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The Hefty Yoke of Student Loan Debt

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High & Low Finance

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More than five years after the binge of irresponsible lending led to the credit crisis and Great Recession, the amount of consumer debt in the United States has begun to rise again, but with an important difference. This time the credit standards appear far tougher. Those who should not borrow generally do not.

Fewer consumer loans became seriously delinquent last year than in any recent year, the Federal Reserve Bank of New York reported this week.

Except, that is, for one type of debt: student loans.

There delinquencies continue to rise, and loans continue to be made without regard for the ability to repay.

At one time, student loans were a clear way to provide economic opportunity to people who might not have been able to attend college otherwise. In many cases, they still are. But increasingly it is becoming obvious that student loans are creating large problems that may persist for decades to come. They will impoverish some borrowers and serve as a drain on economic activity.

Since 2003, the New York Fed has been using a unique database of consumer credit — the credit files from Equifax, one of the main credit reporting services. Taking a sample of accounts, the Fed is able to see the trends in both lending and repaying and determine what is happening to people who do, or do not, have student loans outstanding.

Until 2009, young adults with student loan debt were more likely to own homes and were more likely to have car loans outstanding than were people of the same age without student loans. Those loans had enabled many of them to obtain college degrees and earn more money, qualifying them for mortgages. Those with student loans generally had better credit scores than those who did not.

But now the opposite is true. “Young people with student loans are less likely to buy a house,” said Wilbert van der Klaauw, a senior vice president of the New York Fed’s research and statistics group.

Those with student loan debt also are less likely to have taken out car loans. They have worse credit scores. They appear to be more likely to be living with their parents.

In other types of personal loans, those who owe the most are the most likely to default, for obvious reasons. But the opposite is true for student loans. “This suggests that borrowers who default are overwhelmingly noncompleters,” said Rohit Chopra, the student loan ombudsman for the Consumer Financial Protection Bureau. “These borrowers take on some debt but do not benefit from the wage increase associated with a degree.”

A lot of people are defaulting. The New York Fed report shows that while seriously delinquent personal loans have generally been declining since early 2010, delinquent student loans have been soaring. The report, for the fourth quarter of 2013, showed that 11.5 percent of such loans were at least 90 days behind in payments. In credit cards, traditionally the type of loan most likely to default, the rate was just 9.5 percent.

Actually, those figures seriously understate the problem. They ignore the fact that nearly half the student loans outstanding do not currently require any payment at all, either because the student is still in school or because the student has taken advantage of other ways to defer payment.

Before the Great Recession, many families financed college by taking out home equity loans, or by refinancing their mortgages, or by simply using savings. But the decline in home values, coupled with tougher lending standards, closed off the home equity route for many, and unemployment no doubt drained savings for others.

But the real issue may be that the most important lesson of the credit crisis — that those who make loans need to have good reasons to care if they are repaid — was not extended to the student loan market.

These days, federal student loans — the largest part of the market — are essentially made by the colleges, using government money. There is no underwriting criteria and few limits on how much any student can borrow. The limits that do exist apply to so-called dependent undergraduate students, who are at least partly supported by their parents. Graduate students can borrow what they want, and parents of dependent undergraduates can take out their own student loans after the student has maxed out.

Obviously, there is no way to apply conventional loan underwriting standards to students who, by definition, are not at the moment earning enough money to repay their loans. But the program is subject to abuse by colleges whose primary — if not only — goal is to get their hands on the money.

For programs that do not lead to conventional degrees — largely the training programs pushed by for-profit private schools, the kind that do a lot of advertising on New York subways — the Department of Education has been trying to come up with a rule to exclude programs that have a clear history of not producing people who can earn enough to repay their loans: a "gainful employment" rule.

The department's first effort was rejected by a federal judge after the Association of Private Sector Colleges and Universities sued.

The department has now submitted a second rule to the Office of Management and Budget; the details are not yet public. The department did that after a panel it appointed, including representatives of various types of colleges and students, could not reach agreement.

The student representative on that panel, Rory O'Sullivan, the research director of Young Invincibles, an organization formed by Georgetown law students to push for the involvement of young people in public policy, told me that he was worried that too many concessions were made to the commercial colleges, which are likely to be able to "game the rule."

The private sector colleges group has made clear it will fight the new rule. "Take Action Now! Against Gainful Employment," reads a plea on its website. It is backing a bill proposed by Representative Virginia Foxx, a North Carolina Republican who is chairwoman of the House Subcommittee on Higher Education and Workforce Training, that would block the rule "and prevent future federal overreach in postsecondary academic affairs," according to the subcommittee.

It might make sense for the department to instead, or in addition, design a "skin in the game" rule for the colleges. If a college's former students turn out to default frequently, the college could be required to pay a substantial penalty. That could mean colleges would have good reasons not to promote programs that did nothing to help their students.

On the other hand, colleges whose alumni were particularly good at repaying loans might receive some kind of financial reward, perhaps in the form of a grant that could be used for scholarships.

Any such proposal would prompt protests that such a rule would keep needy students from receiving the aid they need to get ahead. But all too often now, student loans are not a pathway to the middle class but a burden that keep young people from having any real chance of success.

"You want to open doors for students," Mr. O'Sullivan told me, "but you do not want to open doors that lead off a cliff, to default."

More also needs to be done to regulate the companies that service the student loans. "There are uncanny resemblances between issues faced by student loan borrowers and struggling homeowners," Mr. Chopra, the Consumer Financial Protection Bureau official, told me.

In the servicing of government-guaranteed student loans, Mr. Chopra said in a speech at the Federal Reserve Bank of St. Louis, "incentive misalignment may be acute. A default may sometimes be more beneficial and less costly for the servicer, compared to enrolling a borrower in a loan modification program."

One thing the federal student loan program does not lack is ways to collect the money. Bankruptcy will usually not cancel student loans, and the government has the power to seize income tax refunds and garnishee wages as needed. Some parents who guaranteed student loans that have defaulted find the money taken out of their Social Security checks. For a student, a default can destroy a credit record, making it hard even to rent an apartment, let alone buy a home.

And even those who manage to stay current on their loans will be significantly less well off than their predecessors. They are presumably less likely to contribute to 401(k) retirement accounts.

"Rising student debt may prove to be one of the more painful aftershocks of the Great Recession," Mr. Chopra said in his speech to the St. Louis Fed, "especially if left unaddressed."

Floyd Norris comments on finance and the economy at nytimes.com/economix.

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