White paper

Crisis averted or merely postponed?
Examining long-term cohort default rates, resolving defaults, and curing delinquencies

Since the publication of the *Crisis Averted* white paper in March of 2005, there have been some new questions raised about who defaults on student loans. Conventional wisdom has always borne out the fact that very few students in the statutory default cohort have graduated from any institution. When looking at long-term repayment and default statistics, the trend is not as clear. Graduates still do pretty well, but significantly more of them end up defaulting after seven years compared to the two years typically studied.

There is also some variation when comparing different kinds of institutions. We found differences in 2003 and 2005 between students at proprietary, two-year public, four-year public, and four-year private institutions. However we have also found considerable variation between Hispanic-Serving Institutions and other institutions.

This revision of the white paper addresses these two issues for the first time. We feel these are important data to bring to light for the future of student lending practices and for states, like the State of Texas, where the future of the state is closely linked to the future of a rapidly growing Hispanic minority.

Introduction

The higher education community has spent the past several years enjoying success at reducing student loan defaults. The skyrocketing rates of the early 1990s have been legitimately reduced by a significant margin (see fig. 1). However, a closer review of the data requires us to ask: Is our collective success at curbing defaults real; and, equally important, is it sustainable? There are some alarming data that suggest some of the changes implemented since the 1992 Reauthorization of the Higher Education Act (HEA) have merely postponed some student loan defaults for a period from two-to-six years. It must be noted that the amount of pressure brought to bear on all the sectors of the higher education and lending communities has been intense. Initially, the threat of sanctions against institutions garnered a great deal of attention. As time passed, however, it became less a question of official sanctions and more a question of negative publicity. No institution, be it school, lender, or servicer wants to have a high default rate among its borrowers.
This white paper was inspired by several reports. The most immediate inspiration came from the groundbreaking dialogue and study conducted in 2002 by TG and the Council for the Management of Educational Finance (Council). This study confirmed something TG had been tracking for years. Student loan borrowers, when measured over a longer period of time (six years rather than two years), default at significantly higher rates than the publicized cohort rate calculated during the first two years of repayment. Also, a number of Government Accounting Office (GAO) and Office of the Inspector General (OIG) of the U.S. Department of Education (ED) reports published between 1999 and 2003 provided impetus to continue studying defaults and delinquencies. All of these reports recommended changes to the calculation of the cohort default rate or replacement of the cohort default rate. Particularly salient to this White Paper was the recommendation by the OIG that ED publish a lifetime cohort default rate.

In FY 2003 and 2004, students and parents borrowed an estimated $110 billion in additional federal student loans, not including the consolidation of old loans. Private education loans, once a tiny fraction of education borrowing, are estimated to have grown 355 percent between 1995-96 and 2001-02, increasing from $1.1 billion to $5 billion during this period. Going forward, TG and the Council believe it is important to reexamine some of the data collected in 2002, collect comparable data, add to what was collected, and take a fresh look at emerging concerns.

The importance of studying the long-term consequences of student borrowing at this time cannot be overstated. Currently, the pressures applied to the higher education and lending communities appear to have solved the grave crisis of student loan default over the period since the 1992 Amendments to the HEA. However, a period of historically low interest rates and the opportunity to lock in a low, fixed interest rate with a consolidation loan are coming to a close. It would be unfortunate if no one took the initiative to study loan defaults in a way designed to determine the thoroughness of the solution.

The purpose of this updated study is to assess where the student loan community has gained or lost ground, and to suggest data points for future study to improve community performance in this critical area. There are some changes to the good to be seen in the area of Consolidation loan defaults in this study and an overall improvement in default rates. However, the default rate by sector (i.e., public, private, etc.) has not changed appreciably in the
intervening three years. As a comparison with consolidation loans containing prior defaulted loans, TG has added a new data point in this study. This study includes a look at the rate at which rehabilitated loans go back into default over a long period of time.

The study also includes an emphasis on trends in loan servicing through the cures of delinquencies. In many ways, this emphasis is a proxy for the entire student loan community. Servicers, and the default prevention counselors at TG, when dealing with delinquent borrowers, are on the front lines of default aversion. Similarly, those critical policies, procedures, and guidelines individuals follow when dealing with delinquent borrowers represent the intense, aggregated pressure from institutions, lenders, elected officials, and community leaders to reduce the statutory cohort default rate. Servicers must respond to this pressure in a way that their business model can sustain. The result may be reflected in the frequency different cures are used by different servicers.

