
THE STUDENT LOAN DEFAULT TRAP

WHY BORROWERS DEFAULT
AND WHAT CAN BE DONE

July 2012

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ACKNOWLEDGMENTS

This report is a release of the National Consumer Law Center's Student Loan Borrower Assistance Project (www.studentloanborrowerassistance.org). The authors thank NCLC colleagues Carolyn Carter, Jan Kruse, and Persis Yu for valuable comments and assistance. We also thank Emily Green Caplan for research assistance as well as NCLC colleagues Svetlana Ladan and Beverlie Sopiep for their assistance. We also thank the amazing advocates who helped out by surveying their clients, including Herman De Jesus and Liz Fusco with Neighborhood Economic Development Advocacy Project and Meg Quiat, volunteer attorney at Boulder County Legal Services. This report is grounded in and inspired by the author's work with low-income clients.

The findings and conclusions in this report are those of the author alone.



NCLC's Student Loan Borrower Assistance Project provides information about student loan rights and responsibilities for borrowers and advocates. We also seek to increase public understanding of student lending issues and to identify policy solutions to promote access to education, lessen student debt burdens, and make loan repayment more manageable.

www.studentloanborrowerassistance.org



ABOUT THE NATIONAL CONSUMER LAW CENTER

Since 1969, the nonprofit National Consumer Law Center® (NCLC®) has used its expertise in consumer law and energy policy to work for consumer justice and economic security for low-income and other disadvantaged people, including older adults, in the United States. NCLC's expertise includes policy analysis and advocacy; consumer law and energy publications; litigation; expert witness services, and training and advice for advocates. NCLC works with nonprofit and legal services organizations, private attorneys, policymakers, and federal and state government and courts across the nation to stop exploitive practices, help financially stressed families build and retain wealth, and advance economic fairness.

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EXECUTIVE SUMMARY

Despite the amount of attention garnered by student loan defaults since the 1990s, few studies provide answers about why borrowers default and how best to help them. The lack of research helps perpetuate unproven theories about default, including the idea that the recession is solely to blame for increased default rates.

The stakes are high because vulnerable students attempting to better their lives face severe consequences if they default on federal student loans. The government has nearly boundless powers to collect student loans, far beyond those of most unsecured creditors.

This report addresses questions about the causes of default and the effectiveness of programs intended to assist borrowers in default, including a summary of existing research, results from National Consumer Law Center's (NCLC) survey of borrowers in default, and policy recommendations.

Research on Risk Factors for Student Loan Default

The most commonly cited characteristics associated with default are:

- Lack of Completion
- Low Incomes and Unemployment
- Type of Institution
- Race and Ethnicity
- Lack of High School Diploma
- Lack of Information about Borrowing

Although these factors are frequently cited in studies, it is often difficult to determine cause and effect. For example, lack of completion was the most commonly cited risk factor for default in the studies we reviewed for this report. This does not necessarily mean that graduation causes lower default rates largely because failure to complete is associated with other characteristics such as low incomes and higher unemployment rates.

NCLC's Survey of Borrowers in Default

NCLC staff and other advocates administered surveys to 40 individuals in default on federal student loans over one year, beginning in May 2011. We created this survey because of the lack of information in this area, but also because we observed many of our clients getting behind on payments during the transition out of default.

NCLC Borrower Survey

Of the borrowers surveyed:

- 80% Unemployed
- 85% Receive Public Assistance

Nearly 65% Attended One or More For-Profit Schools

Only 47% Completed Their Education

69% Neither of the Borrower's Parents Completed Higher Education

Significantly, the average age of the borrowers surveyed was 43. Just over half, 55%, had at least one child. And 15% had no high school diploma or GED when they signed up for school.

We found a general lack of knowledge about default among those we surveyed.

Twenty-four percent of those surveyed did not know they were in default when they sought legal assistance. Sixty-five percent did not recall any pre-default communications or contact, although a few acknowledged that they had received phone calls that they did not accept or received mail that they did not open. We also asked the borrowers to express in their own words why they thought they were in default. Economic difficulties and lack of employment were by far the most commonly cited reasons for default.

We found one indicator in particular that was not reflected in the existing studies on causes of default. Forty-seven percent of the borrowers in our survey said they did not believe they should have to pay the student loan debt. An additional 10% answered yes and no when asked if they should have to pay the debt.

A few of the borrowers in our survey who did not believe they should have to pay mentioned disabilities or health issues. The vast majority who did not believe they should have to pay back their loans expressed serious problems with the schools they attended. **Nearly all (about 90%) of the borrowers who said they should not have to repay their loans attended for-profit schools.**

Do Existing Programs Work for Financially Distressed Borrowers?

Pre-Default Programs/Default Aversion

Default aversion programs include counseling and other targeted programs to reach borrowers before they default. There is mixed evidence on the effectiveness of default aversion programs. Some studies have shown that those who complete their educational programs are less likely to default regardless of counseling.

Post-Default Programs: Evaluating Rehabilitation and Consolidation

Rehabilitation and consolidation are the two main options currently available to federal student loan borrowers seeking to get out of default. Many view rehabilitation as a superior program because it requires borrowers to make a series of payments before “escaping” default. We found some limited research showing a higher re-default rate after consolidation compared to rehabilitation.

Overall, consolidation is much faster than rehabilitation, mainly because a borrower in default does not have to make any preliminary payments to qualify. Further, there is no resale requirement for consolidation as there is for rehabilitation of guaranteed (FFEL) loans. The main advantage of rehabilitation relates to credit reporting. However, this benefit is often oversold.

The rehabilitation resale requirement has been a major problem for borrowers, particularly during the credit crisis when there were few buyers for the loans. Another problem is that collectors routinely deny borrowers reasonable and affordable payments.

Policy Recommendations

A key recommendation is to increase targeted grant aid for students and increase funding for public education.

We must also attempt to avoid defaults by holding schools more accountable for poor outcomes and providing better information to students.

We must rethink the draconian collection policies that leave vulnerable students with nowhere to turn. We should start by targeting collection efforts to those with resources to pay. Limiting collection in this way should save money for taxpayers. There are significant costs to taxpayers associated with pursuing the most vulnerable borrowers until they die. Under the current system, lenders and collectors profit as the government pays higher and higher collection fees.

Recommendations for reform include:

I. Support Research on Default Policies

- A. Targeted and objective research on causes of default is essential
Researchers should use longer-term default data rather than relying mainly on the limited cohort default rate (CDR) data, and they should study delinquency, not just default rates.
- B. Study the effectiveness of default aversion and servicer quality
- C. Study the effectiveness of existing post-default programs
- D. Study the cost of collection

II. Create More Accurate Default Rate Calculations and Close Loopholes in the Sanctions System

The current cohort default rate is an inadequate and misleading indicator of the true rate of student loan defaults. We recommend changes to track borrowers over longer periods of time.

III. Support Effective Default Aversion Programs

Borrowers will not suffer the consequences of default if they never default in the first place, yet the federal government has generally prioritized collection over default aversion. We urge real reforms to prevent defaults, including:

- A. Create automatic entry to Income-Based Repayment (IBR)
To help catch borrowers before they fall into default, we recommend instituting an automatic entry process so that loan holders can evaluate borrowers for

presumptive eligibility for income-based repayment and place borrowers temporarily in IBR during late stage delinquency. This could involve automatic debiting from borrower paychecks. However, as described in the next recommendation, not all borrowers are employed and the automatic system must accommodate these borrowers as well.

- B. Simplify IBR eligibility for public assistance recipients
Borrowers receiving means-tested public assistance benefits should be automatically placed in a presumptive IBR program. They should be allowed to stay in this program by proving continued receipt of benefits.
- C. Under the current system, ensure that borrowers coming out of default can easily transition into income-based or income-contingent repayment
- D. Support the Voluntary Flexible Agreement (VFA) program for FFEL Loans and create similar incentives for Direct Loans
- E. Improve pre-default counseling
- F. Require servicers to describe all options to borrowers throughout the delinquency process

IV. Improve Current Post-Default Programs

- A. Rehabilitation Reforms
 1. Eliminate the one-time limit on rehabilitation. Borrowers should be given more chances to get out of default. Policymakers could consider an approach where multiple rehabilitations are allowed, but possibly place additional eligibility requirements for subsequent rehabilitations.
 2. Ensure that the new regulations for handling rehabilitations go into effect earlier than July 2014.
 3. Eliminate the FFEL program resale requirement. The Department must also ensure that Direct Loan rehabilitation accounts are processed as quickly as possible.
 4. Provide full credit reporting benefits.
 5. Reduce collection fees after rehabilitation.
- B. Consolidation Reforms
 1. Allow borrowers to choose between consolidating without first making payments (“forced consolidation”) or making three payments prior to consolidation. The regulations clearly present these options as alternatives. However, loan holders and collectors frequently misstate these rights and claim that all borrowers must make payments prior to consolidating out of default.
 2. Clarify the process for consolidation out of default.
 3. Borrowers pursuing consolidation should be informed prior to processing the consolidation if any loans have been reduced to judgment.
 4. Reduce collection fees after consolidation.

V. Require Reasonable Settlements and Compromises

We urge the Department of Education to create standardized guidelines for settlements and compromises that include significant principal reduction as well as elimination of fees and accrued interest. Accepting a reasonable settlement is likely to cost less over the long-term than years of collection efforts.

