

Student Lending's Failing Grade

BY CRISTIAN DERITIS

The student lending industry managed to avoid many of the pitfalls that affected mortgages, auto loans and credit cards during the Great Recession. In fact, volume growth has been steady, if not accelerating, as more individuals sought additional education and training in response to the weak labor market, and as lenders did not tightened standards to anywhere near the degree of other segments. The performance of student loans in recent years has barely changed; delinquency and loss rates on outstanding student loan balances remained steady throughout the recession. While this may sound positive, it is concerning in light of the strong balance and account growth, which would typically push delinquency rates down. In addition, performance of other consumer loan segments has significantly improved as the economy has recovered; performance of student loans has not. In this study, we examine the rapid growth of the student loan industry over the past few years, the weakening performance of loan portfolios, and what these trends suggest for future performance and lending volumes.

The boom in student lending

Dollar balances on student loans grew persistently at double-digit rates throughout the last decade (see Chart 1). Although the year-over-year growth rate has slowed in the last two years, it remains high at above 10%, bucking the trend of balance declines that has occurred across all other consumer lending segments.

During the middle of the last decade, the structure of federal subsidies and falling interest rates led lenders to push borrowers

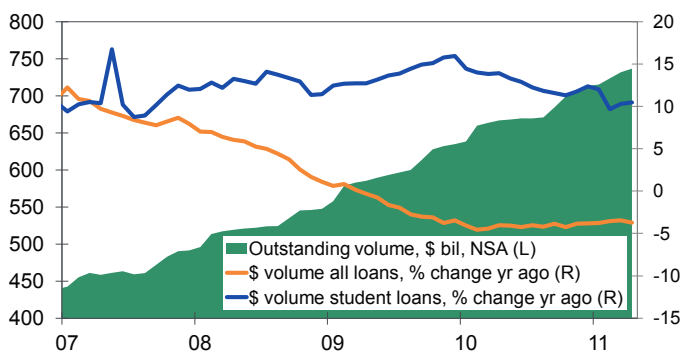
to refinance and consolidate their loans. A borrower with several loans could consolidate them into a single loan at a lower rate, raising his or her average balance but not the total debt level (see Chart 2). The rules changed in 2008 when the government began lending to students directly rather than through private lenders. As a result, Sallie Mae and other lenders stopped offering consolidation loans.

The growth in the number of accounts outstanding has been robust in recent years,

although not much greater than the growth in balances, resulting in relatively constant average balances. However, significant regional differences exist, with individuals in California and the Northeast carrying higher average student loan debt burdens than those in other parts of the country (see Chart 3).

Using consumer credit report data collected by Equifax, we note that new origination volumes have continued to rise nationally over the past two years (see Chart 4). But there are strong regional

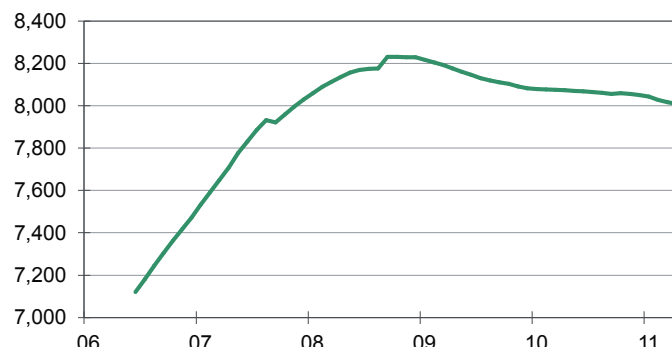
Chart 1: Student Loans Balances Keep Growing



