White Paper

Inceptia

Minimizing Your School's Risk of Exposure: Understanding Your Three-Year Cohort Rate

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Executive Summary

In February 2012, the U.S. Department of Education released the first three-year cohort draft rates—a shift from previous years in which two-year default rates were recognized. Inceptia has forecasted that the switch from a two-year reporting timeframe to a three-year reporting timeframe could substantially increase a school's default rate.

The Department of Education has warned that schools with excessive default rates may lose eligibility in one or more federal student aid programs.

Inceptia published this white paper to help schools effectively understand their three-year student loan cohort default rates by:

- Understanding the default rate calculation
- Anticipating default rate implications for institutions
- Assembling the right team of stakeholders to address default rates
- Examining and understanding borrower characteristics
- Creating and implementing the best plan of action for lowering loan default rates

The recommendations outlined in the white paper will help schools develop plans that help student loan borrowers succeed in repaying their loans.

The nation is facing a widely publicized student loan debt crisis. Increased college costs have led to more student loan borrowers and higher debt loads. At the same time, tough economic times have increased the number of loan defaults. Right in the middle of this situation the U.S. Department of Education (the Department) is changing the method of calculating student loan defaults.

Student Loan Debt Surging

Stafford loan debt has been increasing dramatically. In academic year 2000-2001, aggregated Stafford originations totaled $31.3 billion (Chart 1). Over the following 10 years, Stafford originations expanded 165 percent to $83.1 billion.[1] Clearly, student borrowers are leveraging their futures by taking on more federal loan debt than they did in the past.

By itself, loan volume does not demonstrate that borrowers are facing any more repayment risk today than in the past. Data from the Department's quadrennial National Postsecondary Student Aid Study (NPSAS), the most in-depth student aid study being conducted, enhance our understanding.

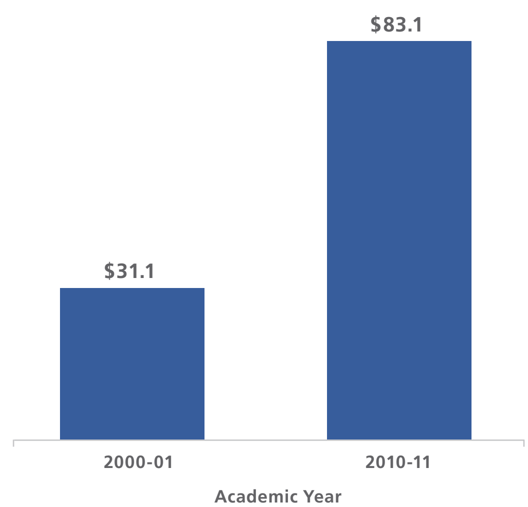
Not only has total loan debt grown, but so has the number of borrowers. Between 1999-2000 and 2007-2008, the number of students who took on non-family[2] debt to earn a bachelor's degree increased 52 percent to 1.4 million students, while the number who took on non-family loans to complete any program[3] grew an amazing 59 percent to 2.5 million students. Institutions across the nation are clearly assisting an exploding number of student borrowers.

Having established that more students are borrowing and accumulating more debt, now consider the burden borrowers must manage on their way to repay their debt. NPSAS data depicted in Chart 3 reveal a few additional points to consider:

- Students completing a bachelor's degree in 2007-2008 accumulated an average of $23,118 in non-family debt, 31 percent higher than similar degree completers in 1999-2000.
- Undergraduates completing any program in 2007-2008 accumulated an average of $18,625, 34 percent higher than their counterparts in 1999-2000.
- What was once a $5,528 gap between the two groups in 1999-2000 shrunk to $4,707 in 2007-2008, suggesting that those completing less than four-year degrees were accumulating relatively more debt over this period than those earning a bachelor's degree.

Chart 1

Federal Stafford Originations ($ in billions)



1 Derived from U.S. Department of Education Federal Student Aid Data Center.
2 Excludes parent loans and loans that had to be repaid to family.
3 Includes any degree of four years or below; i.e., certificates, associate's, etc.

Loans are Easy to Obtain

Accumulating educational debt can be fairly easy. Filling out the right form, meeting eligibility requirements and paying an origination/guarantee fee is about all it takes for a student to receive the loan proceeds. After all, with the federal loan programs being entitlement aid, the system is designed to encourage students to take advantage of this aid, not make it difficult.

