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ABSTRACT

An analysis of the U.S. Department of Education's (ED) default reduction plan under the Stafford Student Loan Program (formerly called the Guaranteed Student Loan program) is presented that concentrates on the new regulations and their implications for schools, students, and program administrators. The default plan's success largely depends upon whether the ED aggressively enforces the new regulations, and the extent to which institutional actions are actually contributing to defaults. Following a background of the default initiative (the problem and the ED plan), the following are covered: the final regulations (provisions affecting schools with high default rates, consumer information, guaranty agency program reviews, borrower counseling requirements, lender notification to school on delinquency, school refund policies, information sharing, and annual information ED); the proposed regulations; administrative actions to reduce defaults; ED legislative proposals to reduce defaults (major default reduction provisions of legislation proposed as part of the fiscal year 1990 budget request, and legislation requested specifically as part of the default initiative); and analysis of the initiative (implications for schools, students, and program administrators). (SM)

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The U.S. Department of Education's Student Loan Default Reduction Initiative: Background and Analysis

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THE U.S. DEPARTMENT OF EDUCATION'S STUDENT LOAN DEFAULT REDUCTION INITIATIVE: BACKGROUND AND ANALYSIS

SUMMARY

On June 1, 1989, Secretary of Education Lauro Cavazos announced regulatory, administrative, and proposed legislative measures to reduce defaults under the Stafford Student Loan program, formerly called the Guaranteed Student Loan (GSL) program. At the core of the Department initiative are final regulations prescribing sanctions to be undertaken against schools participating in Federal student aid programs, when the default rates of their students reach unacceptably high levels. Sanctions range from requiring schools to implement certain default control policies to terminating schools from program participation.

Making institutions responsible for student defaults represents a shift in Federal default control policy, which has concentrated on the roles of lenders and guaranty agencies in pursuing collections on loans and in educating borrowers about their rights and responsibilities. It was based on the premise that some institutions--particularly for profit schools providing short term vocational training--have administrative practices that increase the likelihood that their students will default.

This report analyzes ED's default reduction plan, with particular concentration on the new regulations and their implications for schools, students, and program administrators. Schools with high default rates will apparently be more liable to be terminated from program participation under the new rule, and will be likely to incur significant new administrative and fiscal burdens. Enrollees in high default schools tend to be low income and minority students. If many schools are terminated from student aid programs, such students will have a more limited choice of a postsecondary program. For program administrators one effect of the initiative may be reduced default costs, but such savings could be offset by funding that will be required to implement the new regulations and other enforcement and monitoring efforts.

In summary, the success of ED's default plan will largely depend upon whether the Department aggressively enforces the new regulations, and the extent to which institutional actions are actually contributing to defaults.

TABLE OF CONTENTS

THE U.S. DEPARTMENT OF EDUCATION'S STUDENT LOAN DEFAULT REDUCTION INITIATIVE: BACKGROUND AND ANALYSIS

On June 1, 1989, Secretary of Education Lauro Cavazos announced regulatory, administrative and proposed legislative measures to help reduce defaults under the Stafford Student Loan program. This default reduction initiative culminated the Department of Education's (ED) examination of possible Federal actions to deal with the student loan default problem, which had begun in the fall of 1987 under the former ED Secretary William Bennett.

At the core of the ED initiative are final regulations[1] prescribing sanctions to be taken against colleges, universities, trade and professional schools participating in Federal student aid programs, when the Stafford Loan default rates of their students reach unacceptably high levels. Such sanctions, which are triggered by a school's annual default rate, range from requiring schools to implement default management plans to subjecting schools to suspension or termination from program participation. The regulations also require all institutions to provide first time borrowers with counseling prior to disbursement of loan proceeds and schools with trade, technical or other such career programs to provide prospective students with certain consumer information.

ED also proposes regulations under the initiative in two new areas.[2] One would require lenders to notify a borrower when his or her loan is sold and payments must be sent to a new address. The other would require private trade, technical or other such career schools to enter into an agreement with another school to "teach out" its students in the event that the first school closes.

As another part of its default reduction initiative ED requests certain amendments to the Stafford Loan program legislation. in addition to other legislative proposals to address the default problem it requested as part of its FY 1990 budget. Also, ED will take certain administrative actions to improve default prevention and loan collection efforts.

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[1]*Federal Register*, v. 54, June 5, 1989. p. 24114-24127.

[2]Ibid, p. 24128-24129.

BACKGROUND OF THE DEFAULT INITIATIVE

Under the Stafford Student Loan program, formerly called the Guaranteed Student Loan (GSL) program, private lenders make loans to students to help them meet the costs of postsecondary education, and the Federal Government insures the lender, primarily through State or private nonprofit guaranty agencies, against borrower default. Three different types of federally guaranteed loans are available through the program: Stafford Loans for financially needy undergraduate, graduate, and professional students, for which the Federal Government subsidizes the interest rate and pays the student's interest while he or she is in school; Supplemental Loans for Students (SLS), nonneed tested loans for undergraduate, graduate, and professional students independent of parental support, which are generally unsubsidized;[3] and PLUS loans, also nonneed tested and unsubsidized loans for parents of financially dependent undergraduate students.[4] Stafford Loans constitute about 75 percent of total annual program loan volume, SLS loans, 20 percent, and PLUS loans, about 5 percent.

