HOW MUCH IS TOO MUCH?

EVIDENCE ON FINANCIAL WELL-BEING
AND STUDENT LOAN DEBT

Beth Akers

AEI Series on Reinventing Financial Aid

CENTER ON HIGHER EDUCATION REFORM
AMERICAN ENTERPRISE INSTITUTE
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Executive Summary

The media have paid a tremendous amount of attention to the plight of graduates who struggle to make payments on their student loans. The message is that young people are taking on too much debt. But how much debt is too much?

To answer that question, we need to understand how previous generations of student borrowers are faring financially. This paper examines the incidence of financial hardship among households in the United States that have taken on debt to pay for college. The findings indicate that there is not a strong positive relationship between student debt and financial hardship; high-debt borrowers face financial hardship at only slightly higher rates than comparable households with less debt. Additionally, the highest rates of financial hardship are seen among households with relatively little outstanding student loan debt.

This pattern suggests that discouraging borrowing through restrictive limits on federal borrowing or other means may not be the most effective way to prevent overborrowing and the financial hardship that it can lead to. Rationing federal credit through a more complex system involving individual loan underwriting that assesses the likelihood that a given borrower will be able to repay the debt, rather than through the flat borrowing caps that are in place today, could be a more effective way to protect consumers.

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The federal student loan program was created with the passage of the Higher Education Act in 1965. At that time it was understood that, unless the government provided credit for students seeking higher education, many would not be able to access the opportunities that would lead to both individual prosperity and a greater contribution to society. The scale of federal lending has grown tremendously since that time, with especially rapid growth over the past decade. Among students enrolled in college during the 2012–13 academic year, 34 percent took out federal student loans, a rate 10 percentage points higher than one decade earlier when just 24 percent took out federal loans.\(^1\)

Loans are playing an increasingly large role in the financing of postsecondary education for a number of reasons including tuition inflation, increases in educational attainment, changing demographics of those who pursue postsecondary degrees, and changing attitudes toward debt. With the cost of tuition rising far more quickly than other prices in the economy at the same time society is pushing to enroll more students from low-income households, this reliance on debt is unlikely to let up in the coming years. Given all of this borrowing, it is important to ask: how much debt is too much?

At a fundamental level, the government provides loans to students to correct for a failure in the credit market. Unlike loans that are originated to purchase an item with resale value, such as a house, education loans are not generally secured by collateral. This means there is no guarantee that a lender can recoup its losses if a borrower stops making payments. Lenders cannot compel borrowers to utilize the knowledge and skills they obtained through education to earn wages that can then be used to repay the loan. This makes student loans an inherently risky investment for lenders. As a result, many students for whom college would be a good investment would not be able to obtain the necessary financing without government intervention. The role of the federal lending program is to make education loans to students who will benefit from education but to whom the private market would not lend.

It is clear that the availability of federal loans is critical to our system of higher education, but it is less obvious how the government should allocate credit (that is, who should be able to borrow, and at what level?). In the private market, lenders make credit available insofar as they expect the borrower to be able to repay the debt, with competition between lenders in the market ensuring that borrowers get a fair deal. Government intervention in the market breaks down this mechanism for allocating credit and forces policymakers to decide who should be able to take out loans and how much they should be able to borrow. In determining the appropriate allocation of credit, policymakers must balance the mission to increase enrollment among low-income students with the responsibility to ensure that students do not take on more debt than they can reasonably expect to repay. Policymakers are tasked with setting limits for federal student loans that ensure both that poor students can afford to go to college and that students are not setting themselves up for a future of financial hardship. It is important to remember that access to debt is not the appropriate policy tool for encouraging students to enroll in college.

