Default in Guaranteed Student Loan Programs

By Mark Harrison

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This article presents historical data concerning the set of loan programs formerly known as the Guaranteed Student Loan (GSL) Programs. While the 1992 Reauthorization changed the name to the Federal Family Education Loan (FFEL) Programs, references to "GSL" have been maintained in this article to preserve its historical integrity.

The federal government's Guaranteed Student Loan (GSL) Programs [recently renamed Federal Family Education Loan Programs] have become the major source of financial aid to postsecondary students, accounting for 44% of all student financial aid in academic year 1990–91 (College Board 1992). Lending was over $12 billion in both FY 1989 and FY 1990 (see table 6 in the appendix). These programs include the Stafford Loan, PLUS Loan, Supplemental Loans for Students [the SLS program was not available after July 1, 1994] and Consolidation Loan programs. An estimated 20.5% of undergraduates and 23.5% of postbaccalaureate students enrolled in fall 1986 had borrowed one of these loans (not including PLUS) (U.S. Department of Education, National Center for Education Statistics 1991 tables 263 and 265).

The high cost of defaults in these programs has been a policy issue for most of the decade, and continue to be so. In FY 1990, defaults paid to GSL lenders by the federal government exceeded $2.68 billion. Cumulative default payments exceeded $13 billion (see table 6). In the mid 1980s concern about high levels of default led the federal government to institute a series of default reduction measures.

There has also been much concern about excessive borrowing by students (Hansen and Rhodes 1988, Hauptman 1990 p. 47). Furthermore, high default levels have prompted proposals to move toward an income contingent loan system. The Reagan Administration introduced a pilot income contingent loan program, involving ten colleges and universities, under which borrowers pay a specified proportion of their income (on a sliding scale which varies with income and amount of debt) until the loan is repaid (Hauptman 1990 p. 48). More complex income contingent programs where the total repayment varies with income (an equity financing arrangement) have also been proposed (see for example, Reischauer 1989). The Clinton Administration most recently has proposed similar provisions to extend repayment periods up to 30 years. However, such proposals have raised concern about adding excessive costs to both borrowers and taxpayers.

Default Costs and Default Rates in the 1980s

Figure 1 shows that default costs for GSL programs skyrocketed over the 1980s. The defaults paid to lenders increased seven-fold in real terms. There were large increases in default costs from FY 1983 to FY 1986. Default costs then leveled off but grew significantly in FY 1989 and FY 1990. The data on which figures 1 and 2 are based are set out

FIGURE 1
Defaults Paid to Lenders: GSL Programs
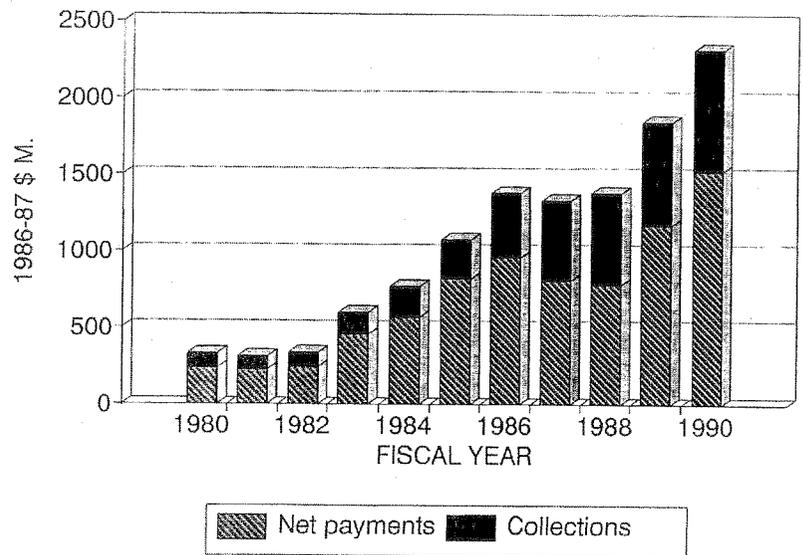
Source: U.S. Department of Education, Guaranteed Student Loan Branch Analysis Section (1991).

in table 6 in the appendix. The dollar amounts are expressed in real terms, in academic year 1986–87 dollars. Nominal figures were deflated using the Consumer Price Index for all urban dwellers.

Since the 1992 Reauthorization of the Higher Education Act, a new Direct Loan program is set to replace private lenders, state guarantee agencies, and servicing organizations. The current plans would make Direct Loans at least 60% of the loan volume by 1998–99.

Loans made under the former GSL programs are guaranteed by state or private non-profit guarantee agencies and are reinsured in part or in full by the federal government under the Guarantee Agency program. The loans were issued through state agencies and private lenders, such as banks and other financial institutions. Most colleges and universities chose not to act as lenders under the GSL programs.

