The Student Loan Crisis: Background, Motivations of Participants, and Regulatory Issues

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Abstract
This paper briefly reviews the history of the student loan crisis. It presents some factual data about the absolute volume of student borrowing and its rate of increase, loan default rates, and actual and expected costs of education. It explores the motivations of various involved parties, including student borrowers, lenders, educational institutions, and governmental agencies charged with oversight. It describes and analyzes the regulatory regime governing the student financial assistance domain. Further, it identifies and analyzes the critical parameters of the student borrowing decision that could be used in a decision tree analysis to determine the economic feasibility of borrowing by students. Finally, it proposes some policy recommendations to alleviate the problems facing student borrowers.

INTRODUCTION
Many Americans, including many professionals, once jumped into the race of chasing the American dream (which many consider to be a birthright) of enjoying a financially successful life by earning a college degree utilizing the financial assistance of student loans. Unfortunately, the relatively easy access to student loans does not work for everyone, and even for those for whom it does, it may have significant costs. For the last few years, the financial burden placed on students and their families because of student borrowing has reached an economic crisis of epic proportions (Martin & Lehren, 2012; American Student Assistance, 2012). In some respects, the motivations of borrowers, lenders and educational institutions, along with lack of proper enforcement of regulations by governmental agencies are reminiscent of the subprime mortgage crisis that led to the worldwide financial fiasco of 2008.

Without adequately taking into account the inherent risk of lacking the financial ability for repaying the loans when they become due, students and parents eagerly borrowed in the government-backed student credit market — many considered it to be like manna from heaven, a free gift.

Students and/or parents are not the only culpable parties in this economic mess. There were, and continue to be, other collaborators whose self-interest was motivated by financial incentives that
contributed to the liberal granting of student loans, creating this morass. Banks always pursue the profit motive through lending, but their lending appetite is moderated by the risk associated with lending. In the case of student loans, however, initially there was no risk of loss to banks, since until 2010, the U.S. government guaranteed the loans (Howard, 2011). Colleges and universities seeking to fill classroom seats encourage students to utilize loans to finance their education. This is a win-win situation for educational institutions that always seem to have a constant need for more funds. Educational institutions’ revenues increased due to higher enrollments as well as increased tuitions and fees. Some would argue that the federal government, pursuing a social goal of making higher education available to all, heedlessly threw money into the venture without ensuring that the future earnings of student borrowers will be enough to repay their student loans.

BACKGROUND AND HISTORICAL DATA RELATED TO STUDENT LOANS
The Federal Student Aid (FSA) Law, administered by the U.S. Department of Education (DOE), oversees more than $134 billion in annually disbursed aid and has a loan portfolio valued at more than $812 billion (U.S. DOE, 2011 A). The DOE disburses more than $150 billion [in federal student aid through grants, work-study, and loans for post-secondary education. A majority of close to 14 million students currently receiving federal loans do so through student loans (U.S. DOE, 2011 B, p. 1). Annual federal student loans increased from $105 billion in 2010 to $129 billion in 2012 (an increase of 23%) and are expected to grow to $161 billion in 2016 (an increase of 53% over 2010) (ibid.). The number of students aided increased from 13.8 million in 2010 to 16 million in 2012 and is expected to grow to 18.7 million in 2016 (an increase of 36% over 2010) (ibid. p. 4).

The total volume of outstanding student loans is estimated by the Federal Reserve Bank of New York (FRBNY) to be $902 billion and by the Consumer Finance Protection Bureau (CFPB) to be $1 trillion, according to the American Student Assistance (ASA, 2012), a non-profit organization whose mission is to help students successfully complete the financing and repayment of higher education. It further reports that out of this total approximately $864 billion is provided by the Federal Government and $150 billion by private lenders (Johnson et al., 2012). In 2012, the FRBNY estimated that about 25% of the student borrowers each owe more than $28,000, 10% owe more than $54,000, 3% owe more than $100,000, and less than 1% (167,000) more than $200,000 (ASA 2012). In 2012, the College Board estimated that the median debt for all bachelor’s degree recipients at public four-year colleges and universities was $7,960; $17,040 at private non-profit institutions; and $31,190 at for-profit institutions (ibid.). The average outstanding loan balance for all student borrowers was $23,300 at the end of 2011 (Brown et al., 2012).