VI. Create a More Efficient and Equitable Collection System

- A. Eliminate private collection agencies from the dispute resolution role
Until such time as the government identifies viable alternatives to private collection agencies, we call on the Administration to issue a moratorium on using private collection agencies for student loan dispute resolution.
- B. Collection charges should be limited to only those fees that are bona fide and reasonable and actually incurred
- C. Require loan holders to provide information to borrowers about all post-default options and evaluate collectors based on borrower service
- D. Eliminate the current incentive commission system that leads collectors and loan holders to withhold important information to borrowers and pursue their own profits rather than borrower needs
- E. The Department of Education must stop delegating inherently governmental functions, such as conducting fair hearings, to third party debt collectors
- F. The Department of Education should make publicly available the process for handling complaints against collection agencies and any disciplinary actions taken against those agencies

VII. Provide Real Relief for Borrowers Harmed by Abusive School Practices

None of the three cancellations (or “discharges”) intended mainly to address fraud—closed school, false certification, and unpaid refunds—provides general remedies for borrowers who attended a fraudulent school. We recommend that Congress and the Department of Education consider new cancellations that will afford relief to all borrowers who attend schools that violate key Higher Education Act (HEA) regulations and for borrowers who have secured judgments against schools based on HEA violations but are unable to collect from the schools or other sources.

VIII. Restore Safety Net for Student Loan Borrowers

Among other reforms, it is time to eliminate the Social Security and earned income tax credit (EITC) offset programs. Policymakers must also restore the statute of limitations for student loan collections and expand the safety net, including bringing back bankruptcy relief for financially distressed borrowers.

INTRODUCTION

“[T]he number of student-loan defaults has skyrocketed in recent years. This is partly due to the shift from grants to loans in Federal student aid, partly due to recessionary unemployment and underemployment, and partly due to the rigid systems of law surrounding defaults.”

—Rep. Bruce Vento, 1992.¹

This statement is as relevant today as it was in 1992. Student loan debt is once again in the headlines. The poor economy has had a huge impact on the job prospects of college graduates and exacerbated student loan burdens, but this is only part of the story. Although the official federal default rates have declined over time, they have remained a problem during good and bad economic cycles. Further, the official rate vastly underestimates the full scope of student debt burdens.

Getting to the bottom of the default problem requires an understanding of the diversity of college students today. The majority of students are non-traditional, meaning that they did not enroll in college after high school, they work part-time or full-time as they attend school, or they support dependents.² Many of the characteristics of non-traditional students are also risk factors for default.

Vulnerable students attempting to better their lives face severe consequences if they default on federal student loans. The government has nearly boundless powers to collect student loans, far beyond those of most unsecured creditors. The government can garnish a borrower’s wages without a judgment, seize his tax refund, even an earned income tax credit, seize portions of federal benefits such as Social Security, and deny him eligibility for new education grants or loans. Even in bankruptcy, most student loans must be paid. Unlike any other type of debt, there is no statute of limitations. At the National Consumer Law Center, we see and hear the human toll of the tattered student loan safety net every day from the low-income borrowers we represent.

Despite this human toll, there is a common view that aggressive collection is necessary to shore up the student loan system. An attorney filing lawsuits on behalf of the government to collect student loans recently stated, “For every dollar collected from defaulted student loans, it’s money that can be used again for student loans or taken off the deficit or used for other issues.”³ One of the government’s largest collectors, ECMC, justified aggressive collection practices by emphasizing that its efforts keep federal financial aid programs solvent.⁴

These statements emphasize keeping the loan programs alive, but at what cost? Should the federal government support a growing student loan program on the backs of defaulted borrowers?

There is no shortage of questions, yet very few answers. Despite the amount of attention garnered by loan defaults since the 1990s, few studies provide answers about why borrowers default and how best to help them. The lack of research helps perpetuate

GOALS OF FEDERAL STUDENT AID

The federal student aid programs began during the 1960s as a way to improve access to education for lower-income individuals. In 1965, on signing the Higher Education Act, President Johnson said, “[The Higher Education Act] means that a high school senior anywhere in this great land of ours can apply to any college or any university in any of the 50 States and not be turned away because his family is poor.”⁵ President Nixon echoed this message in 1970, stating that, “No qualified student who wants to go to college should be barred by lack of money.”⁶

Measured by these goals, student aid policy has failed. College completion rates in the United States have been flat since the 1970s among all sectors of higher education. Lack of completion is a particular problem among lower-income individuals. The shocking reality is that despite all of the government money spent on financial aid, the difference in college graduation rates between the top and bottom income groups has widened by nearly 50% over two decades.⁷ As the *New York Times* reported, this growing gap “. . . threatens to dilute education’s leveling effects.”⁸ Education Secretary Duncan has admitted that college access disparities are “actually worsening.”⁹

unproven theories about default, including the idea that the recession is solely to blame for increased default rates.

This report addresses questions about the causes of default and the effectiveness of programs intended to assist borrowers in default. We begin by summarizing existing research on the causes of student loan defaults. The focus throughout is on federal student loan defaults since there is no comprehensive data on private student loan delinquencies and default. We then present findings from our survey of our clients and other borrowers in default. This section is followed by a review of the existing programs--rehabilitation and consolidation--available to borrowers to get out of default and a summary of the sparse research on the effectiveness of these programs. The final section contains recommendations for further research and policy reform.

MEASURING STUDENT LOAN DEFAULTS

Much of the research on federal student loan defaults is based on the government’s cohort default rate (CDR) data. The CDR is also the measure used to sanction schools with persistently high rates. For schools with thirty borrowers or more, the rate tracks a cohort of current and former students who entered repayment on federal loans during that fiscal year.¹⁰ The school must identify which borrowers in the cohort are in default, defined until 2009 as those who default before the end of the following fiscal year.¹¹ Borrowers are tracked for an additional year as of FY 2009.¹²

CDRs undercount the true number of student loan defaults.¹³ The Department of Education's Inspector General has cited a number of problems with this data, including that the rates reflect defaults during a two-year cohort period and not the life of the loan, that PLUS loans and certain consolidation loans are excluded, and that the rates are calculated based on the number of borrowers in a cohort and not on the number of loans or the loan amount.¹⁴ Further, these rates only show loans that went into default. The full scope of student loan problems is more accurately portrayed by examining delinquency rates as well. In a 2011 report, the Institute for Higher Education Policy found that more than one-fourth of the borrowers in their study who entered repayment in 2005 became delinquent on their loans at some point, but did not default, compared to the national CDR of 4.6% for the same period.¹⁵

To help address problems with the limited CDR tracking period, Congress increased the period used to calculate the cohort default rate from two to three years.¹⁶ This method applies to cohort default rates calculated for fiscal year 2009 and subsequent years.¹⁷ Initial data show that adding just one year makes a big difference. The three-year rates are more than 114% higher than the standard two-year rates for for-profit colleges, 77% higher for public two-year institutions, and 89% higher for private four-year colleges.¹⁸

A number of studies and media accounts affirm the importance of tracking defaults beyond the longer three-year CDR period. According to the *Chronicle of Higher Education*, one out of every five government-backed loans issued since 1995 has entered default.¹⁹ Texas' guaranty agency found that the default rate was much higher than expected if analyzed over a longer term.²⁰

"Default management" companies working for schools seeking to reduce CDRs also undermine the credibility of the official default statistics. Many schools hire these companies to track down former students and get them into forbearances or other programs that will help them avoid sanctions.²¹ The U.S. Senate Committee on Health, Education, Labor and Pensions released documents in 2011 that help illuminate the default management strategies at for-profit schools.²² Among other concerns, the documents show how many of these schools have managed defaults through the two-year CDR window by placing borrowers in forbearances, the easiest option for the schools, but not a long-term debt management solution for borrowers.

RESEARCH ON RISK FACTORS FOR DEFAULT

Introduction

Following is a summary of the existing research on this issue, highlighting generally accepted findings. A bibliography of selected studies reviewed for this report can be found in Appendix A.

There are some important caveats to this research, including:

- The amount of research is limited.

- Much of the research is dated. Most of the studies using national databases occurred during the late 1980s and 1990s.²³
- The studies are based on different data sets. For example, many recent studies evaluate data from just one school or from one guaranty agency.

Summary of Research on Student Loan Defaults

The most commonly cited characteristics associated with default are the following:

1. Lack of completion

Completion rates are low in all sectors of higher education and have shown little improvement over time. According to the Department of Education, 58% of first-time full-time students who started college in 2004 completed a bachelor's degree within six years, compared with 55% of students who started in 1996. Students at four-year for-profit colleges had only a 28% graduation rate.²⁴

Among those who borrowed, the percentage of students who dropped out between 2003 and 2009 was larger than the percentage that dropped out between 1995 and 2001.²⁵

Lack of completion was the most commonly cited risk factor for default in the studies we reviewed.²⁶ In a 2008 Power Point presentation, the Department of Education stated that of the borrowers who defaulted on their Direct Loans (6-7 million borrowers), 70% withdrew before completing their program.²⁷ Some claim that those who drop out from school are 10 times more likely to default, although the more commonly cited figure is that students who drop out are about four times more likely to default.²⁸