Regardless of the limits set on federal borrowing, there will always be borrowers who struggle financially. While the returns to education are positive on average, there will always be some investments that do not pay off. Safety nets such as payment deferral, income-based repayment, and loan forgiveness are in place to help those who face bad outcomes. The mechanism...
for rationing federal student loans should not aim to eliminate the possibility of future financial hardship but should be set in such a way that overborrowing and the resulting financial hardship does not occur in a predictable and therefore avoidable manner. While the rationing of credit in the federal loan program can have budgetary implications, this paper will focus on the optimal policy with regard to consumer protections.

One conceivable way to reduce the instance of financial hardship brought on by overborrowing is to ration credit in a more conservative manner. However, as these findings indicate, lowering borrowing limits would not necessarily achieve that objective. Many of the borrowers who are struggling financially have borrowed very little. Likewise, the relatively low rate of hardship reported among high-debt households suggest that these debts funded educational investments that provided a large return. In other words, a high level of indebtedness alone does not necessarily indicate overborrowing, and a low balance does not rule out the possibility of overborrowing and related hardship. To create adequate consumer protections, it is necessary to recognize that overborrowing occurs when students borrow more than they can expect their degree to return in higher future wages. These findings highlight the need for a more complex system of underwriting to determine eligibility for federal loans. A system that takes into account an individual borrower’s predicted ability to repay a debt has the potential to reduce the number of student borrowers who struggle to repay their debts in the future.

I conclude with a set of policy recommendations regarding loan limits and the regulation of the private lending industry that emerge from the empirical analysis. The recommendations in this paper are intended to contribute to the debate over the upcoming reauthorization of the Higher Education Act. With all of the discussion over a pending crisis in student lending, it would be prudent to revisit the consumer protections implicit in these programs.

### Background on the Federal Student Loan Program

The federal student loan program plays a critical role in financing the market for postsecondary education. Among the approximately 21 million students enrolled in undergraduate programs in 2007–08, 35 percent took out loans through the federal student lending program to help pay for the cost of attendance. As of 2010, almost 40 percent of adults under the age of 40 had some outstanding student loan debt.

The highest rates of late bill payment, an indication of financial hardship, are observed among households with outstanding debts less than $5,000.
Students are also using loans to pay for a growing proportion of college costs. At the national level, 50 percent of net tuition expenses are now financed using student loans; this is up 10 percentage points from a decade earlier. Even so, the maximum allowable borrowing for undergraduate students covers only a fraction of the total cost of attendance at many institutions. Students would likely cover an even larger fraction of their college costs with loans if there were less restrictive limits on borrowing in the federal student loan program.

Under current law, students face different borrowing limits at each stage of their educational career. Students in their first year of postsecondary education face the lowest limit on annual borrowing, with dependent students able to borrow only $5,500 and independent students able to borrow $9,500. These limits increase in the second and third years of study until they reach the annual cap of $7,500 and $12,500 for dependent and independent students, respectively. In addition to these constraints, there are lifetime borrowing limits: $31,000 for dependent students and $57,000 for independent students.

Graduate students, whether claimed as dependents or not, may borrow up to $20,500 in Stafford loans each year they are enrolled, up to a lifetime maximum of $138,500. Graduate students may also borrow at a higher interest rate from the PLUS loan program, up to an amount equal to their cost of attendance including living expenses. There are no aggregate limits in the PLUS program.

The current limits on lending were set in the Ensuring Continued Access to Student Loans Act of 2008, which was passed to head off a liquidity crisis for student loans. These limits are not pegged either to prevailing prices in the market for postsecondary education or to other prices in the economy and will not change again without further legislation.

Since the total cost of attendance at many institutions exceeds the limits on federal student loans, students without resources to pay the remainder out of pocket turn to the private market. Whether a student can access credit in the private market depends on the lenders’ willingness to lend. Unlike the federal loan program, the private sector employs an underwriting process to assess the likelihood that a given borrower will be able to repay the debt. The outcome determines both the student’s access to credit and the interest rate at which he or she can take out the loan. Interest rates on private student loans tend to exceed the rates on federal student loans by a wide margin. Unlike other forms of consumer credit, student loans are generally not dischargeable in bankruptcy, meaning they must be repaid in full even if
borrowers are absolved of their other debts. Private loans also lack the income-based repayment protections that accompany federal student loans.

