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AN EQUAL SAY AND AN EQUAL CHANCE FOR ALL

How State Banks Can Reduce Student Debt

Introduction

In 2013, student debt surpassed $1.2 trillion,[1] highlighting a disturbing new reality: for an increasing share of students, higher education comes at the cost of long term debt. In 1989, 41 percent of graduating college seniors left school with student loan debt, which averaged $26,600. By 2012, two-thirds of graduating seniors had assumed such debt.[2] Higher education was once the gateway to the middle class. Now, students face a "debt-for-diploma" system that compromises their long-term financial stability and constrains the economic future of the country as a whole.

The debt-for-diploma system reflects state disinvestment in higher education. As states have slashed higher education budgets, public colleges and universities have shifted costs to students and their families. Between 1990 and 2012, tuition at public four-year institutions increased by 112.5 percent.[3] During this period, however, wages remained stagnant, making it impossible for students and their families to bear these additional costs. Consequently, they have nowhere to turn but student loans. Increasingly, they are taking on loans offered by large financial institutions that have entered this market much as Wall Street banks turned to mortgage-backed securities.

Addressing the student debt problem will require providing relief to existing borrowers and, over the longer-term, returning public higher education to a debt-free system. To achieve these goals, it will be vital for states and the federal government to provide new resources

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for funding higher education and focus existing resources to ensure affordability for working and middle class students.

State banks could be an important part of the solution by providing low-cost alternatives to onerous private student loans, extending relief to existing borrowers through refinancing, and by generating revenue for the state—revenue that could, in turn, be reinvested in higher education.

The state bank model—in place in North Dakota since 1919—could promote progress in each of these areas. Rather than serving as a stand-alone financial institution, a state bank facilitates lending among a state's community banks and credit unions. Through this coordination function, a state bank helps keep dollars in the state and moving through its community financial institutions, instead of allowing those dollars to flow to Wall Street. In addition, a state bank can also help direct affordable credit to worthy borrowers—such as students—and provide additional revenue to the state.

How Do State Banks Work?

The Bank of North Dakota (BND) was created in 1919 to serve industry and commerce in the state. The nation's only state-owned and operated bank, BND handles multiple functions for North Dakota while supporting and expanding—rather than replacing—local banking institutions. As the state's bank, BND provides banking services for which most other states turn to Wall Street, both providing interest earnings for the state and keeping servicing fees within North Dakota. BND also lends out a portion of state deposits and generates profits from those loans. In the banking world, returns of 1-2 percent on a bank's total assets is considered profitable. BND has averaged 1.7 percent over the past decade.[4]

Currently, BND manages more than $6 billion in total assets, with $3 billion invested in loans for businesses, farmers, property owners, and other borrowers in the state, including students.[5] However, BND's model is predominantly that of a bankers' bank. Rather than focus on retail lending, it partners with the local banking sector, allowing it to expand the reach of local financial institutions while avoiding taking on retail functions (such as managing branches) that could hamper its efficiency.

BND partners with local financial institutions through loan participations, in which multiple financial institutions come together to meet a particular funding need. Such loan participations allow smaller banks and credit unions to engage in lending of a scale that would otherwise be beyond their reach. With loan participations, the originating lender services the loan while secondary lenders, which provide supplemental funding, share in both the return and the risk.

Such arrangements have benefits for the local banking sector, the state bank, and local and regional economies. In the wake of the Great Recession, "too-big-to-fail" Wall Street banks have grown even larger, squeezing community banks while also retreating from those small communities (particularly rural ones) that community banks serve best. The state bank helps local banks keep investment flowing into their communities, providing funding for projects considered too small by Wall Street banks. By partnering with the state bank, community banks share in the risk associated with such loans and also help keep the state bank insulated from political influence that might otherwise affect its investment decisions.