Sources: Equifax, Moody's Analytics

Chart 2: Average Debt Levels Rise and Stabilize

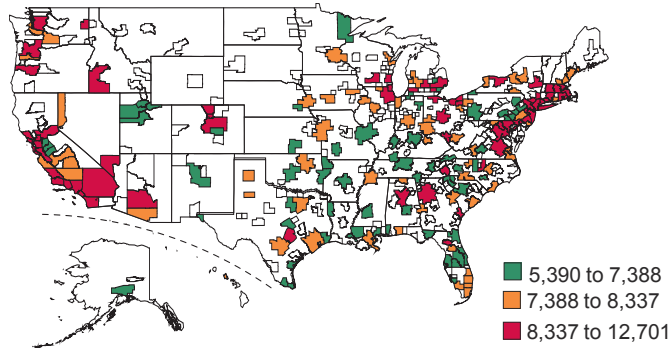
Outstanding \$ volume per loan, 12-mo moving avg



Sources: Equifax, Moody's Analytics

Chart 3: Balances Are Highest in the Northeast

Outstanding \$ per account, Apr 2011, NSA



Sources: Equifax, Moody's Analytics

differences; the Southeast and Mountain regions are growing quickly while coastal California and many areas in the Northeast and upper Midwest are growing more slowly (see Chart 5). In many ways, this pattern is simply a reflection of the more robust economic growth of commodity- and agriculture-dependent states and the sharper recessions experienced in the southeastern and western parts of the country. However, more recent data suggest that the correlation between unemployment and loan growth during the recession is fading, with declines in the volume growth rate slowing across the board. Given the rising levels of debt and persistently poor employment prospects for new labor market entrants, some students and their families are re-considering the value of a college education and are taking a look at other options offered by public universities, community colleges and proprietary schools.

Rapidly rising tuition

Student lending differs from other consumer lending products in several fundamental ways. First of all, much of the demand for student loans is driven by demographics, as roughly 40% of high school graduates go on to seek some form of higher education (see Chart 6). As the size of the 16- to 24-year-old age cohort has grown, so too has demand for educational services and the student loans to finance the cost of education.

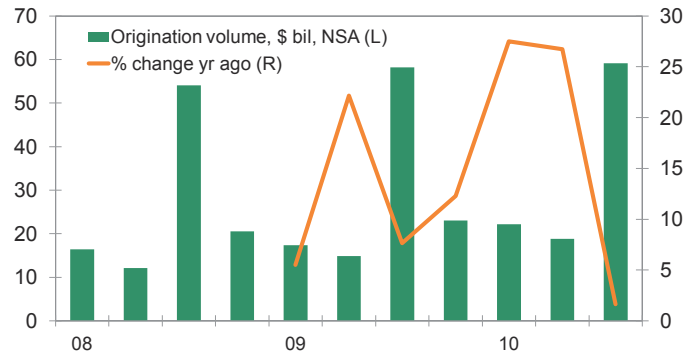
In addition to the number of college-aged students, demand is driven by the cost of education, which has grown at an extraordinary rate over the past three decades. Based on CPI data, the cost of tuition and fees has more than doubled since 2000, outstripping the inflation rate across all goods as well as the growth rates of energy, housing and healthcare costs (see Chart 7). Despite all of the attention that house prices receive, it is noteworthy that even during

the housing bubble, real estate appreciation was far exceeded by the growth rate in tuition. Fears of a bubble in educational spending are not without merit.

While college costs have outpaced overall inflation by a significant margin, financial aid policies at universities and other schools play a large role in determining how much students will actually have to borrow. These aid decisions are highly dependent on the economic cycle and government policies, with more emphasis placed on direct aid when endowments are performing well or government grants are available. At other points in the cycle, students are steered toward larger loans. During much of the last decade, colleges steered students to ever larger loans given declines in the value of their endowments and the abundance of relatively cheap credit provided by government and private sources. With booms in the equity markets

