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Report to Congressional Requesters

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STUDENT LOANS

Direct Loan Default Rates

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Abbreviations

ACS	Affiliated Computer Services, Inc.
AFSA	Academic Financial Services Association
FDLP	Federal Direct Loan Program
FFELP	Federal Family Education Loan Program
PLUS	Parent Loans for Undergraduate Students

United States General Accounting Office
Washington, D.C. 20548

October 17, 2000

The Honorable William F. Goodling
Chairman, Committee on Education and the Workforce
House of Representatives

The Honorable Peter Hoekstra
Chairman, Subcommittee on Oversight and Investigations
Committee on Education and the Workforce
House of Representatives

The Honorable Howard P. McKeon
Chairman, Subcommittee on Postsecondary
Education, Training, and Life-long Learning
Committee on Education and the Workforce
House of Representatives

Two major federal student loan programs, the Federal Direct Loan Program (FDLP) and the Federal Family Education Loan Program (FFELP), together provided student borrowers with about 9 million loans totaling $42.9 billion in fiscal year 1999. The federal government's role differs significantly between the two programs. Under FDLP, often referred to as the direct loan program, students or their parents borrow money directly from the federal government through the schools the students attend. The first FDLP loans were made in the fourth quarter of fiscal year 1994. Under FFELP, also known as the guaranteed student loan program, money is borrowed from private lenders such as banks, and the federal government guarantees repayment if the borrowers default. FFELP is the older of the two programs, having started in fiscal year 1966. The Department of Education administers both programs.

As of March 31, 2000, borrowers were repaying on more than $34 billion in direct loans. Yet little information has been available on the extent to which borrowers in the direct loan program are defaulting on their loans. Consequently, you requested that we provide information on recent FDLP default rates. We focused our work on answering the following questions:

- What are the default rates for FDLP loans, both overall and by type of school, and how do these rates compare with FFELP rates?

- Do default rates for FDLP loans differ according to the various repayment options available?
- What measures has Education taken to ensure that FDLP student loans are being properly serviced and collected?

In comparing the default rates of the FDLP and FFELP programs, we relied upon Education's annually calculated school cohort default rates, which are the rates at which schools' FDLP and FFELP borrowers have defaulted on their loans within 2 years of beginning repayment.[1] In comparing default rates within the FDLP program, we used a different database that gave a more complete and current view of all FDLP defaults by two main categories of loans—nonconsolidated and consolidation—and, within these categories, by four repayment options. The default rates within FDLP were calculated using a different time frame—namely, defaults that occurred at any time during repayment—and are not comparable to the school cohort default rates that Education computes annually.[2] Nonconsolidated loans are the basic loans with which students or their parents can help finance postsecondary education, while consolidation loans allow borrowers to combine their various federal education loans into a single loan. The four repayment plans—standard, extended, graduated, and income contingent—differ in the length of the repayment period and the flexibility of the repayment schedule. We were unable to compare FDLP and FFELP cohort default rates by type of repayment options student borrowers used because Education's National Student Loan Data System did not have information on repayment plans used by FFELP borrowers. Appendix I further describes our scope and methodology. We conducted our review between March and September 2000 in accordance with generally accepted government auditing standards.

[1]Education gathers data required for calculating school default rates by cohort. Covering a 2-year period, a cohort constitutes a group of student borrowers who began repaying their loans during a given fiscal year and also identifies those in the group who defaulted before the end of the next fiscal year. Although it covers a 2-year period, a cohort is identified by its first fiscal year. For example, borrowers in the 1998 cohort began repaying during the 1998 fiscal year, and the default rate for the 1998 cohort reflects defaults through fiscal year 1999.

[2]For FDLP nonconsolidated and consolidation loans in repayment as of March 31, 2000, we computed simple borrower-based default percentages that reflected the total number of borrowers who had entered repayment status and had subsequently defaulted (had not made a payment for more than 270 days) at any time during repayment.

Results in Brief

The most recent student loan default rate statistics for schools—the 1998 cohort default rates—showed that overall, the direct and guaranteed student loan programs had similar default rates—6.6 percent for FDLP and 6.7 percent for FFELP. The two programs also had similar default rates when the comparisons focused on the type of school. At 4-year schools, for example, the default rate was 5.3 percent for FDLP borrowers and 4.9 percent for FFELP borrowers. At 2-year and proprietary (for profit) schools, both programs had default rates about twice this high. The higher default rates for borrowers attending 2-year and proprietary schools are indicative of the higher risk of default that has historically been associated with these borrowers. Considering that FDLP is a relatively new program, more time will be needed to tell whether this similarity in rates will continue.

Within FDLP, default rates differed substantially between nonconsolidated and consolidation loans for two of the four repayment options—standard and income contingent repayment. Among borrowers using standard repayment, those with consolidation loans had a much lower default rate (5.1 percent versus 9.6 percent). Among borrowers using income contingent repayment, the opposite was true: borrowers with consolidation loans had a much higher default rate (9.3 percent versus 4.3 percent). (See table 1.) Although the reasons for these differences are not clear, student loan experts we talked with said the results tended to reflect differences in the overall creditworthiness of borrowers who used the various options. For example, over 20,000 borrowers repaying consolidation loans under the income contingent option had already defaulted on one or more of their underlying loans. This group of previous defaulters continues to have high default rates under consolidation (above 40 percent).

Table 1: Number of Borrowers in Repayment and Default Rates as of March 31, 2000, for FDLP Nonconsolidated and Consolidation Loans, by Type of Repayment Plan

		Nonconsolidated loans		Consolidation loans	
Repayment plan	Type of payment and maximum repayment period	Borrowers in repayment	Default rate (%)	Borrowers in repayment	Default rate (%)
Standard	Fixed; 10 years	1,861,908	9.6	308,835	5.1
Extended	Fixed; 30 years	68,124	1.7	81,101	1.8
Graduated	Increasing; 30 years	269,764	3.8	132,523	3.3
Income contingent	Flexible with income; 25 years	13,647	4.3	172,945	9.3
All plans		**2,213,443**	**8.6**	**695,404**	**5.4**

Source: U.S. Department of Education.

