Community Development Research Brief

Student Debt and Default in the 12th District

Federal Reserve Bank of San Francisco

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INTRODUCTION

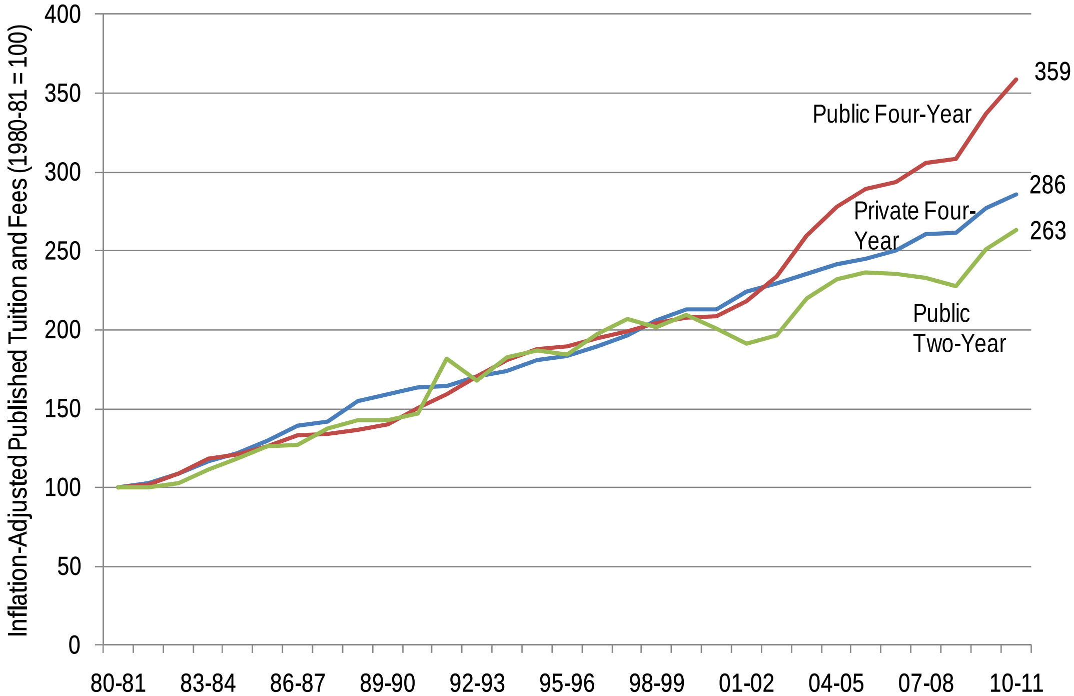
Postsecondary educational expenses and student loan balances have been trending steadily upward over the past two decades, but persistent unemployment and weak economic conditions have created an alarming new trend of rising student loan defaults. Recent graduates are facing severe unemployment or underemployment, making it difficult to fulfill their student loan obligations. Media reports are full of anecdotal evidence suggesting that students didn't fully comprehend the terms of their loans or that they mistakenly over borrowed, believing that a college degree was a surefire investment that would easily pay for it itself in the future.[i]

These stories are strikingly similar to those of overleveraged homebuyers during the subprime crisis, but unlike mortgages, student loans are very difficult to walk away from. There is no physical asset to foreclose upon and it is currently extremely difficult to discharge student loans through bankruptcy. This research brief examines broad trends in student loan borrowing and default in the Federal Reserve's 12th District, with an emphasis on students from low- and moderate-income (LMI) households. The rise of student debts and defaults has important community development implications as it directly impacts the present and future financial well-being of LMI individuals.

MEETING THE RISING COST OF COLLEGE

Increased educational attainment is a key factor in improving job prospects and future earnings for LMI individuals, but the increasing cost of college attendance poses significant challenges for LMI students and their families. Over the past thirty years, the cost of attending a public four-year college has more than tripled, and costs for private four-year and public two-year programs have more than doubled, after adjusting for inflation (see Fig. 1).[ii] However, family incomes and student aid programs have not increased at the same pace, requiring students to take on larger debt loads as a result.

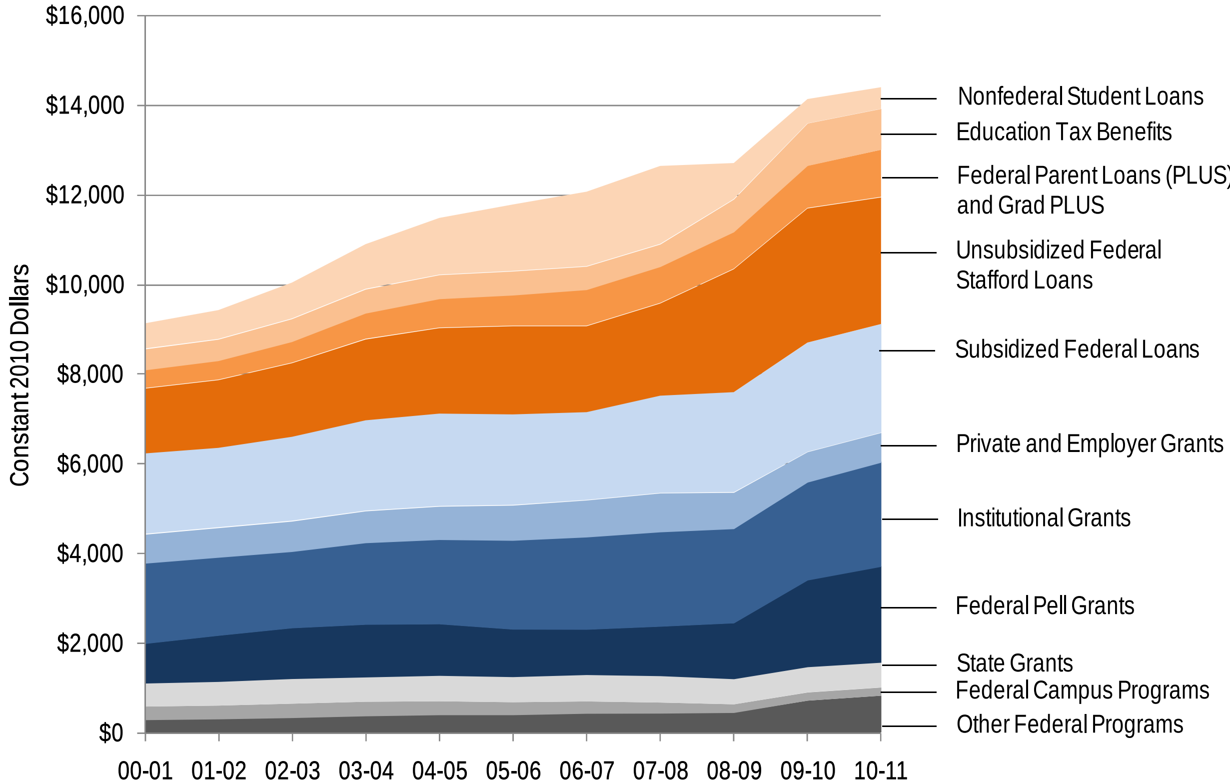
FIGURE 1 – CHANGE IN INFLATION-ADJUSTED PUBLISHED TUITION AND FEES, 1980-2011



