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ABSTRACT

As the number and volume of student loans increase nationally, lenders and policymakers look more closely at the use of loan forbearance. This paper examines whether forbearance really cuts the risk of loan default by reporting on a study of more than 9,800 Stafford loans in forbearance in December 1996. That research shows that the default rate for loans in forbearance was similar to the overall loan default rate for the Federal Family Education Loam Program. The length of time in forbearance reduced the risk of borrower default. Forbearance may have saved 4% in potential loan default costs by enabling some borrowers to repay their loans in full. Borrowers who defaulted were likely to have attended less than four-year institutions. Among loan defaults, forbearance reduced the loss to taxpayers by at least 4%. Forbearance, however, substantially increased repayment costs for borrowers who capitalized interest. (SLD)

November 2001

SYNOPSIS

Higher Education in Highlights

By Derek V. Price
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Summary

As the number and volume of student loans increase nationally, lenders and policy-makers are looking more closely than ever at the use of loan forbearance. Their main question: Does forbearance work? In other words, does forbearance — allowing a borrower to delay payment because of hardship — truly cut the risk of default, or does it simply represent a costly delay of the inevitable? This paper examines that question by reporting on a study of more than 9,800 Stafford loans in forbearance in December 1996. That research, though by no means the final word on this subject, does show the following:

- The default rate for loans in forbearance was similar to the overall loan default rate for the Federal Family Education Loan Program (FFELP).
- The length of time in forbearance reduced the risk of borrower default.
- Forbearance may have saved 4 percent in potential loan-default costs by enabling some borrowers to repay their loans in full.
- Borrowers who defaulted were likely to have attended less-than-four-year institutions.
- Among loan defaults, forbearance reduced the loss to taxpayers by at least 4 percent.
- Forbearance substantially increased repayment costs for borrowers who capitalized interest.

Student Loan Forbearance and its Relationship to Default

Student borrowers' use of loan forbearance has come under increased scrutiny by policy-makers and lenders.[1] Although default rates have been declining, loan volume and the number of borrowers have increased. Thus, even a minor increase in default rates can be costly. For borrowers, loan default can result in negative credit ratings and bankruptcy, which can ruin their financial well-being. For taxpayers, loan default undermines the efficiency of the student loan program. And for loan providers, loan default reduces the profitability of the student loan market because of lost revenue.

The cost of forbearance can also be substantial to both borrowers and taxpayers because interest costs are capitalized if they are not paid during the forbearance period. Forbearance allows borrowers to delay payment on principal and/or interest due to hardship such as unemployment, disability or medical emergency. Federal legislation limits each borrower to 60 months of loan forbearance. Since forbearance implies a hardship on the part of the borrower,

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questions have been raised about the relationship between forbearance and default. Does forbearance provide a safety net for borrowers and reduce the risk of loan default, or does forbearance delay the inevitable loan default and thus increase the personal and financial costs to borrowers, lenders and taxpayers?

Does forbearance provide a safety net for borrowers and reduce the risk of loan default, or does forbearance delay the inevitable?

This paper reports on an examination of 9,859 Stafford subsidized and unsubsidized loans of 2,999 borrowers from the portfolio of USA Group.[2] The loans in this sample, valued at $33.9 million, were in forbearance in December 1996 and were followed through December 2000.

Characteristics of Loans in Forbearance

Table 1: Characteristics of Loans in this Sample

Number of Loans in Forbearance – December 1996	9,859
Total Original Guarantee Amount – December 1996	$33,901,808
Average Loan Amount – December 1996	$3,339
Total Capitalized Interest – December 2000	$5,517,688

Table 1 illustrates summary data of this sample of loans in forbearance as of December 1996.

