THIRD WAY

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Why the Cohort Default Rate is Insufficient

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Your credit score is ruined. Your tax refund is offset. You can't get a car loan or a mortgage. And, eventually, your paycheck is garnished. These are just some of the terrifying and life-altering consequences Americans face after defaulting on their federal student loans. This scenario is absolutely devastating for the millions of people who find themselves in this position each year, but it should also be terrifying to the taxpayers who continue to pump billions of dollars into institutions where a large number of former students struggle to pay down their educational debt.

One safety mechanism the federal government has put in place to protect students and taxpayers from institutions where a high number of students default is the Cohort Default Rate (CDR). This memo examines what the CDR measure is, and how effective it is at protecting students from attending institutions that consistently leave them unable to repay their loans.

What is the Cohort Default Rate?

The Cohort Default Rate (CDR) is a mandate of the federal *Higher Education Act.* It says that if a higher education institution has too many former students defaulting on their federal loans, it can no longer be eligible to receive taxpayer-funded student grants and loans. [1] Originally written into law in the 1980s, CDR was intended to curb alarmingly high student default rates following a recession that caused many Americans to turn to higher education as a way to obtain new skills for working in the changing economy. Enrollment at colleges across the United States swelled, increasing every year from 1985 to 1992, and many new colleges (of varying degrees of quality) cropped up to meet the demand. [2]

While this growth spurt provided more students with an opportunity to access postsecondary education, it also created an opening for low-performing providers to enter the college market. As a result, loan defaults skyrocketed to a startling 20% of all students—doubling from just a decade earlier. [3] Entering default is really the worst-case scenario for students, as it indicates that they have been unable to make a single payment on their loans within the past 360 days. [4] And to put this one-fifth of borrowers in perspective, mortgage delinquencies only hit 10% during the peak of the housing crisis in 2010. [5]

To tame the crisis, Congress needed a way to restrict bad actors from continuing to operate within the federally-funded higher education system. With the CDR "test," Congress could limit an institution's ability to receive federal financial aid if a certain percentage of their students defaulted on their loans within two years of beginning repayment (this changed to three years in 2008). [6] This was a way of drawing attention to—and cutting off access to taxpayer dollars for—institutions that were thought to be preying on low-income students, who often have more difficulty repaying their educational debt, and discouraging students from attending schools that could leave them worse off than when they started. [7]

The initial implementation of CDR after its introduction into law was effective; many low-performing schools lost access to federal funding, closed down, and student defaults began to decline. However, with the more recent introduction of income-driven repayment plans and—sometimes unscrupulous—default prevention strategies, the reliability of CDR as a dependable gauge of student loan repayment has waned.

How Does the Cohort Default Rate Work?

The most recent update to the CDR came through the last reauthorization of the *Higher Education Act* in 2008. [8] The CDR has two tests that will ultimately make an institution ineligible to receive federal student grants or loans:

1. If an institution has a CDR of 30% or higher for three consecutive years; or
2. If an institution has a CDR of over 40% in any one year. [9]

In other words, if an institution has 100 students who have taken out federal loans, and 30 of those students fail to make payments and enter default within three years of entering repayment on their student loans, that institution will have a CDR of 30%. And, if 30% or more of its students default for three consecutive years, it will lose its ability to access federal grants and loans. The same will happen if an institution has more than 40% of its students default in any given year.

Institutions can appeal their CDR if they serve a high percentage of economically disadvantaged students or if a small percentage of the student body takes out student loans. Some institutions successfully appeal each year, meaning that they can continue to receive federal student aid even though their CDR is above the acceptable federal threshold. [10]

How is a Cohort Default Rate Calculated?

CDR measures the percentage of borrowers who have entered default within a three-year period after leaving an institution. It is calculated by taking the number of former students who defaulted on their federal loans at an institution (including Subsidized Federal Family Education Loans, Unsubsidized Federal Family Education Loans, Direct Subsidized loans, or Direct Unsubsidized loans) and dividing it by the total number of student borrowers in that same cohort. [11] Generally, default is defined as if they have not made a payment on their federal student loan for 360 days or longer —about a year. [12]

CDR = # of Students Who Entered Default ÷ Total Number of Student Borrowers

However, there are a number of students who struggle to pay down their loans, yet are not counted negatively in an institution's CDR test, making it a less useful measurement when determining post-college success. These include students that are enrolled in income-driven repayment plans that make minimal payments, as well as some students in forbearance or deferment.

