Student Loan Debt

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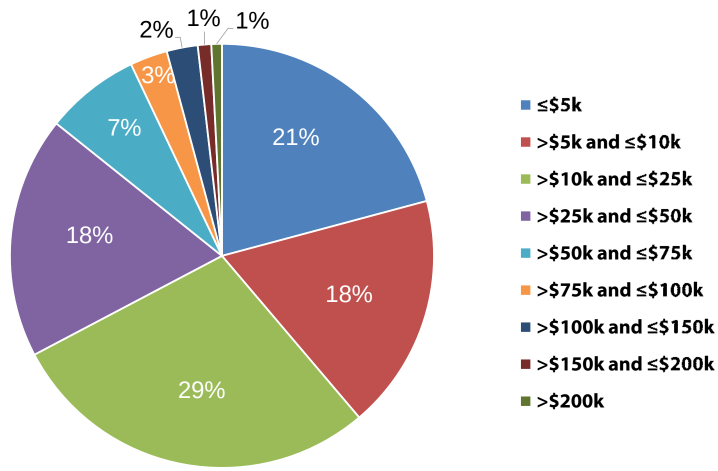
By several measures, student loan debt increased rapidly in the last 10 years, leading to concerns that the United States is facing a student debt crisis. During this time period, the federal government has implemented several policy changes designed to assist borrowers—becoming the direct lender of federal loans, expanding income-driven repayment options and changing the way interest rates are set. States—concerned about the adverse effects of student debt—have also taken action. This brief reviews recent trends in student borrowing and highlights several policy options states have taken to address the growing loan burden of college students.

Trends in Student Borrowing

Student loan debt has received more attention in recent years as the number of borrows, balance per borrower and total amount of outstanding debt increased rapidly. Total student loan debt has increased from $350 billion to approximately $1.2 trillion since 2004.[1] During this time period, outstanding student debt surpassed the amount households owe on auto loans, home equity loans and credit cards. The amount Americans owe on their student loans is surpassed only by home mortgages as the largest form of household credit. Part of the reason for this rapid increase is that more students and parents are borrowing to pay for educational opportunities. In 2004, 22.5 million people had student loans, now 43.3 million people do—an increase of 92 percent.[2] Not only has the number of borrowers increased but the average amount each person is borrowing has increased as well, from $15,300 in 2004 to $26,700 today.[3]

Even though the average balance per borrower has grown 74 percent in the last decade, the very large loan balances often featured in news stories are still rare. More than two-thirds of students owe $25,000 or less.[4] Figure 1 illustrates the distribution of student loan balances at the end of 2014. Only about 4 percent of borrowers owe balances of $100,000 or more, and most of these students are graduate and professional students.[5] Only .03 percent of undergraduate students borrow more than $100,000.[6]

