Cohort Default Rates: Predicting the Future

Knowing the Facts Will Help in Making Good Decisions

by Mary Lyn Hammer

Since the early nineties, Americans have been looking at the world through rose colored glasses. We've enjoyed low unemployment rates, increases in wages, a good economy, easy-to-find credit that gave people buying power, and substantial increases in equity for homeowners. While the view might be easier on the eyes through these rose colored glasses, the view is completely different today. Everything that most of us have ever experienced has changed. For most of us, it is very new and very scary. We can no longer plan our future based on what has worked for us in the past. Innovation and creativity in managing our circumstances will be what carries us through the hard times ahead.

The following history of student loans will demonstrate the dynamics between past and present.

In the past, adverse circumstances that affected cohort default rates were limited to "pockets" of locations in the country. These pockets were affected by natural disasters (i.e. New Orleans) or circumstances like "9/11" where specific locations (New York and Las Vegas, indirectly with a decrease in travel) experienced adverse affects.

Special "forbearances" for natural disasters temporarily gave relief to borrowers and the schools where they attended by pushing potential defaults out of the window of measurement. Subsequent cohort default rates (after the natural disaster forbearances ended) experienced dramatic increases in cohort default rates because recovery from these disasters takes much longer than the government allows in the natural disaster forbearances.

We can no longer plan our future based on what has worked for us in the past. Innovation and creativity in managing our circumstances will be what carries us through the hard times ahead.

It will be prudent to anticipate that the same will occur when our troops return from the Middle East. Many have loans in deferment with payments due soon after separation. They will not immediately get back into the workforce and be able to make timely payments on those loans.

On a broader perspective, a similar pattern will begin to appear with the flurry of consolidations that were made a couple of years ago. In the years where the consolidations were funded, the cohort default rate denominator (number of borrowers) was artificially higher than in historic years. Schools with higher denominators have, historically, had lower default rates because the borrowers who exercise their rights to consolidate tend to be more financially literate and responsible. If the borrowers consolidated when they were delinquent, the consolidation cured the delinquent status on the loans and helped lower the school's numerator (number of borrowers in default.)

When borrowers' payments go up, they can no longer make timely payments. Most payment schedules increase in the second to third year of repayment. This will coincide with the new three-year cohort default rate definition.

Subsequent cohort default rates will see the opposite effect of the masses of consolidations. Borrowers who forfeited their grace period by consolidating moved their loans into earlier cohort years, so the number of borrowers in the denominator of subsequent years is lower and, in some cases, contain borrowers who are in multiple cohort years. Those borrowers in more than one cohort year are a concern because they have multiple payments with multiple lenders and servicers that get very confusing. Subsequent loans have higher interest rates and higher payments than those in the consolidation loans made two years ago when the lowest interest rates in history were offered. To cure delinquencies for these people entails having borrowers work with every lender and servicer involved in their loans. If one loan falls through the crack, the borrower will be in a school's default rate because it is measured by the number of borrowers not by the number of loans.

Consolidation loans will also begin to show similar patterns to those in mortgage lending when we compare the adverse effects of ARM mortgage loans to graduated payment options in consolidation loans. When borrowers' payments go up, they can no longer make timely payments. Most payment schedules increase in the second to third year of repayment. This will coincide with the new three-year cohort default rate definition.

MARY LYN HAMMER's belief that *education is the vehicle for making dreams come true* has led her in a passionate fight, that began in 1987, for identifying problems in the higher education industry and finding solutions to ensure future participation for all students. Her innovative *"Hands On" Default Management Program* is recognized by the U.S. Department of Education for its remarkable results. Ms. Hammer is the owner, founder, president and CEO of Champion College Solutions, an international company offering default prevention, job placement verification, skip tracing, education debt recovery, and consulting services.

Ms. Hammer has actively worked with the U.S. Congress and the U.S. Department of Education since 1988. Her many recognized accomplishments include, most recently, the 2005 CCA National Achievement Award for the Allied Member of the Year and 2008 Best Associate Member for the Arizona Private School Association. She has served numerous elections to the board of directors with the Career College Association (CCA), the NorthWest Career Colleges Federation (NWCCF) and is the charter member and former chairwoman for the HEAL Coalition (Higher Education Allied Health Leaders Coalition).

Contact Information:

Mary Lyn Hammer
President and CEO
Champion College Solutions, LLC
4600 S. Mill Ave., Suite 180
Tempe, AZ 85282
Toll Free: 800-761-7376
Phone: 480-947-7375
Fax: 480-947-7374
Web site: www.championcollegesolutions.com

The bottom line is that we are just starting to see the unintended negative effect of the consolidation loan frenzy. The consolidation phenomena will affect cohort default rates nationwide. Unlike many other circumstances, the public sector will see a significant impact with this because the lenders marketed heavily to their students. Many proprietary students will also suffer the consequences. This broadens the picture of "pockets" of people who were adversely affected to a pocket that covers the entire nation.

More devastating than any other factor is the state of our economy. In a report released by the U.S. House of Representatives' Committee on Appropriations on January 15, 2009, the opening statement was, "The economy is in a crisis not seen since the Great Depression."

