Designing Better Ways to Regulate Colleges with Too Many Students Who Default on Federal Loans

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As more students take out loans to pay for college, growing numbers struggle to repay their debts. America's national student loan default rate has steadily risen – reaching the point where one in every seven students now defaults. Federal law currently provides one tool to limit or reverse this worrisome trend – using the so-called "Cohort Default Rate" defined in the Higher Education Act. This rate is defined as the percentage of borrowers from a given college or university who begin to repay their loans but default within three years. If a given college's cohort default rate rises above 30% for three consecutive years – or shoots above 40% for one year – then the college is supposed to lose the ability for its students to get federal Pell Grants (for low-income students) or to take part in the Direct Loan program (which helps students borrow at reduced rates).

This sounds like a good way to keep colleges from dumping large numbers of defaulting former students on the U.S. taxpayer. But unfortunately the current version of the policy does not work very well and cries out for reform.

Who Defaults on Student Loans?

Researchers used to think that minority and low-income students were automatically the ones most likely to default, but they now have a more precise understanding. Tellingly, the sheer level of debt a student builds up is not a good predictor of default. Many defaulters leave college without degrees, so their average debt load of $14,200 is far below the national average of $24,400. New studies reveal that the students most likely to default are those who leave college with debt but no degree, those who cannot find employment, and those who have attended for-profit colleges. For-profit colleges boost their profits by heavily recruiting poor and minority students who are eligible for federal aid. The average for-profit institution receives over two-thirds of its revenues from federal student aid, even though many students do not graduate.

How the Cohort Default System Applies to Colleges

A "cohort" of borrowers are all those who begin repayment in the same fiscal year, and colleges must report to the federal government on the default rates for each cohort every year as their students who have borrowed – whether they graduate or not – become part of the repaying cohorts. It is important to follow each cohort of borrows for multiple years, because it takes at least nine consecutive months of non-payment for any given student's loan to enter into default. If borrowers were followed for the full lifetimes of their loans, then default rates would be much greater than they seem to be when re-payers are followed for just three years. Nevertheless, the average three-year cohort default rate is currently 14.7% – quite high, but not high enough to cause most colleges to loose eligibility to participate in federal grant and loan programs.

Cohort default rates vary sharply by the type of colleges. For-profit institutions have the highest rate of defaulters, 21.8%, followed by public colleges at 13.0% and non-profit private colleges at 8.2%. Overall, for-profit colleges are the most likely to surpass the default threshold, making them ineligible to have their students get further federal aid.

Why the Cohort Default Rate System Does Not Work

However, colleges with many defaulting students hardly ever face serious sanctions. Even when a college exceeds the 30% level, it has three years to get its cohort default rate below that high level. Many colleges that get into trouble simply start advising their student borrowers to apply, as individuals, to enter the existing federal program for deferment and forbearance of loan payment requirements. This step actually raises long-run repayment costs for such student borrowers, but if many students get deferments, the institution can get its cohort default rate back below 30%, even if just for one year. That achievement, in turn, restarts the clock to allow the college to avoid federal sanctions and keep collecting revenues from federal aid.

Another big issue is that the current system fails to account for the proportion of student borrowers enrolled in a given college. A brief example shows how that can lead to unfortunate results. Cuyamaca Community College in El Cajon, California enrolled around 13,000 students in a particular year, only 63 of whom borrowed using federal loans. But 20 of those 63 defaulted, creating a cohort default rate of 31% that threated to subject the college to federal sanctions. A relatively tiny number of defaulters, in short, put the institution at risk of losing the $9.5 million it disburses to more than 3,000 low-income students who are Pell Grant recipients.

Colleges in this situation can make a special kind of appeal to the U.S. Department of Education, but there is no guarantee the appeal will succeed. For that reason, fully one-fifth of the nation's community colleges do not allow students to take out federal loans in the first place. This step protects institutions from facing sanctions due to elevated cohort default rates, but it also forces many young people of modest incomes – the types of students who attend community colleges – either to pay higher loan rates or forego college attendance altogether.

How Can Federal Policymakers Improve the System?

A range of reforms could give the federal government more effective tools to reduce student loan defaults and hold colleges accountable:

- **Adjust cohort default rates to include the proportion of students who borrow.** By combining a school's default rate with its borrowing rate, the system would ensure that colleges with relatively few borrowers would be unlikely to face sanctions. A new "Student Default Risk Index" has been proposed by the Institute for College Access and Success.

- **Track repayments for longer periods of time.** Student loans are often repaid on ten-year plans, but repayments are only tracked for three years, which underestimates the overall default problem. Cohort default rates should be tracked for as long as the standard repayment period.

- **Make it harder for poor-performing institutions to use federal aid.** Colleges are eligible to participate in federal aid programs only if they are accredited by designated agencies. Right now, the worst cohort default rates are found in institutions, especially for-profits, accredited by a few agencies. The Secretary of Education could move to remove accreditation rights from agencies that have, in the past, approved too many colleges with poor repayment rates.

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