STUDENT LOANS

The State of Lending in America & its Impact on U.S. Households

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Student Loans

AN INTRODUCTION TO STUDENT LOANS

Income and employment opportunities are at the heart of wealth accumulation and financial well-being. The current marketplace demands a higher skilled and more educated workforce, even for entry-level workers. Families today see investing in a college education as necessary not only for graduating high school seniors but also for unemployed mid-career workers. And although many have begun to question the rate of return on what has become an increasingly expensive investment, earnings data continue to show large gaps in annual salaries by educational attainment. In 2010, for example, young adults ages 25–34 with a bachelor's degree earned 50% more than young adults with a high school degree or equivalent, and this gap in earnings has held consistent since 1995 (Institute of Education Sciences, 2012). While a college education does not automatically provide a well-paying job upon graduation, it nevertheless remains critical in today's competitive job market.

Although post-secondary education has never been more important, it has also never been more expensive. Recent increases to federal grant programs have helped many families who might otherwise be unable to enroll in post-secondary education. Nevertheless, most families still have to rely on loans as an important source of funding. Student loan debt has seen a massive increase, now exceeding the level of national credit card debt and recently topping one trillion dollars (Chopra, 2012)—$850 billion in federal loans and $150 billion in private loans (Consumer Financial Protection Bureau [CFPB], 2012). This is higher than any kind of consumer debt other than mortgage loans. Much of this increase can be attributed to the higher number of college enrollees, including students of color and non-traditional students. Still, **the percentage of students taking out loans, as well as the average amount of college debt per student, has steadily increased over the past decade** (College Board Advocacy & Policy Center [CBA&PC], 2011).

The results have made a significant impact on the debt burden of American families. Nearly one in five (19%) US households held student debt in 2010—more than twice the share in 1989 (9%). And student debt per borrower now averages $23,300 (Federal Reserve Bank of New York [FRBNY], 2012). Student loan defaults are also on the rise: nearly one-third of borrowers who have begun repaying their loans are delinquent (FRBNY, 2012).

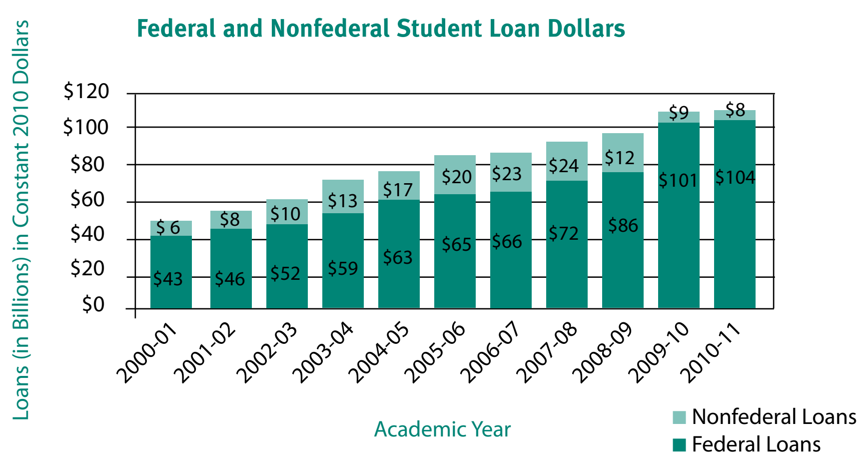
Federal Student Loans

The federal government offers a variety of student loans for undergraduate and graduate students and their parents, including subsidized and unsubsidized Stafford loans, Parent PLUS loans, Grad PLUS loans, and Perkins loans. From 1965 to 2010, most federal student loans were originated by private lenders and guaranteed by the federal government under the Federal Family Education Loan program (FFEL). In the 1990s, concerns over the costs of the program persuaded policymakers to create a direct federal loan program to be administered by the Department of Education (USED). This program was marginalized when Congress passed a law prohibiting the USED from encouraging or requiring colleges to utilize it. As a result, colleges continued to steer student borrowers to the privately originated, federally guaranteed programs, often under marketing pressures from lenders or in some cases as a result of inappropriate financial relationships between the lenders and educational institutions (New America Foundation, 2012) (CFPB, 2012).

In 2010, President Obama signed a law eliminating FFEL loans for all loans made as of July 1, 2010, and requiring all future federal student loans to be originated and administered by the USED. As a result, today all federal loans are originated directly by the federal government. However in FY 2010, $424 billion in FFEL loan volume remained outstanding (Department of Education [USED], 2011).