With regard to ensuring proper loan servicing and collection, Education and its prime loan-servicing contractor assess the appropriateness of FDLP loan servicing and collections through ongoing monitoring and periodic reviews. The prime contractor uses a subcontractor with FFELP loan-servicing experience to service FDLP loans and a separate subcontractor, a major public accounting firm, to independently monitor loan-servicing activities and report its findings to Education. The Department regularly reviews the prime contractor's compliance with contract loan-servicing requirements. Several recent external reviews have also been conducted, revealing no significant loan-servicing problems.

Background

FDLP and FFELP provide funding that is vital to helping students meet postsecondary education costs. FDLP has two types of loans and offers multiple repayment options.

FDLP Has Nonconsolidated and Consolidation Loans

Nonconsolidated loans are the basic loans with which students or their parents can help finance postsecondary education. Within FDLP, which was our main focus for considering loans by type, there are three kinds of nonconsolidated loans: subsidized and unsubsidized Stafford loans and Parent Loans for Undergraduate Students (PLUS) loans. Subsidized Stafford loans, available only to students with a demonstrated financial need, are considered subsidized in that the federal government does not charge interest while the student is in school at least half-time, during a 6-month grace period after the student graduates or otherwise leaves school, and during periods in which loan repayment is deferred (such as when the borrower is seeking but unable to find full-time employment). In contrast, unsubsidized Stafford loans are available to all students regardless of financial need and do not include an interest subsidy. If the borrower chooses not to make interest payments while in school, the interest is added to the principal balance to be repaid as part of the total loan amount. PLUS loans are available to parents of dependent students to help pay for their children's education; they are unsubsidized loans, and parents are responsible for paying all interest charges.

Consolidation loans are the second major type. During the course of their education, students may obtain loans from more than one federal program. By obtaining a direct consolidation loan, borrowers may combine their loans from different programs and make only one monthly payment.[3] Borrowers may consolidate their loans at any time, and the interest on their consolidation loans may be subsidized or unsubsidized, depending on the kind of original loans they consolidated. Borrowers in default on a student loan who have made satisfactory arrangements to repay the defaulted loan, or who agree to repay under the income contingent repayment plan, may also obtain direct consolidation loans. Parents with multiple PLUS loans may combine them into a single PLUS consolidation loan.

FDLP Offers a Variety of Repayment Options

Borrowers most commonly repay their FDLP loans using one of four repayment plans: standard, extended, graduated, or income contingent.[4] These four options differ by the amount of time allowed to repay loans and the flexibility of the repayment schedule. With standard repayment, borrowers make fixed payments of at least $50 a month for up to 10 years. With extended repayment, they make fixed payments of at least $50 a month over a period generally ranging from 12 to 30 years, depending on the total amount borrowed. With graduated repayment, borrowers' payments start out low and then increase, usually every 2 years; the repayment period generally ranges from 12 to 30 years, depending on the total amount borrowed. The income contingent repayment plan is the most

[3]Some of the federal student loans that are permitted to be incorporated into an FDLP consolidation loan include FDLP, FFELP, and Perkins loans, as well as health professions loans such as Health Education Assistance and Nursing Student loans.

[4]A fifth type of repayment plan—alternative repayment—is also available to FDLP borrowers. Because data showed that borrowers rarely used this plan (only 0.1 percent of FDLP borrowers), we excluded it from our analysis. Also, the income contingent repayment plan is not available to borrowers of nonconsolidated or consolidation PLUS loans.

flexible, allowing borrowers to make monthly payments that are based on adjusted gross income, family size, and the total amount of their outstanding loans. The maximum repayment period for income contingent repayment is 25 years; if the loan is not repaid after 25 years, the remaining balance is canceled, but the unpaid amount is considered income for tax purposes. Borrowers must use the income contingent repayment plan for consolidation loans if they have not made satisfactory repayment arrangements on any underlying defaulted loans prior to loan consolidation.

Education's Default Rate Monitoring Focuses on Schools

An accurate measure of student loan defaults is an important means for monitoring the extent of financial risk to the Department from its student loan programs. When borrowers fail to meet their financial obligations by not repaying their federal student loans, it is the government, and through it the taxpayer, that ultimately must pay for this failure. Education estimated that default costs would amount to a combined $4.3 billion for FDLP and FFELP in fiscal year 1999.

For Education, monitoring default rates has tended to be focused at the school level and has not been broken down by type of loan or repayment program. Each year, the Department assesses a school's eligibility to continue participating in FDLP and FFELP on the basis of the school's default rates (which are primarily based on nonconsolidated Stafford loans) for the most recent 3 consecutive years for which data are available. For fiscal year 2001, for example, eligibility is based on default rates for fiscal years 1996, 1997, and 1998. A school remains eligible if its default rate is below a 25-percent threshold in at least 1 of these years. Most schools become ineligible if their default rate equals or exceeds the default threshold in all 3 fiscal years.[5]

As required by the Higher Education Act of 1965, as amended, Education calculates a default rate for each school by creating a cohort consisting of all the school's students who are expected to begin repaying their loans in a given year. The Department then determines how many of these students

[5]The Higher Education Act of 1965 exempted historically black colleges and universities, tribally controlled institutions, and Navajo community colleges from the threshold requirement through June 1999.

default on their loans in that year or by the end of the following year. For a school with 30 or more borrowers entering repayment status,[6] the default rate is the percentage that results from dividing (1) the number of students who entered repayment status in a given fiscal year and defaulted in that year or before the end of the next fiscal year (the numerator) by (2) the number of students who entered repayment status in that given fiscal year (the denominator). For example, if 100 students from a school were scheduled to begin repaying their loans in fiscal year 1998 and 25 defaulted on their loans by the end of fiscal year 1999, the school's 1998 default rate would be 25 percent.[7]

