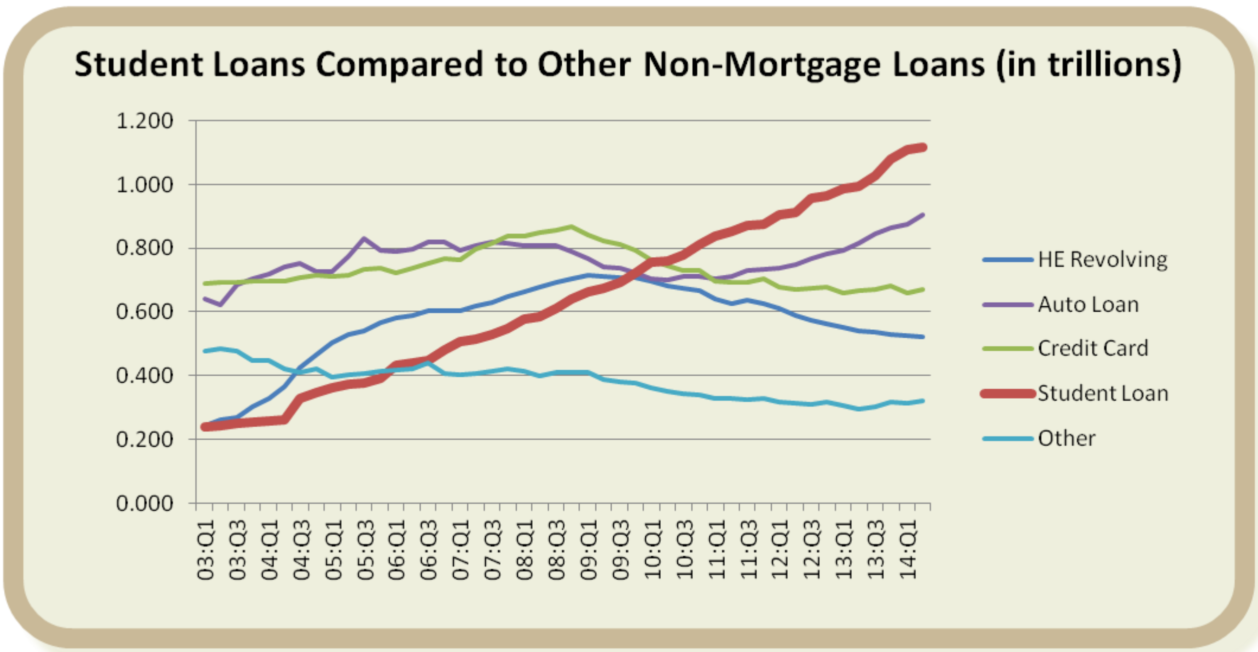
Student Debt

Being Smart about Student Loans

By Kevin Chambers

During the 2008 crisis, total American household debt fell. The amount of money borrowed for mortgages, car loans, credit cards, and home equity loans decreased. Only one type of loan increased: Student Debt.



Sources: New York Fed; Project on Student Debt, The Institute for College Access & Success