In fiscal year 1996, the U.S. Department of Education reported that 81 percent of total FFELP dollars, or $15.7 billion, went to borrowers at public and private four-year institutions (Conner, Saab and Cicmanec 1997: Table 10). In this sample of student loans in forbearance, 56 percent of the loan volume went to students at public or private four-year institutions. In terms of institutional type, this difference suggests that loan dollars

Table 2: Loan Status in December 2000

Status	Number	Percentage
Error or Pending	217	2.2
Forbearance	645	6.5
Deferment	660	6.7
Default	1287	13.1
Consolidated	3085	31.3
Delinquent	1346	13.7
Paid by Borrower	426	4.3
In Repayment	1250	12.7
In School or Grace	44	.4
Removed or Canceled	899	9.1

N = 9,859

in forbearance are not representative of the distribution of all loan dollars in the FFELP.

As Table 2 shows, these loans did not generally remain in forbearance throughout the 16 quarters they were followed. By December 2000, less than 7 percent of these loans had remained in or returned to forbearance, and more than 31 percent had been consolidated.[3] Almost 13 percent of these loans were actively in repayment by December 2000, 14 percent were delinquent, and 4 percent were paid by the borrower.

Characteristics of Borrowers in Forbearance

Most borrowers in this sample had more than one loan; the loan characteristics for the 2,999 borrowers are listed in Table 3. Approximately 140 borrowers (4.6 percent) had loans with dissimilar status types in December 2000. To avoid underestimating the borrower (not the dollar) default rate, borrowers with at least one defaulted loan were considered in default for all of their loans. In cases where borrowers had multiple loan status types and no loans were in default, the first loan status type encountered was used as the universal type for all of that borrower's loans.

The loan status type for borrowers also changed considerably throughout the 16 quarters between December 1996 and December 2000. Figure 1 on Page 4 shows how loan status types changed for this sample. Approximately one in four of the borrowers in this sample (24 percent) had consolidated by December 2000, 6 percent were in forbearance, 6 percent were in deferment, 13.6 percent were in repayment, and 14 percent were delinquent (see Table 4 on Page 4). More than 5 percent of borrowers, representing $1.35 million in loan guarantee amounts, had paid their loans in full by December 2000. Though we can't be certain that these borrowers would have defaulted had they not been in forbearance, it would appear that forbearance cut loan-default costs by 4 percent by enabling some borrowers to repay their loans in full. At the same time, these borrowers paid an additional $104,000 in capitalized interest because of their forbearance status.

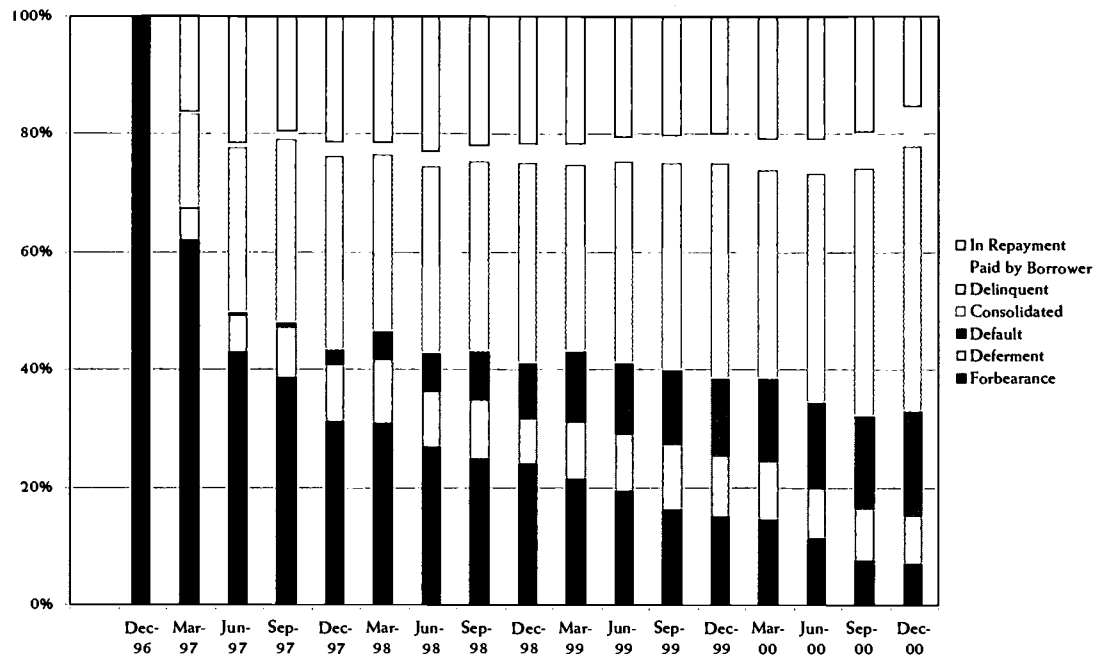
The borrower default rate for loans in this sample was 16.5 percent as of December 2000. That is, about one in six borrowers who were in forbearance in December 1996 defaulted by December 2000. This statistic cannot be compared to the annual cohort default rate reported by the U.S. Department of Education because it represents a cumu-