Source: The College Board, *Trends in College Pricing 2010*

As seen below in Fig. 2, total annual postsecondary education expenses per full time equivalent (FTE) student have increased from roughly $8,800 in 1999-00 to $14,400 in 2010-11 (values are in constant 2010 dollars).[iii] Total grant aid, which includes Federal Pell grants, state grants, institutional grants, and private and employer grants, grew 48 percent from 2000-2001 to 2010-2011 ($3,844 to $5,690). Total loan financing, which includes unsubsidized and subsidized federal Stafford loans, federal parent loans and Grad PLUS loans (see Fig. 3 for a description of different types of federal student aid), as well as nonfederal (private) loans, increased 61 percent over the same period ($4,225 to $6,783). Thus, while both types of student aid increased over time in terms of absolute dollars, the proportion of overall expenses financed by debt increased at a faster rate than grant aid.

FIGURE 2 - STUDENT AID AND NONFEDERAL LOANS PER FTE STUDENT USED TO FINANCE POSTSECONDARY EDUCATION EXPENSES, 2000-01 TO 2010-11



Source: The College Board, *Trends in Student Aid 2011*, Figure 1.

FIGURE 3 – TYPES OF FEDERAL STUDENT AID

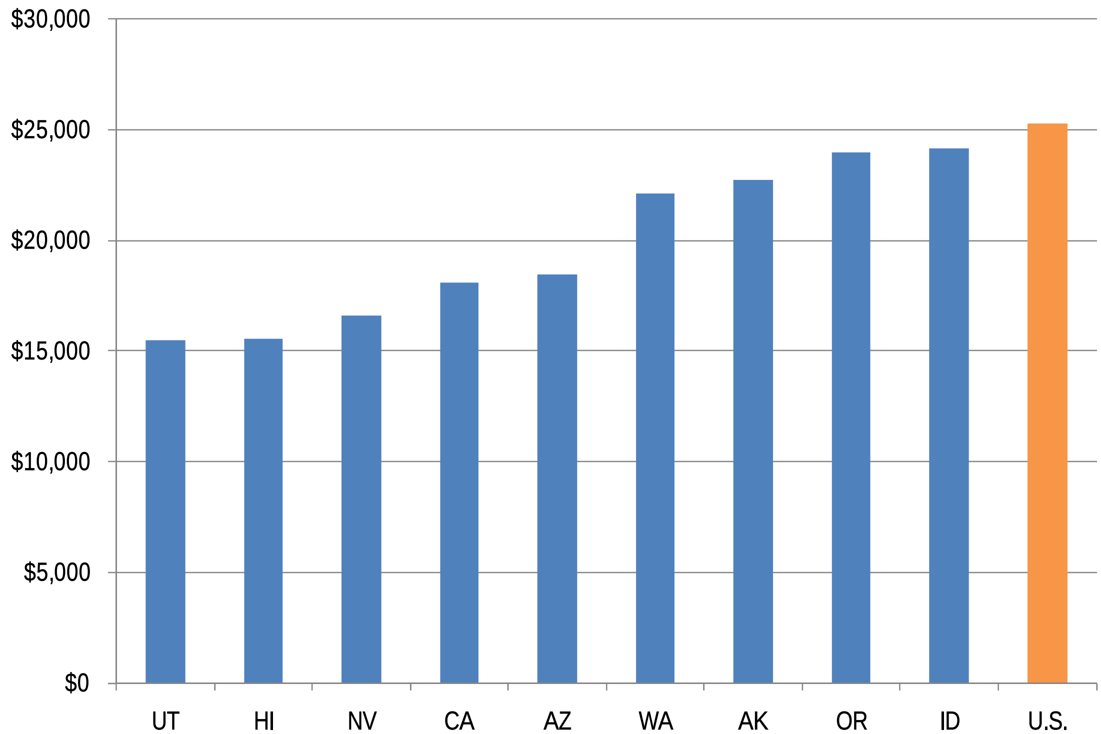
Type of Aid	Description
Pell Grant	Need-based federal grants to low-income undergraduate students to promote access to postsecondary education.
Subsidized Stafford Loan	Federal loan for which the government pays interest while the student is in school; borrower must demonstrate financial need.
Unsubsidized Stafford Loan	Federal loan with no government subsidy (student pays all interest); borrower does not need to demonstrate financial need.
Perkins Loan	Campus-based loan for students with exceptional financial need. The school acts as the lender using a limited pool of funds provided by the federal government.
Parent Loan for Undergraduate Students (PLUS)	Federal loan which allows parents to borrow money to cover any costs not already covered by the student's financial aid package.

