

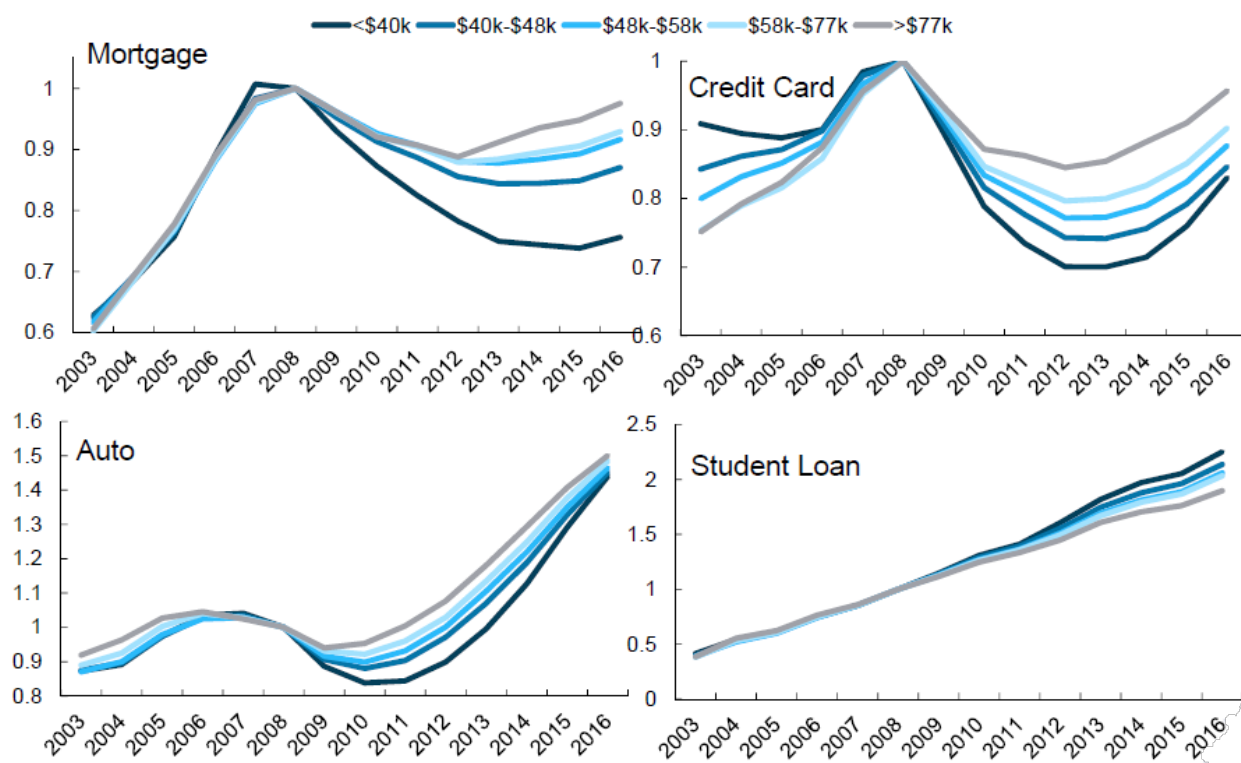
CFI IN FOCUS: Understanding Student Loan Markets

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*The views reflected in this report represent those of the author and not necessarily those of the Federal Reserve Bank of Philadelphia or the Federal Reserve System.

Borrowing for education has been the fastest growing segment of consumer debt in the past 10 years, particularly for lower-income communities. How this increase in debt impacts consumers and the financial system has become a prominent policy issue, especially as an increased number of borrowers are struggling to meet repayment obligations.

Figure 1: Loan Balances Relative to 2008 Peak, by Average Local Income: Steady Rise of Student Loans, Especially in Low-Income Areas



Notes: Data are for the fourth quarter of each year.
Source: Federal Reserve Bank of New York/Equifax Consumer Credit Panel

Compared with other types of credit such as mortgages, however, less is known about consumer financial behavior around student loans. For instance, what are the determinants of delinquency and default among student loan borrowers? What are the advantages and disadvantages of different student loan programs in ensuring access to higher education?