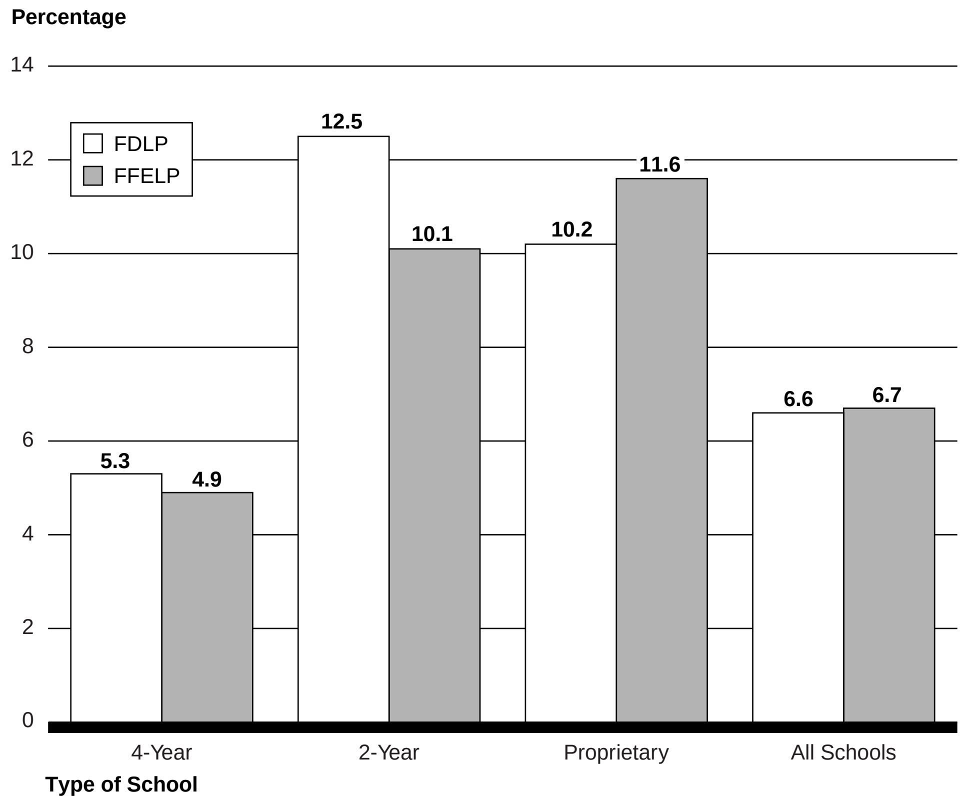
FDLP and FFELP Loan Programs Have Similar Default Rates

The most recent available default rate data—Education's data for the 1998 cohort—showed little difference between the overall default rates for FDLP and FFELP student loan borrowers. The overall default rate was 6.6 percent for FDLP and 6.7 percent for FFELP. The similarity in default rates between the two programs was still apparent when viewed by the type of school the borrowers attended, though the rates for the two programs were somewhat more alike for borrowers attending 4-year schools than for borrowers attending 2-year and proprietary schools. (See fig. 1.)

[6] If a school has fewer than 30 borrowers entering repayment, Education calculates a 3-year average default rate.

[7] FDLP and FFELP have different criteria for determining when a loan is in default for the purpose of being placed in the numerator of the cohort default calculation. For FDLP, loans are considered to be in default if payments have been delinquent for a specified period of time. For FFELP, a default is considered to occur on the date that the guaranty agency pays a claim for insurance on the loan. See app. I for more detail on default criteria.

Figure 1: Student Loan Default Rates for FDLP and FFELP by School Type, Cohort Year 1998



Source: U.S. Department of Education, Default Management Division.

For 4-year schools, the rate of default was 5.3 percent for FDLP borrowers, compared with 4.9 percent for FFELP. Both rates are substantially lower than the default rates for 2-year and proprietary schools. The lower default rates at 4-year schools reflect the fact that students at 4-year schools have long tended to be at lower risk of default. Because most students in the cohort attended 4-year schools, the overall default rates for the two programs are closer to the rates at 4-year schools than to the rates at 2-year and proprietary schools.[8]

The greatest disparities in default rates between FDLP and FFELP occurred among borrowers attending 2-year and proprietary schools. Default rates under FDLP were higher than under FFELP for 2-year schools (12.5 percent versus 10.1 percent), but FDLP default rates were lower at proprietary schools (10.2 percent versus 11.6 percent). Neither Education nor we could explain these default rate differences. In past work, we referred to research that linked characteristics such as a person's academic preparation for higher education or the family's socioeconomic status to likelihood of default.[9] This research suggests that the disparity in default rates between FDLP and FFELP for both 2-year and proprietary schools is more likely attributable to specific differences in such characteristics of individual student borrowers than to characteristics of the schools they attended. Appendix II contains additional detail on FDLP and FFELP cohort default rates.

Default Rates for FDLP Loans Vary by Type of Loan and Repayment Plan

As of March 31, 2000, 2.9 million FDLP borrowers were in repayment status. Most had nonconsolidated loans, and most were using the standard repayment plan. For two of the four repayment options (standard repayment and income contingent repayment), the default rates for borrowers with nonconsolidated and consolidation loans differed substantially. While the reasons for these differences were not clear, student loan experts said they likely reflected differences in the overall creditworthiness of borrowers who used the different options—differences that translate into varying tendencies to default. Education officials told us

[8] Distribution of the cohort by type of school was as follows: 4-year schools—about 78 percent of the cohort for the FDLP program and 69 percent for FFELP; 2-year schools—9 percent for FDLP and 16 percent for FFELP; and proprietary schools—about 14 percent for each program.

[9] *Student Loans: Characteristics of Students and Default Rates at Historically Black Colleges and Universities* (GAO/HEHS-98-90, Apr. 9, 1998).

that these differences in default rates are consistent with their experience that borrowers who choose a repayment plan are less likely to default than those who fail to choose a plan.