A loan is in "default" under the Stafford Loan program after lenders undertake certain required collection efforts on a delinquent loan for at least 180 days. After this time, the guaranty agency insuring the loan pays the lender for 100 percent of the outstanding principal and interest on the defaulted loan, takes over collection responsibilities, as prescribed in regulations, and after 90 days files a claim for reimbursement with ED. Generally, the Federal reimbursement rate is 100 percent, but the rate drops to 90 or 80 percent depending on the guaranty agency's default rate. For statistical purposes, a "defaulted" loan under the Stafford Loan program is a loan on which the Federal Government has paid an insurance claim.[5]

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[3]These loans and PLUS loans become subsidized when the variable interest rate applied to the loans exceeds 12 percent, the maximum rate that may be paid by the borrower. The interest rate is variable for each 12-month period beginning on July 1 and ending June 30 the following year, and is based on the bond equivalent rate of the 52-week U.S. Treasury bill (T-bill) plus 3.25 percent.

[4]For a description of the Stafford loan programs see, U.S. Library of Congress. Congressional Research Service. *The Guaranteed Student Loan Program: Current Status and Issues.* CRS Report for Congress No. 88-727 EPW, by Charlotte J. Fraas. Washington, 1988.

[5]This includes either reimbursements to guaranty agencies or, less commonly, a payment to a lender directly insured by the Federal Government. The Federal Government ceased insuring lenders directly under the Federal Insured Student Loan (FISL) program in July 1984.

THE DEFAULT PROBLEM

Annual Stafford Loan default costs to the Federal Government are at an all time high of $1.8 billion (FY 1989). Default payments rank fourth in expenditures for any single ED program or activity and constitute about 37 percent of the total Stafford Loan program obligations.

Contributing to this level of default costs are significant increases in the amount borrowed annually by students and the amount of loan principal entering repayment. For example, in FY 1980 the total loan volume (principal insured) under the program was $4.8 billion; in FY 1989, the volume is expected to reach $12.2 billion. This rise in volume directly affects default costs because of the increases in the amount of loans in repayment, especially loans entering repayment. Research on the characteristics of defaulters indicates that default is most likely to occur within the first year after a loan enters repayment.

Assuming a stable rate of defaults--even a moderately declining rate--default costs would rise from the large increases in loan volume in repayment. Of particular concern to policy makers and program administrators, however, is the apparent rise in the gross default rate[6] in recent years. This rate has climbed steadily since FY 1984, from 10.9 percent that year to an estimated 14.4 percent in FY 1989. The net default rate, which takes collections on previously defaulted loans into account, has not risen as rapidly, going from 8.4 percent in FY 1984 to an estimated 9.9 percent in FY 1989. Arguably, the gross rate may be a better indicator of the propensity of borrowers to default, because the net default rate is largely a function of the collection policies of lenders, guaranty agencies and the Federal Government.

Why is the default rate increasing? One cause may be changes in eligibility requirements for the program that have resulted in its serving a greater proportion of low income students, who are the borrowers at highest risk of default. Although the program was created to serve middle income as well as lower income students, it has since been refocused to serve primarily low income students as Federal grant and work-study aid have not kept pace with rising college costs. The Higher Education Amendments of 1986 for the first time required all applicants for Stafford Loans to undergo need analysis. While higher income students and parents are eligible for SLS or PLUS loans, the volume of these unsubsidized loans is only about a third of the volume of the subsidized Stafford Loans.

Another factor leading to a higher default rate may be the increasing proportion of Stafford loan borrowers attending short term vocational courses of study in proprietary schools. Default data indicate that students who

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[6]This is the cumulative dollar amount of default claims paid to lenders since the inception of the Stafford Loan (or GSL) program divided by the cumulative dollar amount of the principal of loans that ever entered repayment, or "matured."

attend proprietary schools tend to default at a higher rate than those attending other institutions of postsecondary education, including the most comparable 2-year public institutions (community colleges).[7] Proprietary school students are largely from low income backgrounds, attend the schools for short periods, and have relatively low loan balances, all factors which research has shown to correlate with high default rates. What is unknown is whether proprietary schools have high default rates because their enrollees have these characteristics or because of factors relating to the schools themselves.

Some, such as former Secretary of ED William Bennett, have argued that abusive practices by some proprietary schools cause their students to default at high rates. In testimony before a Senate subcommittee in December 1987, the then-Secretary observed that many proprietary schools lure ill equipped students into their programs with assurances that they will receive training for a good job and that Federal student financial aid will cover the costs of the schooling. Thereafter, the Secretary contended, such students drop out of the school, either because they are unable to succeed or the programs do not meet expectations. The student may or may not have realized that he or she incurred debt as part of the Federal aid package, may feel no obligation to repay the student loan because the school did not live up to expectations or may have no ability to repay the loan because he or she is unemployed. While there has been considerable anecdotal information to support this scenario, no reliable national data exist through which to determine its specific influence on increases in student loan defaults.

THE DEPARTMENT'S PLAN

The default reduction initiative announced by Secretary of ED Cavazos originated in the Reagan Administration. In November of 1987, Secretary of ED William Bennett presented a proposal to reduce student loan defaults, stating that the level of defaults had become "intolerable," and threatened to undermine public confidence in Federal student aid. What was new in Secretary Bennett's approach was to make institutions of higher education accountable for the default rates of their students rather than lenders or guaranty agencies, which had born the brunt of default reduction efforts in the past.

Secretary Bennett said that ED would propose regulations to disqualify schools with default rates exceeding 20 percent from participation in Federal student aid programs after 1990. The default rate used to implement the rule would be a newly calculated "cohort" rate determined by the number of the institution's students entering repayment in a given year who default by the

[7]ED reports that according to its national data on FY 1986 borrowers entering repayment, proprietary school students default at a rate that is twice as high as that of 2-year institutions, and four times as high as 4-year.

end of the following year. ED estimated that the rule would affect more than 30 percent of institutions participating in the student loan program, whose students accounted for over half of default costs.