In the public debate over the issue of student loan debt, it is sometimes implied that large debt burdens necessarily lead to financial hardship. However, the reality is that large debts are often taken on by individuals who ultimately receive high earnings. Debt is benign insofar as it is used as a tool for accessing education that leads to greater earnings in the future. The concern, however, is that increases in borrowing are not being driven entirely by increased investment, but rather by spending that does not generate higher earnings in the future. If this is the case, then the increased indebtedness that has been observed has occurred without a corresponding increase in earnings and thus ability to pay. Examining the financial well-being of previous borrowers can provide some suggestive evidence about whether this is the case.

As of 2010, almost 40 percent of adults under the age of 40 had some outstanding student loan debt.

If borrowers from previous generations fared worse when they took on larger student debts, it suggests that higher future earnings did not accompany the debts. However, if high-loan-balance borrowers have not faced financial hardship more often than their peers, it lends credence to the notion that the growth in debt reflects growth in worthwhile educational investments that should not be suppressed.

Evidence on the Financial Well-Being of Households with Debt

Evidence to inform this discussion draws from an analysis of the Survey of Consumer Finances (SCF), which is administered by the Federal Reserve Board. This survey contains information on personal finances and labor market outcomes for a representative sample of households in the United States. The survey is administered every three years and has been conducted in its current form since 1989.

The survey captures information about households of all ages, but the analysis in this paper is based on households with the average age of adult members falling between 20 and 40 years old. This is the population that we would expect to be dealing with the most severe financial repercussions of taking on educational debt. Since earnings tend to increase with age and experience, the financial burden of monthly student loan payments will generally decrease over time.

The statistics and figures in this report are based on the surveys carried out in 2001, 2004, 2007, and 2010. Since there have been changes over time that would affect the relationship between debt and financial hardship, it is best to focus the analysis on a relatively short window of time. I have combined multiple years to increase precision, but the qualitative findings do not change when the analysis is repeated using data from the 2010 survey alone. Note that each survey year collects data on a representative sample of the population rather than a single cohort of borrowers. This means that the survey administered in 2010 does not sample from a completely different population than the surveys administered in previous years.

A significant challenge in this empirical exercise is the task of determining financial well-being. Two households with similar levels of debt and earnings may vary tremendously in their economic well-being because of differences in cost of living, family obligations, and other idiosyncratic differences. The SCF asks a few questions about household debt (all types) that seek to capture the financial well-being of the surveyed households, including:

1. “Now thinking of all the various loan or mortgage payments you made during the last year, were all the payments made the way they were scheduled, or were payments on any of the loans sometimes made later or missed?”

2. “Were you ever behind in your payments by two months or more?”
While these measures do not necessarily provide a comprehensive description of the financial well-being of a household, they do provide a reliable measure that is comparable across households. Since these measures are self-reported, there is likely some error due to misrepresentation, as some respondents may be less willing to admit to financial hardship. However, it is unclear how this would bias the data in a way that would make comparisons across households ineffective for this exercise.

Among the survey population, 28 percent of households hold some amount of student loan debt (36 percent of households surveyed in 2010 had outstanding debt). Among these households, the average, per-person balance is $14,902.6 This differs from the figures frequently cited by the media because it captures cumulative borrowing from all postsecondary studies (undergraduate and graduate) and because it reflects the balance at a point during repayment rather than initial borrowing.

The average outstanding debt increases with education. Households with some college as the maximum level of educational attainment (among adults in the household) have an average of $3,904 in outstanding debt. This category includes those with associate degrees and those who did not complete a degree. Households with at least one four-year degree holder carry an average balance of $6,987. The average balance for households with at least one graduate degree is more than twice this amount at $14,725.

Nearly one-third of households, regardless of their borrowing behavior, report they have made late payments on bills at least once during the last two years. Households with and without student loan debt reported making late payments at similar rates: 28 percent for households without debt and 29 percent for households with debt.