After getting a loan, the hard reality is that most students typically are not required to do much beyond entrance counseling. The next big effort is not required until exit counseling prior to the student's planned departure. But because students don't always graduate or formally withdraw from school, exit counseling is not always a given. Therefore, it is paramount that new borrowers fully comprehend what it takes to manage their finances in order to keep their accounts out of delinquency.

Simply stated, borrowers need a lot of attention from the very beginning, not only down the road when they miss a payment or two that might lead to default. Some may question the validity of this statement until realizing more and more borrowers are taking on student loans in growing amounts.

Chart 2

Undergraduates Who Borrowed Non-family Education Debt (in thousands)

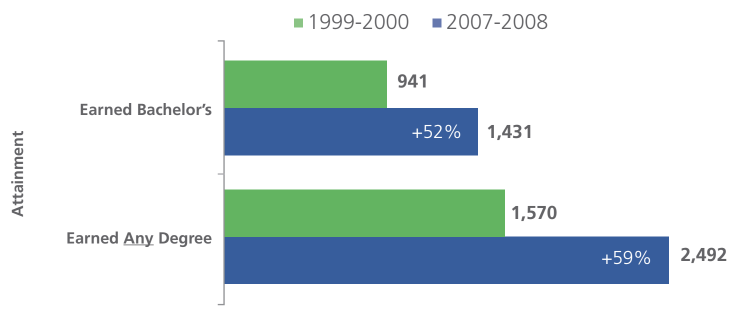
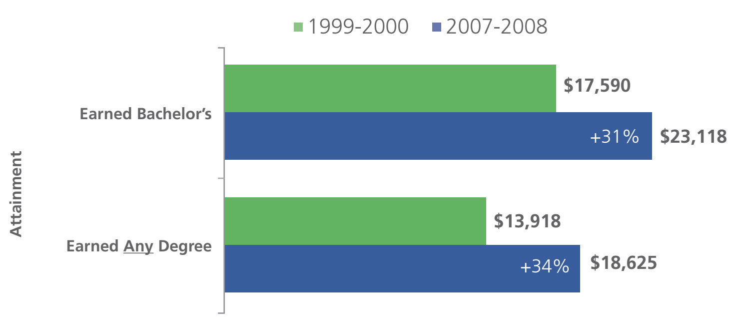


Chart 3

Average Cumulative Non-family Education Debt of Undergraduates Who Borrowed



Default Rates

Even before involvement by lenders and guaranty agencies waned in recent years[4], higher education institutions have been held more responsible for student loan repayment. This is evident in the Department's reason for calculating cohort default rates for the fiscal year 1987 cohort (Chart 4): To encourage participating higher education institutions to work with their student borrowers to reduce default.

In January 1991, after several years of exceptionally high default rates, the Department began initiating proceedings to remove Title IV eligibility from schools. As a result, large numbers of sanctions were imposed:

- From 1991-1999, over 1,800 institutions were sanctioned and the national default rate substantially plummeted from 22 percent to about six percent.[5]
- From 2000-2008, four more schools were subjected to immediate loss, suspension, or termination.[5] During this time the rate declined roughly another percentage point before swinging upward.
- For the 2009 two-year cohort, another four schools were facing loss of eligibility.

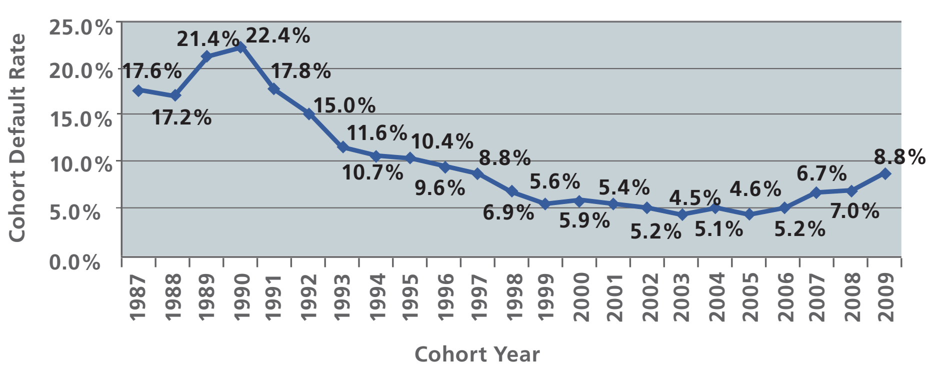
Although removing some "bad" schools from the loan program in the earlier years appears to have improved default rates, the Department has acknowledged that providing schools default prevention training may have reduced default rates as well.[5]

Another possibility that may have helped default rates remain lower is the disbursement exemptions earned in the past by having rates below 10 percent. For example, data for the FY2009 cohort reveals:

- By having three consecutive cohort default rates below 10 percent, 3,373 schools earned exemptions from selected disbursement requirements.
- A total of 494 schools had default rates below 10 percent for FY2007 and FY2008 but recorded rates of 10 percent or higher for FY2009. In other words, they lost the exemption based on these standards.