Reality is that we are no longer looking at "pockets" of circumstances that will adversely affect our cohort default rates. There is no place in this country that will not realize higher default rates at a time when many circumstances put borrowers at a disadvantage and the measuring period has been extended another year.

Let's take a look at everything that can adversely affect cohort default rates. It is a recipe for disaster.

Increased loan amounts. At a time when many jobs are being eliminated, companies are tightening their budgets, and consumer spending is at an all-time low, borrowers are suffering the consequences of a debt burden beyond what they can afford to pay.

Mandatory disbursements to students. Schools must disburse funds to students when tuition payments are current. Financially illiterate borrowers spend the money without budgeting and often have to drop out of school when they run out of money. They are left with a higher debt burden and have not completed the education needed to seek employment to pay for it.

Reduced processing of forbearances. Many lenders want and need their money now. Unlike deferments that must be granted to borrowers who qualify, forbearances are granted at the lender's discretion. Lenders have been publicly criticized for "artificially inflating loan balances by granting forbearances" because the unpaid accrued interest is capitalized when the most likely motivation has been curing the delinquency. Many now feel they are delaying the inevitable by granting forbearances to borrowers who they do not believe will ever pay the loans. The number of forbearances approved for FFELP loans continues to decrease.

Borrowers with multiple loan payments from different loan programs and multiple lenders and servicers. When lenders began pulling out of the student loan market, students who were still in school had to turn to other lenders and, often, new loan programs. Ultimately, this will place the borrowers in situations where they have multiple payments with multiple lenders and servicers. Each different payment is something that needs to be managed by the borrowers. Again, if only one loan falls through the crack and goes into default, the borrower will suffer all adverse consequences to their credit and is counted in a school's cohort default rate.

Borrowers with no consolidation options to simplify and/or lower their student loan payments. In the past, borrowers with multiple loan payments could easily be counseled to consolidate and lower their loan payments to something manageable for them. The current credit market has closed its doors to even traditional criteria for consolidation. Most lenders are not even offering consolidation any more and those who are set very high standards for FICO scores and minimum loan debt (some minimums are as high as $40,000.00).

Cuts in subsidies, lender incentives, and profits have reduced the quality of servicing. The incentives that rewarded lenders for low default rates have been eliminated by the government so many lenders have reverted back to the minimum standards outlined in due diligence. These standards require a phone and letter attempt every 45 days. Not a very effective method of preventing defaults.

FFELP lenders and servicers have already and/or continue to close branches and departments that assist borrowers and schools with default prevention. Legislation over the last three years has reduced profits for lenders to the point where they can no longer continue to participate in student loan programs. Those who remain have drastically cut costs. Many lenders have closed their doors entirely while others continue to close branches and departments that provide support services to borrowers and schools.

Record-high bad address and phone number information where traditional less-expensive electronic databases are becoming antiquated and manual processes must be used for locating borrowers. People have cut back costs in their lives. When they have to choose between a land line and a cell phone, they keep their cell phone. When they lose their home, they are moving in with friends and family. People are not applying for credit because it, simply, is not available. The databases from credit reporting agencies are the same used for locating people during "skip tracing." Because they are not being populated, skip tracing has become more complicated and more of a manual process. Labor-intense processes of searching through the Internet and calling references are now the most effective. References are also moving. A larger quantity of references is needed to be effective for this option in skip tracing. The bottom line is that everything is more complicated and more costly to get the end results.

One of the worst economies in the history of the country. "The economy is in a crisis not seen since the Great Depression" says it all. In the current economic situation, delinquent rates have doubled for many schools showing delinquent rates as high as 53 percent for some student loan portfolios. The last time that our country faced an economic situation similar to today, it took 5–6 years to recover. This was in the early '80s and cohort default rates were high. More detailed data is provided herein in the section titled, "Things to Think About."

An increase in the measuring period for Cohort Default Rates from 2-years to 3-years. With the passing of the *Higher Education Opportunity Act* in August 2008, the definition of cohort default rates increased from a 2-year period to a 3-year period. This new definition began with those borrowers who had a last date of attendance starting on March 30, 2008.

The Department of Education projected increases between 65 percent and 94 percent for default rates when the additional year of measurement was added. The Department's data occurred prior to our current economic situation. They used the FY 2005 data to make this analysis. These are students who left school from 3/30/2004–3/29/2005 and were not affected by a bad economy at the time the analysis was completed. Based solely on this data, schools that have historically been comfortable with default rates in the teens now have to consider that they will be very close to the threshold in the new 3-year cohort default rate definition. The 5 percent increase in the minimum threshold for loss of Title IV funding may not be enough for many schools to maintain eligibility when you add the consequences of the bad economy to the increase in measuring period.

"Double jeopardy" will occur when students are counted in both the 2-year and 3-year definitions during the transition. Until there are three consecutive years under the new 3-year definition, the 2-year definition will be used to determine a school's eligibility for Title IV participation. Schools will be subject to "double jeopardy" in their cohort default rates for the years during the transition. In other words, borrowers in a cohort will be part of both the 2-year and the 3-year definitions during the transition period.