A smaller proportion of the population (11 percent) report they have had bills more than 60 days overdue during the same period. This proportion is slightly larger (14 percent) among households with outstanding student loan debt, and the difference is statistically significant.

### Table 2

**Measures of Financial Distress**

<table>
<thead>
<tr>
<th></th>
<th>Outstanding Debt</th>
<th>Late Payment</th>
<th>Late Payments at Least 60 Days Overdue</th>
<th>Student Loan in Deferral</th>
<th>Unemployed</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Households</td>
<td>$4,117</td>
<td>0.29</td>
<td>0.11</td>
<td>–</td>
<td>0.08</td>
</tr>
<tr>
<td>Households with Education Debt</td>
<td>$14,902</td>
<td>0.29</td>
<td>0.14</td>
<td>0.37</td>
<td>0.09</td>
</tr>
</tbody>
</table>

**Maximum Household Education**

- No College: $3,904, 0.37, 0.16, 0.40, 0.11
- Some College: $6,987, 0.14, 0.05, 0.27, 0.05
- Four-Year Degree: $14,725, 0.12, 0.03, 0.24, 0.02
- Grad. or Prof. Degree: –, –, –, –

**Outstanding Debt (by quartile)**

- $0: –, 0.28, 0.10, –, 0.08
- $0–$3,386: –, 0.34, 0.18, 0.26, 0.12
- $3,386–$8,080: –, 0.29, 0.15, 0.33, 0.09
- $8,080–$18,930: –, 0.26, 0.12, 0.41, 0.06
- >$18,930: –, 0.26, 0.11, 0.49, 0.07

The highest rates of financial distress, as measured by late bill payments, are seen among households with the lowest levels of educational attainment. Thirty-seven percent of households without any education beyond high school report making late payments (16 percent report payments more than 60 days overdue). The rate of reported hardship is only slightly less for households with some college (34 percent). Those with at least a four-year degree fare much better. The rate of late bill payment falls to 14 percent and 12 percent for four-year degree and graduate degree holders, respectively. This is consistent with the fact that degree attainment leads to increased earnings and lower rates of unemployment, making households with more education better able to withstand financial shocks without missing bill payments. Other differences besides educational attainment exist between groups of borrowers with different levels of education, so the observed relationships should not be interpreted as causal.

The relationship between student loan debt and financial hardship is illustrated in figure 1. Both the incidence of late payments and the incidence of 60-day-overdue payments are plotted using a locally weighted scatterplot-smoothing method, which allows for easier visualization of the data (financial distress is a binary variable). A cumulative distribution function for outstanding student loan debt is also provided. The plots reveal that the highest rates of financial hardship are reported among households with very small outstanding debts, and that incidence of hardship does not seem to increase markedly with outstanding debt. High-debt borrowers face hardship at similar rates as

**Figure 1**

**Likelihood of Late Bill Payments by Outstanding Student Loan Debt**


Note: The incidence of late payments and 60-day-overdue payments is plotted using a locally weighted scatterplot-smoothing method, which allows for easier visualization of the data (financial distress is a binary variable). A cumulative distribution function for outstanding student loan debt is also illustrated.
households with more modest levels of debt. While the relationship appears to become negative above $50,000, the estimates above this value are unreliable because of the limited number of observations. Ninety-five percent of borrowers have less than $56,000 in outstanding debt. The values reported in table 2 confirm these patterns. The highest rate of late bill-paying (34 percent) is among households with outstanding debt in the first quintile of the sample distribution ($0–$3,386).

An alternative measure of the burden that student loan debt imposes on a household is the amount due in monthly payments. Since we do not observe the original loan amount in the data set being used here, the monthly payment due can be used as a suitable proxy. The relationship between financial hardship and reported monthly student loan payments is illustrated in figure 2. The pattern seen in these plots is consistent with the previous figure. The highest rates of late bill paying are among households with the smallest monthly payments. The rate of hardship does not vary largely from 0.2 for the majority of the debt distribution.