Chart 4

National Student Loan Cohort Default Rates



4 This is due to the end of the Federal Family Education Loan Program (FFELP). Neither party has guaranteed or originated a loan in nearly two years. Both can have existing portfolios that they continue to service, however.

5 General Accounting Office, Proprietary Schools, Stronger Department of Education Oversight Needed to Help Ensure Only Eligible Students Receive Federal Student Aid, GAO-09660, p. 11.

Regardless of the reason default rates have dropped, one thing is certain: what has been done to date to avert default nationally has not been enough to help *every* borrower avoid default. From the time the Department began calculating a cohort default rate there has never been a year when zero borrowers defaulted.

Often schools do not pay attention to their default rates, except twice a year—in February when the Department issues the draft rate and in September when official rates are published. Even then, attentiveness declines unless their default rates increase to unacceptable levels or drop to outstanding lows.

All schools do need to take heed, however. Over the past few years the Department has been warning schools to prepare for likely higher default rates caused by a switch to a three-year default rate from a two-year rate. Our analysis has found that this new reporting timeframe could increase a school's default rate substantially. For example, a school with a two-year default rate of 10 percent could expect its three-year rate to increase to 16 percent, a 62 percent increase. Even schools with a low two-year default rate may see a 70 percent increase using the three-year calculation.

Transition Time

Though sanctions have been fairly rare in recent years, the current trend of rising default rates might give cause for at least some schools to take another look at sanction parameters. Additionally, schools can receive benefits based on their default rates too. Both are described in the following table.

Two-Year vs. Three-Year Penalties		
Action	**Three-Year**	**Two-Year**
Design and submit default management plan	• One plan required when default rate hits 30 percent. • A second plan required for a second consecutive year of 30 percent.	Previously based on a 25 percent rate, but current regulations addressing two-year default rates no longer include discussion of this.
Loss of eligibility	• 30 percent rate for three consecutive years or • 40 percent for any one year.	• 25 percent rate for three consecutive years or • 40 percent for any one year.
Exemption from disbursement requirements. School may: • Singly disburse for any period of enrollment that is not more than one semester, one trimester, one quarter, or four months. • Not be required to delay delivery of the first disbursement of a loan to a first-year, undergraduate student borrower until the borrower has completed 30 days of the course of study.	Three consecutive years of default rates less than 15 percent.	Three consecutive years of default rates less than 10 percent. Beginning with loans first disbursed on or after October 1, 2011, the applicable rate changed to 15 percent.

Consider again the new three-year cohort rate. Imagine what the potential will be as the default period expands an additional 12 months. True, the default thresholds discussed on the previous page were adjusted upward; however, ponder the following.

- The cohort period expanded by 50 percent (from two years to three) while the consecutive-years threshold rose only 20 percent (from 25 to 30 percent).
- The single-year rate of 40 percent that results in immediate program expulsion *did not* change.
- Borrowers comprising a school's first official three-year rate (FY2009) left school by April 2009—almost three years ago. Students in the FY2011 cohort left school by April 2011. The ability for schools to influence loan repayment of these former students has greatly diminished.

This will cause many schools to take notice, but still others may remain unconvinced. It is important that *all* schools participating in the loan programs seriously consider their default rates and step up.

Know Your Options

Regardless of the magnitude of the national default rate or of a particular school's rate, it is in everyone's best interest to pay more attention to default rates. Waiting until rates have reached high levels typically results in fewer viable options, less time to act, and more stress. Being proactive, on the other hand, involves less stress, relatively more solutions, more time to act (not react) and possibly less undesirable press coverage.

The appeal is for schools to focus less on the default rate as a threshold, and instead appreciate that any default rate above zero percent means there are still student borrowers who need assistance in understanding how they can repay their loans.

Steps Forward

Every school should have a plan designed to do the utmost to help student loan borrowers succeed in repaying their loans. The Department agrees with this statement and has made available a sample default management plan. This sample plan is intended more for schools that are required to develop a plan. However, schools not subject to a mandatory plan have more flexibility, thereby allowing them to focus on repayment success rather than on default management. For schools that are ready to step forward and develop a plan to assist student borrowers, these general steps apply.