Source: FinAid.org

GROWING DEBT BALANCES AND INCREASED RISK

Within the Federal Reserve's 12th District, average student debt balances for recent graduates from four-year public and private nonprofit colleges (among those who borrowed money) ranged from a low of roughly $15,500 in Utah to a high of $24,200 in Idaho (see Fig. 4 below).[iv] All of the 12th District states reflect average debt levels, among students who borrow, below the national average of $25,250. At the national level, states in the Western region tend to have lower than average debt levels, which may be related to the fact that Western states have a larger share of students attending lower-cost public four-year colleges than other regions (students in the Northeast and Midwest attend higher-cost private nonprofit colleges in greater proportions).[v]

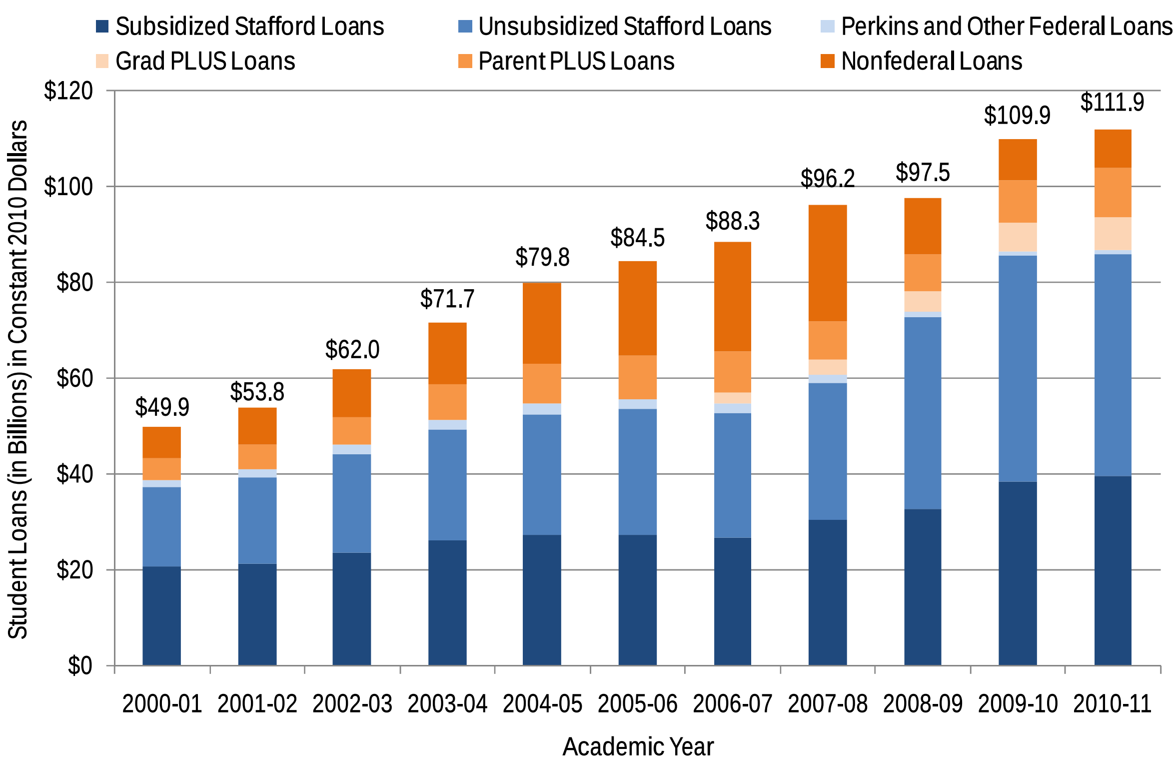
FIGURE 4 – AVERAGE DEBT OF GRADUATING STUDENTS WHO BORROWED MONEY, CLASS OF 2010, 12TH DISTRICT



Note: Reflects recent graduates from four-year public and private nonprofit colleges
Source: Project on Student Debt

Examining national trends over time, we can see that total annual student loans have steadily increased over the past decade (both from increased enrollments and increased costs), from $49.9 billion in 2000 to $111.9 billion in 2011, in constant 2010 dollars.[vi] As seen below in Fig. 5, the composition of total loans has shifted over time. Subsidized Stafford loans, which are need-based and for which the federal government pays accrued interest while students are enrolled in school, decreased as a proportion of total loans, from 41 percent in 2000-2001 to 35 percent in 2010-2011. In contrast, unsubsidized loans, which are more costly to students as the interest accrues from the time the loans are disbursed, increased from 33 percent to 41 percent over the same period.