By enabling some borrowers to repay their loans in full, forbearance reduced the potential cost of loan default by 4 percent.

Table 3: Loan Characteristics by Borrower

Average Principal Debt	$11,304
Average Debt Outstanding – December 2000	$13,216
Median Quarters in Forbearance	4 (less than 15 months)
Average Number of Loans	3.29

Figure 1: Loan Status Types by Borrower – 1996-2000



In this sample, about one in six borrowers who were in forbearance in December 1996 defaulted by December 2000.

lative measure over four years rather than an annual figure. The cohort default rate measures the percentage of borrowers in a given fiscal year who defaulted in that year or in the following fiscal year. U.S. Secretary of Education Roderick R. Paige recently announced that the cohort default rate fell to its lowest rate ever in fiscal year 1999: 5.6 percent. This official measure does not capture long-term patterns of borrower default in the student loan program.

Table 4: Loan Status by Borrower – December 2000

Status	Number	Percentage
Pending or School Error	97	3.2
Forbearance	184	6.1
Deferment	202	6.7
Default	494	16.5
Consolidation	727	24.2
Delinquent	425	14.2
Paid by Borrower	166	5.5
In Repayment	408	13.6
In School or Grace	16	.6
Removed or Canceled	280	9.3

N = 2,999

Table 5: Highest Level of School Attended by Borrower

Type of Institution	Number of Borrowers	Percentage of Borrowers
Vocational For-Profit	812	27.1
Less Than 4-Year Public	367	12.2
Undergraduate	1,505	50.2
Graduate	302	10.1

N = 2,999 (13 borrowers attended foreign institutions)

Table 5 illustrates the distribution of borrowers by the highest level of postsecondary institution attended. The majority of borrowers (60 percent) in this sample attended four-year public or private undergraduate or graduate institutions. The U.S. Department of Education reported that 73 percent of all borrowers in fiscal year 1996 attended public or private four-year institutions (Conner, Saab and Cicmanec 1997: Table 10). Therefore, in terms of the type of institutions students attended, borrowers from this sample of loans in forbearance are not representative of all borrowers in the FFELP.

As the total amount borrowed increases, the probability of default decreases.

Is the Type of Institution Attended Related to the Disposition of Loans in Forbearance?

Table 6 on the next page reports the bivariate correlations between selected variables and borrower default by December 2000. Such correlations provide a statistical test of the relationship between two variables. Put simply, do these variables change in tandem in some way? The results are not surprising to those familiar with default-management policies. A negative relationship exists between loan default status and borrowers who attended vocational, for-profit institutions or two-year public institutions. In other words, borrowers who defaulted were likely to have attended less-than-four-year institutions.[4] These data also show a negative relationship between the number of loans per borrower and default. That is to say, as the number of loans increases, the probability of default decreases. Finally, the cumulative amount of loans originally borrowed and the maximum level of debt outstanding during the study's four-year period are both negatively associated with loan default. In this sample of loans, as the total amount borrowed increases, the probability of default decreases. These relationships are not surprising because the more students borrow, the longer they stay in school. And the longer they stay in school, the more likely they will be to get jobs that pay enough for them to afford to make loan payments.