The combination of a strong rise in student enrollment, climbing college costs, and increased need for funds have contributed to a significant increase in federal loan volume over the past decade. As Figure 1 demonstrates, from the 2000–2001 academic year to the 2010–2011 academic year, federal loan dollars increased 139% in real 2010 dollars over the past decade.

Figure 1.



Source: College Board Advocacy and Policy Center

Private Student Loans

Private student loans are those that are not made or guaranteed by the federal government. Private student lenders include banks and other non-depository institutions, non-profit organizations (many affiliated with state programs), and some schools that offer or guarantee institutional loans. The large majority of these loans are made by banks and other for-profit lenders.

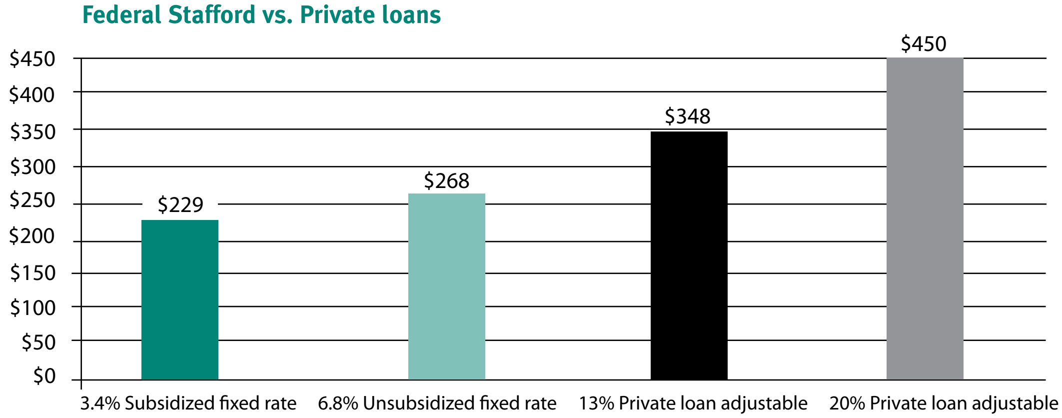
According to the Consumer Financial Protection Bureau (CFPB, 2012), private student loans made up 15% of total student debt outstanding as of January 1, 2012. As with the subprime mortgage boom, private student loan volume exploded between 2004 and 2008 as lenders were able to package and sell these loans to investors in asset-backed securities (ABS). The private market hit peak volume of $24 billion in 2007–2008, then declined sharply after the economic crash because of credit constriction by financial institutions, the collapse of the ABS secondary market, and increased federal grants and loans. Nevertheless, private student lenders originated nearly $8 billion of non-government student loans in the 2010–2011 academic year, and many predict that this market segment will grow again if federal loan rates increase or if federal grants and loans are cut back.

High-cost Private Loans

Unlike the interest rates on federal student loans—which are set by Congress and are uniform for all borrowers within a particular loan program[1]—private student loans typically have variable, uncapped interest rates that are based on the borrower's or co-borrower's credit history. A recent CFPB report on private student loans revealed a wide range of variable interest rates in a sample of private loans originated between 2005 and 2011. Initial interest rates (start rates) ranged from 2.98% to 3.55% at the low end up to 9.5% to 19% at the high end. The Bureau determined that over time, those with the "strongest credits would have paid less than the [fixed unsubsidized] Stafford rate [6.8%], but the average (mean) PSL [private student loan] borrower whose loan was governed by 2011 loan margins would have never paid a lower rate than the Stafford rate. Those with highest rates would have paid between 13% and 20% interest based on historical rates" (CFPB, 2012).[2] Figure 2 demonstrates that **for those with lower credit scores, federal student loans provide much lower monthly payments than do private student loans.**

Figure 2.

Monthly Payment Comparison for Student Loan Borrowers With Lower Credit Scores: Federal Stafford vs. Private loans



Source: CRL calculations of monthly payments based on CFPB reported private loan interest rates, 10-year term

In addition to being significantly more expensive for most borrowers, the private student loans' uncapped adjustable rates make the overall cost of private loans difficult for students to anticipate, many of whom will not be entering the job market for several years. Private student loans present a great risk of payment shock, particularly those with the highest rates.

Unused Federal Loan Options

Although originally designed to supplement and provide needed funds for students who reached their maximum federal loan limits, today the private loan market also competes with existing federal programs. Since private student loans are generally more expensive and provide far fewer repayment

1 All direct federal loan rates are now fixed interest rate products ranging from 3.4% for subsidized Stafford loans to 7.9% for Direct PLUS loans (those for parents and graduate or professional students).
2 To compare the costs of adjustable rate private loans with the federal Stafford loan rates, the CFPB applied 2011 margins to historical rate data to simulate the interest rate that borrowers in different credit score ranges would have paid over time.

options than federal loans, it is in the best interest of the consumer to exhaust all federal loan options before taking out a private student loan. Unfortunately, **the CFPB study found that "more than 40% of PSL [private student loan] borrowers do not exhaust their Stafford loan eligibility" (CFPB, 2012).** These findings corroborate an earlier study by the Project on Student Debt (PSD, 2010) that found 25% of private loan borrowers in 2007-2008 took out no Stafford loans at all and 27% took out Stafford loans but borrowed less than the full amount.