The ASA (2012) provides detailed breakdowns for student borrowers who are facing difficulty in repaying their debt in a prompt manner. It states that, in 2012, 5.4 million (14% of the total 37 million borrowers) had at least one past due account. ASA cited the FRBNY in stating that of the total $870 billion - $1 trillion in student debt, about $85 billion is past due. Finally, ASA reported that the most recent data available shows that only 37% of federal student loan borrowers between 2004 and 2009 made timely payments without asking for deferment of the loan or defaulting on it, while more than $8 billion of debt held by 850,000 student borrowers was in default (ibid.). Dai (2013)
reported that student debt almost doubled from $0.5 trillion in 2007 to over $1 trillion in 2013. The current student debt surpasses both the auto loan debt ($783 billion) and credit card debt ($679 billion) outstanding, though it is less than the mortgage debt. In the third quarter of 2012, the delinquent student loans exceeded the delinquent credit card debt for the first time ever, and this trend kept increasing in the fourth quarter of 2012 (ibid.).

All post high school educational costs have risen markedly and steadily over the years. The cost of education at public four-year institutions shows a growth rate of 6.5% from 2001 to 2010. Though the growth rate is slightly lower for private four-year institutions (5.9%) (U.S. DOE 2011 B, p. 7), the situation is even worse for the most prestigious universities in absolute dollar terms, where annual costs of attendance now reach six figures. In October 2011, President Obama reduced the cap of monthly federal student loan repayment amounts from 15% down to 10% of discretionary income of graduates (Brown et al., 2012). The 2011 Heath Care and Education Reconciliation Act ended private lending of federally subsidized loans (ibid.). This action removed the protection from default risk by student borrowers that private lenders previously enjoyed. It will also conceivably lead to greater risk scrutiny of student loan applicants by private lenders.

STUDENT BORROWER MOTIVATION

Most Americans realize that education provides one major avenue to improve one’s life prospects, to rise from lower to higher income levels and wealth (Stone et al., 2012). The ASA (2012), citing the National Center for Education Statistics, reported that in 2010, 25-34 year-olds with bachelor’s degrees earned 114% more than those without high school diplomas. Further, college graduates earned 50% more than high school graduates and 22% more than those with associate degrees (ibid.). Yet as more individuals pursue this strategy, the demand for university education rises, including direct costs such as tuition costs, as well as the indirect costs of education, including books, room and board, and fees. With this increased cost, savings of students and their parents are ever less sufficient to meet this financial obligation. Consequently, more and more students have turned to greater and greater amounts of student loans.

But student borrowers and their parents often lack a firm understanding of the college financing decision (Martin & Lehren, 2012). Should the economic returns from one’s particular area of study be meager, the eventual heavy burden of repaying the principal and accumulated interest of student loans can burden the student loan borrower for many years during their working life. One source notes that some of the worst careers to go into debt for are careers as a veterinarian, reporter, and marriage and family therapist; reporters, for example, make a median salary of $37,090, about a third of the median salary of $107,950 for someone with a career in advertising. Using those numbers, it is estimated that a reporter could be paying student loans for 32 years! (MarketWatch, 2013). With hope in the future and the optimism of youth, there seems to be little hesitation as these applicants sign up for student loan debt, often with little objective analysis given as to what the ultimate financial burden will be by the time they finish repaying their debt. The only question in their minds when initiating the loan is about how much they can borrow at the front end rather than how the loan will be paid when it comes due.
Many students and their parents universally regard the cost of a college degree as being an investment, similar to purchasing a residence, in the hope that both will provide substantial economic returns and security. The current student loan crisis is at times compared to the subprime mortgage crisis. However, there is an element to the college borrowing decision that distinguishes it from the house financing decision, suggesting that the student loan crisis is more than simply a déjà vu of the mortgage credit bubble. While borrowing is borrowing, the underlying commodity purchased with the borrowed funds is fundamentally different. A house is a good that is tangible, knowable, and used immediately. The house one owns signals to the world that “one has arrived.” An education is a something that is intangible, less knowable, and used only in the future (after graduation). That is, for students pursuing a major with relatively high expected salaries, a student loan provides “the chance to move from one socio-economic level to another, to open doors.” In deciding whether to take on the obligations of a student loan the dominant thought is that this is an all or nothing proposition. With the educational hurdle cleared, the future can lead to a better life. Without clearing the education hurdle, prospects of a brighter future will be dimmer. It is this willingness to seize the opportunity that may lead to a better life that drives people to assume large debt obligations. From this perspective, the payoff of the student loan debt, though uncertain, dwarfs the risk in the minds of parents wishing only a better life for their children.

