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Student Debt Climbs, Credit Risk Gets Steeper: Report

By Paul O'Donnell | CNBC – Thu, Jan 31, 2013 10:03 AM EST

Americans now owe an average of $27,253 in student loans as the delinquency rate has increased by more than 47 percent since 2005, according to a new report.

College students take notes in lecture hall. (AP Photo/Adrian College, Matt Gaidica Photography)

Some 27 million borrowers, or slightly more than 13 percent of the country, have two or more outstanding student loans, according the report from FICO Labs, the research arm of the credit-score agency. That number has more than doubled in the past eight years. In the 2005 report, the average student loan debt was $17,233.

In the latest study, the average credit score for new loans was going down as students with less ability to repay their loans are being granted loans with fewer questions.

The reason student debt is rising so quickly isn't hard to guess. The cost of attending college has been skyrocketing, while the recession and the scarcity of jobs over the past five years has sent 20-somethings back to school in droves. Difficulteconomic times "disproportionately impact young people," said Frederick Huynh, senior principal scientist at FICO,

A study by the Federal Reserve's New York branch last year showed $580 billion of the total $870 billion in student loan debt is owed by people under age 40. The total now exceeds credit card debt ($693 billion) and auto loans ($730).

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The recession is hardly the only factor driving the growth in student loans, which have simply become easier to get. In 2010, the Obama administration pushed through legislation that made the federal government the primary issuer of student debt, and encouraged borrowing by cutting credit requirements, capping interest rates and reducing monthly repayments to 10 percent of a graduate's discretionary income, from 15 percent.

Some observers, including Republicans in Congress, have called the White House's approach a recipe for disaster, while Democrats have moved to lift the burden of debt further by forgiving any loan of any amount on which a graduate has paid 10 percent of his or her discretionary income for 10 years.

Critics are comparing the current situation to the mortgage debacle of the early 2000s that created the housing crisis and helped to bring on the recession.

FICO's report suggests that student debt obligations have already been downgraded in many Americans' minds. Student debt is unlike other debt by nature, because it is unsecured, Huynh pointed out. "If I stopped making my car payments, they would repossess my car. But the lender can't take my degree back. This influences the higher rate of delinquency."

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Student debt is also becoming different in other ways. One chart in the report shows how student-loan debtors pay their other obligations. "What was consistent was that they were least likely to pay student loans," said Huynh. Those who also had auto loans and mortgages would put resources toward those payments first (though, perhaps because of the foreclosure crisis, delinquency on mortgages grew at a much higher rate than on college loans in the period under study). An interesting side note is that car loans are now more likely to be paid before mortgage loans, a switch from 2005.

Most curiously, as the median FICO score of a student borrower fell from 670 to 665 overall, the behavior of even those with better credit scores deteriorated when it came to repaying student debt. A student borrower with a credit score of 697 today is behaving like someone who had a credit score of 667 eight years ago.

"If a lender set a cut-off score of 667 to achieve 10:1 repayment odds in 2005," the report said, "they would need to raise their cutoff 30 points to achieve the same level of risk in 2010." This is a far shift than any other kind of debt in the recession.

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Whether or not student borrowers take their debt seriously, the credit agencies do. "Any default can have a material impact on your score," said Huynh, and the FICO reports, no doubt with gratification, that the agencies' scores still match up well with the actual credit risk posed by college kids. FICO urges greater efforts to educate high-school seniors and their families about what student loans can mean to your financial future.

But among lenders, delinquency on a student loan is clearly not as significant a blot on a person's financial record as on other kinds of debt. That's because, statistically, credit-card defaults are much better indicators of credit unworthiness .

Nothing in report suggests that college grads are simply cavalier about borrowing. Rather, as their financial predicament deepens with the amount they owe, their account balance may lose its sense of reality. In 2005, people who owed $100,000 in student loans were a better risk than the rest of the population. These steep borrowers were more likely then to have bright prospects and burgeoning salaries.

Today, the $100,000 borrower is a worse risk, reflecting the hopeless position in which a young person can find themselves, even with an expensive college degree. Were mere irresponsibility to blame, defaults would logically be equally common for less consequential amounts. Instead, the turning point for increased risk, according to FICO, comes at about $40,000.

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