In addition to loan participations, state banks can serve as a secondary-market for loans originated by community banks. In North Dakota, BND purchases residential mortgages and other loans (particularly federally-guaranteed loans), freeing community banks to engage in more lending. Without the secondary market provided by BND, community banks might otherwise sell these loans to Wall Street banks, which attempt to sell additional services to borrowers, undermining the borrowers' relationship with community banks and increasing risk for them. By purchasing loan participations, BND helps preserve consumer-community bank relations and also ensures that interest payments remain in the state rather than flowing to Wall Street.

For these and other reasons, North Dakota community banks overwhelmingly praise BND's role in their local financial community.[6] They are not alone in benefiting from the state bank. In 1967, BND entered the student loan market, providing affordable financing for higher education and paving the way for alternatives to the increasingly challenging financial environment with which the country's students must contend.

The Current Market in Private Student Loans

DIVESTMENT IN EDUCATION AND THE EMERGENCE OF THE DEBT-FOR-DIPLOMA SYSTEM

The explosion of the market in private student loans stems from public divestment in education. At a time of both growing enrollment and increasing diversity among undergraduates,[7] states have rolled back funding for colleges and universities.[8] Educational institutions have responded by passing costs on to students in the form of higher tuition.[9] However, wages have failed to keep pace with tuition increases, leaving many students and their families with a significant financial gap.[10] Meanwhile, states have shifted financial aid from need-based grants and loans toward merit aid, disadvantaging those students most adversely affected by tuition hikes.[11]

As a result, student debt has become a reality for an increasing share of the nation's young people. In 1989, 41 percent of graduating college seniors left school with student loan debt, which averaged $26,600. By 2012, 66 percent of graduating seniors had assumed such debt.[12] Yet, the young are not alone, and student debt has been growing among all age groups.[13] Now second to mortgage debt,[14] student debt represents the only form of household debt that saw continued growth during the Great Recession.[15]

THE EMERGENCE OF THE PRIVATE STUDENT LOAN MARKET

Although federal student loans account for the majority of student debt, a private student loan market has proliferated alongside the more affordable federal student loan system. This market, dominated by for-profit bank lenders, is capturing a growing segment of the student population.[16] From 2003-2004 to 2007-2008, the portion of undergraduates with private student loans nearly tripled[17] as total student debt raced toward and passed one trillion dollars in volume.

Investor speculation has been a key driver in this market, contributing to rapid expansion leading up to the 2008 recession, much as was seen with the mortgage boom. As investors turned to private student loans as a source of asset-backed securities, the market grew from less than $5 billion in 2001 to $20 billion in 2008. Following a period of contraction,[18] the market has been showing signs of growth once again, with Sallie Mae reporting an increase of 29 percent in the third quarter of 2011.[19] Overall, in the 2010-2011 school year alone, private student lenders originated $7.9 billion in new student debt.[20]

PRIVATE STUDENT LOANS COME WITH MORE RISK, HIGHER INTEREST RATES, AND GREATER COSTS

Not all student loans are created equal, and private student loans present more risk for students and are costlier than federal student loans, leading the CFPB to conclude that "the terms and conditions of a private student loan are almost never as beneficial to a borrower as a [federal] loan."[21] For this reason, and because private student loans also come with fewer repayment protections, the National Association of Student Financial Aid Administrators cautions students to always take federal loans first.[22]

Published interest rates for private student loans vary widely, from deceptively low teaser rates to rates so high they should be considered usurious. While federal student loans apply a single interest rate (currently at 6.8 percent, with financial-need reduction available), most private student loans are priced according to borrowers' credit ratings. According to a CFPB study, as of December 2011, interest rates for fixed-rate loans ran from teaser rates of 3.4 percent to 13.99 percent. The range was even greater for variable-rate loans, where borrowers saw a rate as high as 19 percent,[23] with the students with weakest credit histories—and perhaps the greatest need—generally burdened with the highest interest rates.[24]

By publishing low "teaser" rates, private lenders obscure the high cost of their loans relative to federal loans. These low rates attract borrowers, but ultimately almost all borrowers of private student loans receive higher interest rates than the current federal rate.[25] Costs are least predictable for borrowers with variable-rate private student loans. Should interest rates spike, they will find themselves even deeper in debt, as these rates are also often uncapped.[26]