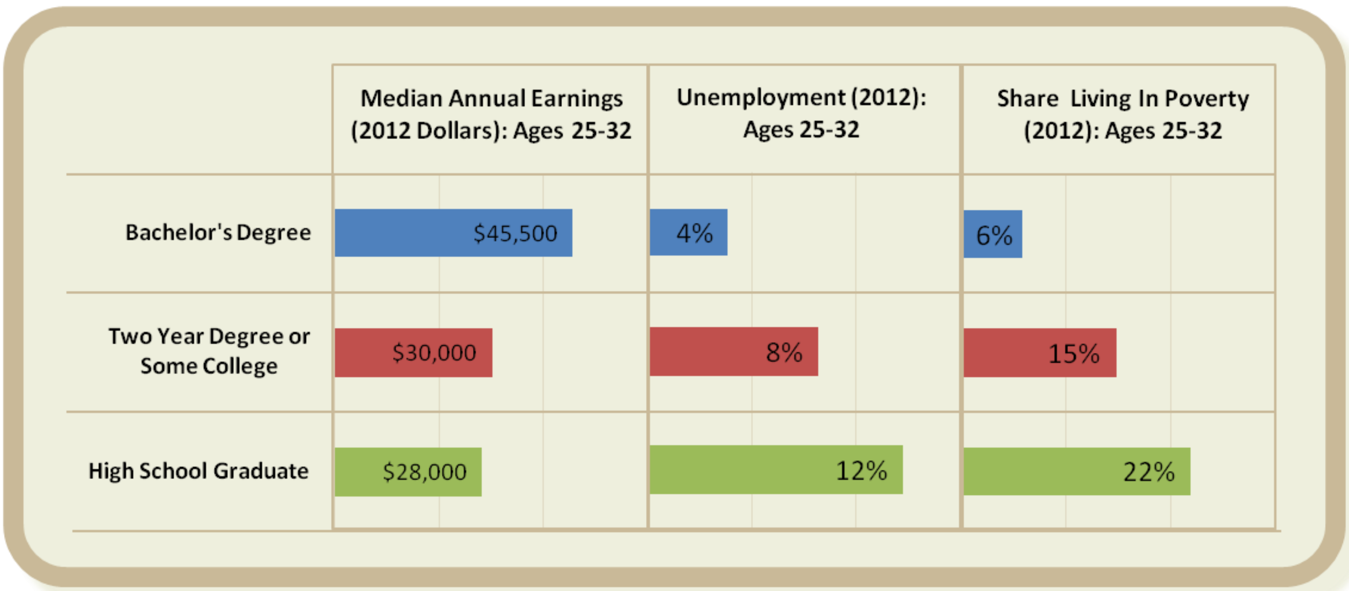
Student debt in 2005 totaled under $250 million, making it one of the smallest debt sectors in the country. Now, total student debt is $ 1.1 trillion, and is the largest non-mortgage source of debt. Each year, more American young people leave college with large student loans hanging over their heads. The average graduate in 2014 finished college with an average $33,000 in student debt (Izzo, 2014). Colleges and Universities are continuing to raise tuition, and students take on more debt to compensate. This is not a sustainable trend. Hopefully, there is a solution before the student debt bubble pops.

The Cost of Not Going to College

An important point not be overlooked in the student debt discussion is the fact that it is still pays to go to college. Average graduates with a bachelor's degree versus a high school education earn more ($45,500 vs. $28,000 on average), have lower unemployment rates (3.8% vs. 12.2%), and a lower percentage are living in poverty (5.8% vs. 21.8%). Further, those who have a bachelor's degree report that they are more satisfied in their job and value their education more (Pew Research Center, 2014).

The importance of a college education has been growing. In 1965, full time workers ages 25-32 with only a high school degree made on average $31,400, measured in 2012 inflation adjusted dollars. This was about 80% of what a college graduate made during this same time. For the Baby Boom Generation (ages 25-32 in 1979-1986), high school graduates made 72% of what college graduates made. The difference in 2013 was about 62% (Pew Research Center, 2014).

Additionally, the job market is more competitive for college graduates now than it used to be. Graduates in the class of 2013 looked for work for 27 weeks on average. A college graduate in 1979 on average would have found a job in under 12 weeks. Recent college graduates also are having more difficulty finding full time employment in a field that requires their college degrees. Over 45% of new graduates are working jobs where their degree is not required. Although this is a normal labor market trend to see in recessionary periods, the quality of jobs since 2008 has not rebounded as in past recessions (Abel, Deitz, & Su, 2014). The lowest 25% of college graduates average a yearly salary of less than $27,000, which is about the average salary for someone with only a high school diploma (Belkin, 2014).



Source: Pew Research Center

The choices that students make in college can have a big impact on their success after graduation. The choice of major can significantly change a student's chances of finding a job. For example: 75% of recent Engineering, Education or Health graduates are in jobs where a bachelor's degree is required. This is contrasted with Liberal Arts at 40%, Agriculture at 38% and Hospitality at 33% (Abel, Deitz, & Su, 2014). The Pew Research Center found that 29% of all graduates of undergraduate and graduate programs thought that a different major would have prepared them better for their ideal job. They also found that about 50% of all college graduates regretted not getting more work experience while in school. It is important for college students to look past their college experience and try to figure out what actions they can take in school to better prepare them for the job market. This means committing to a major early, choosing a major wisely, and looking for opportunities outside of school, such as internships and volunteering opportunities, to better the chances of finding a fulfilling and well-paying job.

Types of Loans

College tuition is expensive and increasing every year. Most people who go to a four year college graduate with student debt. Over 70% of graduates in 2014 had student debt. In comparison, the percentage was below half of the graduates in 1994 (Izzo, 2014). There are many different ways to borrow money for school. The federal government provides 92% of loans used to fund college education.