The Bennett default reduction proposal was controversial. Many in Congress and elsewhere felt that the approach was Draconian, and if implemented as described would reduce the access of many low income and minority students to postsecondary education. Schools serving such students--proprietary schools, historically black colleges, and community colleges--would have the greatest chance of being terminated from the program under the 20 percent criterion. Also, opponents feared that the policy would result in schools being disinclined to admit low income students who would be at high risk of defaulting.

In reaction to the original Bennett proposal and in anticipation of the regulations, the Senate passed and the House reported default control legislation (S. 2647; H.R. 4986) in the 100th Congress to effectively preclude an institution's default rate from being the sole factor in a determination to terminate it from participation in student aid programs. Both bills retained the concept of institutional sanctions but would have had an institution's default rate trigger an agreement between the institution and ED that the institution would undertake certain activities aimed at lowering defaults by its students.

The proposed regulations were not forthcoming until September of 1988,[8] shortly before Secretary Bennett left office. Under the proposal, an institution's annual default rate exceeding 20 percent would cause the Department to consider whether the institution's program participation should be terminated on grounds of its inability to properly administer Federal student aid. To prevent termination, the burden of proof would be on the school to show that its default rate was due to factors beyond its control; a student body largely composed of high risk students would not have been an adequate defense.

When Lauro Cavazos assumed the position of Secretary of ED he extended the comment period on the proposed rules to February 28, 1989.[9] Reportedly, this extension was influential in the decision of House sponsors of default control legislation to withdraw their bill from floor consideration during the last days of the 100th Congress.[10] At the beginning of the 101st Congress, on March 17, 1989 the Senate passed S. 568, the Stafford Student Loan Default Prevention and Management Act of 1989, essentially the same

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[8]*Federal Register*, v. 53, Sept. 16, 1988. p. 36216-36224.

[9]*Federal Register*, v. 53, Nov. 3, 1988. p. 44514.

[10]*A Deal With the Administration: Congress Postpones Action on Student Loan Defaults. Congressional Quarterly*, v. 46, Oct. 1, 1988. p. 2712.

antidefault legislation it passed in the previous Congress. The House has not acted on pending default bills, but default related measures are expected to be enacted as part of FY 1989 budget reconciliation legislation.

DESCRIPTION OF THE DEFAULT INITIATIVE

Secretary of ED Cavazos announced ED's student loan default initiative on June 1, 1989. It consists of final regulations and proposed regulations, which were published in the *Federal Register* on June 5; a summary of actions ED would take to reduce defaults through prevention, enforcement, and collection efforts; and recommendations for changes in the Stafford Loan program's authorizing legislation, title IV, part B of the Higher Education Act, as amended (20 U.S.C. 1071).

THE FINAL REGULATIONS

The final regulations issued by the Secretary affect two parts of volume 34 of the Code of Federal Regulations: Part 668, rules pertaining to Federal student assistance programs generally; and part 682, rules pertaining to the Stafford Loan program (Guaranteed Student Loan program) specifically. The most significant feature of the new regulations is the creation of a tiered structure to trigger sanctions against participating institutions based on the Stafford Loan default rates of their present and former students. The new regulations generally become effective after the Office of Management and Budget approves certain sections as required by the Paperwork Reduction Act. This effective date will be published in the Federal Register. Exceptions to this general effective date are included in the sectional summaries.

Provisions Affecting Schools With High Default Rates

The final rule amends section 668.15, which establishes certain factors such as a high default rate as an indication of an institution's impaired capability to administer title IV student aid programs. Under the change made to this section, after January 1, 1991 an institution's excessive Stafford Loan program[11] default rate[12] **alone** will trigger a range of possible sanctions

[11]Includes Stafford Loans and SLS only.

[12]For the purposes of this process, the rate is a specially calculated "fiscal year default rate" reflecting the proportion of the institution's current and former students entering Stafford or SLS loan repayment in a given fiscal year who default on the loan(s) by the end of the succeeding fiscal year. If a school has less than 30 students entering repayment in a given fiscal year, the rate is the average rate calculated as above for the 3 most recent fiscal years. If a student borrowed for attendance at more than one school, he or she is counted in the calculation for each school for attendance at which a loan in repayment was received.

against the institution by ED. Depending upon the rate above 20 percent, ED's prescribed response ranges from requiring the school to enter into an agreement with ED to undertake certain actions to reduce its default rate, to determining whether to initiate a proceeding to terminate the school from program participation. Under the previous regulations, if an institution's default rate exceeded 20 percent ED could have required the school to submit certain fiscal data. Ultimately, ED could have required the school to undertake certain measures to alleviate the condition causing high defaults, similar to the proposed "default management plan," but it could not have initiated an action to limit, suspend, or terminate (LS&T) (hereinafter referred to as an LS&T action) the school from program participation solely because of the default rate.

Under the new rule, if the institution's **default rate for FY 1989 exceeds 60 percent**, the Secretary of ED **may initiate a LS&T action against the institution, affecting its participation in any Federal student aid program.** This threshold of 60 percent drops in 5 percent increments each year for the next 4 years to 40 percent for FY 1993 and thereafter.