Chart 4: New Loan Originations Growing

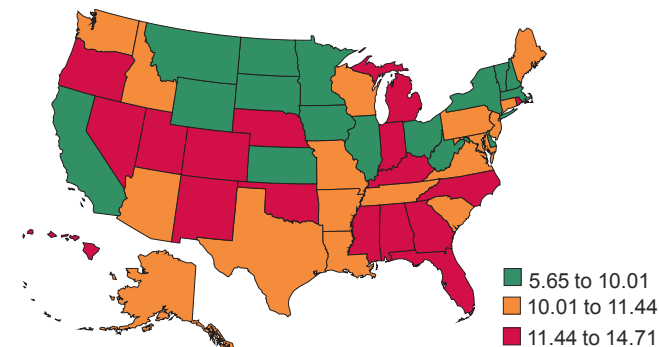
By vintage of origination, \$ bil, NSA



Sources: Equifax, Moody's Analytics

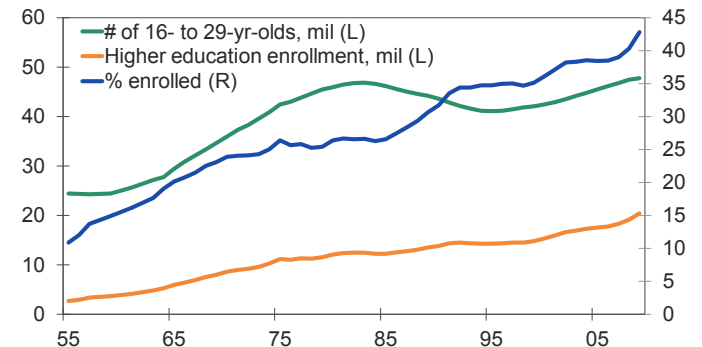
Chart 5: Balances Rising in the Southeast

Outstanding \$ balances, Apr 2011, % change yr ago



Sources: Equifax, Moody's Analytics

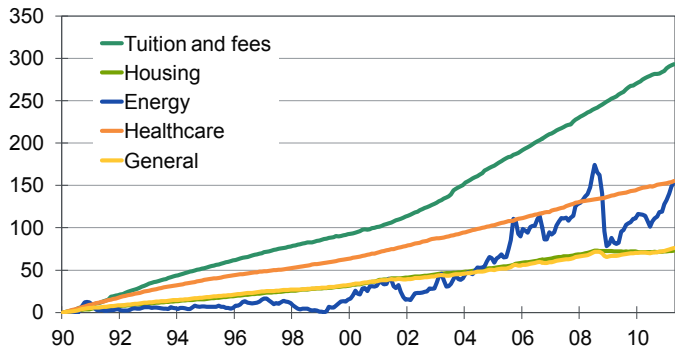
Chart 6: Higher Education Enrollment Rises



Source: Census Bureau: Digest of Education Statistics

Chart 7: Tuition Vs. Other Price Indices

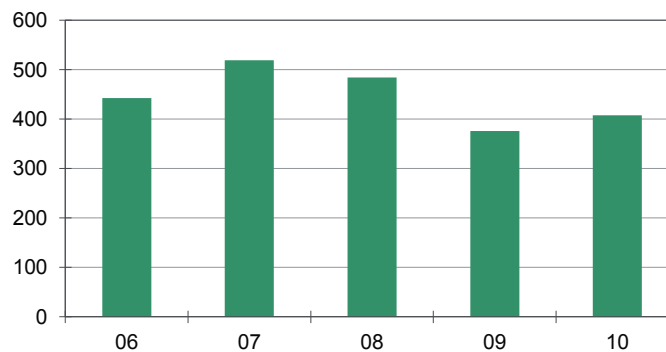
CPI, cumulative % change since 1990



Sources: BLS, Moody's Analytics

Chart 8: College Endowments Recover Slowly...

\$ mil



Source: NACUBO, Endowment Study

as well as the robust labor market of past years, many students believed they would be able to easily pay back their debts. With the onset of the recession, student loans continued to remain in high demand, though more grants and scholarships were used by schools to assist a broader segment of students.