	Subsidized Stafford Loans	Unsubsidized Stafford Loans	Perkins Loans	PLUS Loans	Private Loans
Type	Federal Student	Federal Student	Federal Student	Federal Parent	Private
Loan Limit	$23,000 broken up by years	Total of $57,000 of Stafford loans	$27,500	Cost of school less financial aid	None
Start of Repayment	6 months after leaving	6 months after leaving	9 months after leaving	2 months after receiving	Vary
Interest	4.6%	4.6%	5%	7.2%	Vary
Special Notes	Government pays interest during school (certain restrictions)	Can allow interest to accrue and pay off after or make interest payments during school	Government pays interest during school	Can request repayments start 6 months after leaving	Non-federal financial aid

Stafford Loans

The most common type of loan is called a Stafford loan, which can be subsidized or unsubsidized. The main difference between subsidized and unsubsidized loans is that the federal government pays the interest on subsidized loans during periods of deferment, such as when the student is in school. By subsidizing loans, the federal government can make going to school a little less expensive. While subsidized loans are beneficial, unsubsidized Federal loans still make up over half of all federal loans issued.

The total Stafford loan amount, subsidized and unsubsidized, cannot surpass $31,000. There are exceptions to the maximum limits. For example, students whose parents are unable to attain PLUS loans can qualify for a maximum of $57,000 is Stafford loans.

PLUS Loans

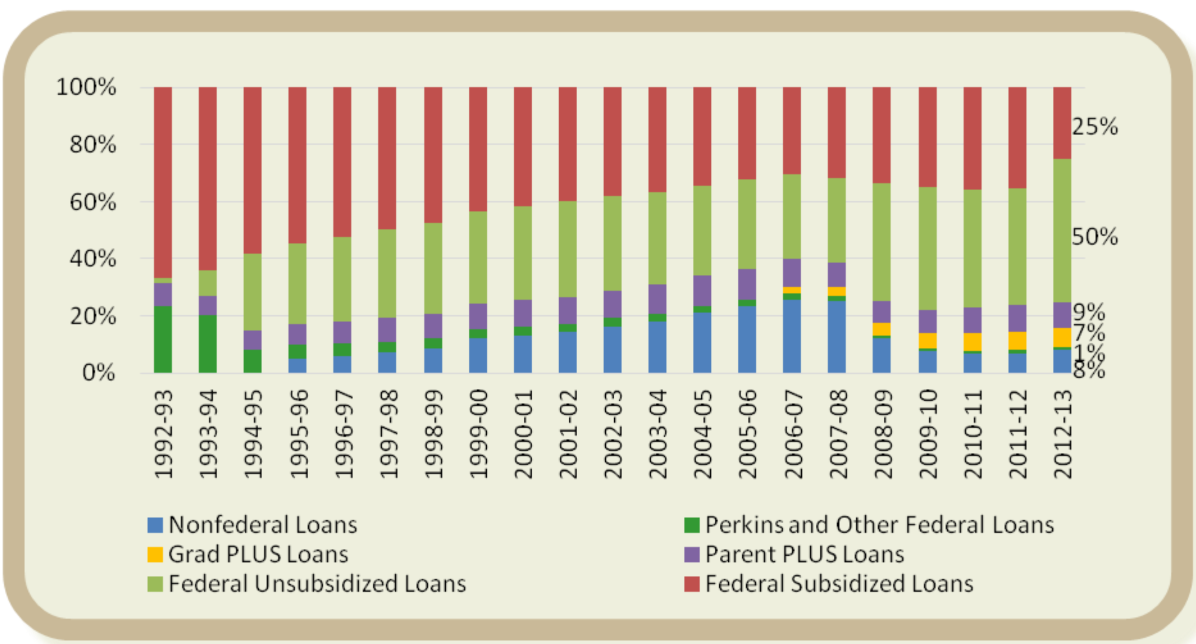
PLUS loans are either for parents of students or for graduate students. These loans have no borrowing limits and can be used to fund the entire cost of admission for a student (minus other aid). Interest rates on these loans are higher than either of the Stafford loans. For the 2014-2015 school year, the PLUS loans had an interest rate of 7.2%. PLUS loans make up about 16% of all loans used for education.

Perkins Loans

There is also a type of federal loan called a Perkins loan, which is for students who demonstrate exceptional financial need. Interest rate for this loan is 5%, but availability of funds is limited based on the college. Perkins loans make up only 1% of total loans currently.

Non-Federal Loans

There are also non-federal loans available. These are issued either by states, institutions, or private lenders. Non-federal loans make up about 8% of total loans. Their interest rates can vary, but are usually higher than even PLUS loans. Private loans usually have less flexibility on options for repayment, deferment, or forbearance. Private loans can be a good option for people that do not qualify for other types of loans.