Much of the variation in student loan debt can be explained by differences in educational attainment. Average outstanding debt increases markedly with educational attainment in this population (as shown in table 2). Likewise, much of the variation in financial hardship can be explained by differences in educational attainment. Because of higher earnings and lower rates of unemployment, households with higher educational attainment are less likely to face financial hardship, regardless of their debts. Therefore, it is helpful to remove this confounding variable and examine the relationship between financial hardship and student

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**Figure 2**

**Likelihood of Late Bill Payments by Monthly Payments Due on Student Loans**

![Cumulative Distribution of Monthly Payments](source)


Note: The downward-sloping segment of the curve (to the right of $1,200) is based on a small number of observations. Ninety-five percent of borrowers make monthly payments of less than $470.
loan debt among households that have similar levels of educational attainment. This is illustrated in figure 3. This figure provides plots that indicate the relationship between incidence of late payments and outstanding debt within each of the three education categories.

The rate of financial hardship is generally highest among households with some college, followed by those with a four-year degree, and then by those with graduate degrees. In every category, some of the highest rates of financial hardship are seen among households with the smallest outstanding debts. In contrast to the previous figure, the rate of hardship then begins to increase with outstanding debt. Over much of the distribution of outstanding debt, there is a slight positive relationship with financial hardship. However, the variation in frequency of financial hardship is quite small. Among borrowers with four-year degrees, 15 percent of households in the first quartile of the distribution of outstanding debt (less than $5,258) report financial hardship, while 25 percent of borrowers in the fourth quartile (more than $23,393) report financial hardship.

Once you control for other factors that vary across borrowers (marital status, age, and survey year), the relationship between outstanding debt and hardship becomes less positive. A simple linear regression indicates that among the survey population, an additional $1,000 in debt is associated with a likelihood of financial hardship that is 0.11 percentage points higher (see regression table in appendix). This relationship is statistically significant, but very small. According to this estimate, the likelihood of financial hardship does not largely differ between the extremes of the observed debt distribution. The likelihood of financial hardship differs by 1.7 percentage points when you compare similar individuals with outstanding debt at the 25th and 75th percentiles of the distribution. It is apparent from visual inspection that the variation across educational categories is larger than the variation within groups across the

Figure 3

**Likelihood of Late Bill Payments by Educational Attainment and Debt**

distribution of outstanding debt.

One reason we do not observe higher levels of financial hardship among high-debt borrowers is because higher earnings offset the higher expense of repayment. The relationship between earnings and debt is illustrated in figure 4, and the underlying statistics are reported in table 3.

Two measures of income are reported: wage income and normal income. Wage income measures the earnings that a household receives from working at a job. We would expect this measure of earnings to be more closely related to educational attainment than some other measures (that is, investment income). However, wage income can potentially be misleading when trying to measure long-run financial well-being because it can vary largely from one month to the next. For instance, zero wage earnings will be observed when an individual is in transitional unemployment (that is, between jobs). In addition to wage income, the SCF asks respondents about their normal level of earnings. Since this measure is not sensitive to temporary fluctuations, it may be better suited to this exercise.

Among households in the sample, the average annual per-person earnings (as measured by normal income) are approximately $36,000. As would be expected, there is large variation in annual earnings across education categories. Households with a maximum educational attainment of a high school degree or less have average annual per-person earnings of $25,000. This increases to $33,000 for households with some college, $52,000 for households with at least one bachelor’s degree, and $66,000 for households with at least one graduate or professional degree. The table also illustrates the relationship between outstanding debt and earnings. The
apparent positive relationship between debt and earnings explains part of why we do not observe a stronger positive correlation between student debt and the incidence of financial hardship.