The former GSL programs offered a 100% guarantee to lenders. However, the new law reduces this full guarantee for agencies whose default rates exceed certain percentages, thus introducing a cost-sharing factor to the program. Until this changes, however, the lenders have little incentive to chase delinquent borrowers for repayment, but instead submit a claim to the federal government after following a specified set of procedures. As McPherson and Shapiro point out:

> Because banks and state guarantee agencies are largely insured against losses from default, they have no real market incentive to identify bad risks or collect loans. Moreover, federal rules severely restrict the ability of lenders to reject loans. . . . . [T]he lenders' incentive under the 100% GSL guarantee is to be procedurally correct rather than to be effective;

lenders do not profit from collecting a loan from the borrower rather than from the government. Similarly, lenders have no financial incentive at the outset of the process to reject high risk loans. This important function of the credit market is blocked by the fundamental aim of the GSL programs: creating access to loans for people who would not normally get them. (McPherson and Shapiro 1991, p. 164)

Payments to lenders do not reflect any collection activity by the federal government subsequent to the default. Net default costs are defaults paid to lenders under the guarantee provided by the federal government, less collections by the federal government on these defaulted loans.

During the 1980s the federal government improved its own efforts at collecting defaulted loans by introducing penalties for nonpayment, reporting defaults to credit reporting agencies, withholding government licenses and college transcripts from defaulters, and garnishing wages and lottery winnings. The Deficit Reduction Act of 1984 enabled tax refunds to be withheld from defaulting borrowers (Hastings 1987), in effect using (in a limited way) the Internal Revenue Service (IRS) to collect debts. The IRS student loan collection program now accounts for 20% of Stafford loan programs receipts, raising $235 million in FY 1990 (U.S. Department of Education, Guaranteed Student Loan Branch Analysis Section 1991).

The tougher collection efforts by the federal government have resulted in a substantial increase in collections, increasing faster than defaults paid to lenders between FY 1985–86 and FY 1986–87. However, the recent increase in defaults has reduced the proportion of defaulted loans collected by the federal government. Net default costs have increased spectacularly from $167 million in 1980 to $1.762 million in 1990 (see Table 6), more than a six-fold increase in real terms (illustrated in Figure 1).

Changes in lending are reflected in default costs a few years later (as the borrowers enter repayment). For example, there was a surge in GSL lending between FY 1978 and FY 1981 (Harrison 1993, p. 31), resulting in rapid increases in default costs (both lenders' claims and net costs) in the mid-1980s (FY 1983 to FY 1986). The increase in loan volume in FY 1987 and FY 1988 (substantially due to growth in SLS loans, Harrison 1993, p. 32) led to a dramatic increase in default costs in FY 1989 and FY 1990.

Default costs reflect changes in default rates as well as changes in loan volume. Default rates have increased over the 1980s, boosting default costs. All default rates have increased rapidly since 1988.

Figure 2 shows the change in various default rates over the 1980s. The loan volume default rate has increased dramatically throughout the 1980s, but especially since FY 1988. It is computed by dividing defaults paid to lenders by loans made in any given year. This figure is distorted by lending booms, which lower the rate while lending surges, and then raise it once the loans go into repayment and defaults occur.

FIGURE 2
Default Rates on GSL Programs
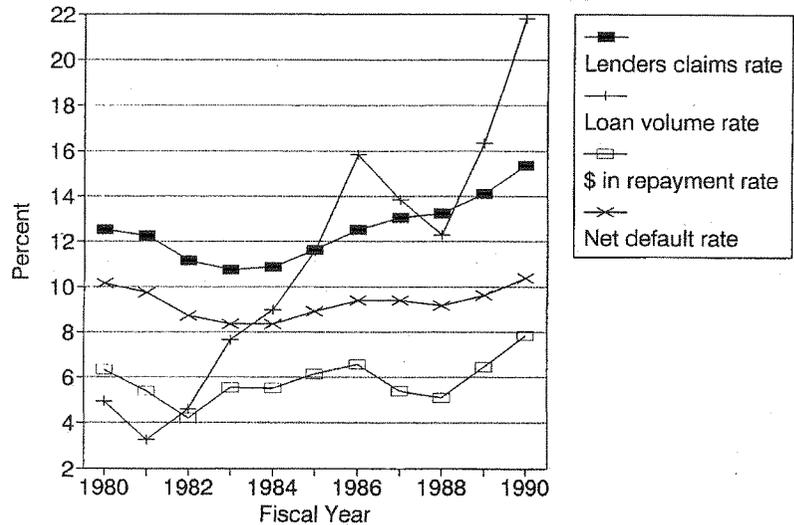
Source: U.S. Department of Education, Guaranteed Student Loan Branch Analysis Section (1991).

The lender claims rate is computed by dividing cumulative defaults paid to lenders by cumulative matured paper (the amount of loans that have entered repayment). Thus it is a measure of how the program has performed since inception rather than a measure of default activity within any one year. This gross default rate declined in the early 1980s and has steadily increased since FY 1983. The gross rate of 10.7% in FY 1983 had risen to 15.3% by FY 1990.

