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Debts and Defaults

The growing market — and tab — for student loans

BY BECKY JOHNSEN AND JESSIE ROMERO

After the financial crisis, consumers curtailed their credit card debt. However, as the economy has recovered, another form of debt has grabbed attention: student loans. In June 2010, for the first time in history, total student loan debt, at more than $850 billion, exceeded credit card debt, estimated at less than $830 billion. The statistic was first reported by Mark Kantrowitz, publisher of FinAid.org, a leading resource on student financial aid. The finding was one in a series of sobering statistics concerning student loan debt.

Last year, the U.S. Department of Education released its *2007-2008 National Postsecondary Student Aid Study* (NPSAS). The NPSAS data show that the average loan debt of four-year undergraduate borrowers was $20,200 at public institutions, $27,650 at private nonprofit institutions, and $33,050 at private for-profit institutions. This represents increases of 20 percent, 29 percent, and 23 percent, respectively, since 2004. In total, the data showed that about two-thirds of graduates from four-year institutions had student loan debt.

Despite increases in public awareness and federal support, students seem less able to manage these debts. Although student loan debt is not dischargeable through bankruptcy under current law, a number of borrowers stop making payments regardless. In early September 2010, Secretary of Education Arne Duncan announced that the 2008 national cohort default rate on student loans increased to 7 percent, the highest rate since 1997. Defaults increased from 5.9 to 6 percent for public institutions, from 3.7 to 4 percent for private institutions, and from 11 to 11.6 percent for for-profit schools. The high default rates at for-profit institutions in particular have sparked a debate in Congress to regulate these institutions.

The official cohort default rate counts only people who default within two years of beginning repayment. (A cohort is composed of borrowers who enter repayment within the same fiscal year.) Because many people default in later years, the actual number of defaults is much greater. Beginning in 2012, the official rate will cover a three-year window, and preliminary data put the rate nearly 70 percent higher.

These figures point to a growing problem with postsecondary student debt on a national scale. In the Fifth District, students in Washington, D.C., graduated with an average debt of $29,793 per student, versus the national average of $23,200. (The data are based on where the student attends college, not on home state; Washington, D.C., has only one public university.) In West Virginia, 73 percent of students graduating from college had debt, compared with 67 percent nationally. According to the NPSAS, however, the rest of the District had both lower average student debt levels and a lower proportion of students with debt in 2008 (the most recent data available).

The Federal Loan Market

Most student loans are provided by the Department of Education. The Higher Education Act of 1965 established the Guaranteed Student Loan Program (now called the Federal Family Education Loan Program, or FFELP) to encourage college attendance. Through FFELP, a student borrows from a private lender, but the government guarantees the loan against default and guarantees the lender a "competitive" rate of return, enabling the student to borrow more cheaply. In 1993, the Department of Education also began lending directly to students via the Federal Direct Loan Program (FDLP). Schools could participate in FFELP or FDLP, and within five years, 35 percent of new loan origination was through the direct lending program. By 2006, though, that number dropped to 20 percent, which many attributed to aggressive marketing and incentives offered to schools by lenders. (The federal government also issues Pell grants, which do not have to be repaid, to students with demonstrated financial need. The maximum award in 2010-2011 was $5,500, depending on the student's eligibility.)

When the financial crisis hit in 2007, many lenders exited the market, or failed entirely, because they could not raise capital by selling student loan asset-backed securities (SLABs). Government caps on interest rates also prevented them from covering higher lending costs. To ensure students' access to credit, the Federal Reserve allowed financial institutions to use SLABs as collateral, and Congress allowed the Department of Education to buy loans from lenders. Many schools reapplied to the direct lending program, and FDLP increased more than 50 percent by the end of 2008. At the end of fiscal year 2009, the Department of Education was guaranteeing $457 billion in loans, offered by 2,900 different private lenders. The department's direct loan portfolio was $153 billion, up from $110 billion in FY 2008.

A provision of the recent health care act eliminated the guarantee system and required all institutions to switch to direct lending programs as of July 1, 2010. By issuing all federal loans itself, rather than guaranteeing the loans of third-party lenders, the government estimates it will save more than $60 billion over 10 years, which has been pledged to expanding need-based grants and debt relief efforts. Critics of the legislation are concerned about limiting

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students' choice in borrowing and the potential loss of thousands of jobs in the loan industry.