Another reason we do not observe a stronger relationship between debt and financial hardship is that federal student loans have built-in safety nets to protect borrowers during periods of economic hardship. This means that student loans impose a smaller burden than other types of debt. The survey respondents report using this benefit relatively often. Thirty-seven percent of households report that at least one of their student loans is in deferral.

However, much of this is due to enrollment rather than financial hardship. Repayment of federal student loans can be deferred if the borrower is enrolled at least half-time in a postsecondary program of study. Eleven percent of households with outstanding student loan debt have at least one adult member who is enrolled in a postsecondary program. It is clear that there is a strong positive relationship; households with large outstanding student loan balances defer loan repayment more often than those with smaller outstanding debts. However, the higher frequency of deferral among high-debt households is not necessarily due to financial hardship. The rate of enrollment is also higher among high-debt households. It is not possible to identify the reason for loan deferral in this data set. However, any long-term bouts of financial distress would be apparent in the measures already examined because loans are eligible for deferment (due to economic hardship) for only up to three years.

**Table 3**

<table>
<thead>
<tr>
<th>Average Debt and Earnings</th>
<th>Wage Income</th>
<th>Normal Income</th>
<th>Debt-to-Income Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Households</td>
<td>$34,035</td>
<td>$36,332</td>
<td>–</td>
</tr>
<tr>
<td>Households with Education Debt</td>
<td>$34,400</td>
<td>$36,831</td>
<td>0.32</td>
</tr>
</tbody>
</table>

**Maximum Household Education**

<table>
<thead>
<tr>
<th></th>
<th>Wage Income</th>
<th>Normal Income</th>
<th>Debt-to-Income Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>No College</td>
<td>$23,145</td>
<td>$25,209</td>
<td>–</td>
</tr>
<tr>
<td>Some College</td>
<td>$30,192</td>
<td>$32,554</td>
<td>0.02</td>
</tr>
<tr>
<td>Four-Year Degree</td>
<td>$50,012</td>
<td>$52,447</td>
<td>0.04</td>
</tr>
<tr>
<td>Graduate Degree</td>
<td>$63,254</td>
<td>$66,246</td>
<td>0.04</td>
</tr>
</tbody>
</table>

**Outstanding Debt (by quartile)**

<table>
<thead>
<tr>
<th></th>
<th>Wage Income</th>
<th>Normal Income</th>
<th>Debt-to-Income Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0</td>
<td>$33,895</td>
<td>$36,141</td>
<td>–</td>
</tr>
<tr>
<td>$0–3,386</td>
<td>$29,338</td>
<td>$30,760</td>
<td>0.02</td>
</tr>
<tr>
<td>$3,386–8,080</td>
<td>$32,071</td>
<td>$35,798</td>
<td>0.59</td>
</tr>
<tr>
<td>$8,080–18,930</td>
<td>$35,443</td>
<td>$37,475</td>
<td>0.56</td>
</tr>
<tr>
<td>&gt;$18,930</td>
<td>$40,785</td>
<td>$43,315</td>
<td>0.04</td>
</tr>
</tbody>
</table>


Note: To normalize income across households with different numbers of earners, averages are calculated per person rather than per household.

Implications for Federal Student Loan Policy

The evidence presented here suggests that simple loan limits like the ones in place today may not be an effective way for the federal loan program to protect students from borrowing more than they will be able to afford. Rates of financial distress are not drastically higher among high-balance borrowers, as we would expect if
overborrowing (borrowing more than you can reasonably expect to be able to repay) were concentrated among these borrowers. Therefore, it is likely that overborrowing happens across the distribution. Overborrowing is a function not only of the loan amount but also of the financial return that the borrower reaps in the future.

In the current system, loan limits are based only minimally on an expectation of a student’s future ability to repay, with borrowing limits that increase with educational attainment. The differentiation by educational attainment seeks to minimize excessive borrowing, without unnecessarily limiting access for borrowers who are making sound investments. While this system is superior to one in which there is no differentiation between borrowers by years of attainment, it leaves much to be desired.