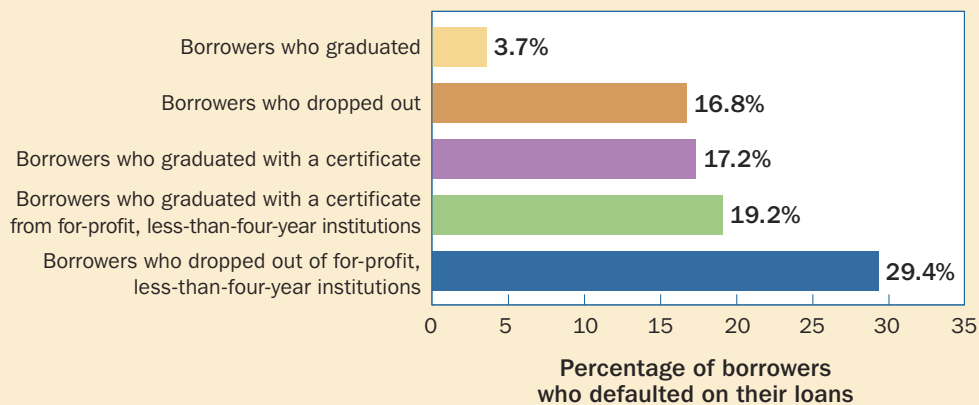
This does not necessarily mean that graduation causes lower default rates. Though there is a strong correlation between completion rates and default, the cause and effect is less clear, largely because failure to complete is associated with other characteristics. Whether they borrow or not, those who do not complete are more likely to come from low-income backgrounds and their parents are more likely to have lower levels of education than those who complete.²⁹ Borrowers who fail to complete generally have higher unemployment rates and lower incomes.³⁰

Not all graduates escape default. In fact, graduates from certain sectors of higher education may be at greater risk of default than those who drop out from other sectors. The Institute for Higher Education Policy found that borrowers who graduated with a certificate had a similar default rate as those who dropped out from public four year schools.³¹ This is significant because certificates comprise about 22% of all college awards.³² Borrowers who graduated with a certificate from a for-profit school actually had a higher default rate than the category of borrowers who dropped out from all types of institutions.³³

2. Low incomes and unemployment

There is strong evidence that borrowers from low-income families are more likely to default. Some researchers note that families with more money are able to provide a financial safety net not available to students from lower-income families.³⁴

Default Rates and Completion



Source: Mary Nguyen, "Degreeless in Debt," *Education Sector* (Feb. 2012).

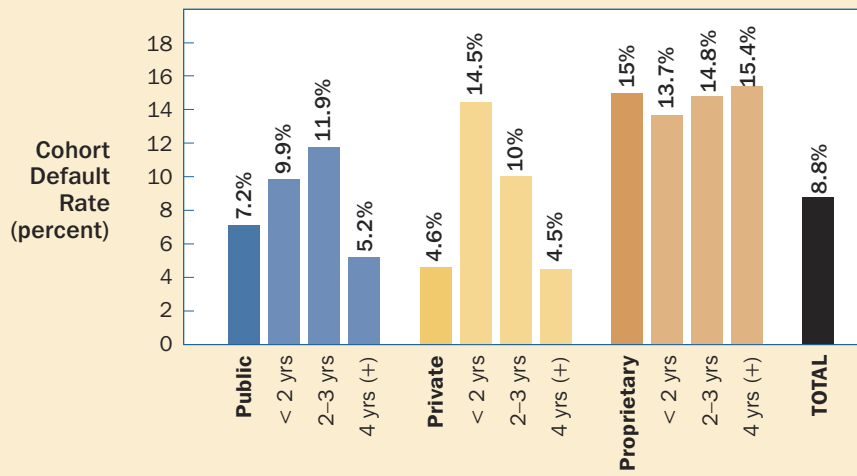
It is not just pre-enrollment income status that matters, but also borrowers' income after they leave school. Researchers compiling a 2009 review of the literature on student loan defaults stated simply that most students default because their personal income is inadequate to keep up with their payments.³⁵ This is likely magnified among students from lower-income families because the unavailability of a family safety net makes it more difficult to make payments during fluctuations in income.³⁶ A study using Department of Education data found that the percentage of borrowers who still owed student loans after ten years was related to the borrowers' salaries. Thirty-three percent of the borrowers in the lowest income group still owed loans compared with 19% of those in the highest income group.³⁷

Unemployment is another risk factor and clearly connected with lower incomes. For example, the Texas guaranty agency found a significantly greater risk of default among unemployed borrowers.³⁸

3. Type of institution

A number of studies affirm that the type of institution attended is correlated with default.³⁹ For-profit colleges consistently have the highest two-year default rates, with a 15% cohort default rate for borrowers entering repayment in 2009.⁴⁰ The Institute for Higher Education Policy found that borrowers who attended four-year public or private nonprofits saw only a third or fewer borrowers become delinquent or enter default. In contrast, more than half of the students attending for-profit schools and two-year public institutions became delinquent or defaulted.⁴¹

Student Loan Cohort Default Rates by Education Sector (2009)



Source: Federal Student Aid, September 12, 2011.

Borrowing rates are also highest in the for-profit sector. In 2007–08, 92% of students at for-profit colleges borrowed student loans, compared to 27% at public colleges and 60% at private non-profit colleges. The percentage of students borrowing is lowest at community colleges, at about 13%.⁴²

The debate in this area centers on whether the higher default rates, particularly in the for-profit higher education sector, are caused by factors associated with the institutions or due to the characteristics of their students. A disproportionate number of low-income and minority students attend for-profit schools. Low-income and minority students comprise 50 and 37 percent of students at for-profits, respectively.⁴³ Representatives from the for-profit higher education sector argue that the higher default rates are due to the individual characteristics of the students they enroll, not due to institutional characteristics.

Some studies agree with the industry view. According to a review of student default research from 2009, once borrowing behavior, student background characteristics, and institutional resources are considered, the differences between institutional default rates largely disappear.⁴⁴

However, even some industry studies affirm that not all of the disproportionately high rates in the for-profit sector can be explained by student demographics.⁴⁵

Other studies have concluded that after controlling for student demographics and

completion rates, default rates are still much higher at for-profit institutions.⁴⁶ Most important, students may have low incomes when they enter school, but they are enrolling in order to improve their financial circumstances. They may have come from low-income backgrounds, but their financial prospects should improve if they receive quality educations and meaningful credentials. Schools should be held accountable for high drop-out rates, which are connected to high default rates, and for the employment outcomes of graduates.

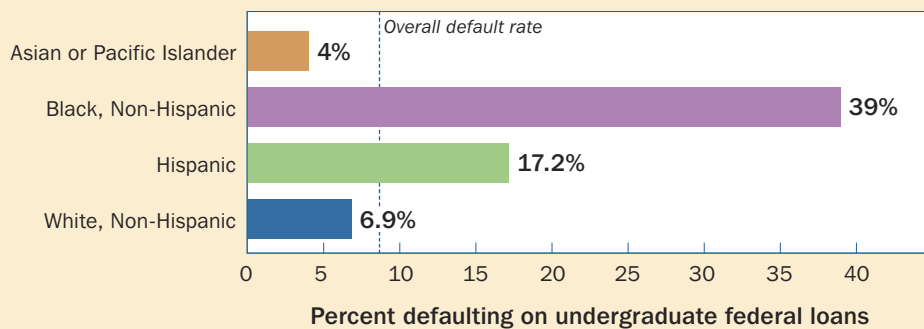
The demographic determinism argument is further undermined by the efforts of some for-profit institutions and other schools with traditionally high default rates, such as historically black colleges and universities (HBCUs), that have managed to lower default rates significantly.⁴⁷ Many HBCUs successfully reduced their default rates without overhauling their admissions process to change student demographics.⁴⁸

The resources of the particular school attended may also impact default rates. Researchers have found that students that attend wealthier institutions have greater access to social and economic capital and are less likely to default.⁴⁹

4. Race and ethnicity

Some researchers have found a correlation between race and higher default rates, mainly among African American and in some cases Latino and Native American student borrowers.⁵⁰ In a 2007 study, the Education Sector found that black students who graduated in 1992-93 had an overall default rate that was over five times higher than white students and over nine times higher than Asian students. The difference for Hispanic students while not as pronounced, was still substantial.⁵¹ The researchers concluded that the differences could not be fully explained by differences in borrowing patterns or salaries.⁵²

Ten-Year Default Rate Among 1992-93 Bachelor's Degree Recipients, by Race/Ethnicity⁵⁵



Source: Erin Dillon, "A Closer Look at Student Loan Default Rates," Education Sector (Oct. 23, 2007).

In a 2009 review of student loan literature, researchers concluded that the finding of higher default rates among certain racial groups was remarkably consistent.⁵³ The authors cite numerous studies that find students of color with higher default rates even after controlling for post-graduation earnings. However, they also acknowledge that relatively little is known about the factors that contribute to this difference. Among other issues to consider, these students tend to borrow more. According to some studies they are also more likely to be unemployed and less likely to be satisfied with their educational experiences. Discrimination after leaving school may also play a role.⁵⁴

5. Age

There is less conclusive evidence of the effect of age on default. While a number of studies associate older students with default risk, some have found the opposite. For example, the Institute for Higher Education Policy found a higher rate of default among younger borrowers, with six out of ten of borrowers under the age of 21 becoming delinquent or entering default. Those who were 45 or older who entered repayment yielded a 33% rate of default and delinquency.⁵⁵

6. Gender

There is some evidence of higher default rates among males.⁵⁶ This relationship, however, is less clear than many of the other factors discussed above. Many studies show no significant difference in default rates among male and female borrowers.⁵⁷

7. Amount of debt

There have been contradictory findings regarding whether the amount of debt has a strong impact on default. According to a few studies, the amount of debt is not a good predictor of default when other characteristics are considered.⁵⁸ The Institute for Higher Education Policy found, for example, that borrowers who defaulted had fewer loans and lower loan amounts than those who did not default.⁵⁹ This may be because those who drop out generally have lower balances, but are otherwise at risk for default.

However, in a 2006 report, the Department of Education followed a group of federal student loan borrowers for ten years and found a correlation between the amount borrowed and default.⁶⁰ Twenty percent of the borrowers in the study with \$15,000 or more in Stafford loans defaulted at some point, compared to 7%-8% of those who borrowed less than \$10,000.⁶¹

8. Lack of high school diploma

Under rules in existence until July 2012, borrowers without high school diplomas or GEDs could qualify for federal aid as long as they met certain “ability to benefit” requirements. Congress eliminated this path to federal aid as of July 2012.