Step 1: Understand the Default Rate Calculation

Establish an understanding of how the default rate is determined. Through cohort fiscal year 2008, only two-year default rates were applied to schools. So, start with the two-year rate calculation:

Numerator: **Number of borrowers in the denominator considered in default in the cohort year or in the subsequent fiscal year.**

Denominator: **Number of subsidized and unsubsidized loan[6] borrowers entering repayment in the cohort fiscal year[7]**

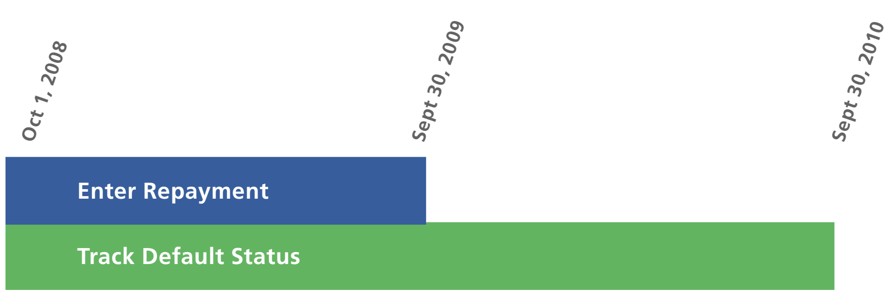
Note that the two-year rate's numerator highlights that the default period is the cohort year plus the subsequent fiscal year. The three-year formula expands the period of default one more fiscal year, but retains the denominator's definition. That formula is:

Numerator: **Number of borrowers in the denominator considered in default in the cohort year or in the two subsequent fiscal years.**

Denominator: **Number of subsidized and unsubsidized loan borrowers entering repayment in the cohort fiscal year**

The next two figures use the FY2009 cohort to exemplify the two rates. The first figure shows the two-year formula. The cohort year begins October 1, 2008 and ends September 30, 2009. This is the fiscal year in which borrowers must have entered repayment to be in the cohort. September 30, 2010 is the end of the second year, the point by which those in the cohort could have defaulted.

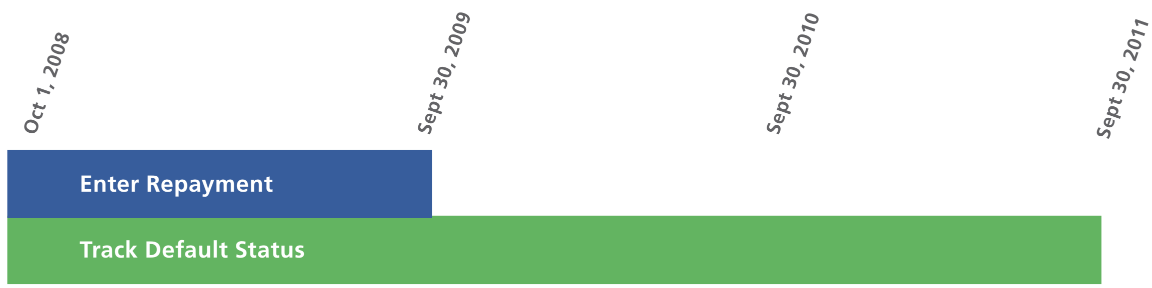
Two-Year Default Rate Calculation Example



6 Stafford and in a rare case, SLS.
7 A cohort fiscal year spans October 1 in one calendar year and ends September 30 in the following calendar year.

Now look at the three-year cohort below. The cohort year remains the same as for the two-year rate, but there are 12 extra months in which the very same borrowers could default.

Three-Year Default Rate Calculation Example



Also reflect on the earlier discussion about benefits and penalties that can be imposed on institutions based on default rates. It is up to each institution to determine the real impact of its default rate.

Step 2: Understand Default Rate Impacts

The following further exemplifies the potential differences between a school's two- and three-year rates. Both are based on a cohort of 500 borrowers. The only difference is the additional third year.