Most Borrowers Had Nonconsolidated Loans, and Most Used Standard Repayment

The original loan dollars of the FDLP borrowers in repayment status as of March 31, 2000, amounted to $34.1 billion. Over 76 percent of these borrowers had nonconsolidated loans. On average, borrowers who had consolidation loans had larger loan balances than borrowers with nonconsolidated loans ($19,167 versus $9,395). (See table 2.)

Table 2: FDLP Nonconsolidated and Consolidation Loans in Repayment as of March 31, 2000

	Nonconsolidated loans	Consolidation loans	Total
Borrowers in repayment[a]	2,213,443	695,404	**2,908,847**
Percentage of total borrowers in repayment	76.1	23.9	**100**
Loan dollars in repayment[b]	$20,795,152,674	$13,329,017,731	**$34,124,170,405**
Percentage of total loan dollars in repayment	60.9	39.1	**100**
Average loan amount	$9,395	$19,167	**$11,731**

[a]Some borrowers were counted more than once because they had more than one loan being paid under different types of repayment or they had both nonconsolidated and consolidation loans.

[b]Loan dollars reflect original loan amounts.

Source: U.S. Department of Education.

Most borrowers used the standard repayment plan. This was particularly the case for borrowers with nonconsolidated loans, 84 percent of whom used this option. While borrowers with consolidation loans also used the standard option more than any other, as a group they made more use of the other repayment options. (See table 3.) The standard repayment option may be used more than the other repayment options because borrowers are assigned to this option unless they specifically choose otherwise, and because it is generally the least costly option. The standard repayment plan usually results in the lowest total interest paid (in current dollars) because the monthly payment is higher and the repayment period is shorter than under the other plans. Appendix III contains additional information about FDLP nonconsolidated and consolidation loans in repayment.

Table 3: Distribution of FDLP Borrowers in Repayment as of March 31, 2000, by Repayment Plan

	Nonconsolidated loans		Consolidation loans	
Repayment plan	**Borrowers in repayment**	**% of total**	**Borrowers in repayment**	**% of total**
Standard	1,861,908	84.1	308,835	44.4
Extended	68,124	3.1	81,101	11.7
Graduated	269,764	12.2	132,523	19.1
Income contingent	13,647	0.6	172,945	24.9
Total	**2,213,443**	**100.0**	**695,404**	**100.1**[a]

[a]Percentages do not total 100 because of rounding.

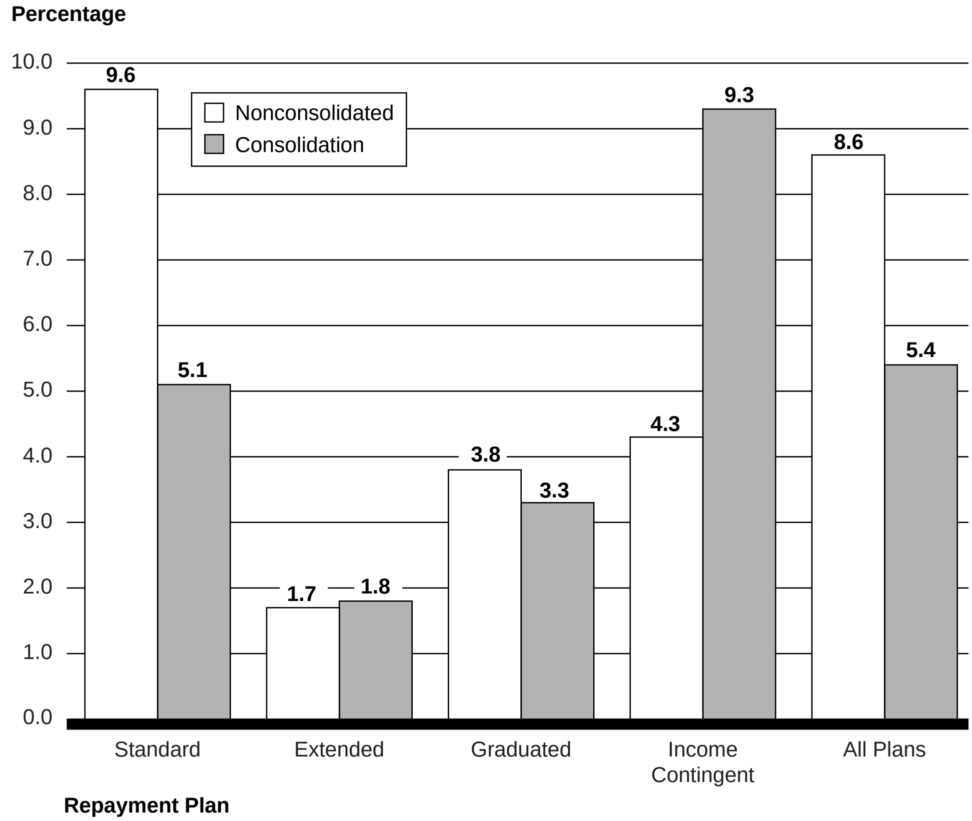
Source: U.S. Department of Education.

Default Rates for Standard and Income Contingent Repayment Borrowers Varied Substantially

Among borrowers using the standard repayment plan, those with consolidation loans had a much lower default rate than those with nonconsolidated loans: 5.1 percent versus 9.6 percent. However, among borrowers using income contingent repayment plans, those with consolidation loans had a much higher default rate: 9.3 percent versus 4.3 percent. Also, among those borrowers who had nonconsolidated loans, standard repayers had a much higher default rate than did borrowers using the nonstandard repayment plans—extended, graduated, and income contingent—with rates ranging from 1.7 percent to 4.3 percent.[10] (See fig. 2.)

[10]As noted earlier, these default rates within FDLP were calculated using defaults that occurred at any time during repayment and are not comparable to the school cohort default rates presented earlier.