Although there has been less study of this issue, the lack of a high school diploma is often cited as a risk factor for default. A few of the for-profit school companies, for example, have cited higher default rates among these students.⁶²

9. Lack of information about borrowing

The Consumer Financial Protection Bureau's collection of complaints about private student loans indicates high levels of confusion among borrowers regarding their loans and the financial aid process. Many borrowers did not know the rules for federal aid eligibility and some could not identify whether they had federal or private loans.⁶³

A phone survey by the Texas guaranty agency showed that defaulted borrowers received counseling that was unclear or not understood. Borrowers who repaid their loans possessed a better understanding of their options.⁶⁴ In a profile conducted by the University of Illinois, Chicago, of student loan defaulters, the most commonly cited reason for defaults was lack of information.⁶⁵ Other studies have found mixed results regarding the relationship between knowledge about student loans and likelihood of default.⁶⁶

The Texas guaranty agency found a high level of hopelessness concerning the future among the borrowers in default they surveyed.⁷²

10. Other factors

Some studies have cited other factors that contribute to default, including lower parental educational attainment and high incidence of life traumas, including health crises. The Texas guaranty agency found a high level of hopelessness concerning the future among the borrowers in default they surveyed.⁶⁷ A few studies have also developed a general measure of academic success and found lower default rates among successful students.⁶⁸ Graduation status was only one element of academic success. Some also found lower default rates in particular fields of study, such as engineering.⁶⁹ Another finding is that default is associated with borrowers who have more dependents.⁷⁰ The Texas study found that servicer quality had an important impact in preventing defaults.⁷¹

NCLC'S SURVEY OF BORROWERS IN DEFAULT

Few of the studies previously discussed included interviews or surveys of student borrowers. This is a glaring omission as borrowers are often very insightful and certainly have the most direct information about why they defaulted.

To help fill in these gaps, we created a survey to gather more information from borrowers in default. A copy of the survey is attached at Appendix B. NCLC staff and other advocates administered these surveys to 40 individuals over a period of about one year, starting in May 2011. Most of the borrowers surveyed lived in the greater Boston area, but about one-third were from other locations, including New York City; Rochester,

A Boston Single Mother's Story

Pat, a single mother in her mid-40's, started college almost 20 years ago. She attended the University of Massachusetts Boston, but dropped out before graduation. She suffered through a number of life crises, including the wrongful incarceration of her step-father (since released after many years in prison) and bouts with substance abuse and alcoholism. Throughout these life trials, Pat kept her dream alive of going back to school. However, she could not get financial aid to go back because of a number of student loan defaults, including a Perkins Loan that had gone to judgment. Pat did not recall receiving court papers and did not know there was a judgment. After a year of unraveling the complexities of Pat's case and ultimately vacating the judgment, Pat was able to get out of default by consolidating her loans. She expects to graduate from UMass this year.

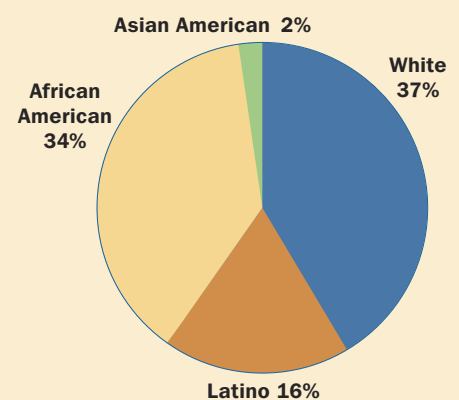
New York; and Colorado. Only borrowers already in default were surveyed. All were seeking legal assistance to address student debt problems.

We began this project because of the lack of information in this area, but also because we observed many of our clients getting behind on payments during the transition out of default. We provide intensive counseling about repayment responsibilities going forward, but we work with a vulnerable population and fear that many re-default. On the other hand, many succeed and the opportunity to get out of default makes all the difference for these individuals. We were frustrated by the lack of objective research on the key factors that trigger default and re-default.

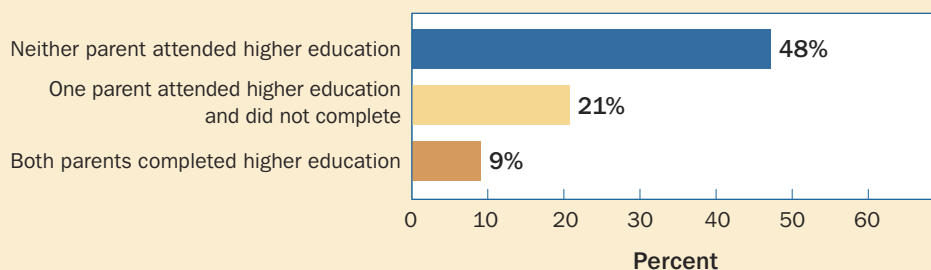
The vast majority of the borrowers in our survey (76%) were female. Thirty-seven percent were white, 34% African-American, 16% Latino, and 2% Asian-American, and the rest were other. Significantly, the average age of the borrowers surveyed was 43 years. Just over half, 55%, had at least one child. Fifteen percent had no high school diploma or GED when they signed up for school.

Some of the results mirror the research on default previously discussed. An overwhelming majority of borrowers, about 80%, were unemployed. About 85% received some type of public assistance. All had low incomes because they qualified for free legal assistance. Nearly 65% had attended at least one for-profit school. Lack of completion was also a problem. **Only 47% of those surveyed completed their education.**

NCLC Survey Demographics by Race



Parental Educational Attainment of NCLC Survey Respondents



We also found low parental educational attainment rates. Of those who knew their parents' educational attainment:

- 48% stated that neither parent had completed or attended higher education.
- 21% had only one parent who had attended, but had not completed, higher education.
- 9% had two parents that had completed higher education.

Overall, 69% did not have a parent who had *completed* higher education.

Other studies have found a strong correlation between parental educational attainment and the ultimate credential obtained by their children. According to one study, only about 30% of 18 to 24-year-olds whose parents did not graduate from high school reach college, compared to about 85% of individuals in that age group where the household has a bachelor's degree or more from college. A student with college-educated parents was almost three times as likely to reach college as a student whose parents did not graduate from high school.⁷³ This is particularly troubling because parental educational attainment varies significantly by race. This is likely due in part to limited resources or connections of counselors and others at high schools in lower-income areas.⁷⁴

We found a lack of general knowledge about default among those we surveyed. Twenty-four percent of those surveyed did not know they were in default when they sought legal assistance. Sixty-five percent did not recall any pre-default communications or contact, although a few acknowledged that they had received phone calls that they did not accept or received mail that they did not open.

We also asked the borrowers to express in their own words why they thought they were in default. Economic difficulties and lack of employment were by far the most commonly cited reasons for default. A few borrowers noted that they did not know they had options. Others specifically mentioned disability or other health problems. A few stated that it was not their loan.

We found one indicator in particular that was not reflected in the studies described above. Forty-seven percent of the borrowers in our survey said they did not believe they should have to pay the student loan debt. An additional 10% answered yes and no when asked if they should have to pay the debt.

This result highlights the importance of questioning borrowers about their reasons for default. As discussed previously, very few researchers have contacted borrowers in this way. Texas' guaranty agency, however, did telephone surveys of borrowers to "provide more texture to the description of the characteristics of defaulted borrowers."⁷⁵ They used statistical models to predict which borrowers were most likely to default based on a range of characteristics. Among other findings, the agency noted that those who were predicted to default and did default had the highest rate of unemployment AND tended to be angry about the quality of education they received.⁷⁶

A few of the borrowers in our survey who did not believe they should have to pay mentioned disabilities or health issues. Others acknowledged they owed the money, but were too destitute to pay. For example, one borrower said: "I feel like I have to pay it

NCLC Survey Respondents: Why I Should Not Have to Repay My Student Loan

When asked why they thought they should not have to repay the loan, responses included:

"Not working in the field, no placement services. No one I know from the school is working. Went through the phonebook A to Z and wasn't able to get a job with their degree."

"Credits are worthless, I was deceived. I did not get a job or internship. For the amount of money of the debt, the degree is non-existent. I can't do anything with it."

"The school never helped me get a job, and they never gave me any certificate . . . the school had already got their money. I don't know why they charged me twice. The Department of Education also took so much money from me to pay the loan that they paid themselves over and over again. I never got a job in the field."

"Because when I went to the school I felt like they didn't provide enough education for what I paid for or what I took out the loan for. They made so many promises while you're in school and after for helping you and they never did. The credit you're supposed to earn, it's not enough for you to get a job in the real world."

"Because the location closed down so there was no more school."

"Because I didn't gain anything from it. I didn't even go to school for that long, maybe a month, and it wasn't worth anything. They also took triple the amount that I owed."

because I borrowed it, but not when it causes me not to be able to buy food, or pay rent. I am in and out of the shelter system.”

The vast majority who did not believe they should have to pay back their loans expressed serious problems with the schools they attended. **Nearly all (about 90%) of the borrowers who said they should not have to repay their loans attended for-profit schools.**

DO EXISTING PROGRAMS WORK FOR FINANCIALLY DISTRESSED BORROWERS?

