NATIONAL DIRECT STUDENT LOAN DEFAULT RATES: A MEASURE OF ADMINISTRATIVE QUALITY, OR SOMETHING ELSE?

by Mark A. Emmert

Statement Of The Problem

The financial aid community, including institutional financial aid officers, state and federal administrators, students, legislators, and now the tax-paying public, has expressed its anxiety over the high default rates in the student loan programs. The frequency with which students default on their loans is unquestionably too high in many cases. And, as the generic concerns over governmental efficiency increase (as recent political events seem to indicate they will), this anxiety will grow unless the default rates are substantially reduced.

In this regard the Bureau of Student Financial Assistance of the Office of Education has launched a series of actions to "ensure that institutions will better manage the NDSL program."[1] These activities include offering a series of "due diligence" workshops, improving student information efforts, soliciting Treasury/IRS support in providing current addresses of defaulted borrowers, conducting on-site program reviews at "selected institutions where the student default rate is a major problem", and taking "appropriate action to limit, suspend, or terminate participation" of institutions that continue to fail to practice due diligence in collections.[2] Additionally, an institutional NDSL default rate greater than 31% will be one of many factors weighed in identifying problem institutions which will receive high priority for program reviews.[3]

The underlying assumption of all these activities is that there exists a causal relationship between institutional diligence and default rates: that an institution with a 32% default rate is administering its loan program less effectively than a school with a 17% default rate. The existence of such a relationship is unquestionable. Its strength, however, is debatable and, thus, prompts this article. The question to be addressed is whether external factors, in this case the demographic make-up of student populations, have an equal or greater impact upon default

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rates than do internal, administrative factors. And, if they do, how the financial aid community should deal with them.

One response to the concern over default rates has been the discussion and application of dicriminant analysis techniques as a means of reducing the risk inherent in student loan programs. [4] Briefly, discriminant analysis, as applied to loan programs, is a statistical technique for weighing specific characteristics (e.g., age, assets, housing, etc.) of each application and then categorizing the applicant as either a "good" or "bad" credit risk based upon the total score of his or her application. The value of the weight of each significant characteristic is determined through a multiple regression analysis of possible variables (characteristics) related with past defaulters. Thus, by utilizing descriminant analysis techniques we can, like commercial lenders, screen student loan applicants to eliminate poor risks.

Utilizing these methods, three sets of researchers – Dyl and McGann, Pattillo and Wiant, and Spencer – developed lists of characteristics they associated with potential student loan defaulters at several institutions. [5] Included among these characteristics are:

1	Freshman standing
2	Under 17 years of age, or over 27
3	Unemployed
4	Unmarried
5	Male
6	Owns an older car
7	Lives in apartment, not dormitory
8	Does not have telephone
9	Low grade-point average
10	Has a high loan total

Based upon his findings, Spencer described the worst possible risk as "a student without a phone, unmarried, in his (or last) semester, with an old car, 17 years old (or over 26), male, with a large loan, who is unemployed." Through discriminant analysis methods, Spencer has therefore developed a model of the poorest risk applicant. While the exact weight of each characteristic contained in this model will vary from institution to institution, it is a reasonable assumption that on a nationwide basis this description is quite accurate.

If the above model constitutes a list of demographic characteristics of potential student loan defaulters, then it follows that schools with high percentages of students possessing some or all of these characteristics will have a potentially higher default rate than other institutions. Just as there are "high risk" students, there are "high risk" institutions.

The validity of these designations is only as reliable as the data supporting it. In depth, thorough research needs to be conducted to substantiate fully this view. While this paper does not purport to be a comprehensive study, there is, nonetheless, some meaningful data readily available for purposes of comparing institutional student populations and default rates. Through this comparison, we can gain some insights into the utility of determining an institution's "risk" level.

Study And Discussion Of Findings

A comparative study was made between a medium-sized public university and a smaller public community college located within the same urban area, thus eliminating potential regional variances. The data gathered provide profiles of their respective student populations.

The university has freshman student aid applicants of 28%, the community college, 63%. The average student age at the university is 20; at the two year school it is 27.[7] Where 67% of the financial aid applicants live off-campus at the senior institution, 100% live in apartments or with parents while attending the junior college. Of these students, 40% attending the university had parental or personal incomes exceeding $12,000, and only 14% from the commuter school fit this bracket. Similarly, 83% of the heads of household from the university own homes; 66% of the community college heads of household are homeowners. Data from the community college shows that only 19% of its students return after their freshman year. Although data was not readily available from the university, it is assumed that a higher percentage of its students return. Finally, while statistics were not collected, it would seem a reasonable assumption that university students had on the average achieved higher high school grade-point averages than did students at the community college.

Although not all factors which Dyl and McGann, et al, associated with loan defaulters were compared (i.e., telephone ownership or age of cars), we can at least begin to develop a profile of the average aid applicant at both institutions. As is obvious, the university student possesses fewer of the probable default related characteristics than the community college student. On the other hand, the community college student comes much closer to matching Spencer's description of the "worst possible risk." A typical student at the community college might fairly be described as a 27 year old freshman, whose parents have an income below $12,000 and may not own a home, who lives either in an apartment or with his parents, who completed high school in the bottom two-thirds of his class, and who has a low probability of returning for a second year and graduating.