Figure 2: Default Rates for FDLP Nonconsolidated and Consolidation Loans in Repayment as of March 31, 2000, by Type of Repayment Plan



Source: U.S. Department of Education.

The reasons for these differences are not clear. The FDLP program is still in the early phases of its development, with its first loans having been originated in the fourth quarter of fiscal year 1994. Student loan experts we talked with were unaware of any studies or analyses that might explain the differences. In addressing this question, Education officials told us that their experience has been that borrowers who choose a repayment plan are less likely to default on their loans than those who fail to choose a plan or are required to use a specified payment plan. For example, all of the borrowers with standard repayment plans for consolidation loans chose that repayment option. In contrast, some borrowers with standard repayment plans for nonconsolidated loans were assigned to that plan by their loan servicer because they did not choose a repayment plan. This difference may help explain why the default rate for those with nonconsolidated loans was almost twice as high as for those with consolidation loans among borrowers using standard repayment plans.

Student loan experts also suggested that these default rates may reflect the differences in the creditworthiness of the borrowers in these loan categories. Accordingly, we examined information on two groups of consolidation loan borrowers to obtain insight into their creditworthiness. Our analysis of information on whether these borrowers had previously defaulted on one or more of the underlying loans that were consolidated indicated that characteristics of borrowers, rather than some factor of their repayment plan, might explain the reason for default rate differences.[11] Borrowers who had defaulted before could be considered "higher risk," while borrowers who had not defaulted before could be considered "lower risk." For each repayment category, we divided the consolidation loan borrowers into two groups: those who had previously defaulted and those who had not. In each repayment category, the borrowers who had defaulted before had higher default rates on their consolidation loans. More specifically, with regard to borrowers with standard and income contingent repayment plans, we found the following:

- Within the standard repayment plan, lower-risk borrowers had a default rate of 1.6 percent on their consolidation loans and were far greater in number than higher-risk borrowers. Lower-risk borrowers' relatively low default rate and higher numbers kept the overall default rate at 5.1 percent, even though the higher-risk borrowers had a rate of 17 percent.

[11]This information was not available for borrowers with nonconsolidated loans.

- Within the income contingent plan, higher-risk borrowers had a default rate of 40.9 percent. Even though they were a small portion of the total group, their relatively high rate raised the overall average to 9.3 percent. The student loan experts we consulted noted that the high rate of default for the higher-risk income contingent repayers may be reflective of less motivated former defaulters who were required to use the income contingent option in order to consolidate their loans. Borrowers who have defaulted on their underlying loans must consolidate them using the income contingent repayment option, unless they have actively taken measures to make satisfactory repayment arrangements on their defaulted loans prior to consolidation.[12] (See table 4.)

Table 4: FDLP Consolidation Loan Default Rates and Number of Borrowers in Repayment as of March 31, 2000, by Type of Repayment Plan

	Lower risk[a]		Higher risk[b]		Combined	
Repayment plan	**Borrowers in repayment**	**Default rate (%)**	**Borrowers in repayment**	**Default rate (%)**	**Borrowers in repayment**	**Default rate (%)**
Standard	238,777	1.6	70,058	17.0	308,835	5.1
Extended	73,820	0.7	7,281	12.2	81,101	1.8
Graduated	102,162	0.7	30,361	11.9	132,523	3.3
Income contingent	152,810	5.1	20,135	40.9	172,945	9.3
All plans	**567,569**	**2.3**	**127,835**	**19.3**	**695,404**	5.4

[a]Lower-risk borrowers had not defaulted on an underlying loan for consolidation.

[b]Higher-risk borrowers had defaulted on an underlying loan for consolidation.

Source: U.S. Department of Education.

Appendix IV contains additional information on the work we conducted to assess consolidation loans according to borrower risk.

[12]Under FDLP and FFELP, for the purpose of consolidation, three consecutive, voluntary, on-time, full monthly payments constitute satisfactory repayment arrangements. Making such arrangements gives borrowers the option of selecting the standard, extended, or graduated repayment plan (in addition to the income contingent plan) for repaying their consolidation loans.

Education Uses Several Means to Ensure Proper FDLP Loan Servicing and Collection

The Department's procedures for ensuring that FDLP loans are properly serviced and collected involve several outside contractors. Education requires the contractors and subcontractors involved in loan servicing to apply a program of procedures, standards, checks, and measures to ensure that all specific requirements of the contracts are fulfilled, and it requires regular reports that can call attention to servicing or collection problems needing management attention. External audits and reviews have shown that the contractors were meeting loan-servicing requirements, and Education has encountered few situations in which schools' default rates needed to be revised because the loans used to compute the rates were improperly serviced.

Education and Its Loan Servicers Have Monitoring Requirements

Education services FDLP loans through a contract with Affiliated Computer Services, Inc. (ACS), an information technology systems and services company. As prime contractor, ACS has overall responsibility for FDLP loan servicing. ACS has a subcontract with Academic Financial Services Association (AFSA) Data Corporation, under which AFSA has the main responsibility for FDLP loan-servicing operations.[13] Some of the operational activities AFSA performs include establishing payment plans for borrowers, maintaining and updating borrowers' loans on a central database, providing billing services, collecting on delinquent loans, and reporting to credit bureaus.

Education and ACS both monitor the performance of FDLP loan-servicing activities to ensure that all specific contract requirements are met. The Department oversees contract compliance through frequent contact with loan-servicing managers, on-site inspections of service centers, and requiring ACS to submit periodic monitoring reports. For its part, ACS has a quality control unit that performs day-to-day process monitoring. Under the contract, services to be monitored include receipt and processing of materials, data entry, editing, turnaround times, storage of documents, printing, mailing, customer service, correspondence imaging, and collections.

[13] AFSA also provides student loan servicing for banks and secondary markets under FFELP.