Figure 1. Distribution of Student Loan Balances, Q4 2014

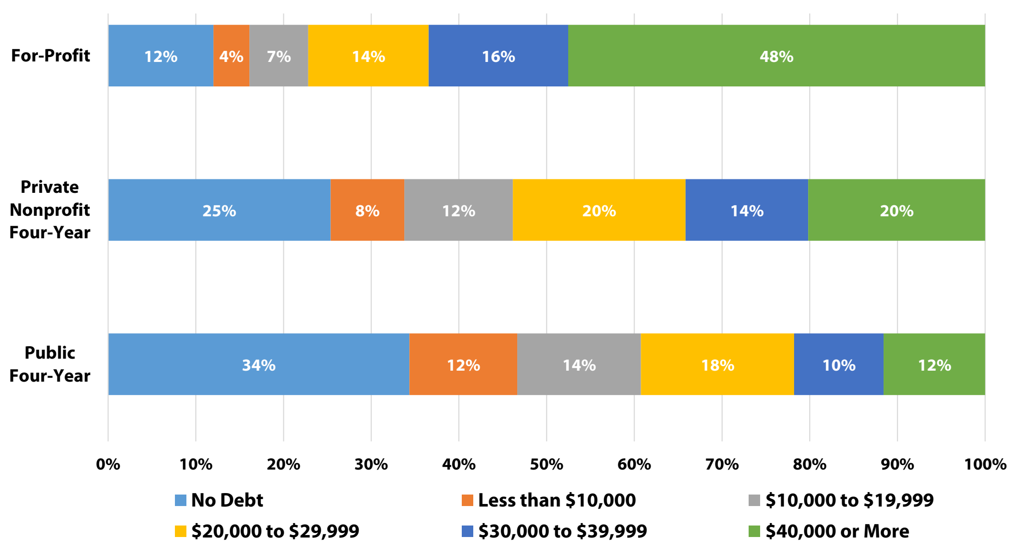


Source: Federal Reserve Bank of New York Consumer Credit Panel / Equifax

Compared to their enrollment, graduate students owe a disproportionate amount of debt. They owe approximately 40 percent of student debt but only account for about 14 percent of students.[7] Within the graduate student category, people earning professional degrees are more likely to take out loans of more than $100,000—54 percent of professional degree students borrow $120,000 or more.[8]

The average amount borrowed also varies greatly by the amount of time enrolled and the type of institution from which a student earns a credential. Figure 2 illustrates the cumulative debt of bachelor degree earners by type of institution. Nearly half of all students graduated from for-profit institutions with $40,000 or more in debt compared only 12 percent of public institution graduates. This trend of greater borrowing among graduates of non-public institutions holds for certificate and associate degree earners as well.[9]

Figure 2. Cumulative Debt of Bachelor's Degree Recipients in 2012 Dollars by Sector, 2011-2012



Source: *College Board. Trends in Student Aid 2014*

Delinquencies and Defaults. The number and percent of total borrowers who have defaulted—not made a payment for 270 consecutive days after a 6-month grace period—on their obligations has also increased in recent years. According to the Federal Reserve Bank of New York, more than 1 million borrowers are defaulting on their student loans each year—a 125 percent increase from a decade ago.[10] Contrary to what might be expected, the students with the largest balances are not the most likely to default. Rather, those with more modest balances pose the greatest risk of defaulting. For students entering the repayment period in 2009, 34 percent of borrowers owing between $1,000 and $5,000 defaulted by the end of 2014, compared to 18 percent of borrowers owing more than $100,000 who defaulted on their loans.[11] On average, students owing very large balances tend to earn graduate and professional degrees with wages high enough to repay their debt.

Because students with low loan balances are also the most likely to have not completed their degrees, they do not receive the earnings bump associated with a postsecondary credential. Other research has shown default rates are higher among low-income students and students who attend for-profit colleges.[12] Students from wealthier households are more likely able to fall back on family support if they have difficulty repaying their loans, while students from lower-income families are less likely to have family members who can make payments on a temporary basis. For-profit institutions tend to be more expensive than public institutions, causing students to borrow more; however, some credentials earned at these institutions may not lead to a significant enough increase in earnings to compensate for the increased debt.

Overborrowing and Underborrowing. Postsecondary education is an investment for individual students. Research shows that for the average student, this investment pays off as long as they earn a credential.[13] If a student borrows more than the anticipated career field will pay or does not earn a credential, he or she will likely struggle to make payments. Unfortunately, earnings information and success rates for individual programs are often not easily accessible, making it difficult for students to make informed borrowing decisions. Consequently, some students end up borrowing the maximum amount each year. Federal regulations limit the total amount students are allowed to borrow each year to the total cost of attending the institution where they are enrolled. Colleges and universities calculate the cost of attendance by estimating the amount students will pay in tuition, fees, books, housing, transportation and other expenses. After subtracting other forms of financial aid, students are able to borrow up to the cost of attendance amount.