The net default rate is computed by dividing cumulative defaults paid to lenders less cumulative collections, by cumulative matured paper. It follows a similar pattern to the lender claims rate. However, improvements in the federal government's collection efforts increased the proportion of defaulted loans collected from FY 1983 to FY 1987. The net default rate has risen more slowly than the lender claims rate over this period.

The dollars in repayment rate was calculated by dividing defaults paid to lenders by total dollars in repayment. It is lower than the other rates because more dollars are in repayment each year than are added to matured paper. It too has risen over the late 1980s.

The 1980s saw a substantial increase in default costs and default rates. Despite tougher collection efforts, default in GSL programs rose considerably in the late 1980s. What explains these rises in default rates?

Why Did Default Rates Increase Over the 1980s?

Tables 1 to 3 set out default rates, in terms of numbers of borrowers, as of 1986, for the entire population of borrowers who received a GSL or Federal Insured Student Loan (FISL) Program loan and left higher education between 1976 and 1985. These figures were derived from the State Guarantee Agencies' (SGAs) cumulative data files by the National

Center for Education Statistics (U.S. Department of Education, National Center for Education Statistics 1989). All individuals who borrow under the FISL and GSL programs are listed in the data systems of the SGAs that administer the GSL programs within their jurisdictions. SGAs build and update their loan record systems using data supplied on a continuous basis by lending institutions authorized by the federal government to participate in the GSL programs.

Borrowers with more than one loan were counted only once and considered "in default" if they were in default on any loan and "paid in full" if they had repaid all loans.

In each table, the number of borrowers increases rapidly each year, reflecting the lending boom of the early 1980s. The number of students leaving higher education who borrowed from the GSL programs increased 15-fold over the decade. Of the 8 million students who had GSL loans in that 10-year period, over 60% left higher education in the last three years (1983–85).

Table 1 shows the overall default rate to be 12.8% of borrowers However, this figure is misleadingly low, as it is skewed down by the low default rate (6.8%) of those only one year out of school.

The default rate for a cohort will rise systematically over time, as more and more defaults occur. Hence, the oldest cohorts should have the highest default rates. This is certainly why the default rate for the 1985 cohort is so low; it will increase over time as more of the cohort defaults.

Although the oldest cohort (1976) does have the highest default rate, the default rate among other cohorts is fairly steady, and even rises, as the years since leaving higher education declines. This implies that the default problem is getting worse; each cohort takes a shorter time period to reach a default rate of 15%.

In tables 2 and 3 the data is disaggregated by whether the borrower went to a collegiate institution or not. Table 2 shows those borrowers who attended two- and four-year institutions of higher education included in the U.S. Department of Education's Higher Education General Information Survey (HEGIS) (using the 1984–85 files). The remaining borrowers are set out in table 3. Non-collegiate institutions include proprietary schools, as well as some two- and four-year institutions.

It is clear that students from noncollegiate institutions were much more likely to default. Their overall default rate was 20.6% compared to 9.7% for those who went to college. The default rates for noncollegiate students were higher for every cohort, and more than double the default rates of collegiate students for the more recent cohorts.

One reason that the aggregate default problem got worse was that the proportion of noncollegiate GSL borrowers increased continuously over the decade from 17% of all borrowers to 34%, more than doubling.

Another reason the default rate got worse was that the performance of noncollegiate GSL borrowers had been deteriorating. The default rates of the 1981 to 1984 cohorts were worse than the preceding five cohorts, despite having less time to default;. 25.8% of those who left in 1984 had defaulted two years later.

TABLE 1
Total Population Distributions for GSL Borrowers

Years Out of School	In Default	Percent in Default	In Repayment	Paid in Full	Total	Percent of Total
1 (85)	149,382	6.8%	1,975,858	81,968	2,207,208	27.5
2 (84)	227,650	14.2	1,276,132	97,568	1,601,350	19.9
3 (83)	191,804	15.6	924,657	114,613	1,231,074	15.3
4 (82)	153,541	15.5	713,705	122,669	989,915	12.3
5 (81)	112,363	15.7	486,599	115,328	714,290	8.9
6 (80)	64,188	14.5	261,997	115,842	442,027	5.5
7 (79)	43,162	14.8	141,813	106,326	291,301	3.6
8 (78)	35,746	15.6	89,764	103,341	228,851	2.8
9 (77)	27,480	15.6	56,204	91,928	175,612	2.2
10 (76)	25,454	16.8	34,944	91,101	151,499	1.9
Total	1,030,770		5,961,673	1,040,684	8,033,127	100%
Percent of Total	12.8%		74.2%	13.0%		

Source: U.S. Department of Education, National Center for Education Statistics (1989).

