Student Loan Losses Seen Costing U.S. More Than $400 Billion

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The U.S. government stands to lose more than $400 billion from the federal student loan program, an internal analysis shows, approaching the size of losses incurred by banks during the subprime-mortgage crisis.

The Education Department, with the help of two private consultants, looked at $1.37 trillion in student loans held by the government at the start of the year. Their conclusion: Borrowers will pay back $935 billion in principal and interest. That would leave taxpayers on the hook for $435 billion, according to documents reviewed by The Wall Street Journal.

The analysis was based on government accounting standards and didn't include roughly $150 billion in loans originated by private lenders and backed by the government.

The losses are far steeper than prior government projections, which typically measure how much the portfolio will cost the government in the next decade, not the entire life of the loans. Last year the Congressional Budget Office estimated that the student-loan program would cost taxpayers $31.5 billion, including administrative costs.

After decades of no-questions-asked lending, the government is realizing that it has a pile of toxic debt on its books. By comparison, private lenders lost $535 billion on subprime-mortgages during the 2008 financial crisis, according to Mark Zandi, chief economist at Moody's Analytics.

The effect this time is different. The government, unlike private lenders, can borrow trillions of dollars at low rates to absorb the losses, without causing a panic. But taxpayers will end up paying a price because Congress will have to raise taxes, cut services or increase the deficit to cover the losses.

The absence of a cataclysmic event like the financial crisis is removing the impetus for the federal government to change its lending practices, which analysts said have enabled colleges to raise tuition far above the rate of inflation.

"There's no market discipline here," said Constantine Yannelis, a former Treasury Department official in the Obama administration who now teaches at the University of Chicago. "In 2007-2008, we saw a lot of lenders who were making risky bets going under. There's no force like that in the student-loan market."

The government lends more than $100 billion each year to students to cover tuition at more than 6,000 colleges and universities. It ignores factors such as credit scores and field of study, and it doesn't analyze whether students will earn enough after graduating to cover their debt.

"We make no attempt to evaluate the quality of the borrower, the ability to repay, the effectiveness of the loans," said Douglas Holtz-Eakin, former head of the Congressional Budget Office who now leads the American Action Forum, a conservative think tank. "The taxpayer ends up picking up the tab."

Borrowers with subprime credit scores -- indicating they have had previous trouble paying off debt -- are among the most likely to default, Federal Reserve research shows. Between 2005 and 2016, nearly four in 10 student loans -- most of them federal ones -- went to borrowers with credit scores below the subprime threshold of 620, according to a Wall Street Journal analysis of data from the credit-rating firm Equifax Inc. That figure excludes borrowers who lacked credit histories. By comparison, subprime mortgages peaked at nearly 20% of all mortgage originations in 2006.

Since the financial crisis, private lenders typically originate loans only to borrowers with clean credit and require cosigners, and default rates are far lower than on federal loans.

Congressional Democrats have stepped up calls for President-elect Joe Biden to use executive action to forgive student debt. Mr. Biden, a Democrat, has reiterated his support for legislation to forgive $10,000 for each borrower with a federal student loan.

The Trump administration has opposed wide-scale debt forgiveness. But the government is already effectively forgiving debt through programs known as income-based repayment, which require borrowers to pay only 10% of their discretionary income -- defined as adjusted gross income minus 150% the federal poverty line -- and then forgive balances after 10, 20 or 25 years.

Worried that government accountants had underestimated losses on student loans, the Education Department under Betsy DeVos hired FI Consulting to project losses. It developed a computer model to produce a much more detailed analysis than prior government methods to value the portfolio. The accounting firm Deloitte was hired to review the model. Neither contractor responded to requests for comment.

The consultants found that income-based repayment programs are a major driver of projected losses. Some students -- particularly those in graduate schools, who unlike undergraduates face no limits on how much they can borrow for tuition -- rack up big debts and then enroll in income-based repayment. Borrowers in modest-paying jobs with less debt have also used the programs to avoid default. Borrowers in income-driven repayment will repay, on average, 51% of their balances, while borrowers in other plans will repay 80%, the Education Department's analysis shows.

Meanwhile, millions of other borrowers continue to default on smaller amounts -- typically under $10,000 -- after dropping out of community college or for-profit colleges. Still others say they defaulted after being defrauded by their schools and failing to land well-paying jobs in their fields of study.

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