Student Loans: the Next Sub-Prime?

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Student loans now total over $1 trillion and delinquency rates are rising. Many young people are burdened in their 20's with tens of thousands of dollars of student debt. Some commentators have pointed to student loans as the "next subprime." What does this mean? Does it mean that student loan defaults are expected to cause another financial debacle at some time in the future? Or does it simply mean that many people are likely to wind up worse off after taking out student loans? To evaluate these possibilities, it is useful to review the subprime story.

The subprime mortgage market is credited with playing a significant role in the housing boom and bust that precipitated the financial crisis and great recession. In the case of subprime mortgages, the idea was to expand home ownership opportunities to an 'underserved" market; namely, people with poor credit scores, who are disproportionately minorities. Both public policy and private sector initiatives pushed forward the development of the subprime market. The basic premise was that traditional mortgage underwriting standards were too conservative. The evidence for this was that credit loss rates for prime mortgage loans were miniscule, just a few basis points a year.

Subprime mortgage loans generally refer to borrowers with low credit scores, like FICO score less than 620. The traditional approach to these loans was to require strong compensating factors such as very large down payments. Thus, the traditional approach to subprime did not entail weakening of underwriting standards. However, this changed in the 1990s and early 2000s. Government programs sponsored by FHA or by Freddie Mac and Fannie Mae included loans with **both** modest down payments and low FICO scores. Innovations in private label securitization (that is, in which no government or quasi-government guarantee is involved) appeared at first to be highly successful. Securities based on subprime loans received high ratings from ratings agencies like Standard and Poor's and Moody's Investor Services and the demand for these securities was very strong. This enabled massive expansion of the subprime market until by 2005 it constituted 20% of all loan originations.

However, subprime borrowers were inherently more financially fragile. The viability of the market depended on the ability of the subprime borrower to upgrade to prime if a series of on-time payments was achieved. So long as housing prices continued to rise, the promise of upgrading to prime stayed intact. But when home prices peaked out in 2006 and began to fall the path out of subprime (and high mortgage rates) was blocked. This meant that subprime defaults were bound to soar. Combining this with early payment defaults by speculators, the value of mortgage backed securities declined sharply and set in motion the financial crisis.

So, in what sense do student loans constitute the next subprime?

I think the best analogy comes in the so-called for profit sector of the education market. The For Profit (FP) sector is to be distinguished from traditional public or not-for-profit private institutions. FP institutions have enjoyed massive growth in recent years, largely by addressing the "underserved" student market, that is, those students that do not attend traditional colleges or universities. Since only about 25% of high school graduates attend traditional colleges and universities, this “underserved” market is huge. While it is surely true than many young people do not aspire to continue their education beyond high school, there are others who are prevented from doing so by financial or other obstacles.

The positive case for FP institutions is that they have significantly expanded access to higher education for those who do not attend traditional colleges or universities.

However, students at FP institutions have less positive financial outcomes than students at the traditional schools. Research by Harvard economists Deming, Goldin and Katz[1] shows that FP students have higher dropout rates and debt levels than students at traditional schools. They also find that the value added of the schooling in terms of increasing wages is lower. This can be due to lesser aptitude (FP students have lower high school ranking), other commitments (FP students are more likely to be working full-time) and the high cost of the typical FP school.

Assuming that the FP institution experience involves less value added, higher costs and higher dropout rates, the average return on investment in the FP programs is going to be lower than it is in traditional programs. Therefore, the potential for financial difficulties for students of FP schools is greater than it is for students of traditional schools.

This is somewhat akin to the situation in subprime mortgages. While the motivation to lower underwriting standards so as to expand the home ownership rate may have been laudable, the end result has been a worsened financial position for many subprime borrowers. Still, the fact that higher proportions of subprime borrowers and FP students end up with worsened financial outcomes does not necessarily mean that these programs are inherently fatally flawed.

For one thing, you should look at the successes as well as the failures. Suppose 90% of FP students were better off for the experience and 10% were worse off. Does the negative result for 10% negate the positive outcome for the 90%?

I think it is likely that the positive outcomes outweigh the negatives. Rather than attempt to curtail FP institutions, we should look for ways to reduce the percentage of negative results. One way to do this is to improve the predictive modeling of returns – that is, given the student characteristics including current employment and training, the prospective educational program and its cost, what is the likelihood of completing the program and achieving greater income? This modeling can form the basis for guidance counseling offered by the FP school or by third parties.

[1] David Deming, Claudia Goldin and Lawrence Katz, “The For-Profit Postsecondary School Sector: Nimble Critters or Agile Predators?” Journal of Economic Perspectives, Winter 2012.