Accounting Firm Provides Independent Monitoring

The FDLP loan-servicing contract also requires ACS to provide for independent monitoring of the loan-servicing system. Deloitte and Touche, LLP, a major public accounting firm, is the subcontractor for this task. Deloitte and Touche alerts Department and contractor managers to problems in the FDLP loan-servicing system so that they can take corrective action. The firm provides weekly written updates, monthly reports, and quarterly presentations. For example, the monthly report contains information on key quality indicators, quality control measures, and issues that could materially affect the program. The report's graphs, charts, and trend lines track various loan-servicing activities. The April 2000 report, for instance, showed that 98 percent of the delinquent accounts sampled in March 2000 were in compliance with due diligence requirements and that each of the previous 15 months generally had similarly high compliance rates.[14]

External Assessments Verify Monitoring Results

In addition to these regular monitoring efforts, several assessments of FDLP loan servicing have been conducted, and none have identified major problems. In June 1999, the Fleet Financial Group, AFSA's parent company, issued an audit report that found FDLP loan servicing to be operating with a "strong" system of internal controls and to have policies and procedures in place to ensure contract compliance. We also examined a sample of loans in 1999 and found that the contractor followed policies and procedures for all the loans in the sample by, for example, promptly sending delinquency notices and other correspondence and contacting delinquent borrowers by telephone. In April 2000, after doing a preliminary review of the accuracy of loans being serviced by the contractor, Education's Inspector General said the discrepancies identified were not sufficient to warrant a more extensive review.

Another type of assessment results when schools question the validity of their cohort default rates on the basis of having identified some aspect of improper loan servicing. If a school believes that improper loan-servicing and collection activities were responsible for some loans (either FDLP or FFELP) not being paid, and if it has a cohort default rate equal to or greater than 20 percent, it may challenge the Department-calculated default rate. An FDLP loan is considered to have defaulted because of improper loan

[14]Due diligence and collection activities include generating and mailing billing and past-due letters, attempting to contact delinquent borrowers by telephone, and attempting to obtain borrowers' new addresses or phone numbers.

servicing if a school can document that the loan servicer failed to perform such activities as mailing required letters to delinquent borrowers or trying to call them by telephone. Of 941 schools in the fiscal year 1997 cohort with default rates equal to or greater than 20 percent, 42 (4.5 percent) submitted appeals that were based on claims of improper loan servicing and 9 (about 1 percent) had their official cohort default rates revised by Education on the basis of their appeals. All nine schools whose rates were revised were proprietary schools participating in both FDLP and FFELP.

Conclusions

Because FDLP loan origination began only 6 years ago, the patterns in default rates for the program's various loan types and repayment options are just beginning to emerge. Thus far, FDLP's overall cohort default rate is about the same as that of FFELP. Considering that FDLP and FFELP have similar loan products targeted to similar student populations attending similar kinds of schools, it is not surprising to see similar rates of default between the two programs. More time will be needed to tell whether this similarity in rates will continue.

Within FDLP itself, borrowers with nonconsolidated and consolidation loans differed in their default rates. For nonconsolidated loans—generally the type of loans included in school cohort default rate calculations—defaults were lower for borrowers with nonstandard repayment plans than for borrowers with standard repayment plans. These lower default rates may reflect various factors, such as differences among borrowers in whether they actively chose their repayment plans. However, we cannot conclusively determine the extent to which the lower default rates currently occurring under the nonstandard repayment plans are attributable to characteristics of the plans, as opposed to characteristics of the borrowers who use these repayment options. As a result, it is not apparent whether this current pattern of default rates will continue as the FDLP matures.

Agency Comments

We obtained comments on this report from Education (see app. V). Education said that the report will provide the Congress valuable information on FDLP and Education's oversight of this program. Education also commented that it has developed a successful approach to FDLP loan servicing and collection through procedures such as ongoing monitoring, periodic reviews, and student counseling. As we noted in the report, recent reviews of FDLP have revealed no significant loan-servicing problems.

Education also provided technical comments, which we incorporated where appropriate.

As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after its issue date. At that time, we will send copies to the Honorable James M. Jeffords, Chairman, and the Honorable Edward M. Kennedy, Ranking Minority Member, Senate Committee on Health, Education, Labor, and Pensions; the Honorable Richard W. Riley, Secretary of Education; appropriate congressional committees; and other interested parties. We will also make copies available upon request.

If you or your staff have any questions or wish to discuss this material further, please call me or Andrew Sherrill at (202) 512-7215. Other staff who made key contributions to this report include Daniel Jacobsen, Robert Miller, and Stanley Stenersen.

Barbara D. Bovbjerg

Barbara D. Bovbjerg
Director, Education, Workforce,
and Income Security Issues

Scope and Methodology

To compare the default rate experience under the Federal Direct Loan Program (FDLP) and the Federal Family Education Loan Program (FFELP) for our first objective, we obtained school cohort default rate data from the Department of Education's National Student Loan Data System through the Default Management Division. We used school cohort default data for years 1997 and 1998, the two most recent years for which both FDLP and FFELP borrowers had entered repayment and been included by Education in its school cohort default rate calculations. These are the default rates annually computed by Education in accordance with the Higher Education Act of 1965, as amended, and its default reduction initiative, to identify those schools participating in federal student loan programs whose students are collectively exceeding statutorily defined rates of loan default.

The criterion for determining when an FDLP borrower has defaulted for the purpose of being placed in the numerator of the cohort default calculation varies from that used for the FFELP program. For FDLP, loans are considered to be in default if payments have been delinquent for a specified period of time. For FFELP, a default is considered to occur on the date that the guaranty agency pays a claim for insurance on the loan. Recent statutory changes have affected the time frames for determining default for both programs.