TABLE 2
Population Distributions for GSL Borrowers Who Attended Collegiate (HEGIS) Institutions

Years Out of School	In Default	Percent in Default	In Repayment	Paid in Full	Total	Percent of HEGIS Borrowers
1 (85)	68,935	4.7%	1,334,866	55,620	1,459,421	25.4%
2 (84)	103,104	9.2	950,048	65,036	1,118,188	19.4
3 (83)	98,834	11.0	715,554	81,874	896,262	15.6
4 (82)	85,933	11.7	559,873	90,058	735,864	12.8
5 (81)	68,332	12.7	382,049	86,723	537,104	9.3
6 (80)	40,400	12.0	207,723	88,184	336,307	5.8
7 (79)	29,321	13.1	114,525	80,310	224,156	3.9
8 (78)	25,596	14.3	73,801	79,890	179,287	3.1
9 (77)	20,713	14.5	47,645	74,103	142,461	2.5
10 (76)	19,598	15.5	30,251	76,270	126,119	2.2
Total	560,766		4,416,335	778,068	5,755,169	100%
Percent of Total	9.7%		76.7%	13.5%		100.0%

Source: U.S. Department of Education, National Center for Education Statistics (1989).

TABLE 3
Population Distributions for GSL Borrowers Who Attended Non-Collegiate (non-HEGIS) Institutions

Years Out of School	In Default	Percent in Default	In Repayment	Paid in Full	Total	Percent of non-HEGIS Borrowers	Proportion of Total GSL Borrowers
1 (85)	80,447	10.8%	640,992	26,348	747.787	32.8%	33.9%
2 (84)	124,546	25.8	326,084	32,532	483,162	21.2	30.2
3 (83)	92,970	27.8	209,103	32,739	334,812	14.7	27.2
4 (82)	67,608	26.6	153,832	32,611	254,051	11.2	25.7
5 (81)	44,031	24.9	104,550	28,605	177,186	7.8	24.8
6 (80)	23,788	22.5	54,274	27,658	105,720	4.6	23.9
7 (79)	13,841	20.6	27,288	26,016	67,145	2.9	23.1
8 (78)	10,150	20.5	15,963	23,451	49,564	2.2	21.7
9 (77)	6,767	20.4	8,559	17,825	33,151	1.5	18.9
10 (76)	5,856	23.1	4,693	14,831	25,380	1.1	16.8
Total	470,004		1,545,338	262,616	2,277,958		
Percent of Total	20.6%		67.8%	11.5%	100%	100%	

Source: U.S. Department of Education, National Center for Education Statistics (1989).

TABLE 4
FY 1985 and 1986 Cohort Default Rates by Type of Institution

Cohort Default Rate as A Proportion of	Type of Institution					
	Four Year		Two Year			
	Public	Private	Public	Private	Proprietary	Total
1985 number of borrowers	13.8%	14.7%	33.4%	16.1%	51.3%	26.3%
1986 number of borrowers	12.9	11.8	31.7	20.0	48.4	24.7
1985 dollars borrowed	12.0	10.4	27.2	11.4	44.8	17.8
1986 dollars borrowed	10.3	10.2	29.7	17.6	43.7	17.4

Source: U.S. Department of Education Guaranteed Student Loan Branch Analysis Section (1991), p. 70–71.

Further evidence on which students default comes from other studies undertaken by the U.S. Department of Education. A random sample of 7,382 Stafford Loan borrowers who took out their last loan in FY 1983 and had entered repayment by October 1987 was used to estimate default rates by type of institution (the results were reported in the U.S. Department of Education, Guaranteed Student Loan Branch Analysis Section 1989, p. 57). This sample was drawn from the Stafford cumulative data tape. The average default rate for borrowers in the sample was 20.1%. The default rate for those in public four year colleges was 10.7%. In private four-year schools it was 10.4%. In two year colleges it was 26.6% for public and 20.9% for private. For borrowers who had attended proprietary schools the default rate was 37.3%.

"Changes in lending are reflected in default costs a few years later."

A similar study done two years later showed the same pattern of default, but default rates had increased substantially across all types of borrowers (reported in U.S. Department of Education, Guaranteed Student Loan Branch Analysis Section 1991, pp. 70–71). This study used a random sample of the FY 1985 and 1986 cohorts of Stafford loan borrowers. Default status was determined at the end of FY 1988 and FY 1989 respectively. The results are set out in Table 4. The fact that the default rates for dollars are lower than the default rates by numbers of defaulting borrowers implies that defaulters tend to have smaller loan balances than average.

The evidence indicated that students attending proprietary schools experience far higher default rates than other borrowers. In addition, those attending community colleges were more likely to default than those attending four year institutions.

Table 5 shows that there has been a dramatic increase in the proportion of borrowers from proprietary schools in all GSL programs over the 1980s. There was also a corresponding increase in the proportion of loan dollars going to proprietary borrowers. Again the data show that proprietary borrowers form a greater proportion of borrowers than of amount borrowed, so they have smaller than average loans.

The increasing importance of borrowers attending proprietary schools was particularly true in the SLS program. In FY 1982 the annual volume of SLS loans was $31 million, of which 3.6% was made to proprietary students (about 600 borrowers). In FY 1986, the annual volume of SLS loans was $279 million, of which 8.2% was made to proprietary students (about 10,000 borrowers). By fiscal 1988, the annual volume of SLS loans reached $2,018 million and 61.5% was made to proprietary students (about 467,000 borrowers) (U.S. Department of Education, Guaranteed Student Loan Branch Analysis Section 1991, p. 14, 20).