Pre-Default Programs/Default Aversion

In a 2006 study, financial aid professionals cited default aversion programs as an important way to prevent defaults.⁷⁷ Default aversion programs include counseling and other targeted programs to reach borrowers before they default. Officials in some states, such as Montana, claim to have kept default rates low by devoting resources to default aversion programs.⁷⁸ A 2010 Education Sector report describes a number of default aversion programs and cites one study that found that counseling is significantly associated with lower default rates.⁷⁹ In interviews with student aid experts, the Institute for Higher Education Policy reported that borrowers are often not aware of options that might have helped them avoid default.⁸⁰ A Department of Education best practices handbook cites counseling and financial literacy as keys to default aversion, but does not cite any data.⁸¹

A report by American Student Assistance, a guaranty agency, states that proactive communication has been proven to protect the financial health of borrowers, lower the cost of the student loan program to the government, and ensure return for taxpayers.⁸²

Others conclude that there is modest evidence of the impact of counseling.⁸³ Researchers note that studies of counseling success could be a function of self-selection as students who participate in these programs may be less likely to default in any case. Further, studies have shown that those who complete their educational programs are less likely to default regardless of counseling.⁸⁴

There is significant evidence that default aversion, even if effective, reaches a small percentage of borrowers. In a 2008 Power Point, U.S. Department of Education staff said that 49% of defaulters had bad telephone numbers and the overwhelming majority (95%) could not be reached during the collection period prior to default.⁸⁵

The standard Department of Education delinquency letter in Appendix C is an example of the serious problems with current default aversion efforts. The letter informs a borrower in late stage delinquency that she must immediately repay the total due, in this case a balance of over \$21,000. This is inaccurate information. In fact, borrowers in these circumstances have a range of options, including deferments and income-based repayment. The letter describes these programs, but only in the last sentence. This information pales in comparison to the large warning at the top that a borrower must pay the entire balance. Presumably this is done to frighten the borrower. From our experience, these

types of claims often have the opposite effect of discouraging borrowers from trying to resolve an account. We recommend revising this letter and similar communications.

Voluntary Flexible Agreements and Default Aversion Incentives

The Obama Administration has highlighted the need to prevent defaults through increased education and information. Secretary Duncan stated in a June 2012 conference call that, “We’re absolutely convinced that a significant percentage of defaults will be averted simply by helping young people better understand their choices and make the right financial decisions.”⁸⁶

The Administration should also ensure that servicers and loan holders are incentivized to help prevent defaults. In the guaranteed loan program in particular, delinquent loans often have less value than loans in default because the government guarantees close to full payment when default claims are filed.⁸⁷

Congress responded in part by giving the Department of Education the authority to develop and sign voluntary flexible agreements (VFAs) with guaranty agencies. These agreements exempted agencies from many regulatory requirements, such as prescribed contacts with borrowers. They also encouraged agencies to set up new types of incentive payment agreements, in many cases rewarding agencies for preventing defaults rather than tying compensation to collection.⁸⁸ Under the VFAs, the cohort default rate was reduced by rates as much as 47% at some agencies.⁸⁹

In May 2011, the Obama Administration invited proposals from guaranty agencies for new VFA agreements. Twelve guaranty agencies submitted a joint proposal to the Department of Education, but the Administration has not yet announced the awards.⁹⁰

Post-Default Programs

Rehabilitation and Consolidation Described

The following sections focus in detail on rehabilitation and consolidation, the two main ways for federal student loan borrowers to get out of default. The first section describes the programs, followed by a legislative history. The final section reviews existing research on program effectiveness.

Most federal student loan borrowers can consolidate their defaulted student loans into a new Direct consolidation loan with a repayment plan tied to their income.⁹¹ After a completed consolidation, borrowers become eligible for the range of pre-default payment options, including income-based repayment (IBR) or income contingent repayment (ICR). These plans set payment amounts based on borrower income. To obtain a Direct consolidation loan, borrowers in default *either* have to make three consecutive reasonable and affordable payments based on their total financial circumstances *or* agree to select an income-contingent repayment plan (ICRP) or income-based repayment plan (IBR).⁹²

An important limit on the Direct consolidation loan program is that defaulted Direct consolidation loans may not be re-consolidated. In effect, this means that borrowers have only one shot at consolidating as a way out of default.

In the alternative, a borrower can renew eligibility for new loans and grants and cure the loan default by “rehabilitating” the defaulted loan. Loan rehabilitation for FFELs and Direct loans may be requested after the borrower has made nine payments within twenty days of the due date during a period of ten consecutive months.⁹³ The monthly payments must be “reasonable and affordable” based on the borrower’s total financial circumstances.⁹⁴ The rules are slightly different for Perkins loans.

For FFEL loans, after the borrower makes the required timely monthly payments under the new plan and requests rehabilitation, the guarantor or the government must sell the loan to an eligible lender if practicable.

FFEL and Direct borrowers are limited to one rehabilitation per loan. This limit applies to loans rehabilitated on or after August 14, 2008 and applies only if the loan returns to default status following the rehabilitation.⁹⁵ Loans that have been reduced to judgment may not be rehabilitated or consolidated.⁹⁶

Overall, consolidation is much faster than rehabilitation, mainly because a borrower in default does not have to make any preliminary payments to qualify. Further, there is no resale requirement. Consolidation is a new loan while the Department views rehabilitation as the same loan sold to a new lender. The faster process is especially important for borrowers seeking to go back to school quickly. In addition, with consolidation, borrowers do not have to make preliminary payments and so are not forced to negotiate “reasonable and affordable” payments with a collector.

The main advantage of rehabilitation relates to credit reporting. Consolidation results in a notation on a borrower’s credit report that the defaulted loan was paid in full. In contrast, rehabilitation removes the default notation completely. This benefit is often oversold. The default notation is removed from the credit report, but any other negative history remains until it becomes obsolete. Borrowers can request that the entire trade line be deleted or that all negative history be deleted, but not all loan holders will comply.

Consolidation can also be a disadvantage for certain borrowers who may lose rights by consolidating. For example, Perkins borrowers lose the unique Perkins cancellation rights if they consolidate with Direct loans.

Borrowers may also regain eligibility for federal student aid by reinstating loans after six months of payments. However, these borrowers remain in default unless they complete the rehabilitation process.

Collection Fees

With both rehabilitation and consolidation, collection fees of up to 18.5% are added to the principal balance. The government may pay these fees in some cases in the rehabilitation program. Collectors receive these fees regardless of whether they have put in the work to “earn” them.

As early as 1996, the Department expressed concern about the fees to guaranty agencies after consolidation.⁹⁷ According to the Department, “Allowing the guaranty agencies to

retain an amount far in excess of the amount they have established as the cost of collecting on the loan (in addition to the reinsurance payment the agency received) would provide an unnecessary and inappropriate windfall for the agencies.⁹⁸

The fee policy for FFEL loan rehabilitation is particularly convoluted and costly to taxpayers. Further, the hefty fees added to a borrower's balance make it even harder for a borrower to dig out from debilitating debt after having defaulted.

According to a summary in a June 2012 Senate report, guaranty agencies are compensated in two ways through the rehabilitation process.⁹⁹ They receive 18.5% of the original defaulted amount *plus* an additional 18.5% collection fee that is charged to the borrower. This means that guaranty agencies retain 37% of each loan rehabilitated.

The Senate Appropriations Committee recommended in June 2012 to eliminate the guaranty agencies' retention of 18.5% of the original balance and require the agencies to remit the original balance to the Department of Education as opposed to selling the remaining 81.5% to an eligible lender. The Committee also recommended reducing the collection fee amount to a maximum of 16%. The Department estimates that this policy would reduce borrower fees by \$58 million in FY 2013.¹⁰⁰

Agencies have argued, without empirical evidence, that higher collection costs deter defaults because borrowers presumably avoid defaulting due to sticker shock.¹⁰¹ We were unable to find any empirical evidence to support this conclusion. The Department has even taken the contrary position, pointing out that limiting the fees on consolidation provides an incentive for borrowers to get out of default.¹⁰²

HOW DID WE GET HERE? A LOOK AT THE HISTORY OF THE REHABILITATION AND CONSOLIDATION PROGRAMS

History of the Rehabilitation Program

Congress added the rehabilitation program to the guaranteed loan program (FFEL) in 1986. This was initially a pilot program.¹⁰³ The first comprehensive description of the program appeared in a September 1986 Conference Report, explaining that rehabilitation was available only to borrowers who, at the time of default on the loan, were unemployed or institutionalized.¹⁰⁴ This limit is no longer in place.

The conflict between collecting as many dollars as possible and assisting borrowers is evident from the outset of the program. In October 1986, a House report described the program as intended both to “. . . assist borrowers who demonstrate a willingness and ability to repay loans earlier placed in default, and to reduce Federal default losses by permitting the removal of the rehabilitated loan from the default category.”¹⁰⁵

Representative Bruce Vento, one of the initial supporters of the rehabilitation program explained that the program was not for “. . . swindlers trying to cheat their Government.” Rather, he described the target population as “. . . ordinary people who can't find

a job with adequate pay and are caught up in an inflexible loan system which denies them the opportunity to get back on their own feet.”¹⁰⁶

Rep. Vento explained further in a 1992 statement:

Under our present system, there are no options for a person in default. In fact . . . even when a borrower does offer to pay as much as possible—and often more than is reasonable—on their loans, they do so only to have their offer rejected.

. . . it seems to me that from the perspective of the Federal Government, accepting nothing in place of something is a nonsensical choice. In light of the total impact on the individual borrowers, their families, and to the Federal assistance programs that frequently must help these people, forcing borrowers into default is nothing short of outrageous . . . it is essential that we as Members of Congress not only concern ourselves with the fiscal deficit, but that we give equal consideration to the human deficit.¹⁰⁷

Rep. Vento also appealed to the government’s interest in collection by stating that, “. . . at present once a borrower has defaulted on a student loan they essentially lose all future eligibility to participate in any title IV financial aid program. While this might appear to make perfect sense upon first glance, it robs the Federal Government of leverage in collecting on the lost loan.”¹⁰⁸

Other supporters focused on the importance of helping borrowers harmed by abusive school practices. The original supporters noted that the monthly payment requirement should establish good habits.