Two-Year vs. Three-Year Example

		Oct. 1, 2008 Sept. 30, 2009	Oct. 1, 2009- Sept. 30, 2010	Oct. 1, 2010- Sept. 30, 2011		Rate
Two-year:	**Defaulters**	**1**	**+ 31**		**= 32**	**= 6.4%**
	Enter Repay	**500**			**= 500**	
Three-year:	**Defaulters**	**1**	**+ 31**	**+ 20**	**= 52**	**= 10.4%**
	Enter Repay	**500**			**= 500**	

Some might believe that a 4.0 percentage point increase, which equates to a 63 percent rise in the rate, is not likely; however, this is a potential reality. The next table shows actual differences between combined four-year colleges' two-year rates and their aggregated trial three-year rates for cohort fiscal year 2008. All schools had at least 30 borrowers in the cohorts. The left side of the table shows that over half of the schools had rate increases of four percentage points or less. Amazingly, 11 percent (84+152) saw their three-year rates surpass their two-year rates by eight points or more. Those experiencing a rate decline were probably successful in getting their defaulted students to rehabilitate by the end of the third year (thereby removing them from default status), simply had data updated that moved a defaulter(s) out of the cohort, or were successful in filing a rate appeal.

The right side of the table reveals that only 17 percent of the schools had their rates change by less than 40 percent. On the high side, a full 45 percent (945) of the schools saw their default rates grow 70 percent or more. So yes, the example shown on the previous page of a school's rate expanding 4.0 percentage points, or 63 percent, is very realistic. How the rate is calculated and how it can impact a school reinforces the need for a solid foundation for student loan repayment. Continue to build the foundation by asking others to share the load.

Actual Differences Between
FY 2008 Two-Year Official and Three-Year Trial Rates
Four-Year Schools With More Than 30 Cohort Borrowers

Percentage Point Change		Percentage Change	
Change	**#of Schools**	**Percentage Change**	**# of Schools**
Decreased	32	*	102
+0-1.9	813	Decrease	32
+2-3.9	631	+0-9. 99%	84
+4.5.9	263	+10-19. 99%	38
+6-7.9	121	+20-29. 99%	82
+8-9.9	84	+30-39. 99%	120
+10 or higher	152	+40-49. 99%	202
		+50-59. 99%	258
		+60-69. 99%	233
		+70%, or more	945
Total	2,096	2,096	2,096

** Could not calculate. Two-Year rate was 0.0%*
NSLP school data.

Step 3: Build Your Team

It is time to think beyond how the Department can affect the institution and focus on other possible impacts. Look across the campus and identify the stakeholders in the school's default rate; you might be surprised who this might include. Consider these possibilities.

- Review the institution's mission statement and refine your understanding about the administration's perspectives. How can implementation of a repayment assistance plan support these?
- Communicate with the Admissions Department. There is a proposal to add a new tool to the College Affordability and Transparency Center that would assist prospective students and their families in comparing colleges before they choose, using key measures of college affordability and value. Student loan repayment is one of the key measures. These key measures are part of what is referred to as the "college score card."
- If students are borrowing more and have fewer disposable funds, is there more pressure placed on the Student Life Office for presenting free or low-cost student activities? Keeping students connected to the campus has proven important in retaining students, which in turn has been shown to relate to student loan default.
- The Institutional Advancement Office might be interested in knowing the frequency at which students are not repaying their loans. Former students not repaying their student loans may be less willing to give back financially to the school.
- Identify supporting partners who will be needed, such as information technology staff. If expertise is lacking from inside the campus walls, consider seeking outside assistance to help keep things moving.

These are only a few possibilities. Those on college campuses are in a better position to discern the best approaches for the institution. The important task is getting stakeholders on board. If they have ownership in the project, there will be that many more people focused on student success.

With the team assembled, the next step is translating the numbers in the formulas into real students who were on campus. Putting a face on the picture can greatly expand understanding.

Step 4: Examine Your Borrower Characteristics

To understand default risk, review published studies about default risk factors at a single school or among a group of schools. But because each institution's students are different, each school should strive to determine the unique qualities common to its student borrowers. Begin with each borrower in a cohort file and add data from institutional records. This is a huge step that allows customization of a school's loan repayment program. To enhance the analysis, break variables into four categories: background, financial aid, experience while enrolled, and experience after leaving school.

Be cautious and fight the temptation to only look at a cohort's defaulters, which is what some schools have done. This approach might seem insightful, but it is not necessarily helpful. Let's say you look at a group of defaulters and discover 75 percent of your defaulters were first-time enrollees as opposed to students who transferred in. Looking no further could result in an inaccurate conclusion that first-time students are at the heart of the default issue. What you might have overlooked is that 75 percent of *all* the borrowers were first-time students as well. In this example, first-time enrollees would not necessarily be a default issue; you would have fallen short of discovering real default problems.

Furthermore, evaluate each cohort file as you receive it and then base your plan on it. This ensures the plan is based on borrowers who are most likely to be similar to your currently enrolled students.

