Higher “Ed” Could be Next Bubble to Burst

While Standard and Poor's downgrade of the U.S. government's credit rating has drawn much attention in the last few days, a generally overlooked report by Moody's Investment Services on the poor performance of student loans suggests higher education may be in a financial "bubble" that could burst in a stagnant economy that offers declining rewards for a college or university degree.

Titled "Student Lending's Failing Grade" the report appeared in the *Moody's Analytics* publication for July, 2011. It notes that dollar balances on student loans have increased by double-digit rates in the past decade and the number of loans has continued to increase in recent years as more people have been seeking education and training in a declining job market. But the tightening of lending standard in other sectors of the economy that followed the financial crisis of 2008 has not affected student loans, the report found.

"Unlike other loan segments, recent student loan originations are performing worse than those originated during the lending boom," the report said. "Tighter lending standards on auto loans, credit cards and mortgages during the recession have resulted in sharply improved performance than earlier vintages, even with the unemployment rate hovering around 9%. But default rates on student loans originated since the middle of 2008 are higher than vintages originated in 2006 or 2007 at similar times in their life cycles . The worsening performance of student loans reflects the fact that student loan origination standards were not tightened as they were for other types of consumer loans."

While other forms of consumer lending are based on tangible factors like the borrower's income and credit history, student loans are "more speculative," the report notes, and are based on the expectation of incomes that will reflect and repay the investment in the borrower's education. But with the nation's unemployment rate hovering at nine percent, today's graduates are hard-pressed to find the jobs and secure the incomes they need to repay the loans.

"Unless students limit their debt burdens, choose fields of study that are in demand, and successfully complete their degrees on time, they will find themselves in worse financial positions and unable to earn the projected income that justified taking out their loans in the first place," Moody's report said.

That has not, however, led to a decrease in the availability of loans or a change in the requirements for obtaining them. "Part of this may be because the federal government ensured that lenders had funds to lend to students throughout the recession," the report said. "With no supply constraints and a federal guarantee taking losses in the event of a default, lenders had little need to curtail their lending and every incentive to expand it. This permitted borrowing to remain robust at the cost of poorer performance."

Along with a weak job market, the challenge to today's graduates in paying off their loans comes from the soaring costs of higher education, with many private colleges charging more than $50,000 and state colleges $25,000 a year for tuition, room, and board. According to National Center for Public Policy and Higher Education, college tuition and fees, on average, rose 440 percent in 25 years, more than four times the rate of inflation and nearly twice the rise in health care costs. With housing prices declining, fewer parents can refinance or take out equity loans to pay tuition bills. In a 2009 article in *Chronicles of Higher Education*, Joseph Marr Cronin, former Massachusetts secretary of educational affairs and Howard E. Horton, president of New England College of Business and Finance, raised the question of whether higher education fit the description of a financial bubble, "an asset that is irrationally and artificially overvalued and cannot be sustained."

"Consumers who have questioned whether it is worth spending $1,000 a square foot for a home are now asking whether it is worth spending $1,000 a week to send their kids to college," they wrote. "There is a growing sense among the public that higher education might be overpriced and under-delivering."

There is another similarity between the housing "bubble" and the inflated costs of higher education. Just as government guaranteed loans provided an increased demand in the housing market, so government-backed student loans have fueled an increased demand and higher prices for college and university education. But can those high prices be sustained if demand slackens due to a growing number of students and parents deciding the diminishing returns in employment and educational opportunities are not worth the investment in four years of college? Many are turning to community colleges or to non-traditional, for-profit schools that teach courses online at a fraction of the cost of education in a traditional college setting. Colleges also face a demographics challenge as the number of college-age students is declining

Colleges and universities have been increasing enrollment for decades, paying for new buildings and more amenities to attract an increasing number of students to pay the tuition bills that keep the colleges going. If enrollment should undergo a sharp decline, what happens to all that investment in plant, faculty and equipment that depends on a growing, or at least a stable, student population?

As the Moody's report put it, "Fears of a bubble in educational spending are not without merit."