The resale requirement was imposed from the beginning as the statute provided that rehabilitated loans had to be sold if practicable. The Department has taken the position that FFEL lenders must sell the loans in order to complete the rehabilitation. However, we could not find any legislative language defining “practicable” or stating that it should be interpreted as an unconditional requirement. The FFEL resale requirement has been a major problem for borrowers, particularly during the credit crisis when there were few buyers for the loans.

There is no resale requirement for Direct Loans. However, there have been serious concerns about the Department’s failure to efficiently process completed Direct Loan rehabilitation accounts.¹⁰⁹

The current statute and regulations clearly state that borrowers should have to pay no more than what is reasonable and affordable during the rehabilitation period. However, the term “reasonable and affordable” was not in the original version of the statute. In 1992, the law was amended to include the sentence, “Neither the guaranty agency nor the Secretary shall demand from a borrower as monthly payment amounts referred to in this paragraph more than is reasonable and affordable based upon the borrower’s total financial circumstances.”¹¹⁰

Agencies and collectors routinely deny borrowers reasonable and affordable payments. This problem derives in part from a system established by the Department which

provides compensation to collectors for setting up rehabilitation plans only if the plans require borrowers to make certain minimum payments. In addition, the Department has had a stated policy of encouraging collectors to base “reasonable and affordable payments” on the amount owed.¹¹¹

The Department has recently admitted problems with this system. In 2012 negotiated rulemaking sessions, the Department agreed to regulatory changes that would affirm that reasonable and affordable payments cannot be based on criteria unrelated to the borrower’s total financial circumstances, including a percentage of the loan balance. However, these regulations may not become effective until July 2014.

Initially, there was no limit on the number of times a borrower could rehabilitate a loan. The 2008 Higher Education Act reauthorization law limits FFEL loan borrowers to one rehabilitation per loan.¹¹² We were unable to find any discussion or testimony in the Congressional Record regarding this change. This is surprising given the magnitude of this change for borrowers.

History of the Consolidation Program

Consolidation as a way out of default was opened up to borrowers pursuant to the Higher Education Amendments of 1992 but there is virtually no legislative history.¹¹³ The Department has restricted eligibility over time. The current regulations prohibit consolidation if any of the loans being consolidated are subject to a wage garnishment order or subject to a judgment, unless the judgment has been vacated.¹¹⁴ One of the most important limits is that defaulted Direct consolidation loans may not be re-consolidated. In effect, this means that borrowers have only one shot at consolidating as a way out of default.

We also studied the legislative change passed in 2005 to limit guaranty agency compensation when an excessive proportion of collections are through consolidation. Although the legislative history is sparse, the change likely stemmed from reports of collection agencies pushing consolidation, particularly in the late 1990s. Congress was concerned about paying subsidies to guaranteed lenders since at the time there was a FFEL consolidation loan program as well as a Direct loan program. Subsidy costs for FFEL consolidation grew from \$651 million for loans made in FY 2002 to \$2.135 billion in FY 2003.¹¹⁵ There were also problems with FFEL lenders steering borrowers away from Direct Loan consolidations. This should no longer be an issue since the FFEL program was eliminated.

Rehabilitation Bias

Many view rehabilitation as a superior program because it requires borrowers to make a series of payments before “escaping” default. We often hear this cited as the basis for incentivizing collectors to push rehabilitation. For example, at negotiated rulemaking sessions in 2012, Department of Education staff stated that getting in a habit of regular payments leads to greater borrower success. When pressed, they acknowledged that they had no evidence or studies to confirm this.

The Department's commission system provides incentives to collectors to push rehabilitation.¹¹⁶ As a result, few collectors neutrally explain the pros and cons of each option to borrowers in default.

Congress has also favored rehabilitation, including standards established in 2005 to limit guaranty agency compensation when an "excessive" proportion of collections are through consolidation.¹¹⁷ Agencies will often claim that this is a limit on how many consolidations they can process. In fact, this is not a limit on how many consolidations they can process, but rather a limit on compensation if they collect too many loans through consolidation in any given year.

Many members of Congress echo the rehabilitation bias. A 2005 House Committee on the Budget Report, for example, presented a strong belief that agencies should "... counsel more borrowers to rehabilitate their loans to get out of default rather than just consolidate the loans." According to the report, "Through rehabilitation, a borrower learns to make consistent payments and earns the benefit of cleaning up his credit record." In contrast, according to the report, borrowers who consolidate do not get in the habit of making consistent payments and the chances of re-default increase significantly."¹¹⁸

EFFECTIVENESS OF REHABILITATION AND CONSOLIDATION: SHOW US THE NUMBERS

There is a dearth of research on the effectiveness of either consolidation or rehabilitation, particularly with respect to borrower success rates. Department of Education staff confirmed in a phone call with NCLC that they did not know of any studies comparing the effectiveness of the two programs. This is particularly shocking since the Department collection contracts incentivize rehabilitation.

There is limited research showing a higher re-default rate after consolidation compared to rehabilitation. The Texas guaranty agency studied the effectiveness of rehabilitation and consolidation in two different studies in 2002 and 2005. In the later study, borrowers with consolidation loans with no underlying defaulted loans defaulted at 3%, compared to 6% in the prior study. The agency also found a much higher default rate, 50% in the earlier study and 40% in the later study, for borrowers who consolidated with underlying loans in default.¹¹⁹

The Texas guaranty agency study found a lower re-default rate for borrowers who rehabilitated than for those who consolidated out of default, but they admitted a lack of evidence on causation. In the Texas study, the default rate for rehabilitation peaked at 25%.¹²⁰ In contrast, the default rate on consolidation loans was as high as 50% at one point, although it had decreased to 40% during the most recent research time period.

With respect to consolidation, the GAO found some evidence that borrowers that consolidate their loans are more likely to default if the consolidation includes underlying loans that were previously in default.¹²¹ The GAO cites student loan "experts" explaining that

this may be reflective of less motivated former defaulters who were required to select income contingent repayment in order to consolidate.¹²² This is typical of the “research” on this topic. It is sparse, relies mainly on speculation about causes, and rarely includes borrower input.

In a 2003 report, the Government Accountability Office found that on average, consolidation loan borrowers had higher levels of debt, higher incomes, and larger loan repayments than nonconsolidated loan borrowers. However, as a group they defaulted at a much lower rate, 8% to 23%, than non-consolidation loan borrowers.¹²³ Because the study does not break out non-consolidation loans into those that were rehabilitated and those that were not, it is unclear from this study whether consolidation directly outperforms rehabilitation.

POLICY RECOMMENDATIONS

Introduction

As long as we rely on loans as the centerpiece of federal aid and retain liberal front-end lending policies with little or no accountability for participating schools, there will continue to be students who obtain loans that they cannot repay. **A key recommendation is to increase targeted grant aid for students and increase funding for public education.** We must also attempt to avoid defaults by holding schools more accountable for poor outcomes and providing better information to students.

We must rethink the draconian collection policies that leave vulnerable students with nowhere to turn. A first step is to target collection efforts at those with resources to pay. Limiting collection in this way should save money for taxpayers. There are significant costs to taxpayers associated with pursuing the most vulnerable borrowers until they die. Under the current system, lenders and collectors profit as the government pays higher and higher collection fees.

Recommendations for reform include:

I. Support Research on Default Policies

A. Targeted and objective research on causes of default is essential

It should be clear from the summary above that there are many holes in the existing research on the causes of student loan defaults. Objective study is essential. Researchers should use longer-term default data rather than relying mainly on the limited CDR data, and they should study delinquency, not just default rates. While studying rates at a particular school may be useful, it is preferable to broaden the research and use the most comprehensive data possible.

We urge the Department of Education to make long-term data available to researchers AND to conduct internal studies using this data. Requiring private lenders to report

data on private student loans, potentially through the NSLDS system, would open up another set of data to study borrower behavior over time.

It is critical to isolate the main predictors of default by using appropriate regression analyses. This regression research should focus particularly on the extent to which lack of completion causes default. Studies should also include interviews and surveys of borrowers. Many of these studies will take time as borrowers are tracked over longer periods.

The Texas guaranty agency has done some insightful studies in this area. It acknowledges the limits to its data and has recommended numerous topics for future study, including:

- The impact of servicer behavior on default rates.
- Servicer trends by type of institution to determine if forbearances or other types of cures dominate in particular sectors.
- Whether particular tools, such as forbearance, are associated with higher default rates.
- Tracking a sample of borrowers whose loans are cured from entering repayment, through a cured delinquency, to a period of successful repayment.¹²⁴

The Texas agency concludes that more research is critical to ensure that the lending industry avoids another firestorm of criticism similar to the one that led to the default sanctions program and other changes in the early 1990s. We believe that the motives for future research should be about finding solutions that work best for borrowers. However, we applaud agencies like the Texas guaranty agency, regardless of motives, for being willing to test common assumptions and look for better solutions.

B. Study the effectiveness of default aversion and servicer quality

It is not enough to measure whether counseling and other interventions increase borrower knowledge. The focus should be on measuring borrower behavior over time after receiving counseling or other default aversion services.

C. Study the effectiveness of existing post-default programs

As the Texas agency recommends, different cohorts of borrowers should be tracked after rehabilitation, reinstatement, and consolidation to assess re-default rates. It is not sufficient, however, to look only at success rates over time for the programs. Researchers must also take operational problems into account and quantify their effects. From our experience, for example, many borrowers re-default because of confusion or servicer error in submitting paperwork or other operational barriers. This is a major reason why the one-time limit on both consolidation and rehabilitation is so unfair to borrowers.