DETRIMENTAL IMPACT ON SOME STUDENTS’ LIVES
Unfortunately, not all students have the ability to repay educational loans unless they are able to procure a job that pays enough to meet their loan obligations and live comfortably (ASA, 2012). If these students pursue trades or majors that do not provide adequate economic remuneration, they are forced to take jobs that are low paying or even minimum wage jobs. Students end up working tremendous numbers of hours and/or multiple jobs in an attempt to repay the tens of thousands of dollars they borrowed for their education that they sometimes never even complete (Martin & Lehren, 2012). Of course there are many of those who successfully graduate, repay their student loans, and eventually accumulate a good return on their investment (ibid.).

GOVERNMENT CULPABILITY
Just as the federal government created government-sponsored enterprises like Fannie Mae and Freddie Mac to make housing affordable, it also created the Student Loan Marketing Association (Sallie Mae) in 1972 to make education affordable by making more loans available to more people (Howard, 2011). Sallie Mae has been privatized since then, yet it still is the country's largest originator of federally insured student loans (ibid.). Sallie Mae earns revenues by servicing loans and by the interest rate spread between the borrowing and lending of funds. Also, just as the government utilized Fannie Mae and Freddie Mac as a backstop against risky home loans to promote even greater homeownership as mortgage default risk was rising, Congress used Sallie Mae to guarantee lenders a 9.5% return on loans even during the troubled economic times in the 1980s (ibid.).

At the time of the writing of this article, there are five major types of government student
loans: Stafford subsidized, Stafford unsubsidized, PLUS loans, Consolidated loans and Perkins loans. These loan facilities favor undergraduate or graduate education by adopting policies that in many ways increase the chances of eligibility for these loans. These policies are basically geared towards easing repayment plans and loan cancelation policies.

BANK MOTIVATION
The classical method that banks employ to generate profits is to borrow from depositors and lend money to borrowers at higher interest rates, called the interest rate spread. This is not always guaranteed profit because the bank faces the risks of borrower defaults, interest rate fluctuations, and timing issues of uncertain depositor withdrawals. In this line of business, student loans are particularly attractive. Bankruptcy is a tool that borrowers can utilize in extreme circumstances to eliminate their obligation to repay most debts such as mortgages, credit cards and automobiles. Student loans are a major exception, since student loan obligations are excluded from discharge by bankruptcy (Howard, 2011). Because private student loans are virtually impossible to liquidate, even after declaring bankruptcy, lenders receive a higher degree, if not absolute, assurance that sooner or later student loans will be repaid. As a result, student loans may seem more favorable for private lenders compared to other types of loans, and provide an incentive for them to invest in this lending activity.

EDUCATIONAL INSTITUTIONS
Educational institutions, for their own self-interested reasons, have also facilitated and contributed to this dramatic increase in student loans. Both for-profit and not-for-profit educational institutions, striving to meet enrollment and registration targets necessary to generate enough funds to accomplish their financial and academic goals, encouraged students to borrow regardless of their ability to pay. These institutions have established financial aid departments in order to help students navigate the complex set of student aid rules required to be satisfied in order to obtain student loans. Student aid offices state that, unfortunately, their small staffs are not capable of keeping thousands of students up to date regarding their student aid or of providing debt counseling. They contend that students and their families are responsible for monitoring this debt progression.

Increased student borrowing has enabled colleges and universities to raise their tuition and fees by unprecedented percentages and amounts. Some of these universities are even willing to sacrifice quality of education in trying to meet these tight budgets and still remain profitable. As far back as 2006-2007, there were more than 11,200 college-level programs that could be completed exclusively online, even though it is still questionable how effective completely online programs are (U.S. DOE, 2012 A, p. 12).

LEGAL AND REGULATORY MATTERS
Much has been written concerning the causes of the subprime lending crisis. As previously stated, substantial attention is also being given to the looming student loan crisis, similar to the mortgage
crisis, concerning student loans. Therefore, an analysis comparing and contrasting the student loan crisis with the subprime lending crisis, which has been described previously (Razaki & Koprowski, 2012) may be worthwhile. There are a number of areas/factors where such comparisons are possible including verification of loan eligibility, ability to repay/risk assessment, disclosures, delinquencies v. foreclosures and regulatory oversight.

However, before discussing the student loan crisis, some background information about student loans is necessary. Students seeking financial assistance have two sources of funding: the federal government and private lenders. The following is a brief overview of the available federal loan programs (http://www.ed.gov/programs/fpg/index.html):

- Pell Grants
- Direct Subsidized Loans (Stafford Loans)
- Direct Unsubsidized Loans (Stafford Loans)

Federal loans have no prepayment penalties, have lower interest rates than conventional loans, provide for deferment and have more flexible repayment terms. Conversely private lenders, primarily commercial banks, charge higher, variable rates, have less flexible repayment terms, do not provide for deferment and generally have prepayment penalties. In both the federal and private types of loans, the student borrower cannot discharge the debt in bankruptcy.