Alternative Loans

Students face a complicated array of federal loan options. The primary types are subsidized Stafford loans, where the government pays the interest while the student is in school, and unsubsidized Stafford loans, where interest payments can be added to the principal and deferred until graduation. The loans have different limits based on whether the student is an undergraduate or graduate, dependent or independent, and the student's year in school. Dependent undergraduates can borrow up to $31,000 in aggregate, and independent students can borrow up to $57,500. (Generally, dependent students are unmarried undergraduates who rely on their parents for financial support.) With the cost of attendance averaging $12,283 per year at public institutions and $31,233 at private institutions, some students have turned to "private" student loans to make up the difference.

Financial aid experts counsel students to take out federal loans, which have fixed interest rates and more flexible repayment terms, before turning to private lenders. (The private loan market has also faced allegations of predatory lending and collusion with college aid offices). Still, private lending made up more than 20 percent of all new student lending for much of the last decade, and private loans make up 20 percent of current loans outstanding.

While private loans can close the gap between federal aid and college tuition, one-fifth of private borrowers haven't exhausted their federal eligibility, and more than 10 percent haven't applied at all for federal loans. Reasons may include the complicated Free Application for Federal Student Aid (FAFSA), confusion about loan options and limits, or a perception that only students with financial need can borrow. Private lenders also advertise low introductory rates, instant credit approval, and easy application processes.

The rapid increase in private lending has been followed by an even greater decrease. Sallie Mae, the largest private lender in the United States, reported a 68 percent drop in originations from 2007 to 2010, and private lending overall has decreased by nearly a third. The drop is largely due to the lack of demand for SLABs, but also reflects stricter underwriting standards.

The future of the private loan market is uncertain. New regulations, including greater oversight and more lenient bankruptcy discharge rules, may make student lending less attractive. (Because the only thing students have to offer as collateral is their future earnings, the rules are designed to protect the lender's claim on that collateral. Pending legislation would make it easier for borrowers to discharge private loans, although federal loans would be unaffected.) But there are signs of recovery in the securities market, and the end of FFELP may spur lenders to seek out new business in the private market. For students, federal lending and need-based grants are still well below the cost of attending college, and even the newly simplified FAFSA form still has more than 100 questions on it.

What's Behind the Increase?

Several factors are driving the increase in student borrowing. On the demand side, increased emphasis on the importance of higher education has coincided with an increase in college costs: More students want to attend college, and they need more money to do it. In the last 10 years, prices for undergraduate tuition and fees have risen between 34 percent and 46 percent at public institutions and 31 percent at private institutions (adjusted for inflation). College costs have outpaced overall inflation, and room and board has increased more for students living on campus than off campus, which suggests that college costs have also outpaced the cost of living. Still, a $20,000-plus debt may be a rational investment. A report by Georgetown University's Center on

Demand for Graduate School Rises, as Does Its Costs

Rising student debt is not isolated to undergraduate education. Prospective graduate students face many challenges, such as increased competition for admission and higher costs, which may threaten their ability to enter and then remain in a graduate program.

According to a report by the Council of Graduate Schools, applications for admission grew by 8.3 percent between 2008 and 2009; enrollment grew by 5.5 percent.

A 2010 report released by the U.S. Department of Education's National Center for Education Statistics revealed that from 2000 to 2008, the average total price of attendance for graduate school, adjusted for inflation, increased by 52 percent, from $14,900 to $22,700 annually. Perhaps not surprisingly, law and medical programs were the most expensive, at $44,900 and $43,100 respectively.

And the growing price of graduate education shows in students' borrowing habits. In 2000, 30 percent of graduate students took out loans; the average annual loan was $13,500. In 2008, almost 43 percent of students took out loans, the average being $18,500. For professional school students, these figures were much higher. In 2008, almost 82 percent of law and medical students took out loans, with the average topping $30,000.

A 2010 report published by the Census Bureau stated that in 2008, those with advanced degrees earned about $25,000 more than bachelor's degree recipients and over $50,000 more than high school graduates. So, while a postsecondary education usually bolsters earnings, financing that education raises difficult choices for many students not just at the undergraduate level, but also at the graduate level.

— Becky Johnsen

Education and the Workforce estimates that 63 percent of jobs will require a four-year degree by 2018, and the College Board calculates that four-year college graduates earn on average almost $20,000 more per year than high school graduates.