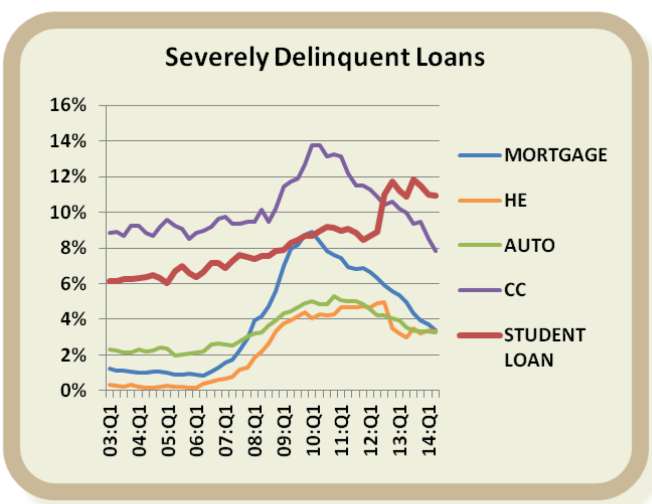


Source: College Board, Trends in Student Aid

Potential Student Loan Crisis

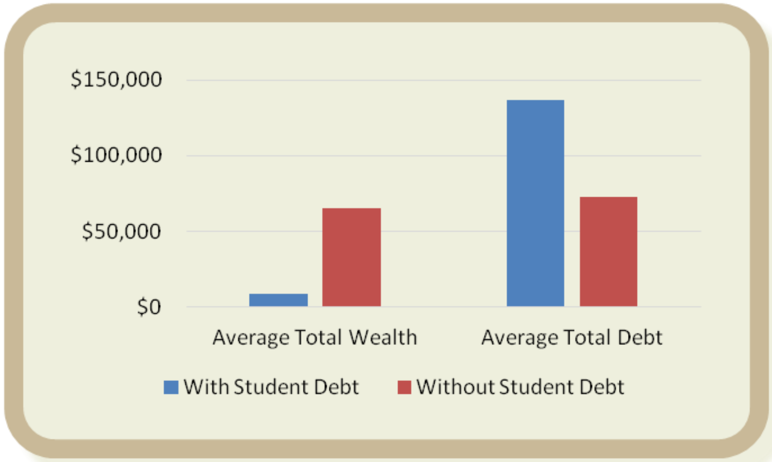
Young households (who are under age 40, have at least one college educated adult, and have no student debt) have accumulated on average over 7 times more wealth than those with student debt ($65,000 vs $9,000). Also, graduates with student debt are more likely to compound that debt and accumulate more. Looking at the same households, those with student debt have a median total indebtedness of about $137,000. Those households without student loans have a median debt load of about $73,000. Households with student debt have larger debts on cars and credit cards (Fry, 2014). Student debt loads also delay homeownership, reversing a trend. For the first time in 20 years, students without student debt are more likely to own a house at 30 then those with student debt (Brown & Caldwell, 2013). One major factor affecting home purchases is the large gap in credit ratings between graduates with student loans and those without them, due mostly to rising delinquencies on student loans (Mitchell, 2014).

Delinquencies on student loans are a growing problem. Recently, student loans have become the loan sector with the most loans that are severely delinquent, meaning they are over 90 days past due. They have surpassed mortgages for the first time in over 10 years.



Source: Pew Research Center

Currently around 11% of all student loans are severely delinquent. That is an equivalent of $123 million in loans that American students can't pay (Federal Reserve Bank of New York, 2014). Going into default is a serious problem for student loans. First, a student loan default is not forgiven in bankruptcy proceedings, so it stays on the credit reports for the rest of the borrower's life. Missing payments hurt the borrower's credit score, making it harder to apply for new loans. People who default on student loans can have tax refunds withheld, wages garnished, and the loan holders or collections agencies can sue the borrower's in court (US Department of Education, 2014). There are some programs that allow for deferment and forbearance; however, these are usually only for 12 month periods.



