[Journal of Student Financial Aid](https://ir.library.louisville.edu/jsfa)

Volume 3 | Issue 1 Article 3

2-1-1973

Defaults: Lowering Cloud Over the Guaranteed Loan Program

John H. Mathis

DEFAULTS: LOWERING CLOUD OVER THE GUARANTEED LOAN PROGRAM

John H. Mathis

College students today are signing up for guaranteed loans at a rate of over $1 billion annually, which places the guaranteed loan program among the biggest businesses in the country.

Unfortunately, the number of students who fail to repay their loans is increasing so fast that some pessimists fear the entire program is in danger of collapse.

As recently as the end of 1965, for instance, the default rate on loans guaranteed by my own organization, United Student Aid Funds, stood at less than 2.5% of which more than half would ultimately be collected through our own agencies. While we recognized that delinquency rates might inch up as more loans entered the payout stage, we felt that this record clearly demonstrated the credit-worthiness of the average college student.

We still do not doubt that most college students are deserving of the credit they need to continue their schooling. But the ability of this deserving majority to contract guaranteed loans is threatened by the irresponsibility of a growing number of borrowers who are not repaying their loans — and in many cases apparently have no intention of doing so.

Mr. Mathis is President and Chief Executive Officer of United Student Aid Funds, Incorporated, a non-profit agency which guarantees bank loans to college students throughout the country. A graduate of Columbia University, he received his law degree from the University of Oklahoma Law School.

How USA Funds Kept Defaults Down

Prior to passage of the Higher Education Act of 1965, United Student Aid Funds agreements with schools and banks provided that we would guarantee loans only for *needy* and *deserving* students. Needy - because we felt the necessarily limited loan funds should go to those who had no other way of financing their college education. Deserving - because we were convinced that a judgment of character, responsibility and motivation should enter into the decision about any loan application.

We asked financial aid officers to examine an applicant's personal and financial situation carefully before recommending a loan. We asked him also to keep the amount at the bare minimum to meet the student's needs after all other sources of money had been exhausted. Too big a loan might tempt the borrower to use some of the money for non-educational purposes. (Even so, some lenders were to discover that their money had been used to finance a vacation or the down payment on a new car.) An unnecessarily large loan also meant an unnecessarily great repayment burden, with an increasing likelihood that repayment might never be completed.

The system worked because character, morality and responsibility were good assets on which to base credit. Repayments matched, or even exceeded, those on commercial installment loans. Bankers who had been dubious about lending to untried college students professed themselves delighted.

Yet since 1965 the default rate has risen from less than 2.5 percent to more than 5 percent. State agencies report equally worrisome losses. According to the Office of Education, seven state and private guarantee agencies accounting for about 60 percent of the volume of all state and private operations (Illinois, Louisiana, New Jersey, New York, Vermont, Virginia, and United Student Aid Funds) showed the following default and collection figures for 1971:

	State group %	USA Funds %
Claims (including deaths)	4.95 of borrowers	4.94
	5.95 of dollars	5.97
Defaults only	4.64 of borrowers	4.62
	5.51 of dollars	5.55
Recoveries (bad debts only)	17.75 of dollars	26.12

Defaults under the federally insured loan program a year ago were said to be running at 4% nationwide, with a high in one region of 13.6%. These figures may lean to the down side; one large western lender, for instance, reports a 19% default rate on its federally insured student loans. In any event, the Office of Education no longer considers that the rapid expansion of loan volume should be its first priority. Instead, it is now shifting its attention — tardily, in my judgment - to the ticklish problems of controls and collections.

Why Are Defaults Shooting Up

The cost of education rises every year. Middle income families find it difficult and often impossible to finance their children's school expenses entirely from their own resources. At the same time, colleges are making a gigantic effort to recruit students from the very lowest income levels, most of whom have no money at all set aside for further schooling.

Under these circumstances, it was natural that financial aid officers should consider their first responsibility to be digging up the needed money. How, or even whether, the loans were to be repaid was secondary.

The loan provisions of the Higher Education Act passed by Congress in 1965 further fogged the picture. Need, said the Act, was not to be taken into consideration in making loans. The financial aid officer was denied the right to cross-question the applicant about his personal and financial situation. He could not even insist legally on proof that the money was to be used for educational purposes at all.