When the SLS program was first established in 1982 (by the Omnibus Budget Reconciliation Act of 1981), independent undergraduate students could only borrow a maximum of $2,500 under the Stafford and SLS programs combined. But when the Educational Amendments Act of 1986 increased loan limits for Stafford (from $2,000 to $2,625 for freshmen and sophomores) and SLS (from $3,000 to $4,000), there was no longer a combined limit. An independent undergraduate could

TABLE 5
Proportion of GSL Loans Going to Proprietary
School Borrowers
(Number of Borrowers and Dollar Amount of Loans)

Fiscal Year	GSL Program FISL No.	$	Stafford No.	$	PLUS No.	$	SLS No.	$
1980	9.6%	9.4%	7.5%	6.1%				
1981	14.6	13.9	7.8	6.3	2.2%	2.1%		
1982	21.7	20.3	12.7	10.7	6.9	5.9	4.7%	3.6%
1983	35.9	33.5	16.5	14.3	9.4	9.4	2.4	2.1
1984	34.3	29.7	21.0	18.8	12.7	12.6	4.9	4.2
1985			24.1	22.3	16.4	16.2	5.8	5.3
1986			29.3	27.6	21.5	21.2	9.6	8.2
1987			35.2	34.9	27.9	28.5	53.7	50.1
1988			34.4	29.9	28.4	26.6	65.3	61.5
1989			32.7	27.2	28.3	25.8	64.5	59.2
1990				21.6				40.4

Source: U.S. Department of Education, Guaranteed Student Loan Branch Analysis Section (1991) p. 18–20. 1990 figures from Chronicle of Higher Education, September 16, 1992, p. A37.

now borrow $6,625. This led to a large rise in SLS volume, particularly among proprietary school students.

The increase in the proportion of proprietary borrowers also occurred in other programs. The proportion of total dollars lent to proprietary school borrowers increasing from 6.3% in FY 1981 to 27.2% in FY 1989 (reaching a peak of 34.9% in FY 1987) in the Stafford program; and from 2.1% to 25.8% over the same period in the PLUS program (peaking at 28.5% in FY 1987). The number of Stafford borrowers at proprietary schools increased from around 155,000 in 1980 to 1,204,00 in 1989 (U.S. Department of Education, Guaranteed Student Loan Branch Analysis Section 1991, p. 13, 19).

Default rates rose over the 1980s partly because all borrowers have become more likely to default and partly because the proportion of borrowers from institutions with high default rates had increased. In particular, the dramatic increase in the proportion of borrowers attending proprietary schools had pushed up default rates.

Individual Characteristics Associated with Default

There is some evidence on the characteristics of defaulters. Knapp and Seaks (1992) found that the most significant variables in determining default are family status (whether both parents are present), graduation, parent's income, and race. These results were consistent with the results in earlier statistical studies. Knapp and Seaks summarize an unpublished study by Schwartz and Baum which found that race, employment status, and presence of children had a significant relationship with default. Wilms et al. (1987) found that failure to complete the program of study was the most powerful predictor of default, followed by race, family income and whether the student had been a high school dropout.

Knapp and Seaks found graduation to be the most significant factor, economically and statistically, and also found the amount bor-

rowed to be insignificant. This confirms other studies that show default-ers tend to be dropouts and one-time borrowers. McCormick (1987) summarizes studies on default. The studies generally found that default-ers tend to have relatively small loan balances, that first-year students are the most likely defaulters and that default fell as class level rose. Defaulters were often dissatisfied with their programs, tended to be younger students, came from low-income families, and were more likely to have attended trade and technical schools and community colleges.

Race is consistently a significant factor in default. Knapp and Seaks found that an African American borrower has a higher probability of default than a non-African American borrower by about 10 percentage points, close to the Schwartz and Baum estimate. This is despite control-ling for family structure, income and graduation. Wilms et al. (1987) also found that African Americans have the highest probability of default, independent of family income, prior education and dropping out. Both sets of authors suggest that other unmeasured economic factors corre-lated along racial lines, such as wealth, are at work.

The Conflict Between Reducing Default and Access Objectives

In the mid-1980s concern about high levels of default led the federal government to institute a series of default reduction measures. The 1989 Budget Reconciliation Act (which came into effect on January 1, 1990) restricted SLS to schools with default rates under 30% and to borrowers with high school diplomas or equivalent (U.S. Department of Education, Guaranteed Student Loan Branch Analysis Section. 1991 p. 8). The default rate used for this purpose was the fiscal year default rate, which is the proportion of borrowers required to begin paying off their loan in a fiscal year who had defaulted by the end of the following fiscal year.

In June 1989 new default reduction measures were announced by the Secretary of Education. Schools with default rates above specified percentages were subject to sanctions such as initiation of proceedings to limit, suspend or terminate their participation in student aid pro-grams. Likewise, all institutions were required to adopt "core" default reduction measures, such as pro rata refund policies and delayed dis-bursement of loans. Entrance counseling for first-time borrowers was made compulsory (U.S. Department of Education, Guaranteed Student Loan Branch Analysis Section. 1991 p. 51–52).