Table 6: Bivariate Correlations with December 2000 Default Status

Variable	Pearson Correlation
Number of Loans	-.089 *
Enrolled in Graduate School	-.068 **
Enrolled in 4-Year Institution	-.153 **
Enrolled in Vocational For-Profit Institution	.183 **
Enrolled in 2-Year Public Institution	.051 **
Original Guarantee Amount	-.113 **
Maximum Debt Outstanding	-.117 **
Total Capitalized Interest[5]	-.117 **
Number of Quarters in Forbearance	-.178 **
Original Guarantee Amount Less Balance on December 1996[6]	.041 *

N = 2,999 ** $p < .01$ * $p < .05$

The longer a borrower is in forbearance, the less likely he or she is to default.

Does Forbearance Reduce or Increase the Risk of Default among Student Borrowers?

Based on the correlations in Table 6, a logistic regression analysis was used to estimate the probability a borrower would be in default as of December 2000 relative to not being in default. Several variables that were significantly associated with default were used in the model. The number of loans was included as a proxy for principal and cumulative interest because a borrower with several loans generally has higher debt levels and thus incurs more cumulative interest while in forbearance. Put another way, the statistical relationship between the number of loans and borrower default is roughly equivalent to the relationship between loan principal and borrower default. The type of institution in which the borrower was enrolled and the number of quarters the borrower was in forbearance were also included in the model.

Table 7 illustrates the results of the multivariate analysis, which confirms the expected relationship between two-year institutions and borrower default rates. Borrowers enrolled in vocational, for-profit institutions are four times more likely to default than are graduate school borrowers. Borrowers in two-year public institutions are more than two and a half times more likely to default than are graduate school borrowers. These results also show that the longer a borrower is in forbearance, the less likely he or she is to default.

Table 8 shows the borrower default rates among students enrolled at the four different types of institutions. These data clearly illustrate the disproportionate number of borrowers enrolled at less-than-four-year institutions who defaulted by December 2000. While 16.5 percent

Table 7: Logistic Estimates for Default among Borrowers in Forbearance – December 1996

Independent Variables	B (S.E.)	Exp (B)[7]
Number of Loans	-.029 (.027)	.971
Enrolled in 4-Year Undergraduate Institution	.171 (.218)	1.187
Enrolled in Vocational For-Profit Institution	1.378 (.219) ***	3.968
Enrolled in 2-Year Public Institution	.990 (.245) ***	2.691
Number of Quarters in Forbearance	-.188 (.019) ***	.829
Constant	-1.434 (.232)	
% Predicted Correctly[8]	83.5% ***	

N = 2,999 *** $p < .001$

of all borrowers in this sample defaulted, almost 28 percent of those in vocational, for-profit institutions defaulted. Similarly, 21.5 percent of borrowers in two-year public institutions defaulted by December 2000. The statistical evidence demonstrates the following:

- As time in forbearance increases, the risk of borrower default decreases.
- Borrowers in forbearance who attended vocational, for-profit or two-year public institutions are more likely to default than are those in graduate programs.

Table 8: Borrower Default Rates by Highest Level of Educational Enrollment

Highest Level of Education ***	Default December 2000
Vocational For-Profit	27.6%
Public 2-Year	21.5
Undergraduate	10.8
Graduate	8.9
All Institutions	**16.5**

N = 2,999 *** Chi-Square $p < .001$

Borrowers in forbearance who attended vocational, for-profit or two-year public institutions are more likely to default than are those in graduate programs.

What are the Default and Loss Rates for Loans in Forbearance?

Forbearance reduced the costs of default to taxpayers by at least 4 percent for the loans in this sample.

Guarantors and lenders measure the risk of loan default by calculating a default rate and a loss rate from a given loan portfolio. The loan default rate represents the ratio of the original guaranteed amount of loan dollars in default to the total loan volume guaranteed. The loss rate represents the ratio of total outstanding principal and interest when the loan defaulted to the total loan volume guaranteed. This sample of almost 10,000 loans represented $34 million in guaranteed principal. Since interest on loans in forbearance is capitalized if not paid in full, this interest represents an additional potential cost to taxpayers if the borrower defaults. For this sample of loans in forbearance, total capitalized interest accumulated by December 2000 exceeded $5.5 million. Approximately $496,000 in capitalized interest was paid on defaulted loans in this sample. The additional cost to taxpayers attributable to forbearance was equal to 1.5 percent of the original guarantee amount of all loans in this sample.[9] However, the loss realized because of the defaults ($3.5 million) was less than the original guarantee amount for these defaulted loans ($3.65 million). Thus, loan forbearance reduced the costs of default to taxpayers by at least 4 percent for the loans in this sample.