The existence of federal grant programs side by side with insured loans also confused some borrowers. Why should I repay a federally insured loan when no one expects me to repay an Economic Opportunity Grant? And if I feel under no obligation to repay my federally insured loan, why should my roommate feel obliged to repay a loan guaranteed by a state agency or United Student Aid Funds?

If students are given to understand that a guaranteed loan is really something owed them by society, then it is scarcely surprising that some of them should see no reason to pay it back.

Why All This Excitement About a Few Defaults

But why all this to-do about a few defaulted loans? Aren't 95 percent of student borrowers living up to their commitments? And anyhow, isn't the important thing to make sure that the students have enough money to put them through school?

Well, yes - that is important. But the lendable funds are not inexhaustible. They must be repaid after they have served their first generation if succeeding generations are to reuse them. And they are counterproductive if their end effect is to damage rather than improve the borrower, the lender, and society as a whole. Which is the exact result of a defaulted loan.

So it is not hard to explain the nervousness about the guaranteed loan program in the board rooms of banks — in college business offices — even in the conference rooms of the Office of Education.

Business, government, and educational leaders know that on purely economic grounds the drain of unpaid loans vitiates and threatens to destroy the guaranteed loan program. No one can say how high the default level must go before one bank after another quietly withdraws its participation. But the pragmatic fact is that the obverse side of a loan is a repayment. No repayment, then sooner or later, no loan. Pile guarantee on guarantee, reinsurance on insurance, tertiary markets on secondary markets, incentive payments on incentive payments — yet banks will not remain in the guaranteed loan business once they are convinced that the program, far from fostering understanding of the need for credit integrity, is actually eroding that understanding.

A Moral Problem

The cloud lowering over the guaranteed loan program is more than a crisis of dollars and cents. It is above all a crisis of morals.

An analysis of United Student Aid Funds' defaults over a six-month period in 1971 shows that only a small fraction were unavoidable. In 78% of the cases, *the default resulted from negligence or deliberate evasion — or the borrower had simply disappeared.*

If a borrower is forced to suspend payments for reasons beyond his control, and comes forward voluntarily to explain his difficulties to the lender, the chances are that he can arrive at an equitable adjustment, and not have to go into default at all. But if he deliberately chooses to default, his trouble is deep.

For a loan is a contract, entered into in good faith on both sides. A borrower who deliberately violates his contract is not just cheating the lender. He is not just cheating United Student Aid Funds. He is cheating society. Above all, he is cheating himself.

The visible evidence is his loss of credit standing. His ability to borrow will be damaged, if not destroyed, for as long as he lives.

And his individual loss goes even deeper. He has become, by his own act, a social cripple. He has lowered himself not just in others' eyes, but in his own. He has shown he cannot be trusted to abide by one of the few indispensable rules that make social and economic intercourse possible: good faith.

The present rash of defaults themselves is not so significant or disturbing as the *reasons* for them. And in the great bulk of cases the reasons are not economic hardship and inability to pay. The borrowers are defaulting because they see no *reason* to pay.

What Can Be Done?

Students are not a new breed. They are neither smarter nor more stupid, better nor worse than the rest of us. They do, however, often appear to "act out" attitudes that their elders keep under the surface.

I fear very much that one of these attitudes, latent among many older people and overt among some who are not so old, is a growing disrespect for the concept of a social contract — an agreement to limit individual liberty as far as may be necessary for the common good.

It would not be realistic to expect students to accept a social contract if we do not accept it ourselves. And until the idea of a social contract once more underlies the relations between one man and another, I expect that the default situation will continue to grow worse.

Yet the situation must be reversed — for we cannot afford to be permissive in accepting default of freely undertaken obligations, unless we are willing to bring down the whole structure of mutual faith on which our society rests.

And there is much that can be done. We can impress on every borrower the reality of the obligation he undertakes. We can remind him of that obligation, at least annually, before the time for repayment arrives. We can develop and make use of more effective controls at every stage of the borrowing-studying-repaying process.

To be sure, these suggestions deal with the symptoms as much as the disease. But in treating the symptoms, we shall be treating the disease as well. Not just in students, but in ourselves.

And we must. For just as every individual default is a personal tragedy, so collapse of the tremendously useful guaranteed loan program would be a national tragedy.

The guaranteed loan program is one of the most innovative and practical social developments of our time. The time to keep it on the track is now, this academic year.

Next year may be too late.