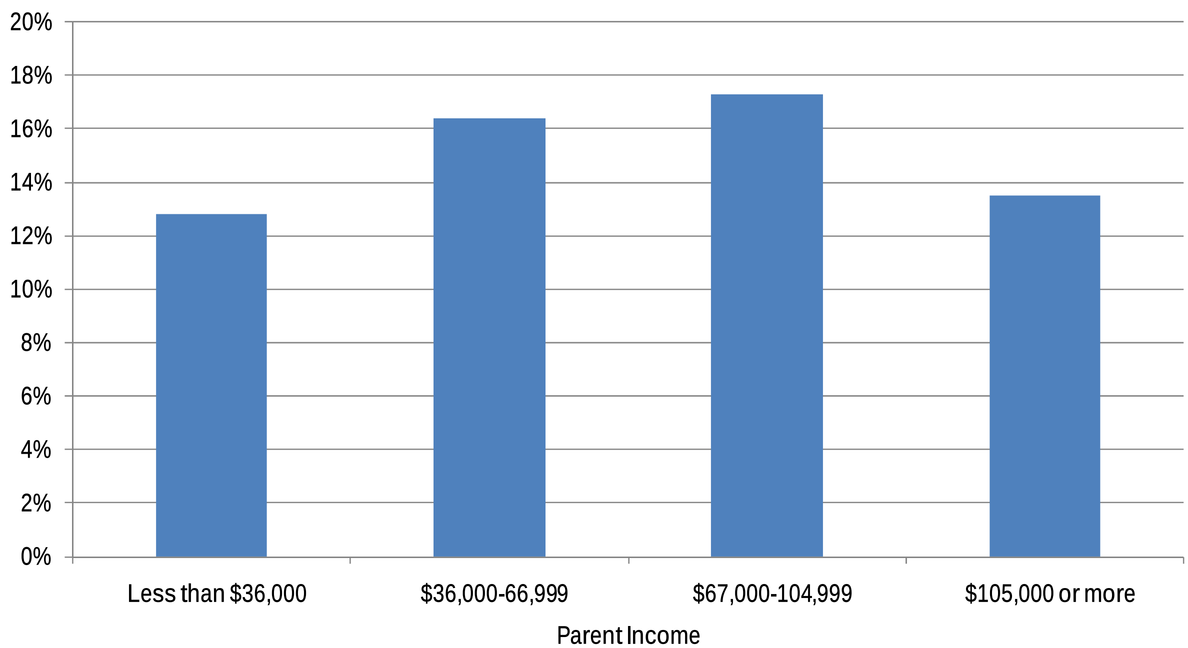
FIGURE 5 - GROWTH OF STUDENT LOANS, 2000 TO 2010 (CONSTANT 2010 DOLLARS)



Source: The College Board, *Trends in Student Aid 2011*

While federal loans make up the majority of student borrowing, there are limits to how much money students can borrow under federal loan programs; the remaining "unmet need" to cover total educational expenses are often financed through private loans.[vii] These private loans often carry higher interests rates and less favorable terms than government loans. For example, federal loans have fixed rates with set caps, limits on origination fees, and flexible repayment options. In contrast, private loans are more likely to have higher variable rates, no caps on origination fees, and strict repayment rules with few options for distressed borrowers.[viii] As seen in Fig. 2, the share of private loans increased rapidly from 2000 through 2007, consistent with the broader trends of easy credit during the housing boom. At their peak, private loans made up 26 percent of the total student loans in the 2006-2007 academic year, for a total of $22.6 billion. As Fig. 6 shows, students whose parents earned less than $36,000 accessed private loans at roughly the same rate as students whose parents earned more than $105,000 for the 2007-2008 school year. Private loan activity began to diminish in 2008, consistent with tighter credit conditions across all sectors, but they still accounted for $7.9 billion in 2010-2011.

FIGURE 6 - PERCENT OF FULL-TIME UNDERGRADUATES RECEIVING PRIVATE STUDENT LOANS BY PARENT INCOME, 2007-2008



Note: Data represent parental income of dependent students
Source: U.S. Department of Education, National Center for Education Statistics, 2007-08 National Postsecondary Student Aid Study

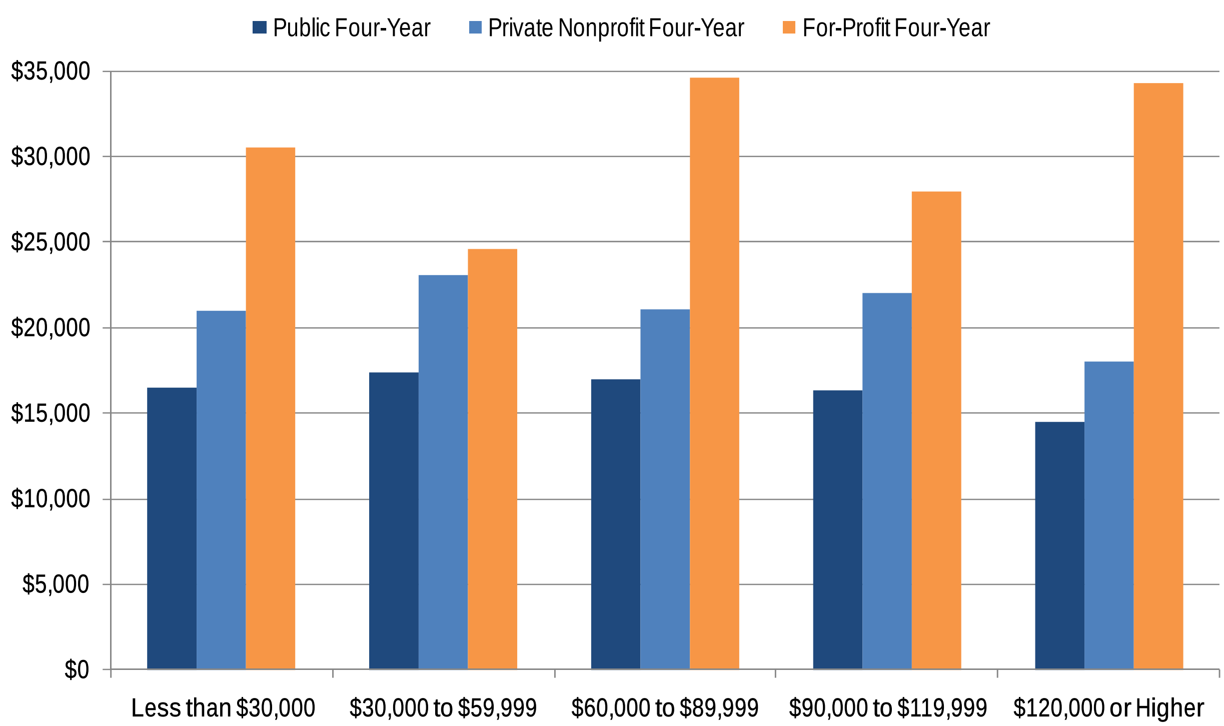
These trends of rising college costs, larger debt loads, and shifts to higher cost student loans are particularly concerning as they relate to students from LMI households. These students are especially vulnerable as they must borrow a larger proportion of funds relative to family income than their higher-income peers in order to finance their education, but are less likely to be able to rely on family assistance to repay educational debt. As seen in Fig. 7, the relative cost of postsecondary education is more burdensome for lower-income households.[ix] A family at the bottom income quintile would be required to pay more than 70 percent of family income to cover college costs, after accounting for grant aid. In contrast, families earning at the highest and second highest income quintiles would be required to pay 14 percent and 21 percent of family income to cover college costs after grant aid, respectively. As Fig. 8 shows, lower-income students carry median total debt levels similar to their higher-income peers.[x] Median debt tends to vary more by the type of institution than student family income, again indicating that lower-income students face a larger debt burden, relative to income, than their higher-income peers.

