Insight

When is a Student Loan Default, Not a Default?

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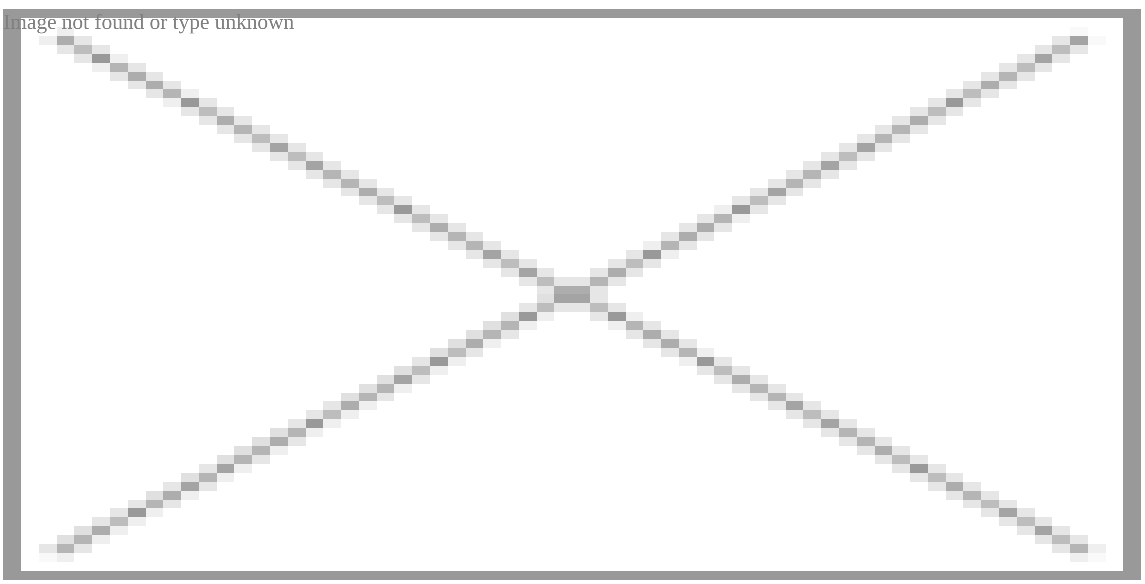
The Department of Education released new data for cohort default rates, the measure of how many students have stopped paying their federal student loans. Although the headline was generally positive – fewer students are in default – the numbers aren't exactly straightforward. By excluding certain defaulted borrowers from its calculus, the Department of Education helped ensure that certain institutions at risk of losing their eligibility for federal financial aid continue to have access to taxpayer dollars.

Cohort Default Rate Defined

A 3-year cohort default rate is the percentage of a school's borrowers who enter repayment on certain federal loans during a particular federal fiscal year (FY), October 1 to September 30, and default or meet other specified conditions[1] prior to the end of the second following fiscal year. The cohort default rate is used as a proxy for institutional quality; the idea is that lower-quality institutions will have higher default rates. It's slightly tortured logic, but it's the law. The rates are calculated annually, and each institution has its own default rate.

Figure 1: Average Rate Formula



The good news, as the Department of Education announced, is that the results for the newly calculated cohort default rates are down from the year before. Default rates fell from last year's reported rate of 14.7 percent to 13.7 percent. That's a positive sign, as it means fewer students are skipping out on their obligations.

Chart 1: Student Loan Default Rates

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Further good news reflected in the numbers, though unheralded by the administration, is the continuing decline in default rates for proprietary schools – down 3.6 percent from the data released in 2012.

Fudging the Numbers

But, this being Washington, things are never as simple as they seem. Prior to the release of the data, the Department raised eyebrows by announcing a change in the way default rates are calculated. Rather than take into account all loans, the Department decided to exclude certain loans from borrowers who had multiple servicers (the companies managing their loan repayments) and who were in default on one, but not all, of their loans.

This decision changed the numerator of the Department's calculation by excluding a number of loans (we're not exactly sure how many) from a number of institutions (here again, we're not sure how many) without changing the denominator. In other words, the Department padded the numbers a little bit by excluding a number of defaulted loans under the guise that certain borrowers probably intended to repay their loans, but simply lost track because more than one servicer held their various loans.

The formula change results in mitigating risk for some institutions, as those schools with higher default rates could lose their eligibility for federal financial aid. The rate used to be calculated for a period of two years from the time a student left school, with or without a degree, but the Higher Education Opportunity Act of 2008 expanded the calculation to a three-year rate. Although the changes were made several years ago, 2014 marks the first time that the three-year rate has been reported, and many institutions feared the longer measurement period might leave more schools ineligible. Many institutions have been vocal about their concerns over the three-year cohort default rate, including Historically Black Colleges and Universities.

There are still many questions about the political motivation around the Department's decision to change the calculation by simply releasing the names of institutions benefitting from the Department's generosity, but that hasn't happened yet. In fact, there's very little information about which institutions benefitted, and how much of an impact the Department's changes had on those institutions.

It could easily be written off as conspiracy and speculation – if the Department would only release the list of institutions benefitting and by what degree. Until then, it's hard to defend the Department's decision without it being shadowed by at least a hint of political motivation.

Conclusion

Given the $1.3 trillion pile of student debt that continues to grow by roughly $100 billion every year, it's shocking that the Department would take steps to excuse certain institutions on their default rates without a clear statement of who they are, and just how much help they receive, particularly when student loan repayments are falling far short of what's expected.

[1] The Department of Education details the "special conditions" in a *Cohort Default Rate Guide* published in September 2014.