Lack of Repayment Flexibility and Protections on Private Loans

Federal student loan programs include a variety of repayment options that are often unavailable to private student loan borrowers. Options on federal loans include the income-contingent repayment plan and the income-based repayment plan, both of which allow monthly payments to be calculated as a portion of the borrower's income. This helps ensure that a borrower can repay their loan without causing undue financial hardship. For borrowers who are unable to make their payments, the federal government offers two options: deferment, in which payment is postponed and interest charges can be waived; and forbearance, in which payments are postponed and interest continues accruing. Most private loans do not offer these types of repayment options, making it harder for borrowers facing financial difficulties to work out a payment solution and prevent default.

Private Student Loans Cannot be Discharged in Bankruptcy

Before 2005, private student loans generally were dischargeable in bankruptcy. Since then, private student loans have been dischargeable only for borrowers who can show that payment would cause "undue hardship" for them or their dependents—something that is exceedingly hard to prove. Private student loans are effectively non-dischargeable in bankruptcy and are treated the same way as child-support debts or criminal fines. The severe treatment of private student loan borrowers was justified as a way to make it harder for students to "abuse" the bankruptcy system, but there is no evidence that this is a real issue. Other provisions in the bankruptcy code, like counseling requirements and the means test, address the abuse concerns.

Questionable Financial and Educational Outcomes at For-Profit Institutions

Although still a small portion of the overall student population (nine percent of total enrollment), the for-profit post-secondary- education industry has enjoyed exponential growth over the last decade. This segment also consumes a disproportionate share of federal student aid and contributes disproportionately to U.S. student debt burden levels and default rates (Nguyen, 2012). In 2009–2010 for-profit institutions received $32 billion or 25% of total Department of Education funds and $280 million or 50% of the Department of Veterans Affairs total tuition assistance benefits. Meanwhile, default rates were over twice as high at for-profit institutions than at public colleges and universities. Several recent reports raise important questions about the investment of these public funds; the marketing and recruiting techniques of these institutions; and the educational, employment, and financial outcomes of those who attend these schools (see next section).

For-profit colleges consume a disproportionate share of federal student aid and contribute disproportionately to student debt burdens and default rates.

Note: Many servicing and collection practices produce problematic outcomes for student loan borrowers. These issues will be covered in the "Abuses in Debt Collection" section of State of Lending to be released in the first half of 2013.

IMPACT ON U.S. HOUSEHOLDS AND REMAINING CHALLENGES

Strong Growth of Student Debt

According to a recent poll, "more than three in four (76%) young adults say that college has become harder to afford in the past five years" (ICAS et al, 2011). The inflation-adjusted cost of tuition and fees at public four-year colleges and universities has increased 368% since 1981 and 277% at public two-year institutions. Over the past decade, year-over-year nominal dollar increases have averaged 5.6% (CBA&PC, 2011).

Another study found that "About 65% of students who earned bachelor's degrees in 2009–10 from the private non-profit four-year colleges at which they began their studies graduated with debt. Average debt per borrower was $28,100, up from $22,600 (in 2010 dollars), a decade earlier" (PSD, 2010). Graduating students are increasingly entering a challenging job market saddled with large amounts of debt. Students who have taken on debt but are unable to complete their programs face an even heavier financial burden, as they must pay the debt but do not have a degree that would allow for higher wages. Low-income students and students of color are even more likely to need to rely on student loans and to become saddled with large amounts of debt upon graduation. In 2008, 16% of African-American graduating seniors owed $40,000 or more in student loans, compared with 10% of whites, 8% of Hispanics, and 5% of Asians (PSD, 2010).

This debt can have long-term implications for these students for years to come, impacting everything from one's ability to purchase a home to retirement decisions. In fact, Americans 60 and older accounted for nearly five percent of past-due student loan balances (FRBNY, 2012).

Difficulty Assessing Financing Options

Unfortunately, many borrowers and families face a dizzying array of financial aid options—including grants, scholarships, federal loans, and private loans—and are often confused and unsure about their options. A recent survey of student loan borrowers with high debt levels found that about 65% misunderstood or were surprised by aspects of their student loans or the student loan process. In addition, the survey found, "about two-thirds of private loan borrowers, including those who took out both private and federal loans, said that they did not understand the major differences between their private and federal options" (Whitsett, 2012).