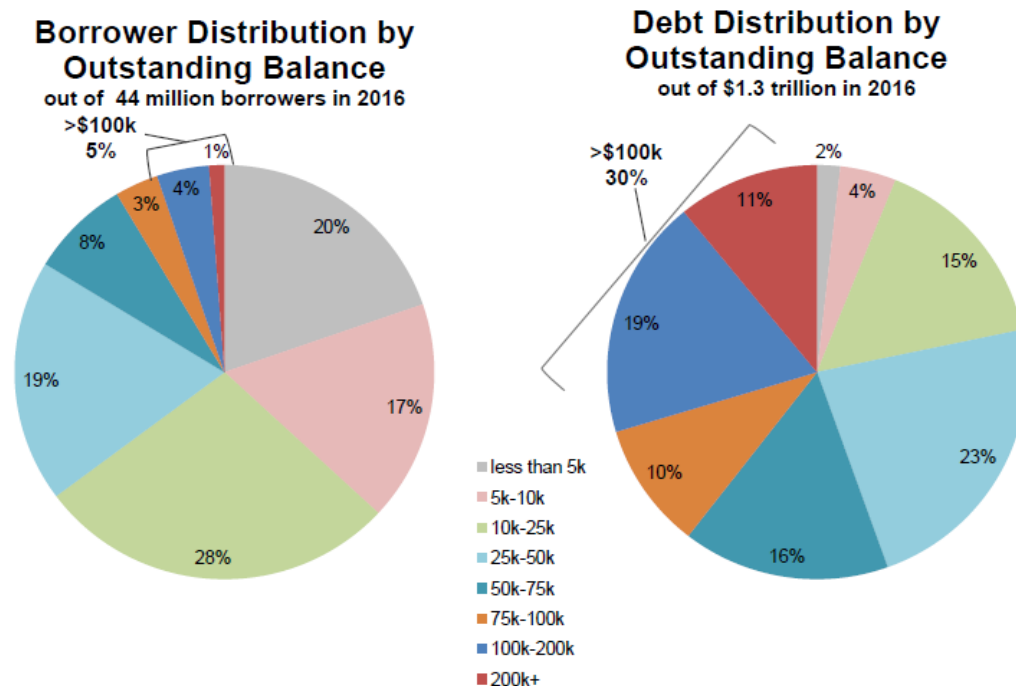
Over the past five years, the Federal Reserve Bank of Philadelphia has been a significant source of research in the area of student lending.¹ This work is continuing under the auspices of the Bank’s newly established Consumer Finance Institute (CFI). This CFI in Focus article presents some of the work done so far, including conferences and workshops featuring industry participants, consumer groups, academic researchers, and policymakers as well as recent economic research.

2015 Conference Challenges Common Myths and Plans Next Steps

In September 2015 — as concerns about student loans were increasing — the Bank’s Payment Cards Center (PCC) hosted a conference focused on topics pertaining to student loan repayment in the U.S. The event, titled Student Loan Repayment: Research, Data, and Policy, reviewed existing research on loan repayment, outlined the policy-relevant research questions still unanswered, and examined researchers’ capacity to answer these questions given available and emerging data sources.²

Participants outlined the benefits and limitations of existing data sources in supporting research efforts and ways in which researchers have and could produce more rigorous and policy-relevant applied research through innovative partnerships with loan program managers, lenders, servicers, and educational institutions.

Figure 2: Distribution of Outstanding Student Debt in 2016



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

¹ Researchers in many parts of the Federal Reserve System, and particularly at the Federal Reserve Bank of New York and the Board of Governors of the Federal Reserve System, have contributed significantly to research of student debt.

² A detailed summary of the conference proceedings is forthcoming.

Keynote speeches were delivered by prominent economic researchers in the field of education finance. Susan Dynarski of the University of Michigan dispelled some common myths surrounding student loans in the U.S., including that debts of \$100,000 are the norm (the median debt is about one-fifth of that) and that student loan defaults are driven primarily by large debt loads when individuals with smaller student loan debts are actually considerably more likely to default on their loan obligations.

Caroline Hoxby from Stanford University challenged the practice that all borrowers with federal student loans must pay the same interest rate despite predictable differences in the probability of default and earnings potential. She proposed a redirection of federal student loan guarantees into the competitive, risk-based underwriting environment of private lenders, combined with extending to the private lenders comparable collection remedies currently available only to the government.

Over the course of the two-day conference, speakers and audience members agreed on five key points:

- 1) The determinants and effects of student loan default are becoming better understood.
- 2) Financial counseling for student loan borrowers is challenging.
- 3) Researchers need to understand better the relationships between student debt and other outcomes, such as employment, family structure, and continued education.
- 4) Data linkages are key to providing a comprehensive analysis of the outcomes for student loan borrowers.
- 5) Vulnerable borrowers are particularly at risk of repayment difficulties.

The fifth issue was explored further in the 2016 Symposium on Student Loans and Socioeconomic Mobility, described next.