One alternative to the system of loan limits currently in place is to make loan eligibility determinations on an individual basis, taking into consideration all of the circumstances faced by the individual, as well as the outlook for future ability to repay. This could be achieved using an underwriting process, like the one used in the private sector, to determine borrower loan eligibility. The Department of Education is uniquely positioned to be able to underwrite loans effectively because of its access to the universe of data on student loan repayment and a wealth of information about individual borrowers.

The process of underwriting loans entails making an implicit prediction about a student’s future earnings and using that information to determine how much debt would be affordable for the borrower. Recall that the current system determines loan eligibility based on educational attainment. Since borrowing limits, like earnings, increase with educational attainment, this is effectively an imprecise method of underwriting. However, this process falls short of the goal of providing effective consumer protections; the ability to repay debts varies tremendously even within groups of borrowers who have the same level of educational attainment. Current policy does not succeed in discouraging borrowers from taking on debt even when it is very likely, based on the experiences of previous borrowers, that they will be unable to repay it. Rationing credit through an underwriting process can reduce the number of students who overborrow and face negative financial consequences as a result.\textsuperscript{8}

An individual student’s ability to repay debts in the future can be predicted with far more accuracy if additional information beyond educational attainment is taken into account. For instance, program of study (major) explains a significant portion of the variation in observed earnings among individuals with the same level of education. Likewise, the institution of enrollment can have a strong relationship with future earnings. Both pieces of information could be used to generate more precise estimates of an individual’s future earnings and his or her ability to repay debts. Predictions regarding future ability to repay debt could be improved further by taking into account academic achievement and previous borrowing, as repayment rate (conditional on debt) is likely to differ systematically across these dimensions.

\textit{Because of higher earnings and lower rates of unemployment, households with higher educational attainment are less likely to face financial hardship, regardless of their debts.}

One serious implication of an underwriting system of this nature is that it will not maintain the equity of loan availability that is achieved by the current system of loan limits. If loan eligibility is determined according to predicted ability to repay, it is very likely that disadvantaged students will face the lowest limits on borrowing. In one sense, this will limit the students’ ability to access higher education. However, an effective underwriting process will restrict access only in those instances where borrowing would have led to a bad outcome for the borrower.

It is important to remember that federal loans are not the appropriate policy lever for encouraging disadvantaged students to enroll in college. Allowing needy students to borrow more than they can reasonably expect to repay is not a good strategy for promoting social mobility, and may actually represent a disservice to those that policymakers have the greatest interest in helping.
Generating a precise prediction about the probability that a borrower will be able to repay a debt is the best way to both ensure access and protect borrowers from financial distress in the future.

Allowing lenders to have a protected claim on borrowers’ future earnings increases their willingness to make credit available.

The empirical evidence presented in this paper suggests that a more precise system of loan underwriting is necessary to improve consumer protections in student lending, but it unfortunately does not provide any insight into the appropriate specification for the underwriting formula. The formula should aim to tailor loan eligibility to meet individual students’ needs, but should do so without introducing unnecessary complexity. It has been shown that complexity in the financial aid system can serve as a barrier to access, especially for students from lower-income households.

To minimize complexity, underwriting should be based on a limited number of important dimensions, and it should be clear to borrowers how these dimensions affect their ability to borrow. Prospective students should be able to understand both their eligibility for loans and how their actions (such as their choice of institution and major, and their academic success) will impact that eligibility. The growing number of initiatives aimed at providing information to prospective students would need to communicate these aspects of the federal aid program. The simplicity of the existing loan program may help students access credit, but it does not help them make good decisions about their higher education investments.

The evidence presented in this paper does not indicate that aggressive regulation of the private lending industry is necessary. As discussed, financial institutions have little incentive to provide loans they do not expect the borrower to repay. In this sense, the industry is self-regulating by design. However, one aspect of the regulation of the private student lending industry should be reconsidered.