Some policymakers are concerned about reports of students using loan money to live a lifestyle beyond their means, buying clothes or even cars.[14] This concern that students are accumulating more debt than is necessary to pay for non-educational items is known as "overborrowing." Arguably a bigger problem is "underborrowing,"[15] when students opposed to taking on debt choose to work more hours or take fewer courses than they could if they borrowed a modest amount. For these students, borrowing small amounts and working fewer hours could increase their probability of earning a credential.

Policy Options

These trends—more students borrowing, larger average loan balances and higher default rates—have propelled what has traditionally been a federal issue into state-level policy discussions. While states generally focus on reducing the cost of college, a growing number of legislatures are exploring and enacting policies that address student debt. Because one policy solution will not address all issues with student debt, states have implemented a variety of policies. The following section outlines several of the policy options states have adopted.

Loan Forgiveness and Repayment Programs. At least 35 states have some type of education loan forgiveness or repayment program for qualified borrowers written into statute. Under the typical program, borrowers agree to live and work in a certain region in exchange for states making loan payments or forgiving certain loans. Traditionally these programs were used to offer incentives to graduates of professional programs to work in underserved areas. Many programs helped recruit primary care physicians and other health care workers to rural areas. However, in recent years, states have created repayment and forgiveness programs to include additional occupations and fight population losses. Several states now offer programs targeting moderate-wage professions such as teachers and social workers.

The Kansas Rural Opportunity Zone program is designed to retain college graduates in the state and is a partnership with rural counties that fund half of the loan payments. New York created a forgiveness program in 2015 that will make low-income borrowers earning less than $50,000 the primary beneficiaries. The program makes full monthly payments for up to two years for former students enrolled in a federal income-based repayment program. While these programs have successfully brought doctors to underserved areas,[16] the timing of delivering benefits assumes students must take out loans and students with degrees are the beneficiaries. Consequently, repayment and forgiveness programs likely contribute very little to the enrollment and completion decisions of students, but rather contribute more to the decisions graduates make about where to work upon completing a degree.

Providing Students More Information. Research by the Brookings Institute found that many student are not fully aware of how much they are borrowing to pay for college.[17] While several states require institutions to report general financial information in the form of averages, Indiana passed a bill in 2015 that requires postsecondary schools to report student loan information specific to each individual student. Indiana HB 1042 requires higher education institutions to provide students with information estimating: a) the total amount of loans taken out, b) total payoff amount, c) monthly repayment amount and d) how close the student is to reaching the maximum federal borrowing limit. All institutions that take part in state grant programs must report this information to students. The new reporting requirements are based on an initiative Indiana University implemented. The university found a correlation between providing students this information and reduced borrowing.[18]

Policy Options

- ***Loan Forgiveness and Repayment Programs***
- ***Providing Students More Information***
- ***Refinancing Existing Loans***
- ***Tax Deductions and Credits***
- ***Low-Interest and No-Interest Loans***
- ***Improving Student Protections***
- ***Child Savings Accounts***
- ***Focus on Affordability***
- ***Build and Maintain Capacity***

Refinancing Existing Loans. Seven states have either started a pilot program or enacted legislation to begin refinancing student loans. These programs are in the early stages of implementation but are designed to offer lower interest rates, which allow borrowers to repay loans at a lower total cost. California, Connecticut, Maine, Minnesota and North Dakota all passed legislation related to refinancing programs, while Iowa and Rhode Island have started programs without legislative authorization. These programs are typically designed to be self-sustaining and do not receive additional support through annual appropriations. Many states created student loan authorities to issue loans and act as a guarantee agency for federal loans in the 1980s. While the role of these authorities has changed some with the Education Department becoming the direct lender of federal loans, many still operate state programs and issue new loans annually. Because state loan authorities already have loan portfolios and experience servicing student loans, states are granting them the power to refinance existing loans.