As a final reflection before moving to Step 5, review Step 3 based on the knowledge gained about the borrowers. Consider whether there are others on campus not yet on board who should be consulted.

Step 5: Derive and Implement Your Plan

After obtaining results of the cohort examination, bring the stakeholders together and discuss the findings. Experience has shown that each department representative can understand the data differently, which feeds rich discussion leading to right conclusions.

What did the analysis about the borrowers reveal?

- If findings suggest characteristics related to default were known when the students arrived on campus, apply these to incoming students and determine what programs can help these students when they first arrive at school.
- If financial reasons are related to defaulting, implement financial education actions for selected students. The program could be designated for specific students or included as part of a freshman seminar for all incoming students.
- If students in default require remediation upon arrival, possibly include additional information about loan repayment during the remediation courses.
- If characteristics are more correlated to student experiences and outcome, it might require another approach. Borrowers with low GPAs might benefit from specialized counseling. Since non-graduates nationally tend to default more often, retention efforts could prove beneficial.

- Another option involves activities conducted after the student borrowers leave campus.
  - A program to contact borrowers while in their grace periods—especially those who left campus unexpectedly and did not have exit counseling—could help educate them on loan repayment options.
  - A similar program could be instituted for borrowers when they become delinquent.
  - With the implementation of the three-year reporting timeframe, the additional year actually provides necessary time for borrowers to remove themselves from default via the loan rehabilitation program. A special calling program might inform borrowers on how to rescue themselves.

These are realistic examples but are not all-inclusive. Options for individual schools are limited only by the amount of available resources, creativity levels, and the level of motivation. A happy medium can surely be found.

It is imperative not to assess blame. Keep the focus on helping students to be better borrowers. Also important is that once the school has a plan, continue monitoring it to determine its success. Never give up on student borrowers. Keep working to find the right results for the institution and its borrowers.

Closing Thoughts

Using the five steps discussed can serve as a guide.

1. Understand how your default rate is calculated.
2. Understand how default rates affect the institution.
3. Build your team of stakeholders.
4. Examine your borrower characteristics.
5. Design and implement your plan.

Finally, stay centered on the success of student borrowers, not simply on the institution's default rate. A Department report that tracked student borrowers for 10 years after earning bachelor's degrees in 1992-1993 found that Stafford borrowers defaulted, on average, four years after earning their degrees,[8] outside the timeframe established by the Department's default rates.

Look outside the two- or three-year timeframe established by the Department's default rate formulas. Focus on the success of students until the day they each have repaid their student loans. Each student is worth the effort.

8 Susan P. Choy and Xiaojie Li, Dealing With Debt: 1992-93 Bachelor's Degree Recipients 10 Years Later (Washington, DC: National Center for Education Statistics, June 2006).

About the Author

Kent Wolfe, Inceptia's senior marketing research analyst, has more than 23 years of experience in the areas of research, compliance, claims, and finance. He works extensively with cohort default files and has assisted in the development of Inceptia's Cohort Repayment Analysis. He assists schools in understanding their default files, and serves as a presenter and consultant. He graduated from Doane College with a bachelor's degree in business administration.

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The Inception Of A Movement.

For more than 25 years, as the not-for-profit loan guarantor National Student Loan Program (NSLP), we provided guidance to both schools and students. We made great strides in default aversion, compliance and financial education, working directly with students on their quest to fulfill their educational dreams and uphold their commitment to repay their student loans.

As the student loan landscape changed, we changed. We created Inceptia, a new brand and movement poised to become a school's crucial support system. Our goal is to continue providing guidance to schools and, ultimately, helping students become financially responsible adults. Through carefully planned tools, resources and practices, we can work with schools to establish new processes that focus on students' needs and deliver extensive support.

Ultimately, we want to assist schools as they help all of their students—not just borrowers—become financially responsible adults.

Inceptia offers schools several services designed to manage their cohort default rate, including:

- **Cohort repayment analysis** of borrowers in repayment, identifying characteristics and trends of student borrowers. By recognizing specific traits, Inceptia creates a customized repayment success plan that keeps healthy students in good standing and reaches out to at-risk students, getting them back on the right financial path. The plan may include peer counselors, internal and external outreach centers and financial education.
- **Repayment solutions** with steady contact that fully supports students, providing much-needed guidance and answers to the question, "How am I supposed to pay for this loan?" Depending on a school's needs, Inceptia equips them with the tools to effectively reach students.