Source: Pew Research Center

Keeping Perspective

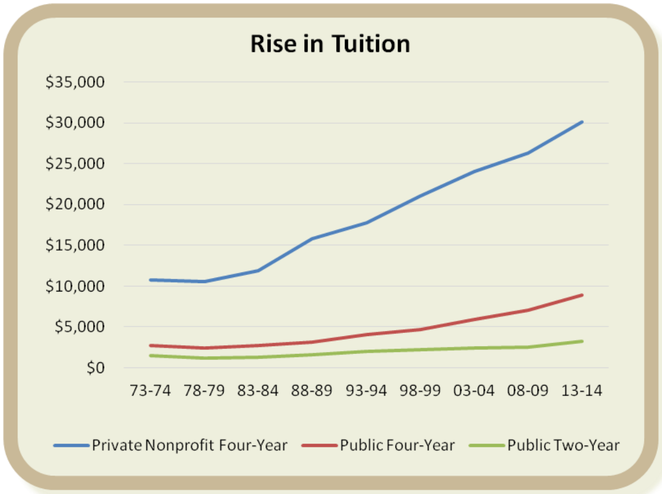
The Brookings Institute released a study in June of this year which argued that the recent increase in student debt is not necessarily an indication of a growing bubble at risk of popping. The study stated that about a quarter of the increase in student debt can be directly attributed to an increase in the number of students attending college and graduate school. They also found that the average household that has taken on debt from 1992 to 2010 has been more than compensated for the increased student debt loan by higher incomes. The study also reveals that more than half of the increase in student debt can be attributed to an increase in average college tuition. But, they are careful to point out that by taking on debt, students are still taking a risk. The average borrower comes out ahead on the student loan bet, but there are borrowers for whom loans don't pay-off, leaving them in a less than desirable situation. Basically, they showed that American student borrowers are no worse off than they were a generation ago (Akers & Chingos, 2014).

Despite this study, some troubling data is arising. It is possible that problems related to the recent rapid increase in student debt have not yet shown up in the data. There are surprisingly high rates of student loan ownership for higher risk subsets of Americans:

- 9% of Americans with only a high school education;
- 25% of students with less than 2 years of college;
- 15% of the unemployed;
- 23% of part-time employed; and
- 20% of Americans making under $25,000 a year have student debt (Ratcliffe & Mckernan, 2013).

While those Americans with the highest incomes hold the most student debt, low-income households have the largest student loan debt as a share of household income (Elliot & Nam, 2013). For households that own student debt, those in the lowest 20%, in terms of annual income, owe 24% of their income in student loans vs. 4.5% for the richest 20% (Fry, 2012). This means that those in a high risk subset who are not experiencing the higher incomes and more job security associated with the average student borrower are going to have a harder time paying off their loans.

Looking at history, the mortgage system collapsed on the backs of people who were given mortgages they could not afford. Hopefully, the bottom quartile of student loans won't bring down the whole student loan system.



Source: College Board, Trends in Higher Education

Breaking the Cycle

The cycle of funding annual tuition hikes with more student debt is unsustainable, pointing out the need for the higher education system in the United States be revamped. Hopefully, it will not take a catastrophic market solution to enact change. There are encouraging stories. Former Indiana Governor Mitch Daniels, now the president of Purdue University, has frozen tuition after 36 consecutive years of increases. He was able to enact the freeze mostly by making the school run more financially efficient. He combined the business techniques of systematic cuts, organizational realignments and cash incentives" (Belkin, At Purdue, a Case Study in Cost Cuts, 2014) to increase the value of a Purdue degree. Gov. Daniels is setting a precedent that other universities and colleges should follow.

Be Smart About Student Loans

For those high school juniors and seniors who are going to soon make decisions about what colleges and universities to attend, it is important to understand the costs and funding options. There are regulations from the federal government that require higher education institutions to provide consumer information to prospective students. One tool is called the "net price calculator," and it can be found somewhere on all college and university websites. It is a calculator that will ask questions about the prospective student and compare the cost of the college to other institutions. The net price calculator is required to be on the website for all Title IV institutions[1] website and needs to be found within three clicks.

Other useful tools for prospective students are the "College Scorecard[2]" produced by the US Department of Education College Affordability and Transparency Center and the "College Navigator[3]" produced by the Institute of Education Sciences at the National Center for Education Statistics. Both of these online tools offer information about the costs, net costs, financial aid rates and amounts, graduation rates, loan default rates, median borrowing costs, and other important information to have when deciding on a school.

Source: http://collegecost.ed.gov/

Avoiding Another Credit Crisis

By getting relevant information, making informed decisions, being smart about the loans that are needed, and making the most of the education, college students can limit the burden of student loans and lessen the risk of default.

Keep in mind, the burden of student loans can hurt the economy as a whole. Consequently, the growing amount of student debt should concern all Americans, not just those going to college. With the new tools available and heightened awareness of the danger of increasing student loans, we will hopefully see a reversal of this trend without a major credit crisis.

[1] A Title IV institution is an institution that has a written agreement with the Secretary of Education that allows the institution to participate in any of the Title IV federal student financial assistance programs.

[2] http://collegecost.ed.gov/scorecard/index.aspx

[3] http://nces.ed.gov/COLLEGENAVIGATOR/

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