Before starting a refinancing program, states may want to consider a number of factors. One of the most important is, which loans will be eligible for refinancing? Because the refinancing proposals that are moving forward are designed to be self-sustaining, states are not able to match the fixed interest rate offered to undergraduate students through the existing federal loan programs. As a result, the pool of borrowers will likely be limited to students who took out private loans, as well as graduate students and parents with federal loans—these loans tend to carry higher interest rates.

For example, California specifically limited the refinancing program to those with private loans. States should also consider the amount of risk they are willing to accept. Borrowers with high-interest-rate private loans would be among the greatest beneficiaries of a refinancing program, but they also are likely to carry the most risk. Cherry-picking graduate students with high incomes and stable employment would make a state program financially healthy but do little to help students struggling to make payments. Moreover, the low-interest-rate environment has led to a fairly robust private market for refinancing loans. Private lenders use underwriting standards and even the reputation of a student's institution to determine if a borrower is eligible to refinance and at what rate.[19] State programs would have to compete with the interest rates provided by these private lenders.

Finally, states assume the risk of a borrower defaulting when they refinance loans. Students who refinance federal loans will lose access to the deferment and forbearance protections built into the federal programs. Deferment and forbearance allow borrowers to temporarily stop making payments if they return to school or suffer economic hardship. As a result, states may also want to consider offering similar protections to the borrowers who refinance through state programs.

Tax Deductions and Credits. Proposals to create tax credits and deductions for student loan payments are introduced in several states each year, but only a few states have formally adopted these benefits. Massachusetts allows borrowers to deduct the full amount of interest paid on loans used to earn an undergraduate degree.[20] Maine offers a tax credit to individuals and businesses for student loan payments. The amount of the credit is tied to the price of tuition at Maine community colleges and universities.[21] Rhode Island enacted a tax credit in 2015 that will require applicants to be full-time employees with a Rhode Island-based employer and be limited to certain science, technology, engineering, mathematic and health fields.[22] The amount of the credit will be based on the type of degree earned. The maximum credit is $1,000 for an associate's degree, $4,000 for a bachelor's degree and $6,000 for a graduate degree. The goal of both the Maine and Rhode Island credits is to retain and attract college graduates to the state.

Low-Interest and No-Interest Loans. The federal government limits the aggregate amount of federal loan money students are able to borrow—dependent undergraduate students may borrow a maximum of $31,000 and independent undergraduates may borrow a maximum of $57,500. However, some students will need to borrow more than the maximum federal amount to complete their degrees. These students must often turn to private loans, which are likely to carry higher interest rates. Several states offer loan programs with fixed interest rates for all borrowers as alternatives to private loans. A few states offer loan programs with particularly generous interest rates.

For example, Massachusetts offers a no-interest loan program.[23] Georgia offers a low-interest loan to students who have exhausted their federal loan eligibility, but the students must graduate in four years in order to receive the lower interest rate.[24] Because state loan programs compete with private loan providers that charge variable interest rates based on a borrower's credit risk, state loan programs that offer better interest rates typically require some type of additional support from the state.

Improving Student Protections. States are taking a greater interest in protecting student borrowers given some of the questionable practices of some loan servicers. Connecticut enacted a Student Loan Bill of Rights into statute. The bill of rights creates a student loan ombudsman to assist students and provide information to the public. It also requires loan servicers be approved by the state. Oklahoma passed legislation in 2013 known as the Oklahoma Private Student Loan Transparency and Improvement Act, which establishes restrictions on private loan lenders and requires specific disclosures prior to issuing a loan.

Child Savings Accounts. A growing number of states are employing a longer-term strategy of building assets through child savings accounts to influence the college-going decisions and borrowing behavior of future students. At least seven states—Colorado, Connecticut, Maine, New Hampshire, Nevada, Oklahoma and Vermont—have passed legislation or begun offering child savings accounts for children born in state or enrolled in kindergarten.