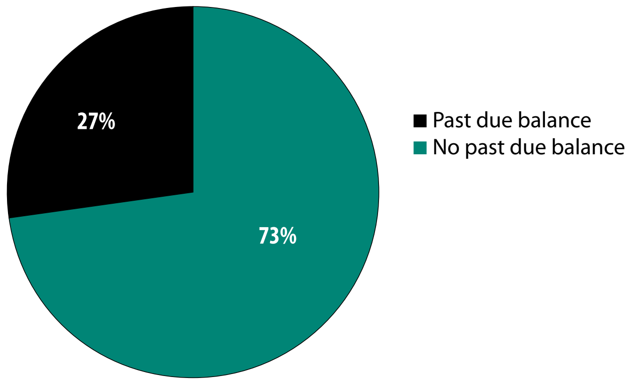
Until recently, little guidance on the financial consequences of those choices was available for students. Although efforts are underway to provide more financial education and greater transparency to the financial aid application and payment process, more work is needed.

Increased Loan Defaults

Higher unemployment and underemployment in recent years has pushed up default rates on student loans; after declining significantly during the 1980s and 1990s, they are once again on the rise. The Federal Reserve Bank of New York reported that, of the 37 million borrowers who have outstanding student loan balances as of third-quarter 2011, 14.4% or about 5.4 million borrowers, have at least one past-due student loan account. See Figure 3. But as the study points out, this figure represents the delinquent fraction of all outstanding student loan debt, including loans that have yet to enter the repayment cycle. In fact, almost half of outstanding debt has not yet entered repayment status. Of the 20 million borrowers that have entered the repayment cycle, 27% are past due (FRBNY, 2012).

Figure 3.

Delinquent Student Loan Borrowers in the Repayment Cycle (2011Q3)



Source: Federal Home Loan Bank of New York

Higher unemployment rates are driving some of the increase in student loan defaults; these are also growing because of higher dropout rates, particularly among for-profit college students.

- Rate of degree completion

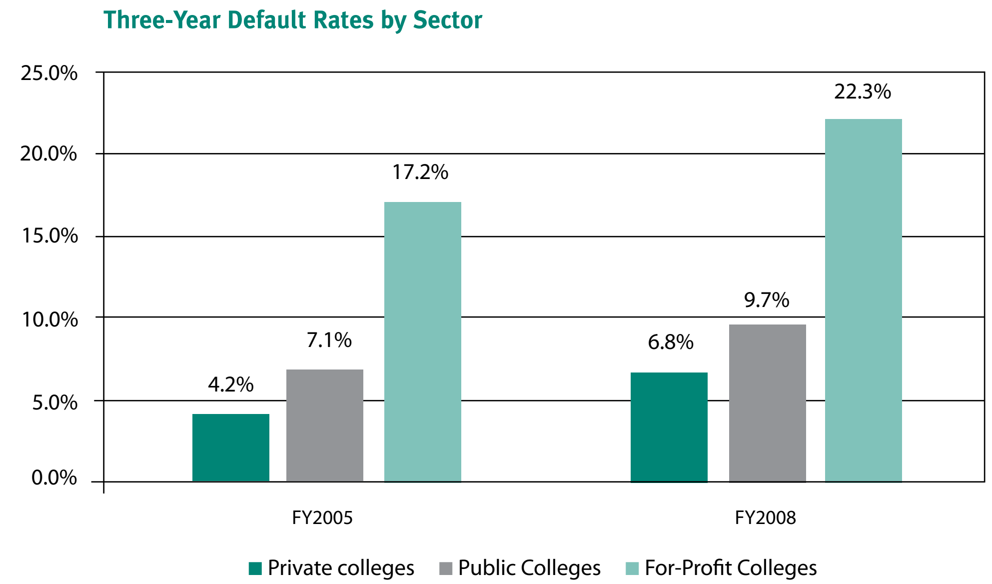
  Dropout rates have increased in recent years. Between 2005 and 2009, 29% of all student loan borrowers dropped out of college, up from 23% in 2001. Not surprisingly, borrowers who do not finish their degree are more likely to default on their student loans; one recent study found that "borrowers who dropped out were more than four times more likely than borrowers who graduated to default on their loans: 16.8% versus 3.7%" (Nguyen, 2012).