The loan default rate for this sample of loans in forbearance was 10.8 percent, which is similar to the overall loan default rate of 10.2 percent the U.S. Department of Education reported for all Stafford subsidized and unsubsidized loans in 1996 (Conner, Saab and Cicmanec 1997: Tables 6 and 7). This comparison suggests that loans in forbearance do not default at different rates than do all FFELP loans. The corresponding loss rate for these loans was 10.4 percent. Loan default rates do vary considerably by level of education: Graduate and undergraduate loans have default rates lower than the overall rate, while public two-year and vocational, for-profit loan default rates are considerably higher than the overall loan default rate (see Table 9).

The proportion of default dollars tells a slightly different story. Although the default rate for student loans at four-year

Table 9: Default and Loss Rate Statistics for Loans in Forbearance December 1996, Controlling for Type of Institution

Institutional Type	Default Rate	Default Dollars	Loss Rate	Loss Dollars
Graduate	5.2%	$368,415	5.3%	$376,149
4-Year	8.5	1,608,624	7.4	1,393,256
Public 2-Year	16.2	300,900	15.9	294,065
Voc/For-Profit	23.9	1,370,049	25.1	1,440,843
All Institutions	10.8	3,647,988	10.4	3,504,313

N = 9,859

undergraduate institutions is relatively low (8.5 percent), these loans make up 44 percent of the total default dollars. Defaulted loans at vocational, for-profit institutions also make up a considerable portion of total default dollars (38 percent). The combination of high rates of loan default and loss with the high *probability* of borrower default makes it clear that vocational, for-profit institutions represent higher-risk investments for loan capital. Although the default and loss rates are also high at public two-year institutions (about 16 percent), relatively few loan dollars are invested in this sector.

Conclusions

This research demonstrates the following:

1. The default rate for loans in forbearance was similar to the overall loan default rate for the FFELP.
2. The length of time in forbearance reduced the risk of default.
3. Forbearance may have saved 4 percent in potential loan-default costs by enabling some borrowers to repay their loans in full.
4. Borrowers who defaulted were likely to have attended less-than-four-year institutions.
5. Among loan defaults, forbearance reduced the loss to taxpayers by at least 4 percent.
6. Forbearance substantially increased repayment costs for borrowers who capitalized interest.

Almost one in four borrowers (24 percent) in this sample of loans in forbearance had consolidated by December 2000, yet this sample did not provide data to compare the relationship between loan consolidation and default. That information is needed because it would allow researchers to investigate further the impact of consolidation on borrower and loan default rates.

What *can* be said based on the results of this study is that the use of forbearance appears to benefit taxpayers and both the government and private participants in the student loan program. Forbearance also benefits student borrowers by helping them avoid default, but this benefit increases the cost of borrowing, sometimes substantially.

Researchers (should) investigate further the impact of consolidation on default rates.

Glossary of Loan Status Types

Consolidation – Transfer of multiple loans for a single borrower into one loan.

Default – Failure to repay a loan in accordance with the terms of the promissory note.

Deferment – Temporary postponement of loan payments.

Delinquent – Late or missed payments as specified in the terms of the promissory note and the selected repayment plan.

Forbearance – Arrangement to postpone or reduce a borrower's monthly payment amount for a limited and specified period, or to extend the repayment period.

Grace – Six-month period before the first payment must be made on a Stafford subsidized or Stafford unsubsidized loan.

Paid by Borrower – Designation that borrower repaid loan in full.

Repayment – Designation that borrower is actively repaying loan.

Removed/Canceled – Loan is no longer part of the system due to removal or cancellation.