Child savings accounts are often linked with 529 college savings accounts or at least function very similarly. While 529 accounts are much more common, the greatest beneficiaries of these savings options tend to be families with greater wealth. States are using child savings accounts as a way to help lower-income families build savings for future education expenses by making an initial deposit. Some states even offer programs to match family contributions. States are implementing these programs based on research that shows even modest amounts of savings have very large impacts on low-income students' decisions to enroll and finish college. Students from low-incomes households with as little as $500 in savings for college are three times more likely to attend college and four times more likely to earn a degree than similar students with no savings.[25]

Focus on Affordability. A common argument made by many state legislators is that student loan debt is really just a symptom of the high prices institutions are able to charge; therefore, the best solution to limiting student debt is to improve college affordability and ensure students complete their degrees. These policy solutions focus on helping students avoid taking out loans in the first place. Tuition policy, financial aid and appropriations are three of the strongest levers states have to influence college affordability. Higher education finance policies that integrate all three levers are likely to be more successful at creating affordable postsecondary opportunities that limit the need for students to borrow.

States have taken bold steps to create more affordable opportunities. Washington mandated a tuition reduction of 5 percent to 20 percent at all public universities for the 2015 and 2016 academic years. Maryland created a tuition stabilization fund with a dedicated revenue source to help offset the negative effects of recessions on higher education funding. Minnesota and Oregon developed shared responsibility models for financial aid programs that delineate the expectation of all parties involved in paying for college. There are a number of innovative solutions tied to appropriations,[26] financial aid[27] and tuition policy[28] being tried in states now that can be modified and replicated in other states.

Build and Maintain Capacity. The lack of capacity to serve all students who wish to attend public institutions, especially during recessions, can push students to enroll at more expensive for-profit colleges. Because students attending for-profit colleges accumulate more debt and are more likely to default, building capacity at public institutions could help lower total debt and default rates. States could consider altering their capital budget process to strategically build capacity in high-demand programs and online programs designed to serve adults. Programs that can quickly be scaled up as demand requires without sacrificing quality will help ensure more affordable public institutions do not turn any students away.

Federal Policy

Because the federal government is the largest lender of student loans—more than 90 percent in 2013-14[29]—states could consider supplementing existing federal programs rather than superseding them. For example, the federal government offers several income-driven repayment options that allow borrowers to pay a portion of their disposable income each month and then have any remaining balance forgiven after making payments for 10 to 25 years, depending on the program in which a borrower is enrolled. There are challenges and disadvantages associated with these programs, but in general the terms should help borrowers with limited incomes avoid becoming delinquent or defaulting. Moreover, borrowers with large balances and modest incomes stand to have a sizable portion of their federal loans forgiven in the future. Consequently, state action helping borrowers enroll in these programs might be a more effective strategy than creating a separate state program or refinancing federal loans. Because states have limited dollars to invest in any policy area, helping borrowers take full advantage of federal programs and benefits before committing state dollars may help states more efficiently allocate limited resources.

Selecting the Best Policy Option

Because there are several layers to student loan debt and no single policy solution will address all aspects, it is important to prioritize which problem is the most important to address. Different policy solutions will address different aspects of student borrowing. For example, if a state is most concerned with student loan defaults, then policies designed to improve graduation rates might be the most useful. Because students with relatively small debt amounts but no credentials are the most likely to default of their loans, policies such as increasing the amount of state grants, improving transfer agreements or providing adult students scholarships to return to school are likely to have a greater effect on default rates than refinancing loans or forgiveness programs. If states are more concerned that students are borrowing too much, coordinating the appropriations, tuition and financial aid policy levers—in addition to providing students with better information about their own borrowing levels, like Indiana does—might prove to be useful solutions.

Because states have limited resources to allocate to any single budget item, many policymakers seek solutions that are affordable for both students and taxpayers. As a result, states may look at taking full advantage of all federal programs before creating new programs. Policies should also be regularly reviewed to ensure they are serving the intended constituents and having the desired results.

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