Given that the factors identified above comprise a reasonable inventory of predominant characteristics of community college and university students, awarding student loans solely on the basis of need should yield a much higher default rate at the two-year school than at the university. For the institutions studied this is, in fact, the case. Both schools award loans only on the basis of need and grade level. Sophomores, for example, receive higher priority in packaging loans than freshman. Neither utilizes discriminate analysis methods beyond consideration of grade level. The result of this approach has been a 11% default rate at the university and 34% at the community college.

The author is the first to admit that numerous independent variables other than those cited will also affect default rates. The use of quarterly or monthly loan billings, the aggressiveness of collection activities, the number of defaulted loans turned over to OE – these and many other factors can have a measurable impact on default rates. But this comparison suggest that the demographic characteristics of an institution's student population also has a substantial, perhaps predominate, correlation to default rates.

If this correlation in fact exists, then it may be inappropriate to make direct comparisons between two different types of institutions. For example, should we compare the default rate of a private professional college with that of an urban community college? Discriminate analysis techniques suggest that we should at least be aware of the differences in the student populations if default rates are to be used as a measure of administrative quality. These demographic characteristics may be the major causal factors that produce such disparate national default averages for universities and community colleges: 16% at universities and 33% at two-year colleges. [6]

As stated earlier, more thorough research needs to be undertaken to provide specific data. Nonetheless, the financial aid community needs to address this issue. If the above hypothesis is valid, we should make policy decisions that reflect this knowledge. Perhaps higher default rates (reduced by improved administration) should be accepted a part of the "cost" of a student loan program at high risk institutions. Or aid administrators might adopt discriminate analysis techniques to reduce the risk factors endemic in their particular student populations. Both options could have a significant impact upon the National Direct Student Loan Program.

A policy of accepting variable default rates for different institutional types would encounter several pitfalls. Initially, the task of weighing and quantifying the many factors contributing to default rates, including the demographic make-up of a student population, would be extremely complex. It is most unlikely that any institution would be pleased with its designated level of risk. Additionally, administrative factors may not be given adequate weight in the effort to reduce default rates, and poor administrative practices may be allowed to continue. The net result could be continuing public displeasure and a resultant loss of funding.

If, on the other hand, colleges with inherently high risk student populations must reduce their defaults to a universal maximum rate, they may be forced to apply discriminate analysis techniques. While this approach would reduce default rates, it too might prove problematic. The question arises of how to package aid for students eliminated from loan programs through discriminate analysis but who still have legitimate financial need. Should the student be offered only employment (regardless of special circumstances that may preclude participation) as the self-help portion of his or her package, or are grants to be substituted? This problem is more acute, of course, at high risk institutions. Additional complexities could arise concerning the legality of eliminating students from loan programs on the basis of sex, economic bracket, or grade-point average, if they meet all other criteria for eligibility. Indeed, the use of such techniques certainly seem at least in conflict with the intent of the programs. These concerns notwithstanding, if reducing default rates to a universal standard is paramount to the survival of the loan programs, then such an approach may become necessary.

Summary Conclusion

This paper has found evidence to indicate that the demographic make-up of a given student population can place an institution in a "high risk" category for student loan defaults. Therefore, schools with higher default rates are not necessarily administering their program less effectively than schools with lower default

rates. Indeed, institutional default rates may not be comparable if the schools' respective student populations are from substantially different backgrounds.

It was suggested that these demographic factors be weighed in order to establish variable default rates for differing institutional types, or that discriminate analysis techniques be applied to reduce inherent risk factors in high default rate institutions. Both approaches posed additional problems.

The author concludes that, short of revising the loan programs, the best possible solution might be the open acknowledgement of tht importance demographic characteristics can have on loan defaults, and an informal system of variable risk rates. By this approach the importance of OE regional offices' familiarity with intitutions becomes paramount. If a program review finds a high risk institution to be administering its loan programs competently, then higher default rates should be accepted. Thus, poor administrative efforts could be identified and upgraded, while competent ones could be recognized as such and removed from the "problem school" list. This approach can only be as effective as the program reviewer's objectivity and working familiarity with the institutions, but nonetheless, it does seem to be an acceptable alternative.

FOOTNOTES

1 U. S., Department of Health, Education and Welfare, *Bureau of Student Financial Assistance Bulletin;* March 1978.

2 Ibid.

3 *National Association of Student Financial Aid Administrators Newsletter,* "OE Takes Hard Look At Potential Problem Schools"; June 5, 1978, NASFAA: Washington, D.C.

4 Several articles have been published concerning the application of discriminant analysis techniques in student loan programs and related topics. Included among these are Dyl and McGann, Pattillo and Wiant, Spencer, and Bergen, Bergen and Miller. Refer to bibliography.

5 Ibid.

6 "Two Year Colleges Lead in NDSL Defaults" *Student Aid News;* Vol. 5, No. 7; April 4, 1978.

7 The average student age at the university was derived from estimates provided by "educated guesses" from financial aid and admissions offices. While the exactness is not reliable, there is no doubt that the average age is within an 18-22 year old range and, therefore, significant to this study.

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