Economics of education

Demand for education typically runs counter to the economic cycle. When faced with poor job prospects, many people choose to invest in education in the hope that the combination of additional training and the passage of time will improve their employment prospects. Under normal conditions, this is a reasonable response that helps to strengthen the recovery once it takes hold. However, during a protracted period of economic weakness, this motivation can weaken. A weak job

market for recent college graduates will discourage younger students from making the investment, or to at least consider more inexpensive colleges and take on smaller debt burdens.

Consumers' reduced willingness to take out loans is likely the prevailing catalyst for the moderation in balance growth from its peak in late 2009, although tighter lending standards, especially for unsubsidized loans, may also be constraining growth. With the cost of education continuing to rise rapidly, the value of schools' endowments still well below their peaks, and state funding to universities being cut, students are being asked to shoulder an even larger share of tuition and fee increases (see Charts 8 and 9). Unless job market uncertainty turns around quickly, the outlook on school enrollment and consumers' desire to borrow to fund their educations will further weaken.

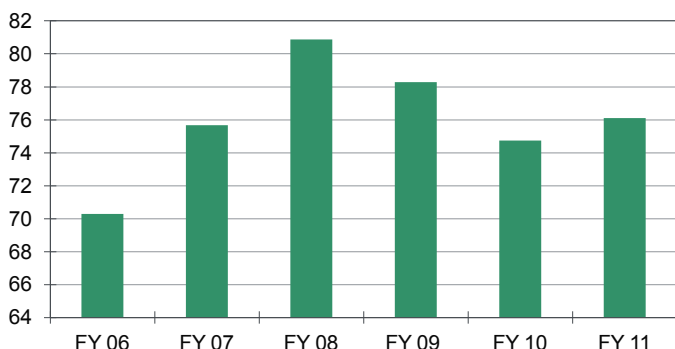
For-profit schools expanding

Aside from rising demand and higher tuition costs, another reason behind the expansion in student lending has been the rapid increase in for-profit schools. Though enrollment at for-profit institutions still represents less than 10% of total enrollment, growth has more than tripled over the past decade (see Chart 10). Vocational schools as well as on-line colleges such as the University of Phoenix and Kaplan University have grown rapidly in recent years to cater to high school graduates as well as older students in offering courses for individuals requiring flexible schedules.

The growth of the private sector has been a result of the need to meet additional demand, as well as aggressive marketing. High-quality proprietary schools can provide a social good by asserting some competitive pressure to keep tuition costs at traditional public and private institutions in check. At issue, however, are the abysmally low gradu-

Chart 9: ...As Does State Support for Colleges

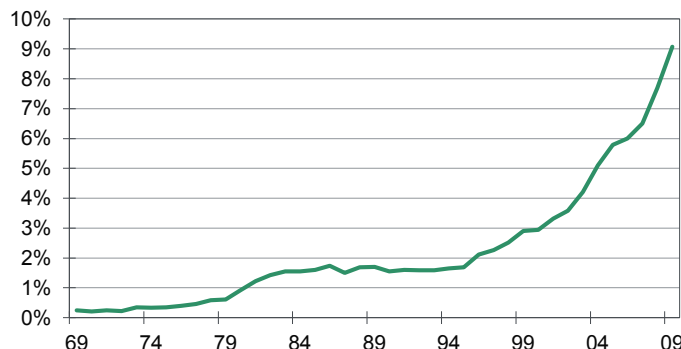
\$ bil



Source: Illinois State University's Center for the Study of Education Policy

Chart 10: Enrollment Rises at For-Profit Schools

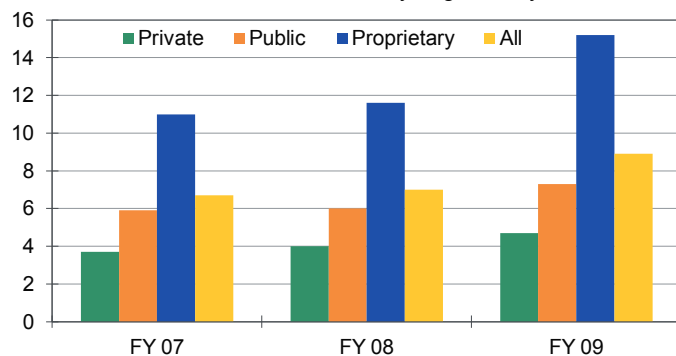
% of total enrollment at higher education institutions