If the institution's **default rate for FY 1989 and thereafter exceeds 40 percent, it must reduce its rate in increments of 5 percent annually until it goes below 40 percent or be subject to the Secretary's decision of whether to initiate an LS&T action.**

The new rule also amends section 668.90 of the regulations pertaining to the decisions of the administrative law judge (ALJ) in LS&T proceedings. The change **limits the discretion of the ALJ in those LS&T actions brought on the grounds of section 668.15 to find that the sanction (i.e., termination, suspension, fine, etc.) recommended by ED is warranted**[13] **unless the institution demonstrates that it has acted diligently to implement those specific default reduction measures described in the new appendix D of the regulations.** Such measures include those to reduce defaults by students who drop out of programs; to reduce defaults related to borrowers inability to find employment; and to improve borrower's understanding of his or her repayment obligation. The diligent implementation of appendix D activities would be considered evidence that factors beyond the institution's control were responsible for its default rate and not its "impaired administrative capability."

Institutions with **default rates exceeding 20 percent for FY 1989 and thereafter** might be required, after opportunity for a hearing, to implement certain measures prescribed by ED to control defaults--**a default**

[13]The section 668.15 cases are set forth as an exception to the rule that the ALJ has the discretion regarding the most appropriate sanction in an LS&T proceeding, regardless of the sanction sought by ED.

management plan.[14] A virtually identical provision has been in regulations since 1975, but apparently was not implemented because the cumulative default data necessary to target schools were inadequate.[15]

For the schools with a default rate exceeding 20 percent, ED could also require the institution to submit an analysis of the causes of default by its students, and/or a description of the additional steps it has taken beyond those otherwise required to reduce student defaults. If the institution **offers an undergraduate nonbaccalaureate degree program designed to prepare students for a particular vocational, trade, or career field,** ED may require it to submit a statistical analysis showing **for each program**: pass rates of graduates on licensure or certification exams; job placement rates for students, as calculated according to the regulations; and completion rates for title IV student aid recipients, high school graduates (or those with General Education Development (GED) certificates), and those admitted on the basis of their "ability to benefit."[16]

Changes to section 682.604 and 682.606 of the regulations affecting the Stafford Loan program require schools with **default rates over 30 percent** to undertake certain actions in their implementation of the Stafford Loan program. Such schools must delay the certification of a loan application of any student applying for his or her first Stafford Loan or SLS loan so that there will be no disbursement of the loan proceeds until the borrower has attended the institution for at least 30 days during the period of enrollment for which he or she received the loan.[17] This provision becomes effective for the certification of a loan application on or after October 1, 1989.

Also, such schools must also adopt a pro rata refund policy for all Stafford Loan program loans, as prescribed in the regulations, for those students who withdraw before the halfway point in their course of study or 6 months, whichever is earlier. This provision becomes effective for refunds due students who withdraw on or after June 5, 1990.

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[14]See section 668.15(e).

[15]See ED's analysis of the regulations in *Federal Register*, v. 54, June 5, 1989. p. 24114.

[16]The term is defined in title IV and regulations for purposes of student aid eligibility. In general, it means a non high school graduate admitted to a program of postsecondary education on the basis of his or her "ability to benefit" from that program.

[17]See section 682.603.

Consumer Information

The new rule changes section 668.44(c) regarding information schools with trade, technical, or other such career programs must provide to students. Previously, institutions offering job placement rates as a means to attract students to enroll had to "make available to prospective students" employment statistics, graduation statistics and any other information to substantiate the truthfulness of the claim. The new rule specifically requires the disclosure to prospective students of more specific types of data, and authorizes ED to initiate an LS&T action if such data misrepresent the nature of the program. Major parts of the new rule[18] become effective for loans certified for periods of enrollment beginning on or after December 1, 1989.

Under the new rule, before a student enrolls in an **undergraduate non-baccalaureate degree program designed to prepare students for a vocational, trade, or career field**, the institution must disclose to the prospective student:

-- all State licensure or certification requirements for the vocational field;

-- the pass rate of the program's graduates for the most recent year on the licensure or other examination required by the State for employment in the vocational field;

-- the job placement rate based on actual placement in the trade for which the program was offered;

-- the completion rate for students in the program, to include students who completed the program or students who obtained full-time employment in the occupation for which the training was offered within 150 percent of the time normally required to complete the program; and,

-- any other information needed to substantiate an institution's claims regarding job placement.

Similar information must be provided for any other programs for which the institution makes a specific claim regarding job placement, including baccalaureate or graduate programs. Further, if a program makes claims with regard to starting salaries of its graduates in a particular job, it must make data available to substantiate that claim.

Appendix A of the regulations provide forms that the institutions must use to disclose pass rates, graduation rates, and job placement rates. These

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[18]Sections 668.44(c)(ii)-(iv) and (d). Presumably other new sections would be effective July 20, 1989.

forms must be signed by the students enrolling in the vocational programs in question.

If an institution misrepresents its program through false or misleading data in any of the abovementioned disclosures, the Secretary could initiate an LS&T action against that institution.[19]

Guaranty Agency Program Reviews

The new rule amends section 682.410 to require guaranty agencies to conduct a **biennial on-site program review** of any institution in a State for which the guaranty agency is the principal guarantor that has a default rate over 20 percent in any fiscal year. Such a review would not be required if the school was under a default management plan, or if the total dollars in repayment in the fiscal year in question were not over $100,000.

Borrower Counseling Requirements

The new rule amends section 682.604 requiring schools to provide loan counseling to Stafford Loan and SLS borrowers, in person or by videotape, before the disbursement of loan proceeds. During such counseling, the school must:

-- emphasize the importance of the repayment obligation;

-- describe the consequences of default;

-- emphasize that the borrower is liable for repaying the full amount of the loan regardless of whether or not he or she completes the program, finds employment, or is to some degree dissatisfied with the educational program.