FIGURE 7 - POSTSECONDARY EDUCATION COSTS BY FAMILY INCOME, 2007 (IN 2007 $)

Family Income	Average Income	Cost of Attendance	Expected Family Contribution (EFC)	Grant Aid	Unmet Need After EFC and Grant Aid	Percent of Income Required to Pay for College After Grant
$0 - 30,200	17,011	22,007	951	9,704	11,352	72%
$30,201 - 54,000	42,661	23,229	4,043	7,694	11,493	36%
$54,001 - 80,400	67,844	23,640	10,224	5,352	8,064	27%
$80,401 - 115,400	97,594	25,050	18,158	4,554	2,339	21%
$115,401 +	173,474	27,689	37,821	3,822	-13,953	14%

Source: The Education Trust

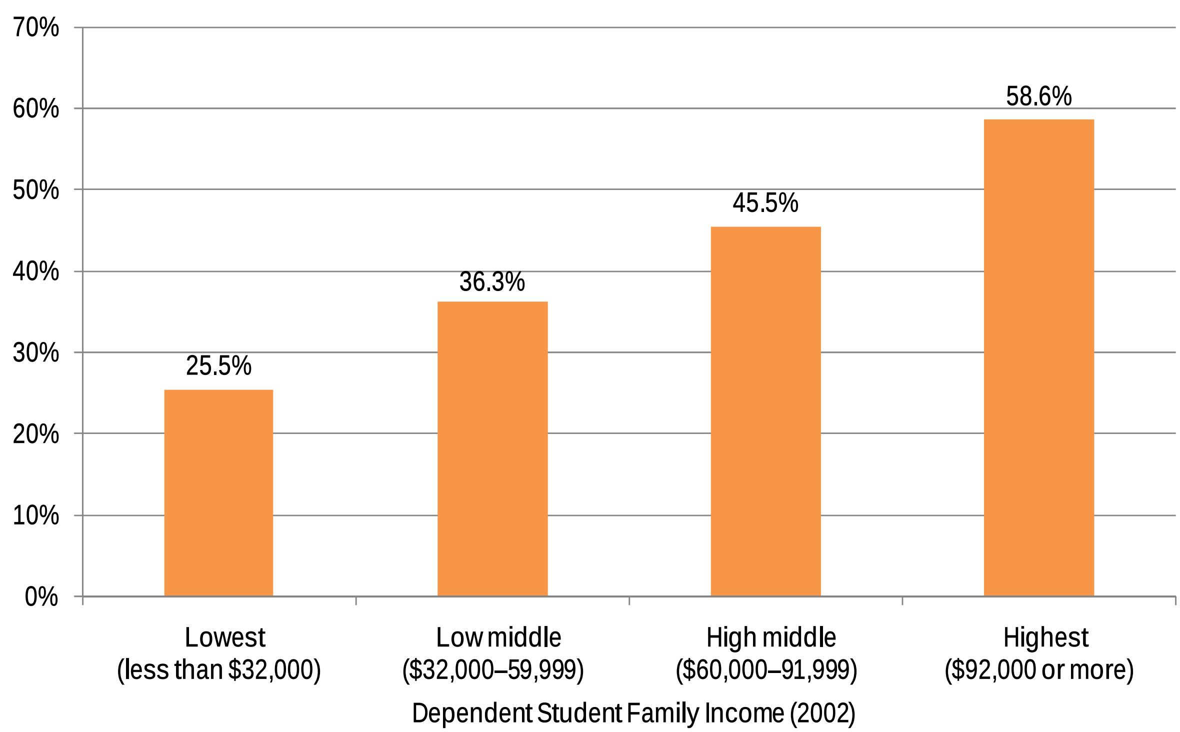
FIGURE 8 - MEDIAN DEBT LEVELS OF 2007-08 BACHELOR'S DEGREE RECIPIENTS WHO BORROWED BY FAMILY INCOME AND TYPE OF INSTITUTION



Source: The College Board, *Trends in Student Aid 2011*

In addition, another cause for concern is the negative relationship between family income and degree attainment, as seen in Fig. 9.[xi] Among students from the lowest family income group (less than $32,000) who first enrolled in 2003-2004, 25.5 percent received a bachelor's degree by spring 2009. In contrast, 58.6 percent of students from the highest income group (more than $92,000) received a bachelor's degree by spring 2009, more than double the rate among the lowest-income students. LMI students tend to have more risk factors than their higher-income peers for postsecondary attrition, including being older, less likely to receive financial support from parents, and more likely to have multiple obligations outside college, like family and work, that limit their full participation in their educational experience.[xii] A full exploration of the barriers to college completion among LMI students is beyond the scope of this paper, but the pattern of LMI students carrying similar debt burdens to their higher-income peers, but attaining bachelor's degrees at half the rate, is troubling. Students borrow money to finance their education based on the assumption that a college degree will provide better paying jobs, but far too many LMI students have taken on unmanageable student debt, with no degree to boost their future earnings.