It is particularly important to research whether making nine months of payments is the reason why re-default rates may be lower under the rehabilitation program. It may seem intuitive that individuals are more invested in programs when they put money on the line, but this is a controversial topic in social science literature.¹²⁵

D. Study the cost of collection

Giving borrowers a chance to get back in good standing may be less costly in many cases than the relentless gauntlet of collection tactics. We particularly need more information about the costs of the Department's collection programs. We urge the Department to be more transparent about these costs. Is the government truly saving money by collecting so aggressively or would it be more cost-effective to provide more flexibility to borrowers to get out of default?

Some cynically argue that default rates should not be a major concern because government collection rates are so high that there is no cost to taxpayers. Nexus Research, an organization funded by the Apollo Group (owner of the University of Phoenix) stated in a 2010 presentation that there is no net loss to the government from their students' defaulted loans.¹²⁶ Among other problems, this view ignores the extraordinary human costs of default. Further, the premise that there is no financial cost to defaults is highly debatable. By most accounts, the government has an extraordinarily high collection rate, but does not profit from collection if the costs are taken into account.¹²⁷

II. Create More Accurate Default Rate Calculations and Close Loopholes in the Sanctions System

The current cohort default rate is an inadequate and misleading indicator of the true rate of student loan defaults. We recommend changes to track borrowers over longer periods of time. The Department should also be more transparent about the limitations of CDR data.

The sanctions program should also be reformed so that schools have fewer opportunities to avoid sanctions through appeal. Over the years, Congress has steadily expanded the grounds for appeal. In particular, provisions in the 1998 HEA allowed schools to appeal based on mitigating circumstances.¹²⁸ The 2008 HEA reauthorization law applies the "mitigating circumstances defense" more broadly and establishes an appeals process for regulatory relief.¹²⁹ Congress should act to close loopholes in this process.

Some have advocated requiring schools to pay directly for student loan defaults. This is a concept that should be explored further. However, there are dangers for borrowers if schools pay off loans and then attempt to collect directly from students. Borrowers in these cases lose the various rights available under the Higher Education Act for federal student loans. We believe it is preferable to adjust the cohort default rate thresholds and calculations so that more schools with default rate problems are sanctioned. Schools should also be held accountable for other outcome measures, such as low completion or low job placement rates, that are correlated with default.

III. Support Effective Default Aversion Programs

Borrowers will not suffer the consequences of default if they never default in the first place, yet the federal government has generally prioritized collection over default aversion. We question whether there is political will to stop placing the financial needs of collectors over borrower needs. We urge real reforms to prevent defaults, including:

A. Create automatic entry to Income-Based Repayment (IBR)

Our survey showed a large percentage (65%) of borrowers who do not recall receiving any contact prior to default. Other studies, including reports from the Department, affirm that loan holders do not reach a large portion of borrowers during the delinquency period. This is critical because borrowers might not even be aware they are about to default.

To help catch borrowers before they fall into default, we recommend instituting an automatic entry process so that loan holders can evaluate borrowers for presumptive eligibility for income-based repayment and place borrowers temporarily in IBR during late stage delinquency.

IBR provides many benefits for borrowers. Most important, automatic placement into IBR will allow borrowers to avoid the draconian costs of collection and extraordinary government collection powers. Current participation in IBR is low due mainly to lack of awareness and operational barriers. Creating an automatic entry, especially during late stage delinquency, would allow more to benefit.¹³⁰ This could involve automatic debiting from borrower paychecks. However, as described in the next recommendation, not all borrowers are employed and the automatic system must accommodate these borrowers as well.

B. Simplify IBR eligibility for public assistance recipients

Borrowers receiving means-tested public assistance benefits should be automatically placed in a presumptive IBR program. They should be allowed to stay in this program by proving continued receipt of benefits. This should be a straightforward form, similar to the economic hardship deferment form attached at Appendix D. Borrowers applying for this deferment need only check the box that they are receiving public assistance payments and provide documentation.

C. Under the current system, ensure that borrowers coming out of default can easily transition into income-based or income-contingent repayment

The Obama Administration took some steps in June 2012 to make it easier for borrowers to enroll in IBR. The Administration announced that it has directed the I.R.S. and Education Department to create a system by the end of September that allows borrowers to transfer IRS data directly into the IBR application and submit it online.¹³¹ This should streamline the process for many borrowers. More needs to be done, particularly for borrowers that do not have IRS data on file because they are not required to file taxes.

D. Support the Voluntary Flexible Agreement (VFA) program for FFEL Loans and create similar incentives for Direct Loans

The Department should continue to incentivize proactive communication with borrowers prior to default. The VFA program encourages guaranty agencies to educate borrowers on a range of repayment options and has a proven track record of lowering defaults. The Department should increase funding for VFA programs and perform a rigorous

analysis to determine the reasons for the program's success. When the Department rewards guaranty agencies that prevent defaults, borrowers avoid the financial consequences of default. The Department should explore similar incentives for Direct Loan servicers and collectors.

E. Improve pre-default counseling

Counseling is not a substitute for strong regulation, including flexible and reasonable repayment options. However, effective counseling programs can complement these other policies by getting information out to students in a timely way and assisting them when problems arise.

F. Require servicers to describe all options to borrowers throughout the delinquency process

IV. Improve Current Post-Default Programs

A. Rehabilitation reforms

1. Eliminate the one-time limit on rehabilitation.

Borrowers should be given more chances to get out of default. Policymakers could consider an approach where multiple rehabilitations are allowed, but possibly place additional eligibility requirements for subsequent rehabilitations.

2. Ensure that the new regulations for handling rehabilitations go into effect earlier than July 2014. These new rules will help ensure that collectors accurately administer rehabilitation accounts and allow borrowers to pay only what is reasonable and affordable for them.

3. Eliminate the FFEL program resale requirement. Because of this "requirement," borrowers who make the necessary payments can get stuck with no possibility of completing the rehabilitation simply because their guaranty agencies cannot find buyers. At a minimum, agencies that cannot find buyers should be required to assign the loans to the Department of Education. The Department must also ensure that Direct Loan rehabilitation accounts are processed as quickly as possible.

4. Provide full credit reporting benefits. Lenders should be given the discretion to erase all negative history in the borrower's credit report, not just the default notation. This is a much more complete "credit clearing" benefit.

5. Reduce collection fees after rehabilitation. Collectors should not make so much profit in excess of the costs of collection.

B. Consolidation reforms

1. Allow borrowers to choose between consolidating without first making payments ("forced consolidation") or making three payments prior to consolidation. The regulations clearly present these options as alternatives. However, loan holders and collectors frequently

misstate these rights and claim that all borrowers must make payments prior to consolidating out of default.

2. Clarify the process for consolidation out of default. The instructions to borrowers should be clear and administered consistently.

3. Borrowers pursuing consolidation should be informed prior to processing the consolidation if any loans have been reduced to judgment. This is critical because the national student loan data system does not inform borrowers about judgments. Some judgments may be so old that they no longer appear on credit reports. In these cases, a borrower may go through the consolidation process and only later learn that she is still in default on the loan with a judgment.

4. Reduce collection fees after consolidation. Collectors should not make so much profit in excess of the costs of collection.

C. Require reasonable settlements and compromises

Our experience is that the Department rarely offers reasonable settlements. We urge the Department to create standardized guidelines for settlements and compromises that include significant principal reduction as well as elimination of fees and accrued interest. Accepting a reasonable settlement is likely to cost less over the long-term than years of collection efforts.

The Department did for a brief time post a 2009 Private Collection Agency (PCA) Procedures Manual detailing compromise standards. Unfortunately, the Department decided to take the manual off-line, apparently because of media reports publicizing the standards.¹³²

The standard compromise requiring a lump sum payment of at least 90% of the current principal and interest balance is unrealistic for most borrowers.

V. Create a more Efficient and Equitable Collection System

A. Eliminate private collection agencies from the dispute resolution role

Dispute resolution is obviously not the primary mission of loan collection agencies. Debt collectors are not adequately trained to understand and administer the complex borrower rights available under the Higher Education Act, and the government does not provide sufficient oversight of their activities. There are certainly times when a borrower is uncooperative or has exhausted all options. In those cases, the loan holder may have no choice but to focus on collection efforts. Yet there are many borrowers who want to find a solution, but are stymied because they cannot get past the rude, harassing, and often abusive behavior of a collection agent.

Until such time as the government identifies viable alternatives to private collection agencies, we call on the Administration to issue a moratorium on using private collection agencies for student loan dispute resolution. Specifically, the government should

bring all accounts in-house for borrowers that are already subject to extreme collection programs such as Social Security offset. These will limit the costs of pursuing borrowers with little or no resources. In addition, if a borrower informs a collection agency that he believes he has a defense to the debt, that the amount is wrong, or that he wants to request a hardship waiver, the file should be immediately brought in-house.

B. Collection charges should be limited to only those fees that are bona fide and reasonable and actually incurred

The amount of fees to be charged must be clearly written in the promissory note. In no event should fees be added to the principal, a standard practice known as capitalization, which balloons loan balances and makes it even harder for borrowers to make a dent in their debts. Reasonable collection fees should be charged only when actual costs are incurred and in no case should fees be charged for government offsets or wage garnishments.

C. Require loan holders to provide information to borrowers about all post-default options and evaluate collectors based on borrower service

D. Eliminate the current incentive commission system that leads collectors and loan holders to withhold important information to borrowers and pursue their own profits rather than borrower needs

This includes the elimination of financial incentives to collectors for:

- Pushing rehabilitation generally and for rehabilitation programs with higher payment amounts.
- Pushing more monthly payments prior to dispute resolution than are required by law.
- Discouraging borrowers from pursuing consolidation or other options on their own.