Source: NCES, Digest of Education Statistics 2010

Chart 11: Default Rates at For-Profits Explode

Cumulative % of loans that defaulted by origination yr



Source: Information for StudentAid Professionals (IFAP)

ation rates at many of these institutions. In addition, many of the degrees offered tend to be in fields with lower demand or do not carry the same value as a degree from a traditional not-for-profit university. The failure of many students enrolled at these institutions to complete their degrees is detrimental, as students will have incurred additional debt without significantly improving their employment or income prospects. Unfortunately, many individuals are finding that they would have been better off had they never enrolled in the first place as evidenced by the extremely high default rates experienced by students at these institutions as compared with more traditional institutions (see Chart 11).

Many proprietary schools have been able to grow their bottom lines as a result of the availability of government grants and loans. To date the federal government did not make a significant distinction between students attending proprietary versus traditional schools in determining student eligibility for financial aid. With little oversight of student performance, schools had an incentive to enroll as many students as possible to tap into government funding. Given the low graduation rates and extremely poor performance of loans to students at for-profit schools, Congress and the Department of Education are now investigating enrollment practices at for-profit institutions and will be instituting guidelines and regulations to curb abusive practices. This could limit the growth of institutions in the short run but may improve the long-term prospects of schools that can meet the higher standards.

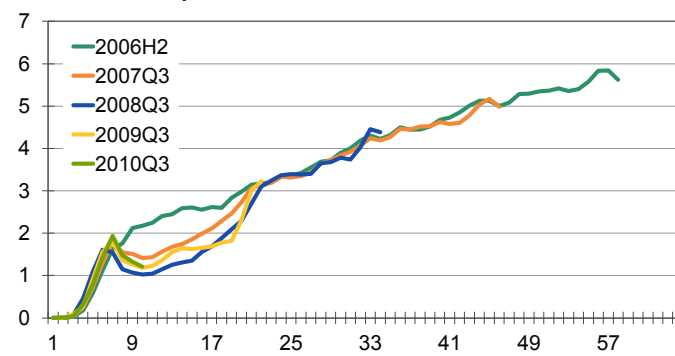
In addition to the rise of the proprietary education industry, private student lending has grown substantially over the past two decades. Historically, a private student loan was intended to provide a small amount of bridge financing as a student transitioned to working life by providing funds to cover a final semester's tuition or job search expenses. However, the balances on such loans have grown enormously and have often been used to finance general consumption rather than education-related services. Unlike other unsecured personal loans, lenders have found these loans to be much more lucrative because student debt is extremely difficult to discharge in a bankruptcy proceeding as a result of the Bankruptcy Reform Act of 2005. Thus, student loan obligations can continue to weigh heavily on individuals' balance sheets for many years.

Government intervention

Government policies regarding student loans dramatically impacted the market during the Great Recession. Throughout the financial crisis, the government stepped in to keep credit flowing—unlike other segments in which credit became very difficult to obtain—and as a result of the changes in subsidies, incentives for private lenders shifted. The largest change to the industry happened last year when the government ended the 45-year-old Federal Family Education Loan Program and announced that it would be originating all subsidized lending directly beginning with the current school year. While the exact implications of this

Chart 12: Delinquency Rates by Vintage Worsen

% of \$ volume, by mo on book, NSA



Sources: Equifax, Moody's Analytics

are unclear, primary lenders will be affected, as they will no longer be able to collect the lucrative fee income they were able to earn under the FFELP.