The rule also mandates schools to provide in-person exit counseling to Stafford Loan and SLS borrowers. Such counseling would provide the borrower with general information about the average loan indebtedness of students who attended that school and the average anticipated monthly payment on the loan; would review repayment options, suggest debt management strategies, and provide other information stressed during the initial counseling session described above.

Schools must maintain information in a student's file to substantiate that all necessary counseling was provided regarding his or her Stafford Loan or SLS loan.

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[19]See section 668.72 of the new regulations.

A statutory provision for exit counseling was added under section 485(b) of the Higher Education Act in 1986, but there have been no regulatory requirements for borrower counseling before the new rule.

Lender Notification to School on Delinquency

The new rule, under section 682.411, requires a lender to notify a borrower's school within 30 days after the lender requests preclaim assistance from the guaranty agency because a loan has gone into delinquency. This section applies to loans for which requests for preclaim assistance are made on or after December 4, 1989.

School Refund Policies

The new rule in section 682.606 extends the period of time from 30 days to 60 days that the school has to repay the lender any refund due on a Stafford Loan when a borrower withdraws from a program.

Also, as mentioned above, a school with a default rate exceeding 30 percent must adopt a pro rata refund policy for Stafford Loan program, (Stafford Loans, SLS and PLUS loans) loans of students who withdraw before the completion of their program. Schools may round the portion of the program completed by the student up to the nearest 10 percent for purposes of the pro rata calculation. The rule affects recipients of Stafford Loan program funds only and not other student aid, and becomes effective for students who withdraw on or after June 5, 1990.

The regulations continue to require all other schools to maintain a fair and equitable refund policy as described in section 682.606.

Information Sharing

Under a new part of section 682.610, upon the request of a lender or a guaranty agency, a school must provide to the requester its latest information on a former or current student borrower's address, surname, employer and employer address.

Annual Information for ED

Another new part of section 682.610 provides that all trade, technical, and other career schools required to provide certain consumer information to their students under section 668 (see above) must transmit to ED **a completed copy of the appendix A forms** as well as **information on charges for tuition, fees, equipment, books and supplies for the program.**

THE PROPOSED REGULATIONS

ED's default initiative also include proposed rules in two areas. The comment period on these rules expired August 4, 1989.

The first proposed rule changes section 682.208 pertaining to loan servicing under the Stafford Loan program. It requires a new holder (party to whom the interest in the loan actually has been transferred or has been pledged as security) of a Stafford, PLUS or SLS loan to notify the borrower regarding the sale, the identity of the new holder, and the name and address of the party to whom payments on the note must be sent.

The second rule, added to section 682.210, would require **private schools offering an undergraduate nonbaccalaureate program designed to prepare students for a particular vocational, trade, or career field** in order to participate in the Stafford Loan program to have a "teachout" agreement with a school offering a similar program. Such an agreement must provide that in the event the private school closed in the midst of a course of study for which a student received a Stafford Program Loan, the "teachout" school would provide the student with the opportunity to complete his or her course of study, at no cost to the student beyond that which would have been owed to the private school to complete the course of study.

ADMINISTRATIVE ACTIONS TO REDUCE DEFAULTS

ED announced three types of administrative actions that it will take to reduce defaults: improving default prevention; improving the enforcement of program requirements; and improving collection efforts.

Some of ED's default prevention activities would concentrate on increasing the consumer information available to potential Stafford Loan program borrowers. The Department intends to publish in a public document the default rate of participating schools, lenders, and guaranty agencies, and compile and disseminate the information on vocational programs that must be reported annually under the new regulations with regard to graduation rates, pass rates on licensure exams, and job placement rates. ED will also further publicize the currently existing toll free consumer "hotline" for students receiving Federal aid.

Other prevention efforts that would be undertaken by ED include the dissemination to schools of debt management and financial planning information for students, and the reporting of effective default prevention techniques to interested parties. ED will also conduct analyses of defaults, and provide training on Stafford Loan program administration for staff of postsecondary schools, lenders and guaranty agencies.

ED's enforcement efforts will focus on the expansion of regular program compliance reviews of schools, lenders and guaranty agencies, and an increase in the resources of the ED's Inspector General's office (OIG) on default related investigations and audits. Other existing efforts that would receive new emphasis would be the enforcement of lender and guaranty agency collection ("due diligence") requirements, and the OIG's fraud and abuse "hotline."

ED's collections efforts under the initiative will include the continued use of the IRS offset of defaulters Federal tax returns, and the offset of the salaries of Federal employees who are defaulters. With regard to collections on defaulted loans it holds, the Department will continue to expand the use of private collection agencies, and to report defaulted accounts to consumer credit bureaus.

DEPARTMENT OF EDUCATION'S LEGISLATIVE PROPOSALS TO REDUCE DEFAULTS

The last major component of ED's default initiative are suggested changes in the Stafford Loan program's statutory authorization.

The Department sent two legislative packages relating to default reduction to the Congress during June 1989. One, dated June 16, included amendments to reduce defaults originally proposed as part of the FY 1990 budget request. The other, dated June 30, included additional reform measures that were specifically proposed as part of the default initiative.

Major Default Reduction Provisions of Legislation Proposed as Part of the FY 1990 Budget Request

Risk-sharing With Lenders

The proposal would reduce the lender's insurance on Stafford Program loans from 100 percent to 90 percent.