By reviewing changes in long-term default rates between 2002 and 2005, comparing different types of default resolutions, and reviewing servicing trends, we hope to see the effects of changes over the last three years. We also hope to spot ways to continue improvements in the long term.

Background

In 2002, TG and its partner, the Council, hosted "An Industry Dialogue with Servicers" in Dallas, Texas. The event brought together members of the servicing, school, and lending communities to discuss policies, practices, and trends regarding deferments, forbearances, loan consolidations, and the future of loan servicing as they relate to default aversion. To prepare for the dialogue, TG examined some of the issues, policies, and practices that lenders and servicers employ to address student loan default — particularly those related to delinquency prevention and default aversion.

Today’s historically low cohort default rates are the result of many individuals working continuously to develop innovative practices and policies. Many of the technological and process improvements in the student loan community are due to the proactive alliance-building of many committed organizations and community stakeholders. It was in this spirit that the 2002 industry meeting was organized and conducted, and this spirit continues to drive the community today.

Analysis

Long-term cohort default rates in 2002 (as quoted from the original White Paper)

TG compiled statistical data on cumulative cohort default rates for TG-guaranteed loans. Nationally, cohort default rates reported to the U.S. Department of Education for the two-year tracking period after a student leaves school have trended down significantly, from rates as high as 15-20 percent in the early 1990s, to less than five percent for the 1999 cohort. This is a good indication of the effectiveness of the policies and practices that the student loan community has put in place to address default within the two years after a student leaves school. However, if the same cohorts are tracked over the life of the loan, the default rate continues to increase, reaching a cumulative cohort default rate in the mid-to-high 20 percent range.
Long-term cohort default rates in 2005

TG compiled statistical data on cumulative cohort default rates for TG-guaranteed loans (see fig. 2). Nationally, cohort default rates reported by ED continue to be low. Long-term cohort default rates continue to be substantially higher than those used to compute an institution's cohort default rate. There are, however, some differences worth noting between current rates and those of three years past. By school-type, the rates have only slightly decreased despite the fact that the default rate after five years for all TG-guaranteed loans has decreased by nearly five percentage points in the same time. What has changed is the number of consolidation loans being made, which continues to increase significantly.

Figure 2: TG cumulative cohort default rates

![Figure 2: TG cumulative cohort default rates](image)

Note: For all cohort default rate calculations, Year 0 refers to the 0-12 month period that forms the cohort, while Year 1 refers to the year-long period (i.e., months 13-24) in which defaults are tracked for the cohort.

Long-term cohort default rates by school type

According to TG data, the long-term default rates reach more than 35 percent six years after borrowers enter repayment for two-year schools (see fig. 3) and more than 40 percent for career colleges and schools (see fig. 4). After six years, the long-term cohort default rate of four-year public schools increased to roughly 17 percent (see fig. 5), and it was nearly 16 percent (see fig. 6) for four-year private schools.
Figure 3: TG cumulative cohort default rates for 2-year schools

Figure 4: TG cumulative cohort default rates for proprietary schools
Figure 5: TG cumulative cohort default rates for 4-year public schools

Figure 6: TG cumulative cohort default rates for 4-year private schools
Default status of repayers by type and place of enrollment

Recently, TG elected to analyze its long-term cohort default rates in a new way. Most data tracked by organizations show that students who graduate are extremely successful in loan repayment and have very low default rates. We have been concerned that we should analyze this assumption over a longer term, as we have for other sectors of higher education. The findings are more troubling than the expectations that many have.

Moreover, TG recognizes the need for Hispanic students to attend and graduate from institutions of higher education at much higher rates than they currently do. Therefore, we also chose to analyze those institutions in Texas that are most likely to be attended by Hispanic students: Hispanic-Serving Institutions (HSIs). For purposes of the Higher Education Act, an institution must have a headcount population that is at least 25 percent Hispanic to be an HSI.