What are the Limitations of CDR?

Students can make $0 loan payments, yet still count positively towards an institution's CDR

While CDR captures the worst of the worst scenario—default —it does not include students who may not be in default, yet who still struggle to pay down their federal loans. In fact, some students can now pay nothing on their loans and still not default. This limitation in the CDR is in large part due to the expansion of income-driven loan repayment programs, which tie a borrower's monthly loan repayment amount to their income. Today, over 27% of all borrowers—or seven million students—are enrolled in income-driven plans, which account for $359 billion in the government's Direct and Federal Family Educational Loan portfolio. [13] While income-

driven repayment is good for protecting student borrowers and giving them needed relief in difficult financial situations, it also makes calculating defaults a less useful metric. That's because former students who earn little to no income can make a recurring loan payment of $0 and still stay out of default. [14]

Deferment and Forbearance Loopholes Make CDR Susceptible to Manipulation

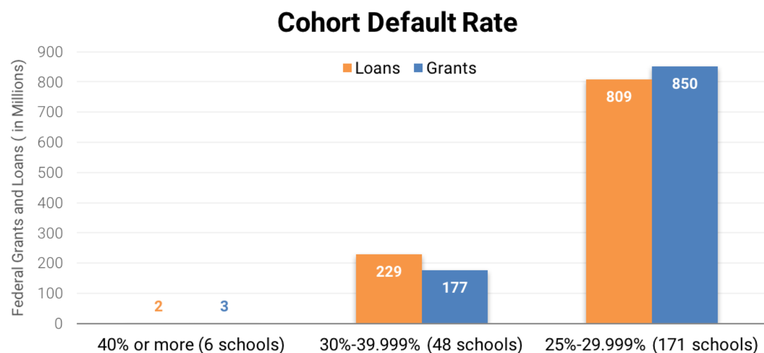
CDR also fails to take into account students in deferment or forbearance—two options that allow borrowers to temporarily reduce or delay payments. Some of the reasons to enter into these loan repayment statuses can be good, like deferring loans temporarily to attend graduate school or join the military. However, many times students choose to delay their payments through deferment or forbearance because they are struggling financially—and these delays can be costly and can increase loan balances over time. Last year alone, $25.4 billion in federal loans were in deferment due to economic hardship. [15] And even though these students are struggling financially, they do not count negatively against an institution's CDR.

Unfortunately, some institutions and loan servicers have taken advantage of—and have abused—this loophole by encouraging former students to enter into forbearance or deferment as a way to subsequently bump them outside the measurement for CDR. [16] The Department has acknowledged these deliberate and harmful actions taken by some institutions, stating that "CDR is susceptible to gaming behavior that may push students toward forbearance and deferments, meaning they stay out of default but don't make progress on repaying their loans and may continue to accrue interest." [17]

Is Today's CDR an Effective Quality Assurance Mechanism?

The implementation of the initial CDR law was extremely effective, leading to a significant decline in defaults across the country. While this was partially explained by an improving economy, it was also because a significant number of fly-by-night institutions failed the CDR test, lost access to federal funding, and closed down. That's exactly what the CDR is supposed to do.