FIGURE 9 –BACHELOR'S DEGREE ATTAINMENT BY FAMILY INCOME (SIX-YEAR ATTAINMENT RATE BY SPRING 2009)



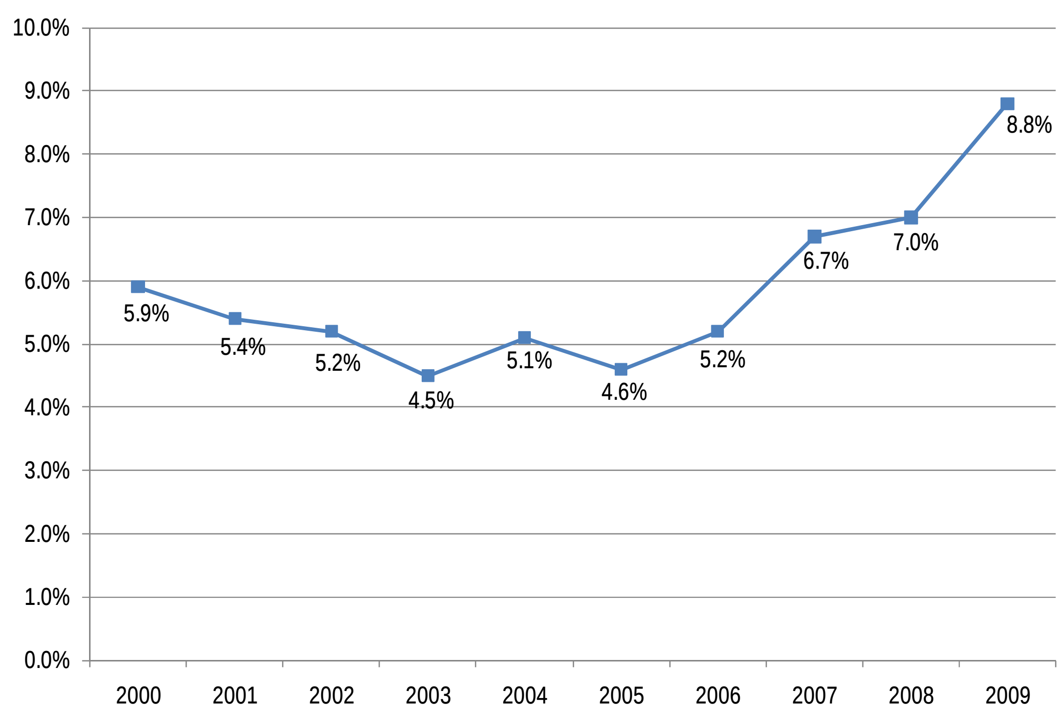
Note: Degree obtained within six years of first enrollment in 2003-2004.
Source: U.S. Department of Education, National Center for Education Statistics.

INCREASING DEFAULT RATES

High debt levels coupled with a historically weak labor market have created unfavorable conditions for student borrowers. An increasing number of students are falling behind on loan payments and defaulting. Students facing default are still legally obligated to repay their loans in full, or risk severe consequences, including: federal and/or state tax refunds may be offset to repay defaulted loans; additional collection costs may accrue if a private collection agency gets involved; the individual may be subject to Administrative Wage Garnishment, requiring an employer to forward 15 percent of disposable pay toward loan repayment; and credit bureaus may be notified, negatively impacting the student's credit rating.[xiii] In addition, if the loans were taken out with any cosigners, often a student's parents, these individuals will also be liable for repayment in the case of default. For LMI students and their parents, who may be struggling to get by on limited incomes, the consequences of default can be particularly troublesome.

Figure 10 depicts national student loan default rates for federal loans, which have been steadily increasing over the past few years.[xiv] The Department of Education reported a 2009 cohort default rate of 8.8 percent (meaning that 8.8 percent of borrowers who entered repayment in the 2009 fiscal year defaulted by the end of the 2010 fiscal year).[xv] At the national level, more than 3.6 million borrowers from 5,900 schools entered repayment during the 2009 fiscal year, and more than 320,000 defaulted.[xvi]

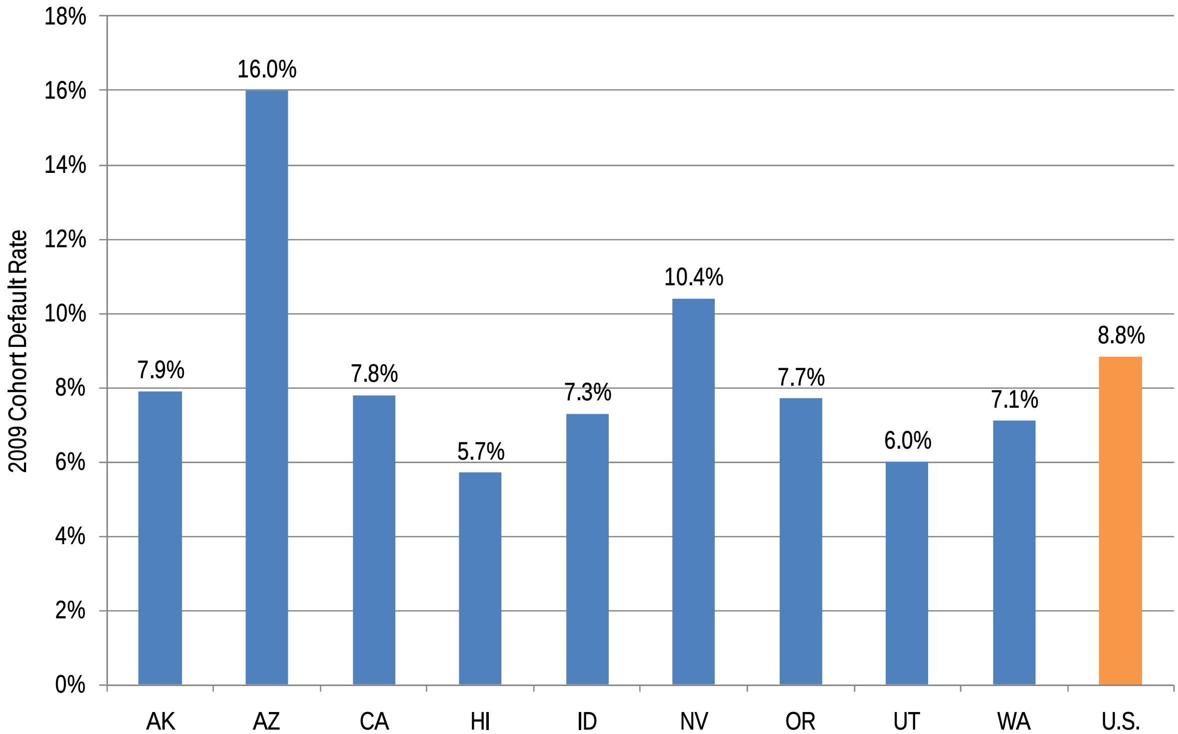
FIGURE 10 - NATIONAL STUDENT LOAN DEFAULT RATES, 2000 – 2009 COHORTS