Figure 7 shows the cohort default rate for all TG borrowers from 1999. It is broken down by enrollment status. So, of all the TG borrowers who were graduates, for instance, only 3 percent of them defaulted on their student loans. Of all the students who were less-than-half-time in 1999, 4 percent defaulted on their student loans within two years. As expected, the group most likely to default was students who withdrew completely without graduating. Finally, of all the students who entered repayment in 1999, 7 percent defaulted within two years.

The makeup of the cohort changes over the long term also.

The number of defaulters who graduated with a degree increases by four times compared to the number of defaulters who left school (which only doubled).

The borrowers we are accustomed to seeing in the statutory cohort — students who left before completing — default in larger numbers soon after departing. Graduates avoid defaulting longer but begin defaulting in significant numbers beyond the two-year cohort. This trend should be of concern for everyone, but is especially alarming for development and alumni officers.
The standard cohort default rate for non-HSIs in Texas is very similar to the national average for all TG borrowers.

Borrowers at non-HSIs in Texas defaulted at a slightly lower rate than borrowers in the TG portfolio as a whole. However, as figure 9 shows, there was still a significant increase in the number of defaulters and in the number of defaulters who graduated.

For borrowers from HSIs, the standard cohort default rate is a little higher than the national average or the Texas non-HSI average.
Anyone looking at the long-term cohort default rate for HSIs would have to be concerned. According to TG’s statistics 20 percent of all the graduates of Texas HSIs in 1999 defaulted before the end of seven years (see figure 10).

While we don’t know exactly why graduates of HSIs default at such high levels, we can speculate about some of the correlations. Looking back at the long-term rate for community colleges — and realizing that HSIs are predominantly community colleges — they must share some of the same factors. Geography, local unemployment and economic factors, and family economic situations are some of the likely reasons contributing to this high rate.
Default rates and the impact of consolidation in 2002
(quoted from the 2002 White Paper)

TG also examined the default rates of Consolidation loans in its portfolio. When borrowers consolidate their loans without having any previous loan(s) in default, the default rate is under 10 percent over the life of the Consolidation loans. However, when one or more of a borrower’s underlying loans has been in default prior to the consolidation, 50 percent of borrowers default on their Consolidation loans.

Default rates and the impact of consolidation in 2005

It bears mentioning that median borrower indebtedness continues to increase for student loan borrowers. Consequently, consolidation loan dollar amounts are rising, as are the dollar amounts of claims on consolidation loans. The number of consolidation loans is also rising with the current borrower-friendly interest rates. While borrowers with consolidation loans with no underlying defaulted loans defaulted at or near six percent three years ago, they default at three percent now. (See fig. 11) For consolidations made after a prior default, the picture is murkier but improving. (See fig. 12) In 2002, default rates for cohorts at six years were around 50 percent. Now, a cohort that has run six years only reaches about 40 percent.

Figure 11: TG cumulative cohort default rates for straight consolidations
Comparing consolidation loans containing defaults to rehabilitated defaulted loans

In 2002, there was no attempt to compare subsequent defaults to the methods used to bring the loan out of default. At that time, the default rate on consolidation loans over a six-year cohort was around 50 percent. Currently, the seven-year cohort default rate for consolidation loans containing defaulted loans is down to near 40 percent.

There are three methods to restore eligibility for Title IV assistance, which is one of the aims of resolving a default. The three methods include consolidation by which the borrower takes a new loan that pays off the defaulted loan. The defaulted borrower can also use reinstatement. To reinstate eligibility, a borrower must make six, consecutive, voluntary, on-time payments on the defaulted loan. Finally, rehabilitation requires the borrower to make 12 consecutive, voluntary, on-time payments on the defaulted loan.

There are pros and cons to each of the three methods. Consolidation is faster, but rehabilitation not only restores Title IV eligibility, but removes the default from the credit report. Because both reinstatement and rehabilitation require making on-time payments, many regard them as superior because they feel these methods instill in the borrower a habit of making payments and budgeting for the payments. Individuals using one of these methods to resolve a default may also have different motivations. Reinstatement and consolidation are much faster than rehabilitation and may be used more by those wishing to further pursue their education. Those individuals may also borrow more.