However, today the CDR hardly affects any institutions—penalizing less than 1% of schools each year. This is true even though a large number of institutions have left an overwhelming amount of their former students unable to make a dent in their educational debt, including over half of all African American borrowers. [18] Yet, this year, only 10 out of 5,000 federally-aided schools lost eligibility for federal financial aid due to poor CDR outcomes (and last year there were also only 10). [19] These institutions served less than 2,000 of the more than 16 million students nationwide. They received only $11 million in federal funding through student grants and loans—a mere drop in the bucket when compared to the $130 billion that went to all institutions in 2016. [20]



Yet, over $400 million went to schools with a CDR between 30% and 40% that remained able to fully access federal grants and loans, as the law requires them to fail the test for three consecutive years before that access is shut off. That means taxpayers continue to be on the hook for funding institutions each year that are leaving nearly one-third of their students at risk of defaulting on their loans post-enrollment. While the original intention of CDR was admirable, new repayment options and deliberate actions to push students in deferment or forbearance mean it's time to

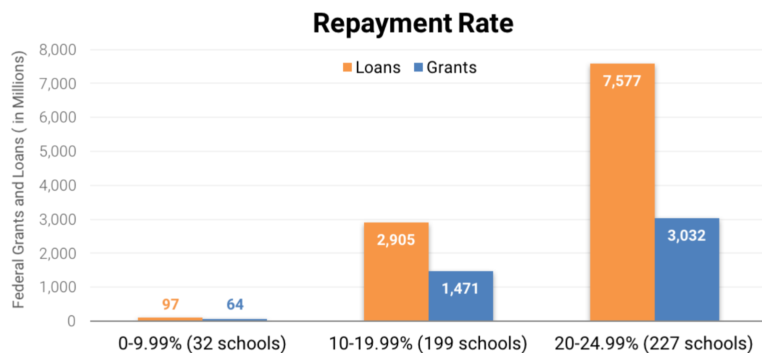
revisit its usefulness as a standalone measure. CDR is supposed to be a mechanism to stop taxpayer dollars from flowing to the worst actors, and at this point, policymakers need to find additional metrics that more comprehensively capture how well institutions are setting up their students to repay their federal loans after leaving school.

A New Way of Measuring Loan Repayment

One option on the table that more effectively captures students who find themselves unable to repay their loans is known as the loan repayment rate. Instead of only looking at actual defaults, the repayment rate measures the percentage of students that are able to pay down at least $1 on the principal of their loans within three years of leaving. That means if a student is unable to begin paying down the principal on a loan during this three-year time period—whether the loan is deferred, in forbearance, or not going down because of their inability to make large enough payments that cover their loan interest—it is captured in this more accurate measurement. After all, if any of these scenarios happen, loans will have continued to accumulate interest, and these students' new loan balances will be higher then when they left school in the first place. That's exactly what we don't want after a student has invested time and money in their education. Similar to the CDR, measuring the repayment rate wouldn't negatively count students who suspend their loans for reasons other than economic hardship, like enrolling in graduate school or the military—it would simply remove them from the calculations.

When comparing CDRs to repayment rates, we can start to see the broader issues of repayment problems across the higher education system. In 2014-2015 alone, nearly 500 institutions displayed a repayment rate below 25%, meaning that less than one-quarter of their students had successfully begun to pay down their loans within three years of leaving school and beginning repayment. There were also 32 schools where less than one in 10 students were able to pay down $1

of their loan principal within three years of leaving (three times as many as are dinged by the current CDR rules). And 231 institutions left less than one-fifth of students able to pay down their loans. Overall, $15 billion went to these institutions with a repayment rate of less than 25% to fund an education that would likely lead to unmanageable debt—significantly higher than what's captured under CDR today.



These striking numbers show why the current default metric is not sufficient to test whether an institution is setting its students up to repay their loans. In fact, out of the nearly 500 institutions where less than 25% of students were able to begin paying down their loan balance, only one institution had a CDR of more than 40%, and only 14 showed a CDR between 30 and 40%.

Conclusion

It's time for an update. The current CDR is ineffective at the job it was meant to perform. Every institution passes it, some institutions are gaming it, and only 2,000 out of 16 million students attended institutions affected by it—even though the data shows that many more students are struggling to actually repay their loans. As Congress works toward overarching policies to better ensure positive student outcomes and effective use of taxpayer dollars, it's clear that we need to rethink this measurement and consider other metrics that more accurately capture students' ability to pay down their federal student loans. If not, we'll just continue down the road of providing federal funding to extremely poorly performing institutions—leaving millions of students

unable to pay down their debt, while sending millions in taxpayer dollars to the institutions that poorly serve them.

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