Source: Department of Education

Taking a closer look at the 12th District in Fig. 11, we see that these states had 2009 cohort default rates generally below the national rate of 8.8 percent. The notable exceptions were Nevada, which had a default rate of 10.4 percent, and Arizona, which had the nation's highest default rate of 16 percent.

FIGURE 11 – 2009 COHORT DEFAULT RATES, 12TH DISTRICT STATES



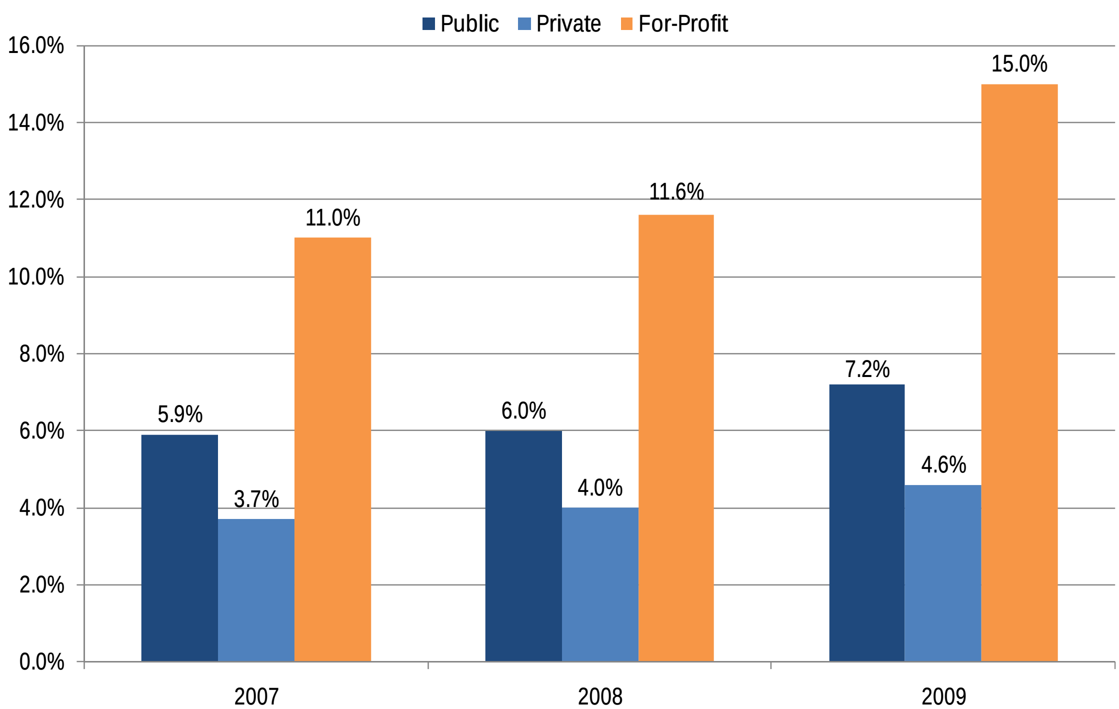
Source: Department of Education

Department of Education officials said one possible reason for the unusually high numbers in Arizona could be the presence of for-profit colleges. "What makes the state of Arizona unique is that it's the home of the University of Phoenix," said the Education Deputy Undersecretary James Kvaal, in a phone conference to discuss the recent cohort default data.[xvii] The University of Phoenix has a large national presence with campuses across the country, but the Department of Education reports default rates at the institution level (thus, the institution-wide default rate is attributed to Arizona, where the school's administrative offices are located). However, further research is required to make any sort of definitive statement about the impact of for-profit colleges on default rates at the state level.

At the national level, default rates at for-profit colleges are roughly double those at public colleges, and triple those at private nonprofit colleges (Fig.

12).[xviii] The default rate for the 2009 cohort was 15 percent at for-profit colleges, and 7.2 percent and 4.6 percent at public and private nonprofit colleges, respectively. In addition to higher overall default rates, for-profit colleges have also seen larger increases in their default rates over time. The default rate at for-profit colleges increased 36 percent from 2007 to 2009; over the same period, the rates at public and private nonprofit schools increased 22 percent and 24 percent, respectively.