TG has maintained cohort data on rehabilitated loans and consolidation loans that contain at least one defaulted loan. These two data sets can provide some basis for comparison. Currently data is not available for borrowers who reinstate their loans and subsequently default.
Rehabilitation defaults

The cohort default rate for rehabilitated loans is relatively unstable but has decreased over time (see figs. 13 and 14). However, at its height three years ago, the seven-year cohort default rate for rehabilitated loans was only 25 percent. That was a much lower rate than for consolidation loans with underlying defaults.
Curing delinquent loans

“Curing” delinquent loans is the process whereby a loan, which is delinquent 60 days, is referred to the guarantor by the servicer. The guarantor then assists the servicer by contacting the borrower and trying to get the borrower either to resume repaying the loan, or receive permission to stop making payments through the deferment or forbearance process. The guarantor, in this case, TG, is assisting the servicer and has to work within the guidelines the servicer uses. Therefore, even though TG may be a part of many cures, the servicer’s individual policies and procedures dictate what is and is not possible.

Some have suggested that the difference in the cures in servicers’ portfolios is due to the different individual borrowers that make up the portfolio. Undoubtedly this plays a role. However, the sample sizes represented by some of the larger servicers’ portfolios and the differences in the outcomes for large numbers of those borrowers suggest very strongly that each servicer’s policies and procedures are powerful driving forces.

Figure 15 is a snapshot of cures from a six-month benchmarking study conducted by TG. The six months overlap FY 2002 and 2003 (June – November). The study includes all cures involving TG during that time period.
In figure 15, it is apparent that cures are achieved using primarily forbearance. The second most frequent cure is for the borrower to resume making payments. The least used instrument for curing a delinquency is the deferment. However, statistics vary widely from servicer to servicer over time.

![Figure 15: Average cure rate by type for all servicers](image)

Reviewing the types of cures per servicer over a three-year period from FY 2001 to FY 2003 yields a very uneven picture (see figs. 17-19). (The names of the servicers in these samples have been removed for confidentiality.) Forbearance is still the primary means of cure, but the frequency of other types of cures varied widely. Furthermore, in any given year, there are several servicers that are not relying primarily on forbearances.

This leads to some notable discrepancies in how different borrowers are treated and the rates of forbearance, deferment, and payment among the cured delinquencies for each servicer. For instance, in figure 16, a borrower is much more likely to have a delinquent loan cured by forbearance if he or she has a loan serviced by Servicer A than Servicer Z. Conversely, a student with a loan serviced by Servicer Z is more likely to receive a deferment or resume making payments than a borrower with a loan being serviced by Servicer A.

In general, servicers that use a significant number of forbearances usually fall into two subgroups — one subgroup that also collects a significant number of payments and uses very few deferments, and another that uses forbearance almost exclusively. Furthermore, deferments are used the least. Only one servicer used deferments as the primary means to cure delinquencies, and that was only in the most recent fiscal year (see fig. 16). Finally, many servicers have an unbalanced cure strategy. For this instance, “unbalanced” is defined as using one or two tools to the exclusion of the other(s). Striking a balance, especially if it means using a high percentage of deferments, is generally the most expensive option because use of deferments is likely the most labor intensive option. However, it is also likely to be the most beneficial for the borrower who qualifies for a deferment.
If we slice the data another way, and view cure types by servicer in each of three fiscal years (see figs. 17 to 19), most servicers’ strategies do not change dramatically from year to year. For instance, Servicer A, which uses a very high percentage of forbearances to cure loans, does so in every year.

As indicated by the data provided above, servicers have used a high rate of forbearances over the past several years to cure loans. Some of the reasons for the continued and increasing use of forbearances include the fact that forbearances are often the simplest cure available. Additionally, for borrowers of unsubsidized loans, there is no difference in the monetary benefit between an economic hardship or unemployment deferment and forbearance. Furthermore, applications for forbearance are readily available from various sources. Applications for deferment should be just as available, but they are usually longer forms with more stringent requirements. Also, forbearances can be granted through a verbal request without all the documentation that borrowers need to gather and provide for a deferment.