To sell such loans, lenders in this market have engaged in practices reminiscent of tactics used in the high-risk mortgage market. Starting in 2005, they began marketing their loan products directly to students, often bypassing the financial aid offices tasked with helping students identify opportunities for non-loan aid, such as scholarships.[27] Between 2005 and 2007, the share of undergraduate loans originated without school involvement or certification of need expanded from 18 percent to more than 31 percent.[28] School involvement helps students assess the appropriate amount of debt to take out and which types of loans are most favorable. Indeed, according to Sallie Mae, the largest lender in this market, school certification can reduce loan amounts for 30 percent of loans reviewed through this process.[29]

In other cases, private lenders recruited educational institutions into their marketing practices, raising serious conflict-of-interest concerns. For instance, in 2007, one loan originator agreed to a $2.5 million settlement with the New York Attorney General's Office following allegations that it had entered into "revenue sharing" and other agreements with universities to steer students toward its loans.[30]

Given these marketing tactics, students frequently take out private student loans without understanding the terms of those loans and without exhausting less costly alternatives, including federal loans. According to the CFPB, more than half (approximately 54.5 percent) of private student loan borrowers were not using the full amount of federal aid available to them before taking on private debt.[31]

The web of private debt includes not only students but their families, as private lenders began requiring co-signers in the wake of the recession. There are now co-signers for more than 90 percent of private student loans, up from 55 percent in 2005.[32] In many cases, lenders refuse to discharge debt owed by a parent even if the student has died, as would occur with federal loans.[33]

BORROWERS ARE STRUGGLING TO PAY OFF PRIVATE STUDENT LOANS

The downturn in the job market has hit private student loan borrowers particularly acutely. As of 2009, 11 percent of recent private student loan borrowers with a bachelor's degree were unemployed,[34] and even those who are employed often find that their wages are not keeping up.

Many private student loan borrowers face loan payments that cut significantly into their income. According to the CFPB, 20 percent of employed recent undergraduate students had monthly loan payments representing more than 10 percent of income in 2009.[35] Five percent had loan payments exceeding 25 percent. The situation was worst for those who continued with their education through obtaining their bachelor's degrees, with 38 percent facing payments of 10 percent or more of income.[36]

Unfortunately, however, private student loans do not come with the repayment protections associated with federal loans, such as income-based repayment, opportunities to cure default, public service debt forgiveness, or discharge in event of death or disability.[37] In fact, many private lenders that once offered a one-year forbearance period have curtailed that option for struggling borrowers, replacing it with more stringent, shorter-term forbearance. As a result, the incidence of forbearance dropped from 17.1 percent in 2007 to 3 percent in 2011.[38]

Even negotiating these more limited options can become very complicated. Just as mortgage originators sell home loans to downstream investors, student loan originators sell off private student loans. This often makes it difficult for borrowers to determine the amount of their debt, the party to whom it is owed, and where to turn to resolve disputes.[39] Finally, it is extremely difficult—if not impossible—to have these debts discharged through bankruptcy.[40]

Thus, this problem of indebtedness is compounded by the reality of PSLs carrying worse rates and terms and have fewer safety features than federal loans. This is a recipe for repayment problems and in fact, the CFPB estimates that default rates will reach 50 percent for some bundles of private student loans that were made direct to consumer, bypassing student aid offices, while other depository lenders (like the Bank of North Dakota) who do not sell their loans and work with schools have seen very low default rates, even in the worst of the economic crisis.[41]

State Banks Can Make Student Loans—and College—More Affordable

A state bank has the potential to address the major factors that are putting college out of reach for students or driving them further into crushing debt. The state owned and operated Bank of North Dakota entered student lending early, making the first federally insured student loan in the United States in 1967.[42] For more than four decades, BND has maintained its focus on affordable student lending while also building a robust economic engine for the state by partnering with the community banking sector. The model developed by North Dakota can be expanded—and is under consideration—in states across the country, with potential to make higher education more affordable at multiple levels.