Even for schools that have historically had default rates in the teens, recoveries are critical early in the cycle to drive down default rates right from the beginning. If you wait until you know you are in jeopardy of going over the threshold, it may be too late. Waiting to increase the intensity of default prevention will be your worst enemy.

The current situation provides no historic data for basing future trends. We have to take an educated guess for what we think will happen to future delinquent and default rates.

The potential for quickly escalating default rates is a reality when you overlay the economic conditions over the existing 94 percent anticipated increase in default rates. With both circumstances added together, the average increase is surely going to be much higher if a proactive approach is not taken.

Here are some ideas for the proactive approach:

- Collect a minimum of six references at different addresses.
- Confirm a minimum of three references prior to the first loan disbursement.
- Increase borrower education at your institution at regular intervals during the student's enrollment. Individual entrance interviews, check disbursement acknowledgements, and exit interviews are recommended.
- Create a manual system for lender notification of address/phone changes and in-school deferments for all changes in attendance. This will bring the "ownership" back to the borrowers. Electronic processes take away ownership.
- Mail test results and grades so that contact information can be confirmed on a regular basis.
- Send out graduation announcements so that you can collect new reference information at the end of the enrollment period.
- Increase borrower education during the grace period to reduce delinquent rates. The most likely borrower to default is the one who never makes the first payment.
- Increase phone calls to counsel delinquent borrowers.
- Increase options for skip tracing. You can't help those borrowers who you can't find.
- Hire a third party default prevention company that practices intense proactive default prevention.

More information about these suggestions can be learned in the course titled "Default Prevention: A State of Mind" offered by MaxKnowledge. This course was also written by the author of this article.

Even for schools that have historically had default rates in the teens, recoveries are critical early in the cycle to drive down default rates right from the beginning. If you wait until you know you are in jeopardy of going over the threshold, it may be too late. Waiting to increase the intensity of default prevention will be your worst enemy.

Predicting the future may be more difficult than usual. What is predictable is that "the definition of insanity is doing the same thing and expecting different results."

Things to Think About

Unemployment

While the overall unemployment rate for 2008 released by the Bureau of Labor Statistics rose to 5.8 percent, a substantial increase occurred in the last quarter of 2008. December 2008 ended with a high unemployment rate of 7.2 percent. Since 1948, when the Bureau of Labor Statistics started tracking unemployment rates, there have only been 3 times when the unemployment rate was this high: 1975–1976, 1981–1985, and 1992. We are not far behind the all-time record of 8.5 percent made in 1975. By the end of 2008, there were approximately 8,924,000 unemployed with 1.9 million job losses in the last four months of 2008. The total released by the Department doesn't include about 1.7 million people receiving benefits under an extended unemployment compensation program authorized by Congress last summer.

In a report released by the U.S. House of Representatives' Committee on Appropriations on January 15, 2009, they reported, "The economy is in a crisis not seen since the Great Depression. Credit is frozen, consumer purchasing power is in decline, in the last four months the country has lost two million jobs and we are expected to lose another three to five million in the next year. The economy is in such trouble that, even with passage of this package, unemployment rates are expected to rise to between eight and nine percent this year. Without this package, we are warned that unemployment could explode to near twelve percent."

According to the Bureau of Labor Statistics, the top profile for "who is unemployed" are people between 25 and 34 years of age. Let's not forget that this is also the target market for most career colleges.

With public announcements by large corporations closing more than 3,500 retail stores nationwide, the situation is only going to get worse. These announcements include bankruptcy by greats like Disney Store G and mass closures and layoffs by Starbucks, Time Warner Inc.'s AOL division, IBM Corp., Boeing Co., Pfizer Inc., Home Depot, Ann Taylor, Eddie Bauer, Cache, Lane Bryant, Fashion Bug, Catherine's, Talbots, J.Jill, Gap Inc., Foot Locker, Wickes, Levitz, Bombay, Zales, Piercing Pagoda, CompUSA, Macy's, Movie Gallery, Pacific Sunwear, Pep Boys, Sprint Nextel, Ethan Allan, Sharper Image, KB Toys, and Dillard's Stores. Companies have announced about 130,000 layoffs in January, according to an *Associated Press* tally.

Mortgages

According to a survey completed by the Mortgage Bankers Association, by the end of the 3rd quarter of 2008, the seasonally adjusted total delinquency rate was at the highest ever recorded at 9.96 percent. Subprime delinquent loans soared to a high of a 20.03 percent delinquent rate. Foreclosure rates rose to 1.58 percent for prime loans and 12.55 percent for subprime loans.

The Commerce Department recently reported that new home sales fell 14.7 percent in December to a seasonally adjusted annual rate of 331,000, the lowest pace on records dating back to 1963. For 2008, builders sold 482,000 homes, the weakest results since 1982. The median price of a new home sold in December 2008 was $206,500, a drop of 9.3 percent from a year ago. The median is the point where half the homes sold for more and half for less.

Consumer Loans

In an *Associated Press* release dated January 7, 2009, the American Bankers Association stated, "Late payments on consumer loans in last year's third quarter hit the highest level since record-keeping