Wilms et al. (1987, p. 42) agree that although limiting the participa-tion of schools with high default rates "would no doubt reduce default rates, it would also limit the participation of many students at whom the program is targeted—those from families with limited resources." They say (p. 52) "simply punishing the schools diverts attention from the thorny issue of how to reduce defaults without sacrificing another important policy goal of ensuring educational access for low income students." Withholding funds from high default schools would "have the most adverse effect on the students who need help the most."

There is a conflict between the goals of reducing default and increasing access to higher education for low-income and minority groups. The two conflict because low-income and minority groups also tend to have high default rates. For example, as the government reduced

its loan guarantee to below 100% to encourage greater care and collection efforts by the banks, the disadvantaged may be more likely to be denied loans, "the very students [whom] federal financial assistance was designed to rescue, to aid" (McCormick 1987).

Nevertheless, just because low-income groups have high default rates does not mean that anti-default policies should not be pursued. Although much default is due to low-income, willingness to repay is still a significant factor in default. For example, Orr (1987) reports the findings of the Massachusetts Higher Education Assistance Corporation Loan Counselling Task Force on default which concluded "that there is no definitive profile of a defaulter; instead we found that the single most frequent feature of importance was borrower attitude. . . . willingness to repay is even more important than ability to repay" (p. 51).

Tougher default reduction policies will certainly decrease access by low-income groups. But rejecting anti-default measures is not the best way to help low-income groups. The resulting expenditure by the government is poorly directed, helping the dishonest as well as the poor. The answer is not to abandon default reduction policies, but to accompany them with policies targeted at increasing the access of the disadvantaged.

In Gladieux (1989, p. 140) there is a discussion on possible reforms to student loan programs to deal with default problems. One suggestion was to replace loans to schools with high default rates with grants. This point was challenged by questioning

> . . .the logic of giving grants rather than loans to people who were likely to fail in their educational objectives. It points to something radically wrong in the educational system, and particularly with high-default institutions such as proprietary schools. A major target of scrutiny and remediation should be the quality and consistency of programs for which the grants and loans extended. (Gladieux 1989, p. 140–41)

Certainly it can be agreed that federal aid should not be given to schools blatantly abusing the system with very low quality programs. But the idea that grants are more effective than loans in helping the poor may have merit.

The fact that the disadvantaged tend to be more prone to default means that there is a large element of subsidy involved in lending to low-income groups. However, it also means that a large proportion of low-income borrowers will have to bear the costs of default, which reduces the attractiveness of loan aid to them. Hence loan programs tend to be a poor instrument to achieve access objectives. If the implicit subsidies given to the disadvantaged through covering their default on loans was instead given in the form of grants, it would be more effective, by avoiding imposing default costs.

It may be conceded that it is not a good idea to give grants to certain groups because they are poor credit risks. However, it may be desirable to subsidize the education of certain groups who may also be bad credit risks. Because they are bad credit risks, financial aid may be best given in the form of a grant rather than a loan.

Who Should Receive Federal Loan Aid?

Some of the federal government's default reduction measures have targeted schools with high default rates. This policy has been criticized on the grounds that default is due to individual characteristics and this policy unfairly penalizes schools that enroll high-risk students. Knapp and Seaks note (1992, p. 411) "As one would expect a trauma center to have a higher death rate, a university that serves high-risk students is likely to have higher default rates."

Others claim that the educational institutions play a vital role in student default. In particular, there has been dissatisfaction with proprietary school performance. One commentator claims that high default rates exist among proprietary students because they "often don't feel they got any real benefit from education, so they don't see why they ought to repay the loan, which often they didn't understand they actually had. And that seems to be a special problem in the proprietary sector" (Bosworth 1989 p. 132). McPherson and Shapiro (1991 p. 140–41) quote claims that proprietary schools "fail to emphasize to students their obligation to repay loans" and engage in deceptive practices.

The Congressional Budget Office quotes concerns that proprietary schools

> have incentives to admit students who are academically unqualified but eligible for student aid, who are more likely to become disillusioned and fail to complete their programs, and who are more likely to default on their loans. (Congressional Budget Office 1991 p. 84)

McPherson and Shapiro (p. 142) note the lack of information on the performance of proprietary schools, even information on program completion rates being unavailable. In the Wilms et al. data set (which was drawn from high default schools) 60% of proprietary school students completed their programs. Only 40% of community college students did. The Lee and Merisotis (1990) study on proprietary schools found exactly the same figures. Low completion rates may be due to some institutional characteristics and result in dissatisfaction with the program and default on the related student loan.

Breneman (1989) at p. 150 says:

> the default problem primarily stems from extending loan programs to students attending institutions that are ill-suited to handle them. . . . We would be far better off focusing on where the defaults are and whether it makes sense for this country to try to finance high-risk students in institutions with questionable motivation.