Currently, the private student loan market is dominated by large financial institutions accountable to maximize profits for shareholders, such as Wells Fargo, Discover and Sallie Mae, which accounted for three quarters of private student debt generated in 2010-2011.[43] Other lenders in this market include non-profit entities, often affiliated with states, and educational institutions themselves. However, as student loans are relatively small and require greater staff time to originate and service than do other forms of lending, large financial institutions remain dominant, drawing on their robust credit evaluation systems, capacity to lend, and access to low-cost funds.

This dominance contributes to the problems that so many students face in private student loan market: lack of affordable options, increased risk, increasing debt loads, and limited or no access to debt relief when borrowers fall behind. Moreover, the dominance of large financial institutions—which sell the debt to downstream investors and return profits to out-of-state shareholders—also drains the states of potential returns on investment that could be used for public purposes, including making higher education more affordable. The state bank model can address each of these problems.

As occurs in North Dakota, state banks can support private student loans with terms that are more consumer-friendly than those available without state-bank support. Through its Dakota Education Alternative (DEAL) program, BND lent $117.6 million in 2012, with interest rates averaging 4.77 percent for fixed-rate loans and 1.965 percent for variable-rate loans, both below the federal student loan interest rate.[44] Furthermore, rates on these loans are not calculated according to borrower credit score, and residents of North Dakota pay no fees for the processing of such loans.[45] Finally, interest rates are capped at 10 percent, whereas many borrowers are taking out private market loans that start with rates far higher.

Although new student borrowers would be the immediate beneficiaries of affordable loan options provided by state banks, they are not the only ones who stand to gain from the state bank model.

Over the past decade, BND has earned $525 million in net income, typically returning approximately $30 million to the state each year.[46] This figure represents approximately 10 percent of the state's higher education budget of $311.7 million for 2010-2011.[47] This revenue source is one reason North Dakota is among the top states in terms of higher education funding per student and overall affordability.[48] State banks in other states could serve as an economic engine just as BND does for North Dakota, generating revenue that legislatures can use for a range of public benefits, including education.

If states choose to use state bank profits toward higher education, they can take one of two approaches—increasing funding for education or offering debt relief for existing borrowers—or they can opt for a combination of both. A direct investment in tuition reduction would make higher education a possibility for more graduating high-school seniors, significantly reducing their debt load or helping some avoid student debt altogether. If a state wished to target its tuition-reduction investment to those who need assistance the most, it could fund a state-level work study program or scholarships for students in need.

As important as tuition reduction is, this approach would not help existing borrowers. To provide such debt relief, a state could use state bank profits toward debt consolidation for those already burdened by student debt, particularly private loans. A consolidation program could have multiple benefits. For borrowers, it would reduce the costs of debt and relieve borrowers of private loans with onerous terms and conditions. For the state as a whole, it would keep more dollars flowing in the local economy: with lower loan payments, borrowers would be able to direct more of their spending to the small businesses that form the backbone of their communities.

Conclusion

State disinvestment in higher education is driving more and more of the country's young people into crushing debt. The emergence of the debt-for-diploma system is draining borrowers of much-needed wealth, closing the doors to the middle class, and jeopardizing the economic health of the country as a whole. However, lawmakers have options for reversing this trend and restoring access to higher education for millions of young people who now wonder whether a college diploma is worth the cost.

At the state level, the state bank model is receiving increasing attention as states look for ways to prevent their dollars from flowing out-of-state and into Wall Street banks. In recent years, state bank legislation has been introduced in at least fourteen states, from Arizona to South Carolina.[49] Continued attention is expected in upcoming legislative sessions.

The state bank model should be of particular interest to lawmakers taking action to address the debt-for-diploma system. When it comes to student debt, state banks could promote progress on multiple levels, providing low-cost alternatives to onerous private student loans, extending relief to existing borrowers, and generating revenue for the state—revenue that could, in turn, be reinvested in higher education. In short, a state bank could help a state restore its young people's confidence that their investment in education will pay off in the long run. As students suffer under the weight of historic debt levels, this confidence is needed more than ever.

This brief was written by Jared Gardner.

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