Some economists, including Andrew Gillen of the Center for College Affordability and Productivity, a nonprofit research organization in Washington, D.C., argue that tuition hikes are an effect, rather than a cause, of increased student borrowing. In a 2008 policy paper titled "A Tuition Bubble? Lessons from the Housing Bubble," Gillen details a vicious cycle. Because the government views postsecondary education as a public good, it provides subsidies (relatively cheap and plentiful student loans) to pay for it. The subsidies increase the ability of more students to pay for school, which leads universities to raise their prices, which then leads the government to provide greater subsidies, and so on. Normally, the price would settle at a point where the ability and willingness of students to pay for an education matches the ability and willingness of a school to supply that education. But because the subsidy artificially increases the ability of students to pay, and because the supply of higher education is relatively inelastic, the normal laws of supply and demand may be distorted.

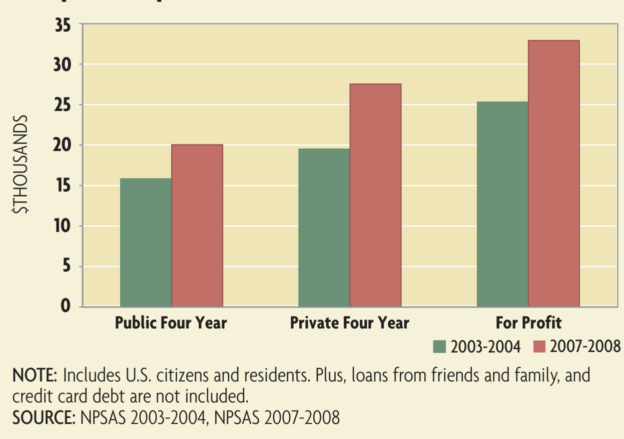
Implications

The rise in student debt poses several challenges to the increasing number of students striving for a degree. Student debt can linger for decades, preventing graduates from making important decisions such as buying a house, getting married, or having children. Parents who co-sign their children's loans also share this burden, and it may prevent them from making their own life decisions, such as retiring.

For borrowers who fall into delinquency, their lenders can exact several harsh penalties. In addition to harmed credit scores and higher payments, further financial aid is denied, academic transcripts may be withheld, tax refunds may be withheld to repay the student loan, and federal payments like Social Security may be reduced. The longer a borrower remains delinquent, the less likely he or she will be to resume control of the debt.

There are strategies that borrowers can use to delay or reduce their payments, but they require thorough research and strict adherence to the terms set by the lenders. Although it is possible to defer payments by obtaining additional schooling or through economic hardship, the interest on unsubsidized loans continues to accrue — and if a student takes out additional loans to remain in school, the ultimate burden only grows larger. And in the case of forbearances, which are similar to deferring payments but are available to those who are in default, interest on all loans continues to accrue. In the end, interest can turn a seemingly manageable loan into a significant liability.

Average Cumulative Loan Debt for Bachelor's Degree Recipients Upon Graduation



NOTE: Includes U.S. citizens and residents. Plus, loans from friends and family, and credit card debt are not included.
SOURCE: NPSAS 2003-2004, NPSAS 2007-2008

To minimize payments, two often cited options are the federal Income Based Repayment (IBR) Plan, which caps the required monthly payment based on the borrower's income, and the Public Service Loan Forgiveness (PSLF) Program, which forgives a portion of the balance for borrowers employed in some public service jobs. The federal government also offers partial loan repayment for service in the military or sponsored volunteer efforts for a few years.

IBR and PSLF were both enacted within the last few years, and IBR is set to expand in 2014. The effect of these programs and the change to federal direct lending on students' borrowing habits will not be seen for several years. Additionally, the current data include students who started school — and thus started borrowing — prior to the financial crisis, so it is uncertain how the decrease in private lending will affect total debt levels. Despite public concern about how much students are borrowing, the recession may mean that many students starting college now may have little choice but to increasingly turn to the loan market.

The consequences of accumulating student debt illustrate how important it is for borrowers to understand the terms of their student loans. And as tuition and incidental schooling costs increase, the next wave of hopeful college applicants must decide whether student loans are a strategy that leads to worthwhile investments in education — or to cumbersome obligations. **RF**

Readings

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