Effective October 7, 1998, the amendments to the Higher Education Act changed the time frames applied to the definition of default for FDLP and FFELP loans that are repayable in monthly installments from 180 days of delinquency to 270 days. For FFELP loans, the time period between the date that a borrower is determined to have defaulted and the date that an insurance claim is paid on the loan can vary but has been estimated to be about 90 days. Therefore, for the purpose of calculating a school's default rate, an FFELP loan would be in delinquency approximately 270 days (180 days plus about 90 days) on or after October 7, 1998, and approximately 360 days (270 days plus about 90 days) on or after October 7, 1998. To make the FDLP cohort default calculations consistent with the FFELP calculations, the time frame for determining default for cohort default rate purposes for FDLP loans was established by regulation to be 270 days (180 days plus 90 days) before October 7, 1998, and 360 days (270 days plus 90 days) on or after October 7, 1998.

To determine default rates by type of school, we used three school categories: 4-year, 2-year, and proprietary. The school cohort default rate statistics were available by 2- and 4-year public and private and proprietary school categories. To simplify our analyses, we combined the 4-year public and private school data to create the “4-year” school category and combined the 2-year public and private data to create the “2-year” school category. For FDLP, there were no cohort default rate statistics for foreign schools or for borrowers not classified by type of school. We excluded such statistics for FFELP borrowers from our analyses.

To determine the extent to which borrowers using the standard, extended, graduated and income contingent forms of loan repayment were defaulting on their FDLP (direct nonconsolidated and direct consolidation) loans, we used Education's direct loan servicer management information statistics on the total number of borrowers and dollar amounts of FDLP loans in repayment as of March 31, 2000. These data provided a more comprehensive and current snapshot of FDLP program data than could be derived from the cohorts used by the Department for calculating school default rates. We computed simple borrower-based default percentages by dividing the number of borrowers who were in repayment status and then defaulted (did not make a payment for more than 270 days) by the total number of borrowers who were in repayment status. These rates are not comparable to the annual school cohort default rates that Education computes, which generally reflect the percentage of a school's borrowers who entered repayment in one fiscal year and who defaulted by the end of the next fiscal year.

Education has not accumulated data in its National Student Loan Data System on repayment options used by FFELP borrowers. For this reason, we were unable to compare FDLP and FFELP cohort default rates by type of repayment options student borrowers used. Moreover, the validity of such comparisons would be questionable because the types and terms of the repayment plans differ between the two programs.

To determine whether Education had properly provided for collecting FDLP loans, we spoke with Department and contractor representatives that monitored the FDLP program. We reviewed various documents, including excerpts from the statement of work for the FDLP service contract and the business rules for the FDLP loan-servicing system. We also reviewed the quality assurance and Electronic Data Processing audit plans, monthly quality control statistics, monthly audit activity reports, and the results of loan-servicing and collection process reviews. In addition, we obtained relevant prior evaluations by external auditors. As another means of assessing the adequacy of loan collection efforts, we reviewed default rate collection appeals, based on improper loan servicing and collection, submitted to the Department by FDLP and FFELP participating schools for cohort year 1997.

In addition to contacting various Education officials, we reviewed laws, regulations, and Department procedures associated with the management and production of cohort default rates for postsecondary schools and the administration of FDLP nonconsolidated and consolidation loans, including options for repaying FDLP loans. We talked with various experts to obtain their views on factors that would help explain differences we found among default rates for certain groups of student loan borrowers. Relying on Department procedures for ensuring data integrity, we did not verify the accuracy of the information and data obtained and used in our analyses. Education's cohort default data are generally accepted and widely used by the agencies, schools, and organizations involved in federal student financial aid programs.

Cohort Default Rates for FDLP and FFELP Borrowers by Type of School, Cohort Years 1997 and 1998

	FDLP borrowers			FFELP borrowers		
	In default	Total	% in default	In default	Total	% in default
Cohort year 1997						
4-year schools	22,789	366,593	6.2	77,427	1,273,190	6.1
2-year schools	5,966	38,927	15.3	36,350	298,849	12.2
Proprietary schools	8,482	64,141	13.2	43,635	276,233	15.8
Total	**37,237**	**469,661**	**7.9**	**157,412**	**1,848,272**	**8.5**
Cohort year 1998						
4-year schools	23,976	451,826	5.3	59,319	1,214,556	4.9
2-year schools	6,276	50,368	12.5	29,085	286,962	10.1
Proprietary schools	8,158	79,601	10.2	29,522	254,173	11.6
Total	**38,410**	**581,795**	**6.6**	**117,926**	**1,755,691**	**6.7**

Note: Borrowers attending foreign or unclassified schools are excluded.

Data on FDLP Nonconsolidated and Consolidation Loans in Repayment

Table 5: Repayment Plans for Borrowers With All Kinds of FDLP Loans, as of March 31, 2000

	Borrowers		Original loan amount			
Repayment plan	**Number**	**Percentage of total**	**Amount (in millions)**	**Percentage of total**	**Average loan amount**	**Borrower-based default rate (%)**
Standard	2,170,743	74.6	$19,975.7	58.5	$9,202	8.9
Extended	149,225	5.1	3,948.2	11.6	26,458	1.7
Graduated	402,287	13.8	6,439.6	18.9	16,007	3.6
Income contingent	186,592	6.4	3,760.6	11.0	20,154	8.9
Total	**2,908,847**	**99.9**[a]	**$34,124.2**	**100.0**	**$11,731**	**7.8**

Note: Borrowers with alternative repayment plans are excluded.

[a]Percentages do not total 100 because of rounding.

Table 6: Repayment Plans for Borrowers With Nonconsolidated Loans, as of March 31, 2000

	Borrowers		Original loan amount			
Repayment plan	**Number**	**Percentage of total**	**Amount (in millions)**	**Percentage of total**	**Average loan amount**	**Borrower-based default rate (%)**
Standard	1,861,908	84.1	$15,847.8	76.2	$8,512	9.6
Extended	68,124	3.1	1,231.8	5.9	18,082	1.7
Graduated	269,764	12.2	3,503.3	16.8	12,987	3.8
Income contingent	13,647	0.6	212.2	1.0	15,549	4.3
Total	**2,213,443**	**100.0**	**$20,795.2**	**99.9**[a]	**$9,395**	**8.6**

Note: Borrowers with alternative repayment plans are excluded.