There are limitations to the data presented. These data do not track the length of time after a cure a borrower remains in good standing, how many borrowers in deferment or forbearance successfully repay without becoming delinquent again, or how many borrowers would have been better served with a different type of cure. As an example of this, how many borrowers becoming delinquent after a period of years are reporting repeated forbearances having been granted for periods of up to 66 consecutive months? How many borrowers used a short-term forbearance to escape temporary hardship and went on to repay their loans?
Figure 17: Cures by forbearance per servicer FY 2001 – 2003

Figure 18: Cures by payment per servicer FY 2001 – 2003
Findings and conclusions

Long-term default rates

Over the last three years, default rates have decreased, despite the increase in median borrower indebtedness during the same period. This correlation might seem surprising; however, borrowers default on loans for a variety of reasons. In fact, borrowing more money is not the primary determinant of whether a borrower will default. These findings are also reasonable given that many in the student lending community have worked hard to keep default rates going down. At least some of what the community is doing must work. However, even the longer-term default cohorts measured do not exceed the total length of time some loans are remaining in forbearance. This reinforces the concern that some of the defaults are being postponed rather than cured.

We must assume that no strategy for default aversion can be 100 percent successful, but over the long-term, some will be more successful than others. The continued focus on the two-year cohort default rate and the pressure associated with it from government and other sectors makes it likely that some manipulation will remain in the system to consciously postpone defaults outside the official two-year cohort window. We must eliminate as much manipulation as possible. Ultimately, long-term success depends on crafting pathways for borrowers over the entirety of the repayment period.

Default rates by sector of higher education (e.g., private, public, degree level) have changed relatively little, but the default rate for consolidation loans has changed significantly over the three years between studies. Additionally, borrowers continue to consolidate at very high rates. It is possible that the availability of low, fixed interest rates for the life of repayment is a key driver of the lowered default rates in the long term. The extended repayment terms available to consolidation loan borrowers also could be a driver.

The attractiveness of locking in low interest rates has been well publicized, and, no doubt, driven many to consolidate their loans. One possibility for the association of very low default rates with never-defaulted consolidation loan borrowers is that through consolidation, some borrowers who would have defaulted became more aware of the repayment process, and therefore, were successful over a long period in repayment. If this premise is true, it is likely that a switch to variable rate consolidation loans or a steep increase in interest rates will cause a big drop in the number of consolidations and a resultant upsurge in overall defaults.
There are other possibilities that could account for some or all of the generally excellent performance of repayers with consolidated loans and no defaults. One possibility is that consolidation loan borrowers are primarily people who are paying attention to their student debts and would have repaid their loans successfully with or without consolidation.

Another view is that simplified repayment and lower repayment amounts from consolidation have helped more borrowers to be successful in repayment. In fact, this is a stated reason for the existence of the program. Consolidation borrowers will continue to benefit by making payments to fewer entities and making lower monthly payments by stretching repayment terms up to 30 years, depending on the amount borrowed. If that is the case, the change in consolidation rules and interest rates will be less likely to have a big effect on defaults.

The decline in the default rate over the last three years for consolidation loans with underlying defaulted loans is an interesting situation. Some analysts have looked at the 40-percent rate at which prior defaulters default on their subsequent consolidation loans with alarm. That may or may not be appropriate. The fact is more than one-half of prior defaulters have managed to stay out of default for five or more years after consolidating. Prima facie, resolving half of the defaults is an achievement. The fact that the rate of defaults for borrowers with rehabilitated loans is pretty consistently half of that for borrowers with consolidation loans with underlying defaults suggests that we could do better.

There are a number of potentially salient differences between defaulted borrowers with rehabilitated loans and consolidation loans. It is conceivable that borrowers use rehabilitation and consolidation for different purposes. Consolidation does not provide the robust reversal of negative effects to a credit report that a rehabilitation does, but it can be completed much more quickly. It may be that defaulted borrowers utilizing a consolidation loan to resolve a default are more interested in regaining Title IV aid eligibility; whereas, borrowers going through rehabilitation are more concerned with solving the default and credit issues. One can imagine that this is a difference that would impact future defaults especially if consolidation borrowers were much more likely to borrow again immediately after resolving their defaults. It has also been suggested that the differences in the default rates of consolidation loans and rehabilitated are due to the borrower having established the habit of making payments and budgeting for them.