He suggests the crisis in student aid could be solved by accrediting proprietary institutions.

It is clear from the data that students attending proprietary schools were more likely to default and that high rates of default in proprietary schools have contributed to the default problem. The issue is whether high student default rates at proprietary schools are because of the individual characteristics of proprietary students (such as being from

a low-income background) or due to some characteristic of proprietary institutions.

The evidence is inconclusive. The Knapp and Seaks study found that "there is nothing related to individual collegiate institutions that has any impact on student default rates." (p. 407) and "it is individual, not institutional characteristics that matter in predicting default." (p. 407). The school, type of school and student body size were not significant. They drew the conclusion that proposals to penalize colleges with high default rates were premature and that actions taken by program administrators may not reduce borrower defaults much.

"Loan programs tend to be a poor instrument to achieve access objectives."

Unfortunately their data set covered collegiate students only. Their paper used a sample of 1,834 Stafford borrowers from Pennsylvania whose loans were guaranteed by the Pennsylvania Higher Education Assistance Agency. The sample included students from private and public two- and four-year colleges, but did not include students from the proprietary sector. So their findings imply that the higher default rate of two-year compared to four-year colleges is due to the fact that they enroll higher risk students. But it is difficult to apply their conclusions to determine whether high default among proprietary students is due to student characteristics or some fault with proprietary institutions.

The Wilms et al. study also found that "student characteristics are of overwhelming importance in correctly predicting defaulters, in contrast to the institutions they attend, or the administrative practices those institutions use to try to curb student defaults" (p. 50).

However, their data set was limited to postsecondary schools with "excessively high" default rates (15% or more), which included only proprietary schools and community colleges. Again, whether there is something related to institutions which distinguishes high default from low default schools was not tested. However, they found that within this sector, administrative practices within the schools (such as conducting exit interviews) had no significant effect on default. They also found that attending a proprietary school rather than a community college, taking account of student characteristics, slightly increased the chance of default.

What has not been shown is whether, once income and other individual characteristics are controlled, proprietary schools have higher default rates compared to other schools. That is, whether attending a proprietary school has a significant impact on the probability of defaulting. Certainly if there is some problem with the proprietary institutions, it should be directly dealt with. But more research on the performance of proprietary schools needs to be done.

The data are consistent with the view that it is the program of study rather than institution that influences the default rate. For example, if default were associated with vocational programs, that would explain why proprietary schools have the highest default rates, followed by community colleges. But it would not be a reason for excluding all proprietary schools and community colleges from student loan programs, as they offer more than just vocational training.

TABLE 6
Defaults Paid Lenders: GSL Programs
(This table sets out the data illustrated in Figures 1 and 2.)

Fiscal Year

	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Cumulative dollars in thousands												
Matured paper	9,981,234	11,488,436	13,798,250	17,758,996	23,374,747	29,651,653	36,663,506	44,756,591	53,296,749	63,486,652	74,036,747	85,585,532
Defaults paid to lenders	1,200,123	1,439,554	1,694,095	1,982,275	2,512,537	3,224,376	4,255,723	5,613,886	6,963,476	8,417,552	10,453,592	13,133,636
Lenders default claims rate	12.0%	12.5%	12.3%	11.2%	10.7%	10.9%	11.6%	12.5%	13.1%	13.3%	14.1%	15.3%
Total collections	202,302	274,254	349,106	430,478	559,290	745,676	992,019	1,412,491	1,949,449	2,584,177	3,332,297	4,250,084
Net default rate	10.0%	10.1%	9.7%	8.7%	8.4%	8.4%	8.9%	9.4%	9.4%	9.2%	9.6%	10.4%
Current dollars in thousands												
Increase in matured paper		1,507,202	2,309,814	3,960,746	5,615,751	6,276,906	7,011,853	8,093,085	8,540,158	10,189,903	10,550,095	11,548,785
Defaults paid to lenders		239,431	254,541	288,180	530,262	711,839	1,031,347	1,358,163	1,349,590	1,454,076	2,036,040	2,680,044
Total collections		71,952	74,852	81,372	128,812	186,386	246,343	420,472	536,958	634,728	748,120	917,787
1986–87 dollars in thousands												
Increase in matured paper		2,095,421	2,890,624	4,616,086	6,322,990	6,788,538	7,313,762	8,239,379	8,452,768	9,686,286	9,573,261	9,981,429
Percentage increase			37.9%	59.7%	37.0%	7.4%	7.7%	12.7%	2.6%	14.6%	−1.2%	4.3%
Defaults paid to lenders		332,874	318,546	335,862	597,042	769,861	1,075,754	1,382,714	1,335,780	1,382,211	1,847,523	2,316,319
Percentage increase			−4.3%	5.4%	77.8%	28.9%	39.7%	28.5%	−3.4%	3.5%	33.7%	25.4%
Total collections		100,033	93,674	94,836	145,034	201,578	256,950	428,073	531,463	603,358	678,852	793,228
Percentage increase			−6.4%	1.2%	52.9%	39.0%	27.5%	66.6%	24.2%	13.5%	12.5%	16.8%
Current dollars in millions												
Defaults paid to lenders		239	255	288	530	712	1031	1358	1350	1454	2036	2680
Loan Volume		4,840	7,822	6,235	6,928	7,916	8,913	8,570	9,736	11,816	12,466	12,291
Defaults as a %		4.9%	3.3%	4.6%	7.7%	9.0%	11.6%	15.8%	13.9%	12.3%	16.3%	21.8%
Dollars outstanding		12,341	18,530	22,679	26,968	31,880	37,088	38,277	42,768	46,404	49,711	52,715
Defaults as a %		1.9%	1.4%	1.3%	2.0%	2.2%	2.8%	3.5%	3.2%	3.1%	4.1%	5.1%
Dollars in repayment		3,762	4,711	6,853	9,524	12,935	16,736	20,615	24,926	28,529	31,538	34,101
Defaults as a %		6.4%	5.4%	4.2%	5.6%	5.5%	6.2%	6.6%	5.4%	5.1%	6.5%	7.9%

