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Should Anyone Be Eligible for Student Loans?

With U.S. college-debt defaults surging, some economists say it's time to introduce standards for federal aid, making it more likely borrowers will actually graduate

Josh Mitchell

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A surge in the share of Americans defaulting on their student debt is generating support for an obvious but controversial idea: restrict who can borrow for higher education.

For decades, the federal government has imposed no underwriting standards in its student-loan program. Just about any American can borrow as much as $57,500 for college—and essentially unlimited amounts for graduate school—with little regard for the person's ability to repay. Everyone taking out federal loans in a given year pays the same interest rate.

Supporters of that no-questions-asked policy say it guarantees every American a shot at a degree and a secure middle-class income. Imposing underwriting standards would deny a higher education to many poor people who can't get loans from private lenders, they argue.

But a sharp rise in delinquencies in the $1.2 trillion federal student-loan program is drawing comparisons to subprime mortgage lending, which added to the housing crisis. It is also stirring debate on other ways to allot student aid.

New research shows a preponderance of the millions of borrowers who have defaulted on student loans in recent years are poor, were unprepared for college, and attended troubled schools that offered little hope of leading to a decent job.

"It's not a gift to a poor person who is not going to be able to complete a degree program to give them a loan," said Caroline Hoxby, a Stanford University economics professor, who calls the soaring load of student debt "a self-inflicted wound on the part of the federal government."

As of Sept. 30, just over 7 million borrowers had gone at least a year without making a payment on their federal student loans, Education Department figures show.

The student-loan delinquency rate has jumped to around 12%, roughly double its level before the recession, according to the New York Federal Reserve. When excluding borrowers still in school, roughly a quarter of all student debt is at least 90 days behind on payments. The comparable number for home-mortgage debt never exceeded 9% after the housing crash.

A recent Brookings Institution study by Treasury Department economist Adam Looney and Stanford's Constantine Yannelis attributes the rise in both borrowing and defaults since the recession largely to "nontraditional students" who enrolled at for-profit schools and community colleges. Those schools typically have low or no academic standards for enrolling.

Such students made up more than two-thirds of defaults among those who left school in 2011, the study found, analyzing government tax records and student-loan figures. The defaulted borrowers tend to be older, from lower-income families, and more likely to be first-generation college-goers compared with students who attend four-year schools.

Likewise, an October paper by Federal Reserve researchers linked defaults to those who had weak credit scores. About 30% of those who had credit scores of between 500 and 599 a year before they left school eventually became delinquent on their loans. But among those with a score of 680 to 729, only 9% became delinquent, according to the paper, by Fed economists Alvaro Mezza and Kamila Sommer.

They and other researchers aren't advocating underwriting based on credit scores—they point out that doing so would penalize high-achieving students from poor families, who are more likely to have bad credit.

But some economists say the government should target more aid toward such borrowers—in the form of grants, which don't have to be repaid, rather than loans. They also advocate underwriting criteria based on borrowers' high-school grades and test scores, colleges' graduation and job-placement rates, and the earnings potential of various majors.

One underappreciated problem is just how many students take on loans when they aren't ready for college-level coursework, which makes them more likely to drop out. The average amount owed by those who default is relatively low—just under $9,000—largely because many borrowers have dropped out after one or two years, leaving them without a path to a good job.

Neal McCluskey of the libertarian Cato Institute said the government should strive to avoid "saddling people with debt who have very little likelihood of completing a degree and being able to pay it back." The way to do that, he said, is to lend only to students who meet minimum test and grade-point-average requirements.

Others suggest giving less-accomplished students grants to cover the first year, then loans to cover subsequent years if they have demonstrated they can handle college-level work.

Policy makers aren't contemplating such big steps, but some plans might have a similar effect on a smaller scale. The Obama administration is implementing new rules that would cut off funding at career-training schools that leave students with high debt burdens and weak incomes. The plan, though, wouldn't apply to most public or nonprofit four-year schools.

Democratic presidential candidate Hillary Clinton has called for colleges to be held liable when their students default on loans, an idea that has gained traction among members of both parties as a way to control costs.

Florida Sen. Marco Rubio, a GOP presidential candidate, has pushed to have all schools publish detailed data on their graduates so that future borrowers can make better borrowing decisions.

Such plans, in a sense, are roundabout ways to keep borrowers from making bad investments, and make students think more carefully about which school to attend and what to study.