan program with the FY2011 cohort, and should be mostly shifted with the FY2014 cohort. The Direct Loan program

is much less aggressive in offering deferments and forbearances to borrowers than the FFEL program, since the federal government does not have a financial incentive to delay inevitable defaults like the FFELP lenders. The switch to 100% Direct Lending will likely lead to an increase in the default rates of several percentage points.

PRIMARY DRIVERS OF COHORT DEFAULT RATES

The primary drivers of default rates are interest rates, graduation rates and job placement rates. A 1% increase in interest rates leads to a 5% increase in the monthly loan payments on a 10-year term and 9% on a 20-year term, making it more difficult for borrowers to afford their debt. Students who don't graduate default at three times the rate of students who graduate. Students who can't get jobs due to high unemployment have greater difficulty repaying loans.

The switch from variable rates that could be locked in as low as 2.88% (2005) and 4.75% (2006) to fixed rates of 6.8% for new loans starting 7/1/2006 meant that borrowers have experienced a significant increase in average interest rate at graduation for the past several years, despite the phased-in rate reduction on subsidized Stafford loans for undergraduate students. The following chart models the average interest rate at graduation for Bachelor's degree recipients based on typical borrowing patterns for subsidized and unsubsidized Stafford loans. The average interest rate will probably increase in 2013 because of the ending of the phased-in interest rate reduction on subsidized Stafford loans, increasing the interest rate to 6.8% in 2012-13 from 3.4% in 2011-12.



High unemployment rates for college graduates, although lower than for people with just a high school diploma, are a key factor. The 3.2% increase in unemployment rates for college graduates from September 2008 to September 2009 exceeds the 1.9% increase in cohort default rates.

Graduation rates appear steady enough that they would not have affected default rates.

Finally, the early repayment status loophole in 2005 shifted a significant number of borrowers from later cohorts to earlier cohorts. These borrowers were able to lock in a low rate of 2.88%, making them less likely to default. The borrowers who did not take advantage of this opportunity were less alert (i.e., not paying attention to all the letters about the opportunity to lock in a low rate while they were still in school) and so are more likely to default. FY2009 is probably the last year in which this shift will have had a significant impact.