**ABILITY TO REPAY/RISK ASSESSMENT**

In reviewing the USDE website, no requirement was found under the various federal loan programs that potential student borrowers provide the government with any information concerning their ability to repay their loans. Upon reflection, this apparent “oversight” is quite understandable. Students attending degree or certificate programs may not be employed, or if they are, the jobs tend to be part-time, or temporary. Any financial information, such as salary, based on this type of employment is not necessarily a good indicator of their ability to repay their loans. Further, a potential additional cost has recently emerged for taxpayers because proposed legislation would allow students to write off unpaid loans after the passage of as few as 10 years if certain conditions are met (H.R. 4170).

Nor is there any risk assessment of potential default undertaken by the government. This is exactly the situation that prevailed during the period leading up to the subprime mortgage crisis when lenders accepted a borrower’s “word” on income and assets (“liar’s loans”). Little attention was given to risk since lenders factored (sold) the loans soon after approving loans. The Dodd-Frank Act addressed this issue by requiring lenders to ascertain the repayment ability of potential home borrowers. In the private sector, lenders do make a risk assessment of the borrowers’ creditworthiness by seeking the information discussed previously in the “Verification of Risk” section and basing their loan decision on that information.

**DELINQUENCIES V. FORECLOSURES**

Elvina Nawaguna (2013), in a Reuter’s article stated that “U.S. banks wrote off $3 billion of student loan
debt in the first 2 months of 2013, up more than 36% from the year ago period, as many grads remain jobless, or under employed.... Delinquencies have spiked in the last 8 years with about 17% of the nearly 40 million student loan borrowers at least 90 days past due on their payments.” Subprime foreclosures in 2008 during the height of the banking crisis were 23%, slightly less than student loan delinquencies (Demyanyk and Hemert, 2011). Now the federal government no longer guarantees those loans and the lenders carry the risk of student delinquencies.

REGULATORY OVERSIGHT
While there is some overlap between government loans and private loans, there are different regulatory requirements depending on the type of loan (See Appendix I). For example, under government Stafford loans, whether subsidized or not subsidized, student loans are administered and regulated by the U.S. Department of Education (“USDE”). Whereas students who seek loans from private lenders, primarily banks, are treated as any other borrower, with some exceptions. The federal agencies regulating private loans include the Federal Reserve Board, the Federal Trade Commission and the Office of the Comptroller of the Currency being the primary oversight agencies. Laws regulating lending include the Equal Credit Opportunity Act and the Truth-in-Lending Act (“TILA”). As discussed above, Regulation Z of TILA does provide specific provisions pertaining to student loans.

IMPLICATIONS
As previously noted, there have been claims that the student credit crisis is similar to the subprime mortgage crisis (for example, Martin & Lehren, 2012). A comparison of the subprime lending crisis and the student loan morass reveals certain commonalities and differences between the two. One major difference is that while the subprime lending crisis had global implications, i.e., foreign banks and economies were adversely impacted by lax lending, or more likely, by investing in mortgage-backed securities, the student loan crisis is primarily a U.S. domestic issue. Another difference is the fact that mortgage lending by its very nature was collateralized with a hard, tangible asset, the house. No such tangible collateral exists with respect to student loans, because their output (a college education) is obviously intangible and ephemeral. The biggest guarantee against non-payment by students is to require a co-signer. This risk avoidance technique is employed by private lenders, but not by the government.

One obvious common feature of both crises is that fact that ultimately, and maybe regrettably, the U.S. taxpayer bears the burden. While private lending institutions were the beneficiaries of the “too big to fail” policy (which cost the American taxpayer $760 billion (Calmes, 2010), the government is the primary source (approximately 85%) of student loans (Johnson 2012). The consequence of relatively easy lending practices by the USDE is that the American taxpayer is on the hook for delinquencies. Overall, it may be a worthwhile investment risk (i.e., subsidizing of our future generations’ education) because it is an investment in our future.
The reality is that there is no way to accurately to evaluate the creditworthiness of an 18-, 19- or even 21-year-old college student. One possible limitation on granting loans may be to restrict loans, or loan amounts, depending on the likelihood of employment upon graduation, e.g., engineering students may be more likely to be employed following graduation than a philosophy or history major. This is not a particularly appropriate solution since, at a minimum, it would discriminate against certain liberal arts majors, who may turn out to be equally productive workers at some point after graduation. The problem is that it is almost impossible to project the career trajectory of graduates in any major because life happens randomly and individual students have an almost infinite number of career paths available to them in the future. Thus, the future income stream, and the ability to repay, of an individual student is usually unpredictable (Hansmann, 2012).