Error/Pending – Loan status type is incorrect due to servicer error.

References

Conner, Donald, Rabab Saab and Karen Cicmanec 1997. *Federal Student Loan Programs Data Book (FY94-FY96)*. U.S. Department of Education. Washington, D.C.

Endnotes

[1] This study was undertaken because forbearance policies are important to those concerned with solving student loan repayment problems. We're grateful to the former affiliates of USA Group for providing the database for this study, and we appreciate the advice and encouragement of USA Funds' Default Prevention Council. This panel of independent, outside experts includes student financial aid, enrollment management, and other administrators from 23 postsecondary institutions in 18 states.

[2] During most of the time frame examined, USA Group was parent company to the nation's largest guarantor of student loans and one of the largest servicers in the student loan industry. Also during this time frame, USA Group Foundation — the predecessor to Lumina Foundation for Education — was the philanthropic and research division of USA Group. On July 31, 2000, USA Group sold most of its operating assets, and the Foundation became an independent, private foundation later to be named Lumina Foundation. The Foundation continues its interest in providing credible research on education access.

[3] The category "Removed or Canceled" may represent loans that were consolidated by the Direct Loan Program or by another private lender. If this assumption is correct,

more than 40 percent of loans in forbearance in December 1996 had been consolidated by December 2000.

[4] Among the 494 borrowers in this sample who defaulted, 303 (61 percent) attended vocational, for-profit institutions or two-year public institutions.

[5] Total capitalized interest is strongly correlated with maximum debt outstanding (.858), original guarantee amount (.714) and principal as of December 1996 (.714).

[6] Since higher remaining balances in December 1996 (the beginning point for this analysis) are positively related to loan default (.041), this sample may be skewed toward borrowers at higher risk of default. Thus, borrower default rates may be over-estimated in this study.

[7] This number represents an odds ratio. The odds ratio in this model provides an estimate for the change in the probability of default associated with a particular characteristic, all other characteristics being equal. This number varies around 1.0; thus a number less than 1.0 represents a negative probability, and a number greater than 1.0 represents a positive probability. For example, the odds ratio .829 means that borrowers who remain in forbearance for longer periods of time are 17 percent less likely (1.0 minus .829) to default.

[8] Although this model predicts overall cases well, it predicts zero loan default cases correctly. The results emphasize the increased risk of default for borrowers who attend less-than-four-year institutions, but this model has little utility for default management.

[9] This statistic measures the amount of capitalized interest paid on defaulted loans by December 2000 (or $496,000) divided by the original guarantee amount of all loans in forbearance in December 1996 ($33.9 million).

About the Author

Derek V. Price is director of higher education research at Lumina Foundation for Education. His work focuses on research and analysis on selected topics associated with higher education access, including enrollment, financial aid and student debt burden issues.

Before joining the Foundation in January 2001, he was an assistant professor of sociology and the director of the Center for Educational Research and Leadership at Morehead State University in Morehead, Ky. Between 1997 and 1999, he served as an adjunct professor of sociology at American University in Washington, D.C., where he earned a doctorate in sociology. He also holds a master's degree from the University of Michigan in Ann Arbor, Mich., and a bachelor's degree from Duke University in Durham, N.C. Price advises the National Center for Public Policy and Higher Education as a National Associate. He has received research grants from the American Educational Research Association and has presented his research at several conferences, including the Financial Aid Research Network, the Association of Black Sociologists and the Council for Opportunity in Education.

SYNOPSIS

The primary mission of Lumina Foundation for Education is to expand access to education by supporting research, innovative programs and communication initiatives. The Foundation focuses its work in three areas related to postsecondary education: financial access, student retention and attainment, and nontraditional learners and learning.

The Foundation frames issues and explores new solutions through research by gathering and analyzing information relating to these three areas. Lumina Foundation encourages original sponsored research, which is typically commissioned by the Foundation to address critical issues surrounding access, retention and nontraditional learning. The results of that research, and therefore the content of these publications, do not necessarily represent the views of the Foundation or its employees.

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