Another potential implication of the change is that borrowers may have an easier time getting deferments and delaying payments during times of financial stress. The government may also shift more borrowers to income-based payments rather than typical amortization plans to minimize the financial burden of student loans. This has the potential to reduce default rates, although balances may increase as distress loans remain active for a longer period of time. Delinquency rates may also rise as distress borrowers take longer to default or cure, which is being born out in the data (see Chart 12).

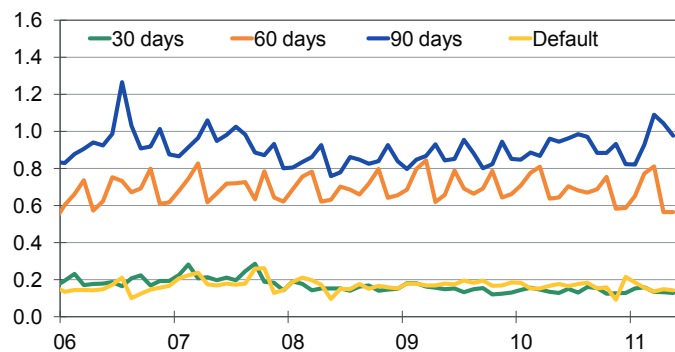
Persistently high delinquency rates

With new student loan originations rising in recent years, increases in delinquency rates have been smaller than in any other consumer credit segment. Indeed, the dollar delinquency rate was not consistently above its year-ago level until the start of 2009. The account-based delinquency rate has risen for an even shorter period, rising consistently starting only in 2010 with small increases continuing this year. Most of this increase was in later-stage delinquencies, while early-stage delinquency categories such as 30- or 60-day delinquencies never rose consistently (see Chart 13).

Delinquency and utilization rates tend to follow similar geographic patterns as volume growth (see Chart 14). Performance is worse

Chart 13: Delinquencies Show No Improvement

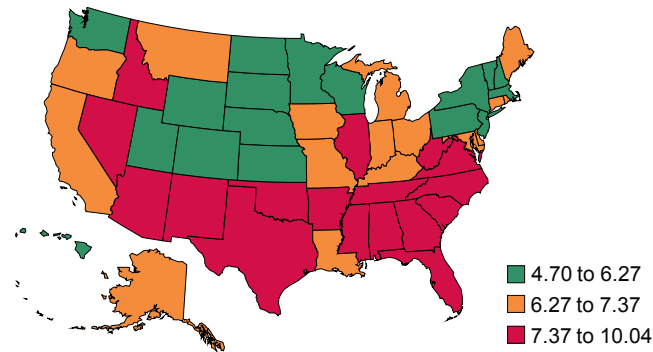
% of total loans delinquent, by days past due, NSA



Sources: Equifax, Moody's Analytics

Chart 14: Delinquencies Highest in the South

% of #, Apr 2011, NSA



Sources: Equifax, Moody's Analytics

in the southern half of the country, while lower rates have been observed in northern states and California. Aggregate default rates were relatively flat through the recession and during the current recovery but have moved up modestly of late (see Chart 15). They remain low because defaults carry significant costs for borrowers relative to other loans including the possibility of not receiving tax refunds and other government checks if the loans were subsidized. Even Social Security checks can be garnished in the event on failure to payment. In addition, default rates may remain low, as it is easier for borrowers to receive deferments than for most other loan segments.

Unlike other loan segments, recent student loan originations are performing worse than those originated during the lending boom. Tighter lending standards on auto loans, credit cards and mortgages during the recession have resulted in sharply improved

performance than earlier vintages, even with the unemployment rate hovering around 9%. But default rates on student loans originated since the middle of 2008 are higher than vintages originated in 2006 or 2007 at similar times in their life cycles (see Chart 16).

The worsening performance of student loans reflects the fact that student loan origination standards were not tightened as they were for other types of consumer loans. Part of this may be because the federal government ensured that lenders had funds to lend to students throughout the recession. With no supply constraints and a federal guarantee taking losses in the event of a default, lenders had little need to curtail their lending and every incentive to expand it. This permitted borrowing to remain robust at the cost of poorer performance.