Risk-sharing With Guaranty Agencies

The proposal would reduce Federal reinsurance rates, which are based on a guaranty agency's defaults in a given year. The reimbursement rate would be 90 percent when the agency's default claims are 5 percent or less of its annual insured principal; 80 percent when the rate exceeds 5 percent but is 9 percent or less; and 70 percent when the default rate exceeds 9 percent. Current law provides 100/90/80 percent reimbursement for the same default rates.

Reduce the Special Allowance

The proposal would reduce the lender's yield on loans made on or after July 1, 1989 by 25 basis points by reducing the special allowance from the 91-day U.S. Treasury bill (T-bill) plus 3.25 percent to the T-bill plus 3.00 percent. The variable interest rate on SLS and PLUS loans would also be changed to a quarterly rate of the 91-day T-bill plus 3.00 percent from its current annual rate of the 52-week T-bill plus 3.25 percent.

Require Credit Checks

The proposal would require lenders to obtain credit histories of applicants for Stafford Loan program loans, Income Contingent Loans and Perkins Loans 21 years of age or older, and require loan applicants with poor credit histories to obtain co-signers. Borrowers could be charged up to $25 to pay for this credit investigation.

Authorize the Use of the National Student Loan Data System for Enforcement

The proposal would authorize the National Student Loan Data System to be used to enforce borrower eligibility rules. Current law prohibits the use of data source, which has not been developed to date, for this purpose,[20] and the Administration has been reluctant to implement the system lacking this authority.

Require Borrowers to Provide Personal Information

The proposal would require borrowers to provide their drivers' license number to lenders upon application for a Stafford Loan program loan, Perkins Loan, or Income Contingent Loan, and to provide other personal information to the school at their exit interview.

Delayed Loan Disbursement

The proposal would require a 30-day delay in the disbursement of Stafford Loans, SLS loans, Income Contingent Loans and Perkins Loans to first-time borrowers at all participating institutions.

Simplified Deferments

The proposal would repeal all of the categorical deferments for Stafford Loan program loans and Perkins loans except those relating to school status and replace them with one 3-year "hardship" deferment.

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[20]See section 485B of the Higher Education Act of 1965, as amended.

Legislation Requested Specifically as Part of the Default Initiative

Modify the Ability to Benefit Provision

The Department's proposal would require students admitted to postsecondary institutions under the "ability to benefit" provision to pass a test to measure their abilities that is both formulated and administered by an independent third party (i.e., <u>not</u> the school), as approved by the Secretary. Current law provides as one of several options for a student to qualify for aid under the ability to benefit provision, that <u>the school</u> administer to the student a nationally recognized, standardized, or industry developed test to measure the applicant's aptitude.[21]

Require Pro Rata Tuition Refunds of All Student Aid at Schools With Default Rates Over 30 Percent

This proposal would extend ED's regulatory pro rata refund policy for schools with over 30 percent default rates to all Department student aid recipients rather than Stafford Loan program recipients only. The policy would apply if a student withdrew from the course of study before it was half completed or 6 months after it commences, whichever is earlier. Current law has no provision specifying the content of a refund policy.

Authorize Guaranty Agencies to Garnish Wages

The proposal would authorize guaranty agencies to garnish the wages of a defaulter for payment on the loan up to 10 percent of disposable earnings. Current law provides an incentive for States to enact garnishment statutes with certain specific features by authorizing the guaranty agency to retain 35 percent of its collections on defaulted loans (the remainder is paid the Federal Government) rather than 30 percent.[22]

Prohibit the Use of Commissioned Salespersons by Schools

The proposal would prohibit schools from employing anyone except salaried employees or volunteers from recruiting or admitting students and prohibit the use of financial incentives based on enrollment or student aid volume for persons involved in recruiting or admissions efforts. Current law prohibits schools from using commissioned salesmen to promote the availability of a Stafford, SLS, or PLUS loan.[23]

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[21]See section 484(d) of the Higher Education Act of 1965, as amended.

[22]See section 428E and section 428(c)(6)(D) of the Higher Education Act of 1965, as amended.

[23] See section 435(a)(1) of the Higher Education Act of 1965, as amended.

Require Lenders to Provide Graduated Repayment Options

The proposal would require lenders to offer to borrowers, before the repayment period begins, a graduated repayment schedule under which interest only would be repaid during the first 12 months, and after 4 years the borrower would resume repayment on an equal installment basis. The graduated schedule could not result in negative amortization. Current law has no similar provision.

Prohibit Certification of Schools for Program Participation After Loss of Accreditation

The proposal would prohibit schools that lose their accreditation by a nationally recognized accrediting agency "for cause" or voluntarily withdraw from accreditation under a "show cause or suspension order" from becoming certified or recertified for student aid eligibility for 24 months. Current law requires institutions to be accredited by a nationally recognized accrediting agency approved by the Secretary of ED in order to be certified to participate in Federal student aid programs. Upon losing accreditation, schools may remain eligible to participate in student aid programs by immediately becoming reaccredited by another agency.

Emergency Action to Suspend Institutional Participation in Student Aid Programs

The proposal would clarify that the Secretary is authorized to take an emergency action lasting 30 days or, under certain circumstances, longer to suspend the flow of Federal funds to a lender or institution when the Secretary finds misuse of Federal funds. The Secretary has taken such emergency actions in the past under his or her "inherent" authority to respond to the misuse of Federal funds. Recently, however, this practice was successfully challenged in U.S. District Court because it lacked specific statutory or other authority.[24]

To date the Administration's legislative packages have not been introduced in Congress. Several of the proposals relating to accreditation, emergency suspension actions, and the prohibition against the use of commissioned salespersons have been adopted by the House Committee on Education and Labor or the Senate Committee on Labor and Human Resources as part of their recommendations for 1989 reconciliation legislation.