2016 Conference Looks at Student Loans and Socioeconomic Mobility

In August 2016, the PCC cohosted a one-day conference with the University of Pennsylvania Graduate School of Education: the Symposium on Student Loans and Socioeconomic Mobility. The event explored potential inequities associated with the availability, take-up, and repayment of student loans. In particular, discussions focused on the ways in which student loans may support or hinder socioeconomic mobility for the most vulnerable or underrepresented students in higher education.

Panelists discussed the preexisting inequalities that affect how students sort into different types of educational institutions and the likelihood with which they take out student loans. Education access and success for underserved students can be affected by the disparities in high school backgrounds, in the access to information about higher education, in culture and social background, and in institution type and major. A frequent hypothesis in academic research and the popular press is that families need more and better information to make optimal choices. However, the broad consensus at the symposium was that some of the disparities described previously are simply so overwhelming that it would be

dangerous to assume that more information would completely rectify such complex and persistent inequalities.

Bruce Chapman from the Australian National University used his keynote address to compare and contrast the repayment burdens for U.S. and Canadian students who face fully amortized, mortgage-style payment schedules versus the system in place in Australia and other countries where payments are contingent on income levels. Chapman focused on two aspects of income-contingent repayment schemes. The first is that significant administrative and transaction efficiencies can be obtained by relying upon the income tax system for collecting student loan repayments. The second is that linking repayment amounts to the borrower's current income provides insurance against the consequences of income disruption and low incomes.

Chapman and symposium attendees also discussed the importance of looking beyond delinquency or default probabilities and to recognize that higher debt burdens may be weighing heavily on some individuals who are repaying their student loans on time despite experiencing shortfalls in their expected or realized incomes.

Moreover, disadvantaged students face the heaviest burdens because returns to higher education are unequal. Research shows that minority student loan borrowers earn less and are less insulated from financial shocks than other borrowers. Consequently, strategies that focus only on college affordability — even free college — may fail to achieve the goal of using education as an antipoverty strategy or “great equalizer.” Panelists agreed that considerably more research is required to understand whether the availability and take-up of student loans has narrowed or exacerbated preexisting inequalities and whether loan availability has improved or hindered socioeconomic mobility.

Workshop Series Focuses on Private Student Loan Markets

During the first half of 2017, Senior Industry Specialist [Dubravka Ritter](#) hosted an internal workshop series on private enterprises (financial institutions, student loan servicers, and financial technology firms) engaged in student loan markets.

Student loan markets have evolved rapidly over the past 15 years. The workshop speakers described their organizations' business models and the markets in which they operate. Other student loan-related topics that the various speakers touched on included:

- Student loans in the context of the rise of for-profit colleges and universities and the effects of these colleges on student debt levels and default rates;
- The expansion of private student debt during the Great Recession;
- The transformation of the federal student loan program from a lender-funded and -administered process to a direct-to-student, Treasury-funded model and the resulting exit of the majority of private lenders from the market;
- The rise of privately funded refinancing of student loans and newer forms of alternative student lending; and
- Potential changes to federal student loan programs in the near future.

Bank employees gained a greater understanding about student loan markets from a variety of viewpoints: risk management, consumer research/marketing, public policy, and legal fields. A forthcoming workshop summary will synthesize our insights from the workshop series.

At a March 2017 workshop, Charlie Rocha, executive vice president and chief marketing officer at Sallie Mae, provided a view of the student loan origination market from the perspective of the largest and most established private student loan originator.

At another workshop in March, Joe DePaulo, cofounder and chief executive officer of College Ave Student Loans, spoke to a Philadelphia Fed audience. DePaulo's company was founded in 2014 by former industry executives and focuses on providing flexible and personalized repayment plans for its borrowers.

DePaulo described the firm's typical consumer underwriting practices, unique application process, and anticipated asset performance. Additionally, he shared his thoughts about the roles of the government and private student loan programs and suggested that the government should prioritize funding for higher-need families who require subsidies to access college.

The workshop in April featured Sarah Ducich, senior vice president of government relations and public policy at Navient, the largest servicer of student loans. Navient was created in 2015 when Sallie Mae spun off its servicing operations from its bank business.

Ducich provided an overview of the student loan servicing industry. She discussed unique challenges facing servicers of student loans (particularly federal loans), including the funding structure for servicing loan accounts, which differs significantly from other credit markets. Ducich also covered issues related to struggling borrowers and the information and data required to analyze borrowing and repayment patterns so that researchers and policymakers can better target borrowers for default prevention and loan rehabilitation.