While other forms of consumer lending depend highly on the borrower's current income streams and prior credit history in de-

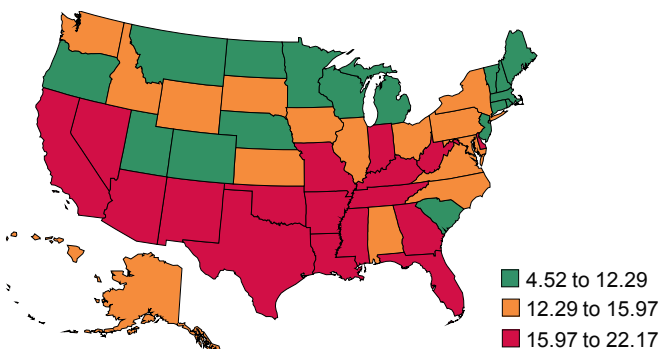
termining creditworthiness, student lending is a more speculative. Borrowers and lenders alike hope that the higher income resulting from the human capital investment justifies the cost of the loan. This has not been the case for recent graduates thus far but could turn around quickly if and when the economy fully re-engages.

Demographic forecast

In forecasting the future of the student lending industry, we must first consider the future demographic shifts in the college-age population. The population aged 16 to 29 years began growing more rapidly than average in 2008 after a three-year period of below-average growth. Growth is projected to peak this year before slowing dramatically; it should remain above average until late 2012 and begin to decline in 2014 (see Chart 17). In addition, the share of high school graduates who continue to pursue

Chart 15: Write-Off Rates High in South, West

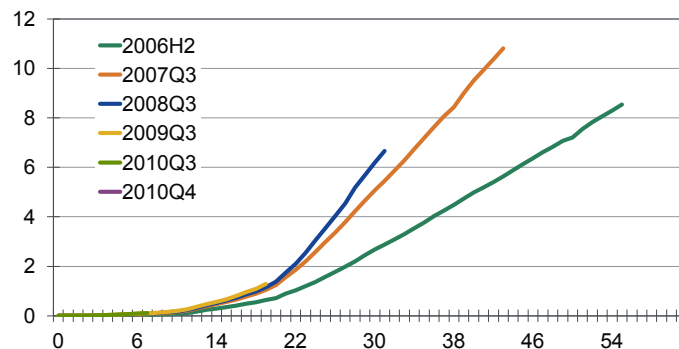
% of #, Apr 2011, NSA



Sources: Equifax, Moody's Analytics

Chart 16: Default Rates Point to Future Trouble

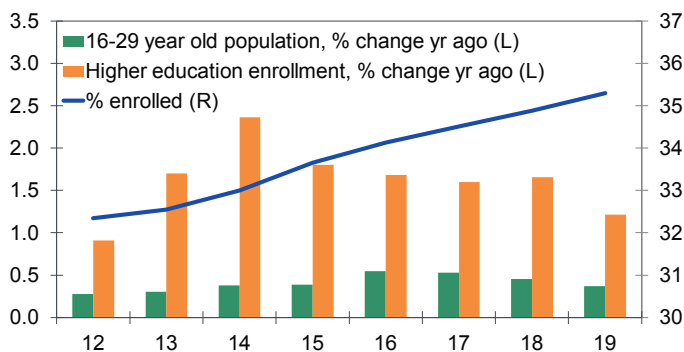
Cumulative % of loan defaults by origination qtr, by mo on book