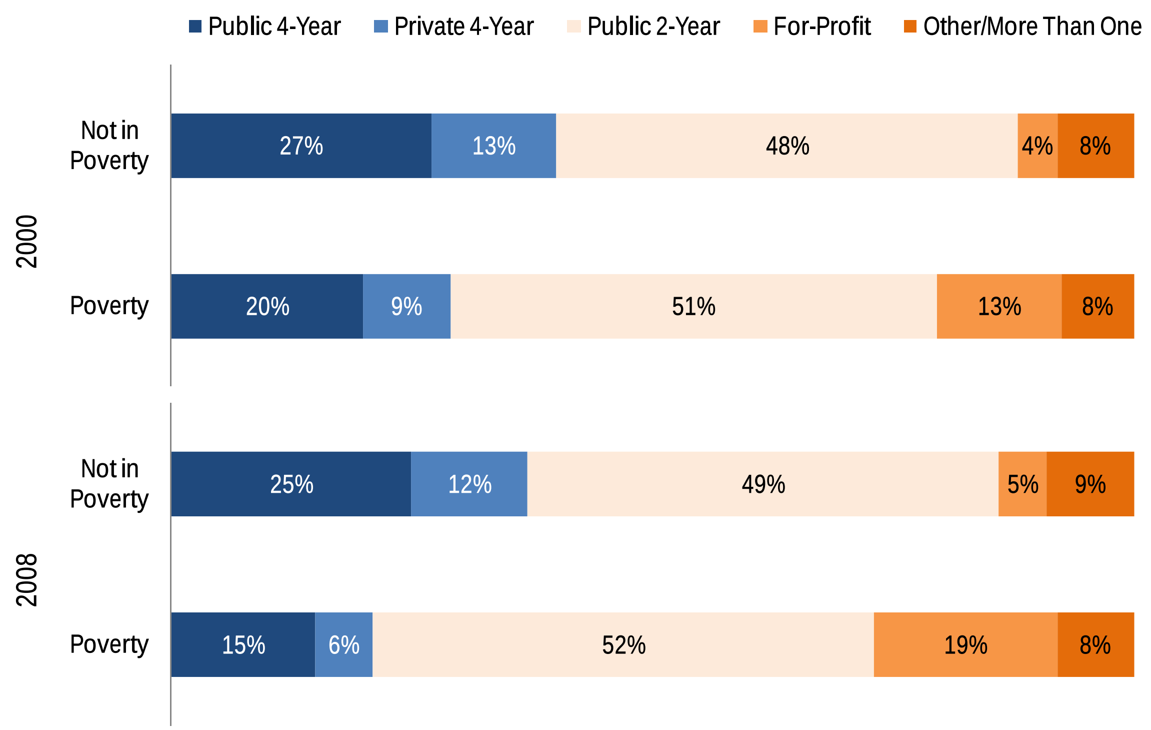
FIGURE 12 – FEDERAL STUDENT LOAN DEFAULT RATES BY INSTITUTION TYPE, 2007-2009



Source: Department of Education

The incidence of higher default rates at for-profit colleges is particularly concerning for low-income students, who are overrepresented at these types of institutions. In 2008, the overall percentage of first-year college students attending for-profit colleges was eleven percent.[xix] However, as seen in Fig. 13, when broken down by poverty status, the data show that 19 percent of students in poverty attend for-profit colleges, almost four times the rate of students not in poverty (at 5 percent).[xx] In addition, enrollment patterns have changed over time, with for-profit colleges seeing an increase in the share of students in poverty. In 2000, 20 percent of students in poverty attended public 4-year colleges and 9 percent attended private 4-year colleges. By 2008, these proportions decreased to 15 percent and 6 percent, respectively. However, over the same period, enrollment of students in poverty at for-profit colleges increased from 13 percent to 19 percent.

FIGURE 13 - PERCENTAGE OF FIRST-YEAR COLLEGE STUDENTS BY POVERTY STATUS AND INSTITUTION TYPE, 2000 AND 2008



Source: Institute for Higher Education Policy

CONCLUSION

The rise of student debt and default is concerning, particularly as it relates to low- and moderate-income students, who are more likely to borrow larger amounts relative to family income and less likely to complete school once they've started than their higher-income peers. Investments in postsecondary education remain a key element of increasing opportunity and future economic stability for LMI young adults, but unmanageable debt repayment requirements can undermine these gains. Additionally, the heightened attention on student loans and the difficulty of repayment may have the less visible consequence of discouraging academically qualified LMI students from pursuing higher education altogether. Low-income students tend to be more debt-averse than higher-income students, and this aversion, heightened by the current environment, may act as an additional barrier to college-access.[xxi] As such, greater emphasis needs to be placed on educating students about different forms of student aid, particularly the availability of federal grants and subsidized loans, and the implications of different loan options and terms.

A variety of federal efforts are underway to help students manage their educational debt, and greater awareness of these efforts is necessary to increase their utilization. Some of these efforts include:

- **Income-base repayment (IBR) plan:** In 2010, President Obama proposed an improved IBR plan, which Congress enacted, allowing student loan borrowers to cap their monthly payments at 15 percent of their discretionary income. Beginning July 1, 2014, the IBR plan is scheduled to reduce that limit from 15 percent to 10 percent of discretionary income.[xxii]
- **Student Debt Repayment Assistant**: The Consumer Finance Protection Bureau (CFPB) released the Student Debt Repayment Assistant, an online tool that provides borrowers, many of whom may be struggling with repayment, with information on income-based repayment, deferments, alternative payment programs, and much more.[xxiii] The Student Debt Repayment Assistant is available at http://www.ConsumerFinance.gov/students/repay
- **"Know Before You Owe" Financial Aid Shopping Sheet:** The CFPB and the Department of Education have introduced the "Know Before You Owe" project to develop a financial aid disclosure form. This form makes the costs and risks of student loans clear, before students have enrolled, outlining their total estimated student loan debt, monthly loan payments after graduation and additional costs not covered by federal aid.[xxiv]

In addition to debt management programs, efforts to increase college affordability, such as strengthened support for Pell Grants and investments in community colleges, and asset building programs such as college savings initiatives are an integral part of improving access for LMI students to higher education. Student loans will continue to play a major role in the financing of postsecondary education and, similar to efforts in the mortgage industry, the risks and long term consequences of educational debt must be understood upfront. Investments in education remain the surest path to financial stability and social mobility for LMI students, and the community development field should continue to push for improvements in college access, affordability, attendance and completion.

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[xxiv] Ibid. Visit http://www.consumerfinance.gov/students/knowbeforeyouowe/ to provide user feedback on the proposed disclosure form.