[a]Percentages do not total 100 because of rounding.

Table 7: Repayment Plans for Borrowers With Consolidation Loans, as of March 31, 2000

	Borrowers		Original loan amount			
Repayment plan	**Number**	**Percentage of total**	**Amount (in millions)**	**Percentage of total**	**Average loan amount**	**Borrower-based default rate (%)**
Standard	308,835	44.4	$4,127.9	31.0	$13,366	5.1
Extended	81,101	11.7	2,716.4	20.4	33,494	1.8
Graduated	132,523	19.1	2,936.3	22.0	22,157	3.3
Income contingent	172,945	24.9	3,548.4	26.6	20,518	9.3
Total	**695,404**	**100.1[a]**	**$13,329.0**	**100.0**	**$19,167**	**5.4**

Note: Borrowers with alternative repayment plans are excluded.

[a]Percentages do not total 100 because of rounding.

Data on FDLP Consolidation Loans in Repayment, by Borrower Risk

Table 8: Repayment Plans for Borrowers With Consolidation Loans, as of March 31, 2000

	Borrowers		Original loan amount			
Repayment plan	**Number**	**Percentage of total**	**Amount (in millions)**	**Percentage of total**	**Average loan amount**	**Borrower-based default rate (%)**
Standard	308,835	44.4	$4,127.9	31.0	$13,366	5.1
Extended	81,101	11.7	2,716.4	20.4	33,494	1.8
Graduated	132,523	19.1	2,936.3	22.0	22,157	3.3
Income contingent	172,945	24.9	3,548.4	26.6	20,518	9.3
Total	**695,404**	**100.1**[a]	**$13,329.0**	**100.0**	**$19,167**	**5.4**

Note: Borrowers with alternative repayment plans are excluded.

[a]Percentages do not total 100 because of rounding.

Table 9: Repayment Plans for Lower-Risk Borrowers With Consolidation Loans, as of March 31, 2000

	Borrowers		Original loan amount			
Repayment plan	**Number**	**Percentage of total**	**Amount (in millions)**	**Percentage of total**	**Average loan amount**	**Borrower-based default rate (%)**
Standard	238,777	42.1	$3,759.5	30.0	$15,745	1.6
Extended	73,820	13.0	2,646.6	21.1	35,853	0.7
Graduated	102,162	18.0	2,723.1	21.7	26,655	0.7
Income contingent	152,810	26.9	3,419.6	27.2	22,378	5.1
Total	**567,569**	**100.0**	**$12,548.9**	**100.0**	**$22,110**	**2.3**

Notes: Borrowers with alternative repayment plans are excluded. Lower-risk borrowers are those who had not defaulted on an underlying loan for consolidation.

Table 10: Repayment Plans for Higher-Risk Borrowers With Consolidation Loans, as of March 31, 2000

	Borrowers		Original loan amount			
Repayment plan	Number	Percentage of total	Amount (in millions)	Percentage of total	Average loan amount	Borrower-based default rate (%)
Standard	70,058	54.8	$368.4	47.2	$5,258	17.0
Extended	7,281	5.7	69.7	8.9	9,577	12.2
Graduated	30,361	23.8	213.1	27.3	7,020	11.9
Income contingent	20,135	15.8	128.9	16.5	6,399	40.9
Total	**127,835**	**100.1**[a]	**$780.1**	**99.9**[a]	**$6,103**	**19.3**

Notes: Borrowers with alternative repayment plans are excluded. Higher-risk borrowers are those who had defaulted on an underlying loan for consolidation.

[a]Percentages do not total 100 because of rounding.

Comments From the Department of Education

UNITED STATES DEPARTMENT OF EDUCATION

THE DEPUTY SECRETARY

October 2, 2000

Ms. Cynthia M. Fagnoni
Director, Education, Workforce,
And Income Security Issues
United States General Accounting Office
Washington, DC 20548

Dear Ms. Fagnoni:

Thank you for the opportunity to review and comment on your draft report, *Student Loans: Direct Loan Default Rates.* We appreciate you providing members of Congress valuable information on the Federal Direct Student Loan Program. (FDSLP) and the oversight role the Department plays. In the FDSLP, the Federal government provides loan capital and uses private contractors to perform loan origination and servicing functions.

The Department welcomes this opportunity to explain how FDSLP performs loan servicing and collections. We are pleased that you recognize our successful approach to managing FDSLP. Our oversight process includes thorough on-going monitoring and periodic in-depth reviews by contractors. In addition to using one subcontractor to service loans, FDSLP also uses a separate subcontractor to perform the independent quality control function of the servicing activities. This independent quality control function is a key feature of the Department's FDSLP oversight and helps ensure high quality outputs and customer service.

Many in the Department and the higher education community have long believed that the ability to offer student and parent borrowers a variety of repayment plans, as the FDSLP provides, will have long term positive effects. In addition to loan entrance and exit counseling provided by the schools, FDSLP conducts additional counseling during the grace period of the loan during which it educates borrowers about the various repayment options. This grace counseling helps ensure that borrowers are in a position to make an informed choice about the various types of FDSLP repayment plans available, including the income contingent repayment plan. Borrowers are also advised of the opportunity to consolidate their loans. This counseling enables borrowers to choose the repayment arrangement that will best suit their needs. We believe that in the long run this will further reduce loan delinquency and loan default rates.

Today, we released the final cohort default rates for FY1998, 6.9%. The cohort default rate for the direct loan program is 6.6%, and for the FFEL program the cohort default rate is 6.7%. We will be happy to share the final data with you.

Again, we appreciate the opportunity to comment on the draft report.

Sincerely,

Frank S. Holleman III

Frank S. Holleman III

400 MARYLAND AVE., S.W. WASHINGTON, D.C. 20202-0500

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