At the June workshop, Robert Lavet, general counsel at Social Finance, Inc. (commonly known as SoFi), visited the Bank to discuss privately funded refinancing of student loans. Private refinancing can alleviate the burden of student debt for highly qualified borrowers (both students and parents). SoFi has grown into the largest entity funding the refinancing of federal and private student loans, processing more than \$500 million of refinancing volume per month.

Lavet shared SoFi's history and business model, current student loan product offerings, and the process for refinancing student debt with the company. He also discussed SoFi's credit modeling and underwriting practices, prevailing regulatory issues, financing sources and consumer deposits, and SoFi's partnerships with depository institutions.

In addition to the 2017 workshop series, Consumer Credit and Payments Industry Expert [Susan Herbst-Murphy](#) hosted a February 2016 workshop featuring MPOWER Financing, a start-up public benefit corporation. The firm was created as a source of student loans for high-potential scholars who either do not qualify for federal aid or who face a gap between

federal aid maximums and the full cost of their educations. MPOWER has taken a unique approach to loan underwriting that is based on future earnings potential rather than past credit experience. Its scoring model helps predict loan repayment for young adults who have yet to establish a credit history and is especially relevant to foreign students attending colleges and universities in the U.S. A summary of the MPOWER workshop is available [here](#).

Research Examines Impacts on Consumers and Economy from Student Loan Debt

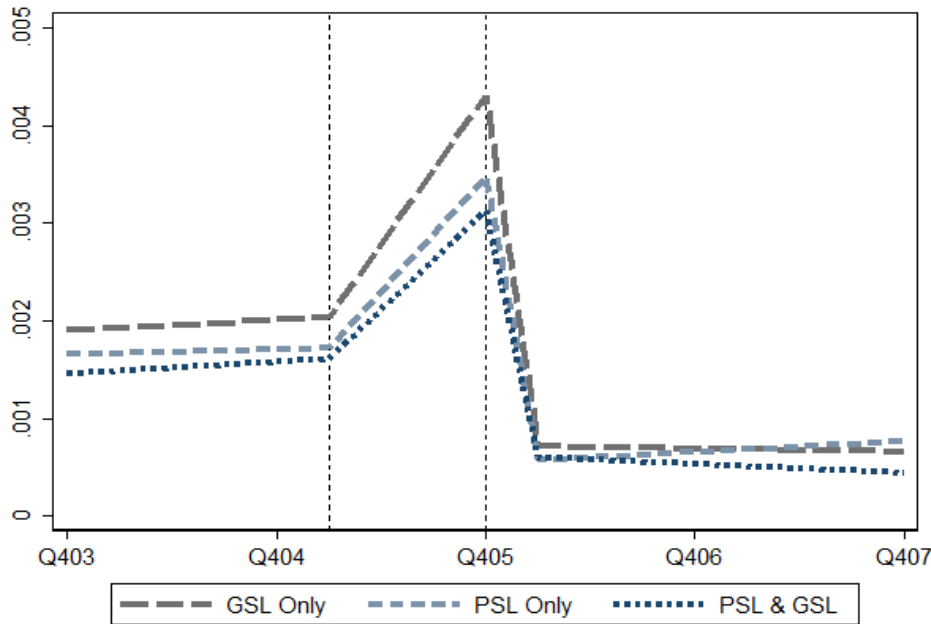
Given the rapid growth of student debt over the last decade, it is not surprising that economists and researchers with the Bank's CFI have been studying student loans extensively. For example, the Bank's research has analyzed the insurance aspect of student loan discharge for borrowers who did not finish college, the relationship between student debt outstanding and the formation of small business startups, and student loan trends in the Fed's Third District (composed of central and eastern Pennsylvania, southern New Jersey, and Delaware).

One recent [paper](#) published by the Philadelphia Fed looked at student loan debtor behavior after the U.S. changed its bankruptcy code in 2005. Among other changes, the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) restricted debtors' ability to discharge private student loan debt in bankruptcy proceedings. This "nondischargeability" provision of the law appears to have been motivated by the perceived incentive of some private student loan borrowers to declare Chapter 7 bankruptcy even if they had, or expected to have, sufficient income to repay their student debt.

Using a national sample of anonymized credit bureau files, Dubravka Ritter of the PCC and visiting scholar Rajeev Darolia from the University of Kentucky examined whether private student loan borrowers distinctly adjusted their Chapter 7 bankruptcy filing behavior in response to the reform. In their study, "Strategic Default Among Private Student Loan Debtors: Evidence from Bankruptcy Reform," they identified the effect of nondischargeability on private student loans by estimating the policy-induced change in private student loan debtors' bankruptcy filing behavior while accounting for the filing trends of debtors who had similar prepolicy bankruptcy filing trends but whose incentives were not directly affected by the BAPCPA.