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[24]See *Ross University School of Medicine v. Cavazos*, No. 89-0985-06 (D.D.C. 1989)

ANALYSIS OF THE INITIATIVE

The central focus of ED's default initiative, as evident in the final regulations, is to make institutions to some degree responsible for student loan defaults. This is a major shift in Federal default control policy set forth in statute and previous rules, which has concentrated on the roles of lenders and guaranty agencies in diligently pursuing collections on loans and in educating borrowers about their rights and responsibilities.

The impetus for the policy shift is the reported program abuses by some institutions participating in student aid programs, particularly for profit (proprietary) schools providing short-term vocational training. As previously mentioned, students at these schools default at significantly higher rates than those at other types of schools. The Administration claims that despite the fact that these schools tend to serve low-income students who are generally at higher risk of default, abusive and even fraudulent practices by some proprietary schools in the areas of recruitment and admissions increase the likelihood that their students will default on their loans. Also the poor program outcomes of some proprietary schools are another factor that may lead to default.

In announcing the default initiative, Secretary Cavazos said:

> There are some unscrupulous and uncaring institutions out there, who are taking advantage of a program to help our students. We must weed out unethical schools and other program participants whose sole purpose is to profit at the expense of our students and taxpayers. Abuses have become so rampant that 'let the buyer beware' will no longer suffice as public policy in education.[25]

Further contributing to the problem are schools with expensive short term programs that do not provide a sufficient return, in terms of the type of employment and salary, for the student to repay the loans that paid for the education.

The new regulations provide a new enforcement mechanism for ED to weed out schools abusing Federal student aid programs. It appears that the default plan, with its tiered approach towards sanctions, is an attempt to strike a balance between facilitating the punishment of schools abusing the program and continuing the access of students to a wide range of postsecondary education alternatives--including schools with high default rates.

The new regulations do not single out proprietary schools for sanctions, but implicitly and explicitly affect them more than other postsecondary institutions. For example, ED default data indicate that proprietary schools

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[25]U.S. Department of Education. *Cavazos Unveils Student Loan Default Initiative. U.S. Department of Education NEWS* (press release). June 1, 1989.

are disproportionately represented in the group of schools with default rates over 60 percent to which the most extreme sanctions would be applied: data for FY 1986 showed about 88 percent of the schools with default rates over 60 percent as proprietary. Also, various provisions of the rules require schools with non baccalaureate vocational programs, which would include all proprietaries but also many community colleges, to provide particular outcome data to consumers that is not otherwise required of most colleges and universities.

Besides the final and proposed regulations, the remainder of the ED default initiative includes many of the same actions and proposals to control defaults that the Department has been advocating for several years. New areas in which it appears ED intends to be active is in providing consumer information about schools, especially vocational schools, and in default control research and dissemination activities.

While it is difficult to predict the specific effect of ED's default initiative, news reports quote Secretary Cavazos as stating that it will save $5.4 billion in default related costs over a 10-year period. ED staff have not provided details on the sources of the cost savings, but they apparently assume the enactment of ED's legislative proposals, including those that would reduce payments to lenders and guaranty agencies on defaulted loans.

Some believe that the marketplace will have a greater impact on the Stafford Loan program and its default rates than the ED initiative. A reporter for *Barron's* concludes,

> There are very few lenders left willing to make loans to students who want to attend schools with default rates above 25 percent. Lenders have discovered that they can't sell those loans on secondary markets . . . and if they can't sell them they don't want them. Student loans are labor intensive; whoever owns a student loan must follow a strict set of procedures before the loan can be declared in default. For most lenders, the effort isn't worth it.[26]

Some observations follow concerning the implications of the new final regulations, which are the heart of the initiative.

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[26]Scholl, Jaye. *They Never Learn: New Rules On Trade Schools Draw An "F"*. *Barron's*, June 5, 1989: 26.

IMPLICATIONS FOR SCHOOLS

How will the default regulations affect schools? They **will not**, as some may perceive from press reports, provide for the automatic termination of a school from program participation because of a high default rate. They **will**, however, apparently make schools with default rates over 40 percent--mostly proprietary schools, but also some historically black colleges and universities, and community colleges--more liable to be terminated from the program from several perspectives.

The first perspective is that the **default rate alone will be sufficient grounds for ED to initiate an LS&T proceeding**. Previously ED has had to identify a specific violation of law or regulation in order to bring about an LS&T action. While a default rate would have signaled an institution's impaired capability of administering student aid programs under the old rules, in practice it would not alone have constituted grounds for the Secretary to initiate an LS&T action.

Another important change under the new rules is **when LS&T actions are brought on grounds of a high default rate, the institution will have the burden to show why the action against it is not warranted** because it has implemented appendix D anti-default measures. In all other LS&T cases, the burden[27] remains with the Department to show why the action is warranted.

Finally, in those particular LS&T actions brought on grounds of a high default rate the new rules **limit the discretion of the Administrative Law Judge (ALJ)** to one of two choices: to find the ED sanction is warranted and impose **only that sanction**; or to find that the ED sanction is not warranted because the institution shows that it has implemented the anti-default actions outlined in appendix D, effectively dismissing the proceeding. The general rule in LS&T proceedings is the ALJ has discretion to impose a fine or a limitation rather than a termination if he or she believes it is more appropriate than a termination action.