E. The Department must stop delegating inherently governmental functions, such as conducting fair hearings, to third party debt collectors

There is an inherent conflict of interest in allowing collection agency officials to conduct and make hearing decisions. The hearing judges must be neutral and independent.

F. The Department and its agents should make publicly available the process for handling complaints against collection agencies and any disciplinary actions taken against those agencies

The Department and other loan holders often excuse examples of bad behavior as “anecdotal” and point to low volumes of borrower complaints. This excuse does not take into account the lack of a clear borrower-friendly complaint process. The Department’s website and other materials should give clear information about how to lodge complaints about collection agencies.¹³³

VI. Provide Real Relief for Borrowers Harmed by Abusive School Practices

We found a high percentage of borrowers in default responding that they did not believe they should have to repay their loans. The vast majority of these borrowers attended for-profit schools and described misrepresentations and other fraudulent practices at these schools. Yet none of the three cancellations (or “discharges”) intended mainly to address fraud—closed school, false certification, and unpaid refunds—provides general remedies for borrowers who attended a fraudulent school. For example, a school may routinely pay admissions officers commissions in violation of incentive compensation rules, fail to provide educational materials or qualified teachers, and admit unqualified students on a regular basis. None of these violations is a ground for cancellation. Instead, borrowers are stuck with a degree they cannot use.

We recommend that Congress and the Department consider new cancellations that will afford relief to all borrowers who attend schools that violate key Higher Education Act (HEA) regulations and for borrowers who have secured judgments against schools based on HEA violations but are unable to collect from the schools or other sources.

VII. Restore Safety Net for Student Loan Borrowers

Among other reforms, it is time to eliminate the Social Security and EITC offset programs. Policymakers must also restore the statute of limitations for student loan collections and expand the safety net, including bringing back bankruptcy relief for financially distressed borrowers.

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APPENDIX A

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APPENDIX B

SURVEY OF BORROWERS IN DEFAULT ON FEDERAL STUDENT LOANS

[Background information section omitted]

SURVEY

1. Before coming to see us today, did you know you were in default on your student loan(s)? ☐ Yes ☐ No
2. Do you know what “default” means? ☐ Yes ☐ No
If yes, what does it mean to you that your loan is in default?
(write down in borrower’s own words)
3. Have you spoken with anyone about your loans since you left or completed school? ☐ Yes ☐ No
If yes, describe, including information about who initiated contact:
4. What are the most important reasons you believe that your loan(s) went into default? ☐ Yes ☐ No
(Do not provide a list. Write down what the borrower says in her words)
5. Do you think you should have to pay back this loan? ☐ Yes ☐ No
If not, why not?

APPENDIX C

BORROWER DELINQUENCY LETTER

U.S. Department of Education
Direct Loan Servicing Center
PO Box 5202
Greenville, TX 75403-5202

**Direct
Loans**
OFFICE OF EDUCATIONAL OPPORTUNITIES

MAY 26, 2012

 
BETHESDA MD 20817-6143

Account Number: 

Dear :

You have continually failed to make your monthly payments, have not responded to our previous notices, and your loan payments are seriously delinquent. Because you have failed to meet the terms of your Promissory Note, we are requiring immediate full repayment of your Direct Loan(s) at this time.

This means YOU MUST IMMEDIATELY REPAY THE TOTAL DUE shown below. We must receive this amount within 30 days of the postmark date of this notice.

Principal Balance Due: \$20,416.29
Interest Due: \$669.22
Late Charges Due: \$.00

TOTAL DUE: \$21,193.90

Send check or money order (with your account number written on it) for the total due to:

U.S. Department of Education
P.O. Box 530260
Atlanta, GA 30353-0260

This is your last chance to avoid default. If we do not receive the entire unpaid balance of your loan(s) within 30 days of the postmark of this notice, your loan(s) will be placed in default. The following actions may also occur:

- Your credit rating will be damaged.
- Your wages may be garnished.
- Your federal income tax refund may be withheld.
- The U.S. Department of Justice may take legal action against you.

If you want to take this last opportunity to arrange a forbearance, deferment, or change repayment plan to avoid defaulting on your loan(s) or if you have questions, please call the toll-free telephone number below.

Sincerely,

Direct Loan Servicing Center

P.O. Box 5629 • Greenville, TX 75403-5629 • T 1-800-848-0179 • Fax 1-800-848-0184 • TTY 1-800-848-0183 • www.myedaccount.com

APPENDIX D

ECONOMIC HARDSHIP DEFERMENT REQUEST FORM

**Direct
Loans**
William D. Ford Federal Direct Loan Program

ECONOMIC HARDSHIP DEFERMENT REQUEST

William D. Ford Federal Direct Loan Program

WARNING: Any person who knowingly makes a false statement or misrepresentation on this form or on any accompanying documents is subject to penalties that may include fines, imprisonment or both, under the U.S. Criminal Code and 20 U.S.C. 1087.

OMB No. 1845-0011
Form Approved
Exp. Date 06/01/2012

HRD

SECTION 1: BORROWER IDENTIFICATION

Last Name	First Name	Middle Initial	Social Security Number
Street Address			Area Code/Telephone Number (Home)
			()
			Area Code/Telephone Number (Other)
			()
City	State	Zip Code	E-mail Address (optional)

SECTION 2: DEFERMENT REQUEST

Before completing this form, carefully read the entire form, including the instructions and other information in Sections 4, 5, and 6.

- I request that the U.S. Department of Education (ED) defer repayment of my loan(s) during the period that I meet one of the conditions checked below, beginning on the following date: []-[]-[]-[]-[]-[]. Except for deferment based on Condition (3), I must reapply every 12 months if I continue to meet the requirements for a deferment. My maximum eligibility for an economic hardship deferment is 36 months.

To qualify, I must meet **ONE** of the conditions listed below and **MUST PROVIDE THE REQUIRED DOCUMENTATION**, as described in Section 6, for only that condition.

Check one:

- (1) ☐ I have been granted an economic hardship deferment under the Federal Family Education Loan (FFEL) Program or the Federal Perkins Loan Program for the same period of time for which I am requesting this deferment. I HAVE ATTACHED DOCUMENTATION OF THE DEFERMENT (see Section 6).
- (2) ☐ I am receiving or received payments under a federal or state public assistance program, such as Temporary Assistance for Needy Families (TANF), Supplemental Security Income (SSI), Food Stamps, or state general public assistance. I HAVE ATTACHED DOCUMENTATION OF THESE PAYMENTS (see Section 6).
- (3) ☐ I am serving as a Peace Corps volunteer. I HAVE ATTACHED DOCUMENTATION OF MY PERIOD OF SERVICE IN THE PEACE CORPS (see Section 6).
- (4) ☐ I work full-time (as defined in Section 5) and my monthly income does not exceed the larger of (A) the Federal Minimum Wage Rate or (B) 150% of the Poverty Line income for my family size and state. I HAVE ATTACHED DOCUMENTATION OF MY MONTHLY INCOME (see Section 6).
- My monthly income (as defined in Section 5) is \$ _____ My family size (as defined in Section 5) is _____.
- (A) Federal Minimum Wage Rate (monthly amount, based on \$7.25 an hour): **\$1,256.67**
- (B) 150% of the Poverty Line income for my family size and state. This amount is listed in Section 6.

SECTION 3: BORROWER UNDERSTANDINGS, CERTIFICATIONS AND AUTHORIZATION

- I understand that the following terms and conditions apply to this deferment:

- (1) I am not required to make payments of loan principal during my deferment. No interest will be charged on my subsidized loan(s) during my deferment. However, interest will be charged on my unsubsidized loan(s). For any unsubsidized loan(s), I will receive an interest statement, and I may pay the interest at any time. If I do not pay the interest that accrues on my unsubsidized loan(s), it will be capitalized at the end of my deferment period.
- (2) My deferment will begin on the date the condition that qualifies me for the deferment began.
- (3) My deferment will end on the earlier of (A) the date that the condition that qualified me for the deferment ends, or (B) the deferment end date provided to me by the Direct Loan Servicing Center.
- (4) If my deferment does not cover all of my past due payments, ED may grant me a forbearance for all payments that were due before the begin date of your deferment. If the period for which you are eligible for a deferment has ended, ED may grant you a forbearance for all payments that are due at the time your deferment request is processed.
- (5) ED may grant me a forbearance on my loan(s) for up to 60 days, if necessary, for the collection and processing of documentation related to my deferment request. ED will not capitalize interest that accrues during this forbearance.

- I certify that: (1) The information I have provided on this form is true and correct. (2) I will provide additional documentation to the Direct Loan Servicing Center, as required, to support my eligibility for this deferment. (3) I will notify the Direct Loan Servicing Center immediately if the condition that qualifies me for this deferment ends. (4) I have read, understand, and meet the eligibility requirements of the deferment for which I have applied, as explained in Section 6.

- I authorize my schools, ED, and their respective agents and contractors to contact me regarding my loan request or my loan, including repayment of my loan, at the current or any future number that I provide for my cellular telephone or other wireless device using automated dialing equipment or artificial or prerecorded voice or text messages.

BORROWER'S SIGNATURE _____

DATE _____

Boston Headquarters:
7 Winthrop Square
Boston, MA 02110-1245
Phone: 617/542-8010
Fax: 617/542-8028
www.nclc.org

NCLC®
NATIONAL
CONSUMER
LAW
CENTER®
Advancing Fairness
in the Marketplace for All

Washington Office:
1001 Connecticut Ave, NW
Suite 510
Washington, DC, 20036
Phone: 202/452-6252
Fax: 202/463-9462