As has been documented in prior research, the BAPCPA induced a large spike in Chapter 7 bankruptcy filings after the bill was signed but before the law was enacted. The spike was present for borrowers with only government loans, borrowers with only private loans, and borrowers with both types of loans. As depicted in the next chart, the rate of these filings declined substantially among all borrowers after the BAPCPA went into effect. If private student loan debtors were strategically filing bankruptcy, one would expect the decrease in Chapter 7 bankruptcy filings to be more pronounced for those borrowers. However, after properly accounting for potential policy-induced changes in credit supply, the authors found similar post-policy filing trends for private student loan (PSL) and government student loan (GSL) borrowers. In other words, they did not find evidence to indicate that the moral hazard associated with the dischargeability of private student loans appreciably affected the behavior of private student loan debtors prior to 2005.

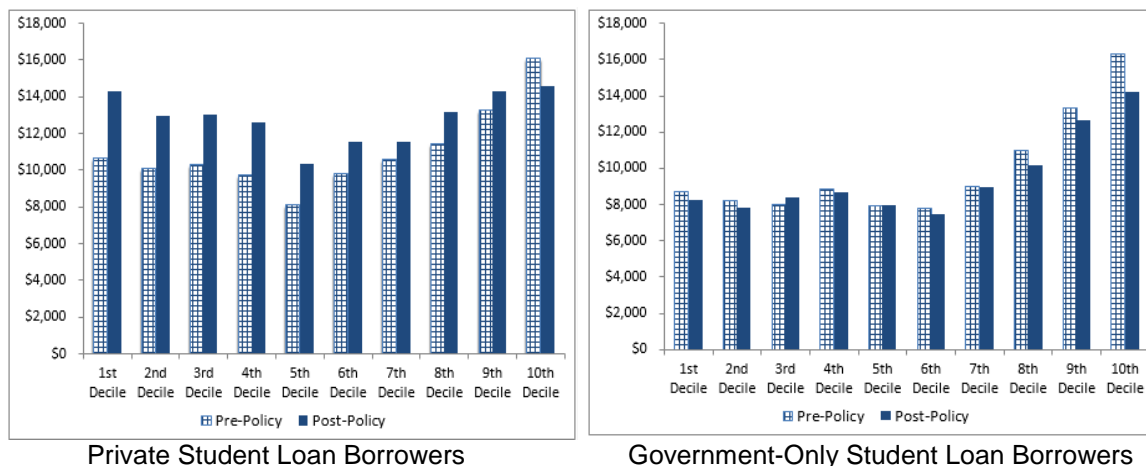
Figure 3: Chapter 7 Bankruptcy Filing Rate by Private/Government Student Loan Holdings



Note: The left vertical line marks the announcement, while the right vertical line marks the enactment of the BAPCPA.
Source: Authors' calculations using data from FRBNY Consumer Credit Panel/Equifax

The authors also provide descriptive evidence that the policy induced an expansion of private student loan supply and relaxed underwriting standards, consistent with traditional theories of creditor remedies. In particular, riskier borrowers (as measured by credit score) appear to have gained greater access to the private student loan market post-policy, and those relatively risky borrowers tended to borrow larger loan amounts. For example, post-policy loan amounts among the least creditworthy private student loan borrowers were more than 30 percent higher than pre-policy loan amounts, as depicted in the next charts.

Figure 4: Student Loan Amount by Risk Score Decile at Origination



Note: The chart analyzes a subsample of individuals with a credit bureau record and at least one new student loan originated in a given quarter. Vertical axis depicts the average student loan amount at origination by risk score decile at origination on the horizontal axis.

Source: Authors’ calculations using data from FRBNY Consumer Credit Panel/Equifax

Conclusion

With a number of research projects on student loans underway or planned, improving understanding of student lending market remains a research and policy priority for the Consumer Finance Institute. In a speech given in February 2017, Philadelphia Fed President Patrick T. Harker described student loan debt as a “problem that can act as a barrier to people getting the education they need.”³ Research done by the Philadelphia Fed has led to a greater understanding of the economic implications of rising student debt. Future work will aim to assist families and policymakers in incorporating the promise and consequences of student debt on the financial choices made by industry participants, government agencies, and consumers, especially younger Americans.

³ Patrick T. Harker, “Economic Outlook,” speech given at the Wharton School of the University of Pennsylvania in Philadelphia, on February 21, 2017.

Related Research

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