The actual impact of the new rules on high default schools will be determined by a number of factors:

- the proclivity of ED to bring LS&T actions against them;
- the sanction chosen by ED if it does bring an LS&T; and,
- the ALJ's interpretation of the appendix D defense.

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[27]Technically known as the "burden of persuasion" in a LS&T proceeding. See 34 C.F.R. 668.88.

At the very least, schools with the high default rates will be likely to incur significant new administrative and fiscal burdens. Anticipating potential LS&T actions against them, it would be prudent for them to implement the measures outlined in appendix D, which calls for extensive activities in the areas of admissions, borrower counseling, and job placement, if they are not already doing so. Schools may also be liable for implementing specific default reduction measures prescribed by ED in a default management plan, and many may also be required to delay loan certification and institute pro rata refund policies.

Regardless of their default rates, all institutions will face specific borrower counseling requirements, and trade, technical or other such career schools will have new data collection and consumer protection requirements under the rules.

IMPLICATIONS FOR STUDENTS

The effect of the regulations on schools will have major implications for students. If many schools with high default rates are those schools serving high proportions of low income and minority students, what will happen to the access of these students to postsecondary education if the schools are terminated from participation in Federal student aid pro[illegible]?

Obviously, if a school is terminated and the stude[illegible] his choice of a school will be more limited. Arguably, if the school i[illegible]ing policies that are somehow leading to defaults, this restriction in the student's choice may be desirable. Whether it will effect the student's access to any postsecondary education is another issue. It will largely depend on the course of study the student wishes to pursue, and the extent to which other schools exist to provide it.

Borrowers should have more information to enable them to make more informed choices of schools and programs as well as their student aid "package" through a number of new requirements in the regulations designed to protect consumers. These include the data collection and disclosure requirements of trade, technical, and other career programs, and the entrance and exit loan counseling requirements. The delay in loan certification for first-time borrowers and the pro rata refund requirements for certain high default schools should add further protections for the students against program abuses.

Another potential implication of the regulations for students is an increase in tuition and fees. The new administrative activities required by some schools to reduce defaults would increase their costs, which could and probably will be passed on to students.

IMPLICATIONS FOR PROGRAM ADMINISTRATORS

The new regulations have the potential to reduce the Stafford Loan default rate by terminating schools with high default rates--and apparently disproportionately high default costs--from the program.[28] A central question is the extent to which these savings will be offset by the implied increase in costs to ED in administering the new LS&T authorities and other enforcement and monitoring efforts. Arguably, if the default reduction effort fulfills the role of restoring program integrity, which the loan default problem is said to endanger, cost savings may be less important.

Since default data will be used to trigger potential program termination, it will be incumbent on the Department for legal and administrative reasons to have the data and rate calculations as "clean" as possible by the time the regulations affecting high default schools are implemented. ED's default data have been criticized as inconsistent and incomplete.[29] The latest FY 1986 cohort default rates, which were released by ED at the same time as the announcement of the initiative, have missing data from some States, and do not include SLS program defaults. According to ED staff, the FY 1987 cohort data will be considerably cleaner (edits will be performed on the data) and it will contain the SLS information.

Program administrators in guaranty agencies could find the new LS&T regulations a benefit because of a provision of current law that they must act as a lender of last resort. As banks have begun to refuse to provide student loans to students attending high default schools, such as some proprietary schools, State guaranty agencies have become responsible for lending to any otherwise eligible student attending these schools. This puts agencies, many of which are not direct lenders, in the position of both owning and guaranteeing a larger proportion of high risk loans. If the new regulations serve to terminate some high default schools from the program or otherwise improve their default situation, this might encourage banks to return to lending to the higher risk populations, and relieve guaranty agencies of this responsibility.

Guaranty agencies have a new responsibility for biennial program reviews of higher default schools under the regulations. This would probably imply increases in personnel and costs to most agencies.

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[28]According to ED, FY 1986 default data indicate that 5 percent of schools had default rates over 60 percent, but accounted for 17 percent of the total dollars in repayment.

[29]See, *Career Schools Call ED Default Data Inaccurate. Education Daily*, v. 22, June 5, 1989: p. 1-3.

CONCLUSIONS

The Administration's default initiative represents its attempt to manage rising Stafford Loan program default rates and costs, which ED attributes, in part, to actions by postsecondary institutions participating in the program. The key question is what will be its effects?

The success of the initiative will depend, in part, upon whether ED aggressively implements the new regulations. The Department has been criticized in recent years for cutbacks in enforcement efforts such as program reviews.[30] Will it now refocus resources, and take decisive actions against schools under its new regulatory authority? The other elements of the initiative--the administrative actions and the legislative proposals--are not as likely to be as significant. Many of the administrative activities are continuations or expansions of current practices. The legislative proposals that have the greatest potential impact in terms of Federal cost savings--risk sharing for lenders and lower reimbursements for guaranty agencies--have been suggested before but have not been acceptable to Congress.

The impact of the regulations--no matter how well enforced--will depend on the extent to which institutional actions are actually contributing to the default problem. Will students who would have attended terminated high default schools default at the same rate at other schools? Will consumer protections and counseling and other actions prescribed for institutions to prevent defaults influence a borrower's future behavior? If the default problem is primarily a function of student rather than institutional characteristics anything short of a fundamental change in student loan policy may be destined to have only minimal effects.

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[30]See, U.S. Congress. Senate. *Problems of Default in the Guaranteed Student Loan Program.* Hearings, 100th Cong., 1st sess. Dec. 11, 16, 1988. Washington U.S. Govt. Print. Off., 1971. p. 63.