Source: U.S. Department of Education, Guaranteed Student Loan Branch Analysis Section (1991).

Whether students are more likely to default due to individual characteristics or due to some problem with their programs of study or schools, the needs of the average vocational student are very different from the average degree student. The appropriate way to provide financial aid to each group is likely to be very different; yet both sets of students participate in the same federal loan programs. The result shows that federal loan programs serve neither group very well. For example, to reduce government exposure to high default by proprietary students, loan ceilings have been held down, making loan options inadequate for students in prolonged high-cost programs of study.

McPherson and Shapiro suggest that the external benefit justification for subsidies is more applicable to traditional collegiate education than to purely vocational training, but that subsidies to postsecondary vocational programs may be warranted by the social goal of "increasing the earnings capacity of socially disadvantaged citizens" (McPherson and Shapiro 1991, p. 141). They point out (p. 141–2) that vocational schools have different objectives from those offering traditional academic programs and their students have different circumstances from degree students. For example, full-time attendance for a number of years at a vocational school is less relevant and there is much overlap with on-the-job and government training programs.

It is not clear whether vocational training should be subsidized in the same way as higher education. The student aid system, based on a conception of full-time attendance at an educational institution, may not be an appropriate way to subsidize proprietary schools. McPherson and Shapiro suggest one reform would be to establish separate programs and funding sources for degree-oriented college instruction and short-term vocational instruction.

> Some version of student aid would continue to apply to collegiate programs, while short-term vocational training would be supported by an alternative mechanism, perhaps overseen by the Department of Labor rather than the Department of Education. An advantage of the latter arrangement is that it would permit greater integration with other training programs currently financed through the Labor Department. One possible version for the mechanism would be financing short-term vocational training through contracts with the providers, who would be screened and paid directly by the federal government rather than through portable payments to students. (McPherson and Shapiro 1991, p. 143).

Should We Move Towards Income Contingent Loan Programs?

The proposals for income contingent repayments have been driven by concern about high default. Concern that high levels of debt were leading to default have been misplaced. Defaulters tend to have smaller than average loan balances. Increases in GSL borrowing have been due to increases in the number of loans rather than increases in average borrowing (which has stayed fairly constant in real terms) (Harrison 1993). Increased default has not been due to increasing tuition in the

traditional college sector. The data show that high default is essentially due to proprietary and community college students.

All this illustrates the importance of separating the design of financial aid programs for academic degree students from the design for vocational students. A large-scale equity style income contingent loan program (as proposed by Reischauer 1989) may or may not be a good idea for college students. It would not be appropriate for vocational students who are in short-term, relatively low total cost programs. But certainly an income contingent program designed for four-year college students should not be introduced because of default problems created by other students.

Conclusion

Default costs for the GSL programs escalated during the 1980s due to rises in loan volumes and an increase in default rates. Default rates rose partly because all borrowers have become more likely to default and partly because the proportion of borrowers from institutions with high default rates has increased. The evidence is that students attending proprietary schools experience far higher default rates than other borrowers. In addition, those attending community colleges are more likely to default than those attending four-year institutions.

In response, the federal government initiated a series of default reduction measures, some of which target schools with high default rates. There is a conflict between the goals of reducing default and increasing access to higher education for low-income and minority groups who tend to have high default rates.

Rejecting anti-default measures is a poor way to help low-income groups. Loan programs tend to be a poor instrument to achieve access objectives, as default costs are likely to be borne by low-income borrowers. Financial aid to help the poor may be best given in the form of a grant rather than a loan.

Some controversy exists over the role of institutions in student default. Proprietary schools have been singled out for criticism. Whether higher default rates by proprietary students are due to the characteristics of the students or due to some problem with proprietary schools has not been established.

It is not clear whether vocational training should be subsidized in the same way as higher education. One reform would be to establish separate programs and funding sources for degree-oriented college instruction and short-term vocational instruction. In particular, income contingent schemes may be appropriate for courses of study that require large amounts of finance, rather than for short-term vocational courses.

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