In 2005, legislation was passed that made education loans from private lenders, including both nonprofit and for-profit institutions, nondischargeable in bankruptcy. This means that individuals with outstanding student loan debt who go through bankruptcy have to repay this obligation even after they have been absolved of their other obligations. While this may seem like a disguised subsidy to lenders, it is actually an attempt to correct the market failure that produces the need for government intervention in the first place. Allowing lenders to have a protected claim on borrowers’ future earnings increases their willingness to make credit available.

The problem with this regulation is that it is not properly understood by students or perhaps by bankruptcy lawyers. It is commonly believed that student loans may not be discharged under any circumstance. While the default practice is that student loans are not discharged in bankruptcy, it is possible for a borrower to be relieved of his or her debt in cases where it imposes undue hardship.

It is necessary for prospective borrowers to understand the terms of their loan so they can make informed decisions about their educational investments. One way to achieve this is with legislation that gives discretion over student loan discharge to bankruptcy judges rather than explicitly setting a rule. However, passing legislation of this sort, through reauthorization of the Higher Education Act or otherwise, may be difficult in the current political climate. An alternative is to increase public awareness about the safety nets that are in place for borrowers who find themselves in economic hardship, including the ability to discharge debts in some circumstances. This information could be included in the counseling process that borrowers go through before signing the promissory note for a federal student loan. Institutions, many of which are already making efforts to increase their students’ financial literacy, could also take steps toward achieving this goal.

Conclusion

The empirical analysis presented in this paper provides new information on the relationship between financial hardship and student loan debt. The findings can be
used to inform the discussion about how to place limits on federal student lending and regulation on the private loan industry. The findings indicate that there is not a strong positive relationship between student debt and financial hardship; high-debt borrowers face financial hardship at only slightly higher rates than comparable households with less debt. Additionally, the highest rates of financial hardship are seen among low-balance households.

These findings suggest that systematic overborrowing may not be concentrated among high-balance borrowers, as is sometimes an implicit assumption in the public narrative on this issue. If this is the case, then discouraging borrowing through restrictive limits on federal borrowing or other means is not the most effective way to prevent overborrowing among future cohorts of students. Creating consumer protections in the student loan market is not as straightforward as determining an amount of debt that is “too much.” The answer to the question “how much debt is too much?” is different for every borrower. Determining federal student loan eligibility through a process that takes individual borrower characteristics into account is the best approach to achieving the balance that is necessary to provide effective consumer protection without limiting access.
# Appendix

## Table 1

**Ordinary Least Squares Estimates of the Relationship Between Financial Distress and Student Loan Debt**

<table>
<thead>
<tr>
<th>Dependent Variable: Distress Indicator</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Outstanding Student Loan Debt (in thousands)</td>
<td>0.00108*** (4.46)</td>
<td>0.00330*** (5.85)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Outstanding Student Loan Debt (in thousands))²</td>
<td></td>
<td>−0.00000*** (−4.60)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Monthly Payment on Student Loans</td>
<td></td>
<td>−0.000078 (−1.41)</td>
<td>0.00005 (−0.37)</td>
<td>0.00000 (−1.48)</td>
</tr>
<tr>
<td>(Monthly Payment on Student Loans)²</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

| N | 22552 | 22552 | 2338 | 2338 |

Note: All specifications include year-fixed effects and controls for spouse and age; t statistics are in parentheses. * = p<0.05, ** = p<0.01, and *** = p<0.01.
Notes


4. The government does not collect information about private student loan interest rates. The best information is available on FinAid.org and is based on surveys of both financial institutions and borrowers.


6. Per person debt is calculated as the total household debt divided by the number of adults in the household. Note that individual-level debt is not reported in the data. All tables and figures are compiled using per person values.

7. Monthly payments would be strictly proportional to initial borrowing if all borrowers used the same repayment plan. Differences in loan terms cause this relationship to break down, making monthly payments an imperfect proxy for initial borrowing.

8. Overborrowing describes the case in which borrowers take on more debt than they can reasonably expect to repay based on the experiences of previous borrowers.