Is College Debt the Next Bubble?

What might a 23-year-old recent college graduate, a 45-year-old entrepreneur, and a 60-year-old pre-retiree have in common financially? They may all be hobbled by student loan debt. According to financial aid expert Mark Kantrowitz, the student loan "debt clock" reached the $1 trillion milestone last year.[1] And even as Americans have reduced their credit card debt over the past few years, student loan debt has continued to climb--both for students and for parents borrowing on their behalf.

A perfect storm

The last few years have stirred up the perfect storm for student loan debt: soaring college costs, stagnating incomes, declining home values, rising unemployment (particularly for young adults), and increasing exhortations about the importance of a college degree--all of which have led to an increase in borrowing to pay for college. According to the Federal Reserve Bank of New York, as of 2011, there were approximately 37 million student loan borrowers with outstanding loans.[2] And from 2004 through 2012, the number of student loan borrowers increased by 70%.[3]

With total costs at four-year private colleges pushing $250,000, the maximum borrowing limit for dependent undergraduate students of $31,000 for federal Stafford Loans (the most popular type of federal student loan) hardly makes a dent, leading many families to turn to additional borrowing, most commonly: (1) private student loans, which parents typically must cosign, leaving them on the hook later if their child can't repay; and/or (2) federal PLUS Loans, where parents with good credit histories can generally borrow the full remaining cost of their child's undergraduate education from Uncle Sam.

The ripple effect

The implications of student loan debt are ominous--both for students and the economy as a whole. Students who borrow too much are often forced to delay life events that traditionally have marked the transition into adulthood, such as living on their own, getting married, and having children. According to the U.S. Census Bureau, there has been a marked increase in the number of young adults between the ages of 25 and 34 living at home with their parents--19% of men and 10% of women in 2011 (up from 14% and 8%, respectively, in 2005).[4] This demographic group often finds themselves trapped: with a greater percentage of their salary going to student loan payments, many young adults are unable to amass a down payment for a home or even qualify for a mortgage.

And it's not just young people who are having problems managing their student loan debt. Borrowers who extended their student loan payments beyond the traditional 10-year repayment period, postponed their loans through repeated deferments, or took out more loans to attend graduate school may discover that their student loans are now competing with the need to save for their own children's college education. And parents who cosigned private student loans and/or took out federal PLUS Loans to help pay for their children's education may find themselves saddled with education debt just as they reach their retirement years.

There's evidence that major cracks are starting to appear. According to the Federal Reserve Bank of New York, as of 2012, 17% of the 37 million student loan borrowers with outstanding balances had loans at least 90 days past due--the official definition of "delinquent."[5] Unfortunately, student loan debt is the only type of consumer debt that generally can't be discharged in bankruptcy, and in a classic catch-22, defaulting on a student loan can ruin a borrower's credit--and chances of landing a job.

Tools to help

The federal government has made a big push in recent years to help families research college costs and borrowers repay student loans. For example, net price calculators, which give students an estimate of how much grant aid they'll likely be eligible for based on their individual financial and academic profiles, are now required on all college websites. The government also expanded its income-based repayment (IBR) program last year for federal student loans (called Pay As You Earn)--monthly payments are now limited to 10% of a borrower's discretionary income, and all debt is generally forgiven after 20 years of on-time payments. (Private student loans don't have an equivalent repayment option.)

Families are taking a much more active role, too. Increasingly, they are researching majors, job prospects, and salary ranges, as well as comparing out-of-pocket costs and job placement results at different schools to determine a college's return on investment (ROI). For example, parents might find that, with similar majors and job placement success but widely disparate costs, State U has a better ROI than Private U. At the end of the day, it's up to parents to make sure that their children--and they--don't borrow too much for college. Otherwise, they may find themselves living under a big, black cloud.