Student Loans :

Discussion



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Disclaimer

The analysis and conclusions contained in this paper are those of the authors and **do not necessarily reflect** the views of the Board of Governors of the Federal Reserve System, its members, or its staff.

Student loan landscape

Currently, there are **\$1.75 trillion of student loans** outstanding.

Majority (~90%) of which are either directly issued by the government or federally guaranteed.





Note: Originations over academic year, whereby, for example, the year '2006' refers to the academic year ending in Spring 2006. Nonfederal loans include loans to students from states and institutions in addition to private loans. Source: College Board *Trends in Student Aid*.

Borrowers may have trouble servicing their debt

Delinquency rates on student loans were high pre-pandemic.

While payment difficulties currently do not pose threat to private lenders, payment burdens can affect HH financial outcomes (e.g., homeownership, other debt accumulation).



fraction of balances that are at least 90 days past due, including

* Change in data estimation methodology.

severe derogatory loans.

Source: FRBNY CCP/Equifax.





Note: Shares are calculated as the balances held by student loan borrowers who are 90+ days past due on their student loan debt obligations or who are classified as subprime. Subprime is less than 620.

Source: FRBNY CCP/Equifax.

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Student loans in policy and research

Federal Student Loan Forbearance Program has provided temporary relief during the pandemic. (Currently through May 1)

- Zero interest rate on outstanding student loan debt.
- No required payments during the forbearance period.
- Delinquent (but not defaulted) federal student loans reinstated into current.

Ongoing policy discussion about student loan forgiveness.

Active research into questions surrounding student loans, their effect on the economy, and affordability of student loan debt payments.

Two **outstanding papers** presented today.

Brown, Grodzicki, and Medina: CARDS Act

Investigates interaction between early-life take-up of student loan and credit card debt:

- uses DiD estimation in unique data for a large public university;
- augments with new survey data analysis of financial literacy.

Exploits Title 3 Provisions of the CARDS Act:

• Act it much more difficult for credit card companies to market credit cards on college campuses, and to issue debt to borrowers below the age of 21.

Upshot: CARDS Act has led to

- an increase in student loan debt (likely though debt substitution),
- but also an increase in on-time graduation rates and GPAs.

Brown, Grodzicki, and Medina: CARDS Act

- The research suggestive of how **consumer protections** can steer young individuals from more costly form of debt (credit cards) to cheaper financing (student loans).
 - This can potentially alleviate mental loads and lead to improved outcomes (e.g., GPA).
- Students from lower-income households were more likely to observe increases in student loan debt post-CARDS act (as well as the improved academic outcomes).
- Policy appears to lead to improved welfare outcomes, with two caveats:
 - Unlike credit card debt, student loan debt *cannot be discharged* in bankruptcy.
 - Credit cards might provide buffers in case of an emergency but can sit idly in normal times. *Key consideration*: the degree on which individuals revolve debt on the cards pre-CARD act.

Brown, Grodzicki, and Medina: CARDS Act

Mechanism: Age 21 cutoff or ease of access? Could test for this looking at seniors as well?

FIGURE 7.

Age Distribution of Undergraduate Students, by Type of Institution





Source: NCES 2016.

Note: Data are for 2015. "Four-year" includes public and private nonprofit four-year colleges and universities. For-profit includes two-year and four-year private for-profit colleges and universities.



College attendance = an **opportunity** but also a **risk**.

- Considerable drop-out risk and risk of low future incomes.
- Current student loan contract assumes full repayment.

Question:

Why not a market for contracts that would help **insure downside**, e.g.:

- Low post-college earnings
- Non-completion
- Unemployment

Potential **answer**: Lender's problem = private information.

Imagine a world where all young college-goers:

- look highly similar in observational characteristics,
- but have private information about their expected future outcomes (incomes, completion rates, etc.). E.g., assume the college-borrowers have two types: high and low probability of completion

Lender wants to advance funds that will be used to fund college but will be repaid in as a share of future incomes.

 Contract has an insurance option: if a borrower does not complete a degree, they will repay a smaller fraction of future incomes than "completers".



Lender does not know who is who, so they can price the cost of advanced funds, λ , based on expectation of future outcomes for the entire pool.



However, borrowers know their own type and set their reservation price for the cost of advanced funds, λ^{H} and λ^{L} , which includes a premium for insuring the risk of drop-out.



If $\lambda < \lambda^{H}$ then market is sustained. If $\lambda > \lambda^{H}$ then market unravels: cross-subsidization fails; lender bound to lose money if they charge λ .

The **authors test** for this type of a problem in the data and **show unravelling** ($\lambda > \lambda^{H}$) for the type of contracts they consider.

But having such contracts could be beneficial: are there **other** ways they could be sustained?

- Government *subsidies*
- *Mandatory participation* in a government program (akin to universal healthcare) ...

...Because everyone participates, private information is not a problem.

Welfare analysis would be key here.

(A market where no other financing contracts for education exit might steer high-type HHs to less debt.)

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Thank you!