**Issues with delinquencies**

Individual borrowers and their situations are unique. There is no “one-size fits all” approach to servicing student loans in delinquency. Despite that fact, the notable differences in the approaches servicers take to curing loan delinquencies lends itself to closer review. The high rate of cures from forbearance is a legitimate cause for concern. For some students, those who have no subsidized loans, a deferment or forbearance makes no monetary difference. However, the process of obtaining a deferment and the time limits on them may confer an advantage.

The real issue with forbearances is the way they are used or possibly misused. In many cases, it is in the best interest of the borrower to receive a forbearance until the borrower’s circumstances enable him or her to begin repaying again. However, when forbearances are used in lieu of a deferment because of the difficulty of negotiating the process or to save phone center time and money, the borrower’s chances of successfully negotiating repayment may be compromised. When borrowers are granted a series of continuous forbearances without any intervening periods of payment, the borrower’s chance for success are certainly compromised. Forbearance can only be granted one year at a time so at least annual follow-up must occur. The real danger with forbearances is the borrower whose loan has been forborne for more than one year, with little counseling or follow-up. This borrower’s debt increases dramatically during the forbearance period so that when the lender finally refuses to grant additional forbearances, the borrower’s payment is so high he or she still cannot afford the payment. Is it feasible that the borrower may have become able to repay long before the end of the forbearance, but does not? That borrower then may be susceptible to owing a much larger amount than he or she would have had the counseling and follow-up been more consistent. In its most extreme cases, a scenario like the one described above, could lead to unnecessary defaults — not just postponing a default, but contributing to the causes.
Recommendations for future study

Several questions arise from the analysis that suggest directions for future research. An analysis of consolidation loans with underlying defaults, rehabilitated loans, and reinstated loans could be invaluable. Reinstatements are also a route to becoming Title IV eligible relatively quickly. They may compare more closely with consolidation loan defaults than rehabilitated loans. If the habit of making payments is a crucial factor in lowering subsequent default rates, we might expect reinstatement default rates to more closely mirror those of rehabilitations. In any future study of default rates among the three categories of previously-defaulted loan borrowers, it would be good to have absolute numbers of borrowers and loan amounts for comparison. Finally, it would seem to be of paramount importance to know which borrowers went on to borrow more after regaining Title IV eligibility.

Future studies of servicing trends would benefit from at least two additional measures. We have stated that what happens between the servicer and delinquent borrowers is a proxy for studying how the pressures from various sectors of the student loan community influence delinquency cures. First, to clarify the picture of what those interactions are, it would be helpful to look at delinquency cures by higher education institution type just as we do for long-term default rates to determine if forbearances, or other types of cures, dominate particular sectors. Second, to improve our understanding of what is most beneficial for borrowers, we need to track a sample of borrowers whose loans are cured from entering repayment, through a cured delinquency, to a period of successful repayment or default.

We have suggested some of the reasons why HSIs might have higher default rates among their graduates, but we need to find ways to investigate the reason more closely. The only way to address the problem is to find correlations that explain the behavior. Similarly, there must be some correlation with what borrowers do several years after graduating from college that explains why they default in larger numbers in the out years compared to their non-graduating counterparts.

Conclusion

TG and the Council are eager to work in concert with the higher education community. We know that only by collaborating will we be able to refine our collective efforts in default aversion. Together the possibilities to create innovative policies and practices are endless. The results will help ensure the viability of the student loan community and the success of students and families across the country.

If the higher education community does not do enough to address the long-term default issue, then we risk another firestorm of criticism similar to the one that launched the changes in the 1992 Reauthorization. It is worth remembering that several GAO and ED – OIG reports have dealt with this issue between 1999 and 2003. We have to address these issues or be prepared to have solutions mandated. Let us not forget the far-reaching nature of some of the reforms initiated in the 1992 Amendments. The cohort default rate and changes in accreditation recognition remain with us, and many schools do not. Legislative remedies, like the State Postsecondary Review Entities (SPREs), which happily never actually went into effect, could return.

For additional information on this study, the Council, or TG's delinquency and default prevention efforts, contact Maria Luna-Torres, TG Director of Education Finance Initiatives, at maria.luna-torres@tgslc.org.