Another major and significant difference between the two crises is that making the American dream a reality for more Americans, while a noble gesture, may have had little long-term impact on the country. However, education is a necessary and critical imperative if the U.S. is to remain a global leader. Educated citizens are the sine qua non for any productive, innovative and prosperous society. Some would argue that in the long term, education can also be a matter of national security. Appendix I provides the detailed differences of the terms and conditions imposed on federal and private borrowers.

**ANALYTIC DECISION MODEL FOR STUDENT LOANS**

For student borrowers, the desired economic outcome should be a scenario whereby they are able to repay their loans without catastrophic quality of life sacrifices and earn an adequate economic return that enables them to enjoy an economic status that they desire. Cost-benefit analysis can be very useful in determining the optimal loan amount that they should borrow. It should be noted that an individual’s acquisition of an education also possesses externalities that provide benefits to them and to society that cannot be captured in an economic analysis of personal economic costs and benefits.

The following factors should be considered by students, parents, and lenders in determining whether the loan amounts which students will have to borrow to fund their desired course of study is justified in economic terms.

**Factors to Consider:**
- Total Cost of Major to be pursued in college
- Amount of existing savings for college
- Amount of parental support for college expenses
- Amount of scholarships available
- Net loan needed for undergraduate major
- Is the undergraduate degree the planned terminal degree?
- Graduate program to be pursued
- Amount of existing savings for college
- Amount of parental support for college expenses
- Amount of scholarships available
CONCLUSION
The American government's model of liberally extending federal loans to students, while improving lower- and middle-class access to higher education, has fostered the formation of detrimental distortions in the higher education market (Howard, 2011). At the same time, the soaring cost of higher education has saddled a generation of young Americans with unmanageable student loan debt. Evidence is beginning to mount that, for too many, their debt-financed higher education represents a stifling encumbrance instead of the great investment that society's collective common sense has long suggested.

REFERENCES


H.R. 4170, Student Loan Forgiveness Act of 2012.


## Appendix I

**Terms and Conditions for Federal and Private Student Borrowing.**

<table>
<thead>
<tr>
<th>Federal Student Loans</th>
<th>Private Student Loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>You will not have to start repaying your federal student loans until you graduate, leave school, or change your enrollment status to less than half-time.</td>
<td>Many private student loans require payments while you are still in school.</td>
</tr>
<tr>
<td>The <strong>interest rate</strong> is fixed and is often lower than private loans—and much lower than some credit card interest rates. View the <a href="#">current interest rates</a> on federal student loans.</td>
<td>Private student loans can have variable interest rates, some greater than 18%. A variable rate may substantially increase the total amount you repay.</td>
</tr>
<tr>
<td>Undergraduate students with <strong>financial need</strong> will likely qualify for a <strong>subsidized loan</strong> where the government pays the interest while you are in school on at least a half-time basis.</td>
<td>Private student loans are not subsidized. No one pays the interest on your loan but you.</td>
</tr>
<tr>
<td>You don’t need to get a credit check for most federal student loans (except for PLUS loans). Federal student loans can help you establish a good credit record.</td>
<td>Private student loans may require an established credit record. The cost of a private student loan will depend on your credit score and other factors.</td>
</tr>
<tr>
<td>You won’t need a cosigner to get a <strong>federal student loan</strong> in most cases.</td>
<td>You may need a cosigner.</td>
</tr>
<tr>
<td>Interest may be tax deductible.</td>
<td>Interest may not be tax deductible.</td>
</tr>
<tr>
<td>Loans can be consolidated into a <strong>Direct Consolidation Loan</strong>. Learn about your <a href="#">consolidation options</a>.</td>
<td>Private student loans cannot be consolidated into a Direct Consolidation Loan.</td>
</tr>
<tr>
<td>If you are having trouble repaying your loan, you may be able to temporarily postpone or lower your payments.</td>
<td>Private student loans may not offer <strong>forbearance or deferment</strong> options.</td>
</tr>
<tr>
<td>There are several repayment plans, including an option to tie your monthly payment to your income.</td>
<td>You should check with your lender to find out about your repayment options.</td>
</tr>
<tr>
<td>There is no prepayment penalty fee.</td>
<td>You need to make sure there are no prepayment penalty fees.</td>
</tr>
<tr>
<td>You may be eligible to have some portion of your loans forgiven if you work in public service. Learn about our <a href="#">loan forgiveness programs</a>.</td>
<td>It is unlikely that your lender will offer a loan forgiveness program.</td>
</tr>
</tbody>
</table>