Sources: Moody's Analytics, Equifax

Chart 17: Demographics Driving Enrollment

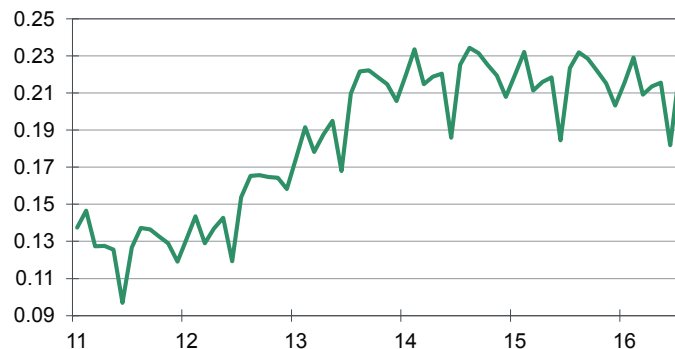
Population age 16-29 and higher education enrollment



Sources: Moody's Analytics, NCES, Projections of Education Statistics to 2019

Chart 18: Charge-off Rates Projected to Rise

% of # outstanding, NSA



Sources: Equifax, Moody's Analytics

some form of higher education is projected to increase, according to the National Center for Education Statistics. Given these demographic trends, the growth in the pool of potential borrowers remains high and is expected to continue increasing at a rate of nearly 2% per year.

The dollar volume of student lending is expected to grow at a faster rate given rising costs, although the growth rate of total tuition paid over the past decade may slow as students seek out cheaper options from proprietary and traditional educators. Significant technological innovations such as web-based instruction and electronic textbooks are also being more widely adopted, which should place further downward pressure on costs. Nonetheless, the expectation is that tuition will continue to rise at a rate greater

than overall inflation over the next 10 years, thereby contributing to persistent growth in new loan originations.

Despite the rise in volume, which should place downward pressure on performance rates, delinquency and failure rates will rise in coming years because many students will be unable to service their loans as income growth falls short of borrowers' expectations (see Chart 18 and Chart 19). Even as the economy recovers and more job openings are made available, heavily indebted students will be unable to meet their debt obligations with the salaries they are able to command.

Conclusion

The long-run outlook for student lending and borrowers remains worrisome. Unlike other segments of the consumer credit economy, student loans have not demonstrated much improvement in performance despite some improvement in the broader economy. Origination volumes have remained elevated and are projected to continue to grow with rising demand. However, there is increasing concern

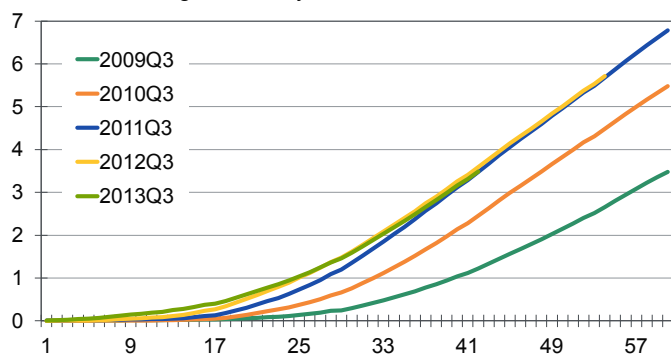
that many students may be getting their loans for the wrong reasons, or that borrowers—and lenders—have unrealistic expectations of borrowers' future earnings. Unless students limit their debt burdens, choose fields of study that are in demand, and successfully complete their degrees on time, they will find themselves in worse financial positions and unable to earn the projected income that justified taking out their loans in the first place.

Fewer people may pursue higher education should the returns fall and the required debt burdens continue to rise. The implications for the macroeconomy of a decline in higher education enrollment are twofold. In the short run, weaker demand for educational services would be a drag on consumption, at a time when the economy continues to suffer from a shortfall in aggregate demand. Longer term, a less educated workforce would necessarily be less productive, putting the U.S. at a disadvantage relative to other countries.

From a regional economic perspective, metropolitan areas with universities have fared much better during the recession than their counterparts as the increased flow of students to college campuses has served as ballast against the lack of demand for other local goods and services. A reversal of this trend could threaten the economic recovery of these areas in the short term and limit their future long-run growth potential.

Chart 19: Cumulative Default Rates To Rise

% of # of loan originations, by mo on book



Sources: Equifax, Moody's Analytics