- Lower graduation rates and higher default rates at for-profit institutions

  Most students at for-profit colleges get little for their financial investment: the average bachelor degree graduation rate is a paltry 22 percent—one-third the level of not-for-profit colleges (Baum & Payea, 2011). It is small wonder that for-profit institutions have significantly higher default rates than either non-profit public or non-profit private institutions. The industry argues that they are reaching a more vulnerable population and therefore lower graduation rates and higher loan defaults should be expected. However, many policymakers and education advocates question both the educational commitment of these institutions and the cost of the financial burden faced by the majority of students attending these schools.

  In July 2012, the U.S. Senate Committee on Health, Education, Labor and Pensions (HELP) released *For Profit Education: The Failure to Safeguard the Federal Investment and Ensure Student Success* (HELP, 2012), reporting on a two-year investigation into the for-profit sector of higher education. The report found that despite accounting for less than ten percent of total enrollment, for-profit students nevertheless make up 47% of federal loan defaults (HELP, 2012). And the three-year default rates for for-profit colleges are two to three times higher than those for public and private non-profit schools, as Figure 4 demonstrates.

Figure 4.



Source: The Senate Committee on Health, Education, Labor and Pensions

In addition, for-profit schools are more expensive than public institutions with comparable programs. The Senate report found a larger share of revenue paid out in shareholder profits (19%) and marketing and recruiting (23%), while only 17% was spent on instruction (HELP, 2012). For-profit students are also more likely to borrow money and graduate with significant debt burdens. The Senate report found, "fifty-seven percent of Bachelor's students who graduate from a for-profit college owe $30,000 or more. In contrast, 25 percent of those who earned degrees in the private, non-profit sector and 12% from the public sector borrowed at this level" (HELP, 2012).

Note: Delinquency and default rates are also influenced by the policies and practices within the student loan servicing industry. This topic will be addressed in the "Abuses in Debt Collection" section of the State of Lending report, to be released in early 2013.

LEGISLATION AND REGULATION

Recent legislative and regulatory efforts have focused on such efforts as preventing fraud in Federal Student Aid programs, increasing the information available to help students make informed decisions regarding their financial aid options, and enhancing repayment options for student loan borrowers. In addition to the Senate HELP Committee report, Congress passed legislation in July 2012 extending the subsidized interest rates on student loans of 3.4% for 7.4 million borrowers for one year.

The current Administration and the CFPB have also come out with several initiatives in response to these policy challenges, including the following:

- The Department of Education established a negotiated rulemaking committee on Federal Student Aid programs focused on preventing the fraudulent use of such funds and improving and enhancing the administration of such funds, including to for-profit schools;

- The Administration introduced the Pay as You Earn plan to enhance borrower repayment options. Qualifying borrowers can now pay as low as ten percent of their monthly income towards their student loan; previously, the minimum was 15%. Loans can also be forgiven after 20 years of payments; previously, loan forgiveness took 25 years;

- The CFPB and the Department of Education issued a report on the private student loan market;

- The CFPB launched its Student Loan Complaint System to help inform the agency of student concerns and potential abusive practices in the student loan industry, documenting 2,900 complaints in seven months. In addition, the CFPB introduced its Financial Aid Shopping Sheet to increase student awareness and education of financial aid options for higher education.

STUDENT LOANS POLICY RECOMMENDATIONS

In order to confront the wide range of challenges that face student borrowers today, lawmakers and regulators will need to use a multi-faceted approach that addresses the cost of the financing and repayment options, simplifies the financial aid process and enhances borrower awareness, and holds educational institutions accountable. Continued cooperation among USED, CFPB, and other regulators is critical to ensuring that effective policies are adopted to address these challenges.

Require School Certification of Private Loans

Given the higher prices and greater repayment risks associated with private loans, students should be encouraged to exhaust their federal and state loan options before acquiring private student loans. Schools should be required to certify the need for and inform students of any untapped federal aid eligibility and the risks of private student loans.

Allow for the Discharge of Private Student Loan Debt in Bankruptcy Court

Congress should change the law so that private student loans are treated the same as any other unsecured consumer debt under the bankruptcy code.

Increase Oversight of For-Profit Education Institutions

Increase federal and state oversight of for-profit institutions, including restricting the use of federal funds for recruiting or marketing purposes, and increasing the percentage of non-federal funds that institutions are required to raise.

Increase Efforts to Help Students Make Wise Decisions about How to Pay for College and Improve Loan Counseling

The CFPB and the Department of Education have recently undertaken efforts to heighten borrowers' awareness of options on how to pay for school and how to compare the costs of attending different schools and different ways of paying for college. The CFPB and the Department of Education should test these tools and disclosures for effectiveness, with a particular emphasis on helping borrowers understand the difference between federal and private loans.

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