

5E

EDUCATOR

Debts and Defaults:
The growing market – and tab –
for student loans

Beyond the Textbook:
Teaching Tips for
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Debts and Defaults: The growing market – and tab – for student loans

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MISSION

The *5E Educator* provides secondary teachers with content to enhance understanding of economics and personal finance. It also offers lesson plans and Federal Reserve resources to reinforce state and local curriculum. We seek to enrich the learning experience for students and highlight the importance of economics and financial literacy in the process of everyday decision-making.

To sign up to receive the online *5E Educator*, visit:
www.richmondfed.org/publications/education/5e_educator/

Dear Educators,



Our financial literacy efforts are intended to help individuals better understand the responsibilities and commitments that come with

their financial and economic choices. The lessons of the recent financial crisis are still fresh in our minds, and reaffirm the need for resources that enrich the financial knowledge of students and adults.

In this edition of the *5E Educator*, we provide several articles on critical issues including financing higher education, which can have a long-term effect on the lives of students and their families. We also look at the degree to which public policy may support greater financial literacy. We hope that you and your students enjoy these readings and that

they generate meaningful dialogue that is helpful to future decision-making.

Regards,

Jeffrey M. Lacker

President

Federal Reserve Bank of Richmond



Hallway Monitor

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Class in Session

Debts and Defaults: The growing market – and tab – for student loans.

This excerpt is taken from the Fourth Quarter 2010, Region Focus magazine published by the Federal Reserve Bank of Richmond. The article, written by Becky Johnsen and Jessie Romero, reflects the views of the authors and does not necessarily reflect the opinions of the Bank or its management.

After the financial crisis, consumers curtailed their credit card debt. However, as the economy has recovered, another form of debt has grabbed attention: student loans. In June 2010, for the first time in history, total student loan debt, at more than \$850 billion, exceeded credit card debt, estimated at less than \$830 billion. The statistic was first reported by Mark Kantrowitz, publisher of FinAid.org, a leading resource on student financial aid. The finding was one in a series of sobering statistics concerning student loan debt.

Last year, the U.S. Department of Education released its *2007-2008 National Postsecondary Student Aid Study (NPSAS)*. The NPSAS data show that the average loan debt of four-year undergraduate borrowers was \$20,200 at public institutions, \$27,650 at private nonprofit institutions, and \$33,050 at private for-profit institutions. This represents increases of 20 percent, 29 percent, and 23 percent, respectively, since 2004. In total, the data showed that about two-thirds of graduates from four-year institutions had student loan debt.

Despite increases in public awareness and federal support, students seem less able to manage these debts. Although student loan debt is not dischargeable through bankruptcy under current law, a number of borrowers stop making payments regardless. In early September 2010, Secretary of Education Arne Duncan announced that the 2008 national cohort default rate on student loans

increased to 7 percent, the highest rate since 1997. Defaults increased from 5.9 to 6 percent for public institutions, from 3.7 to 4 percent for private institutions, and from 11 to 11.6 percent for for-profit schools. The high default rates at for-profit institutions in particular have sparked a debate in Congress to regulate these institutions.

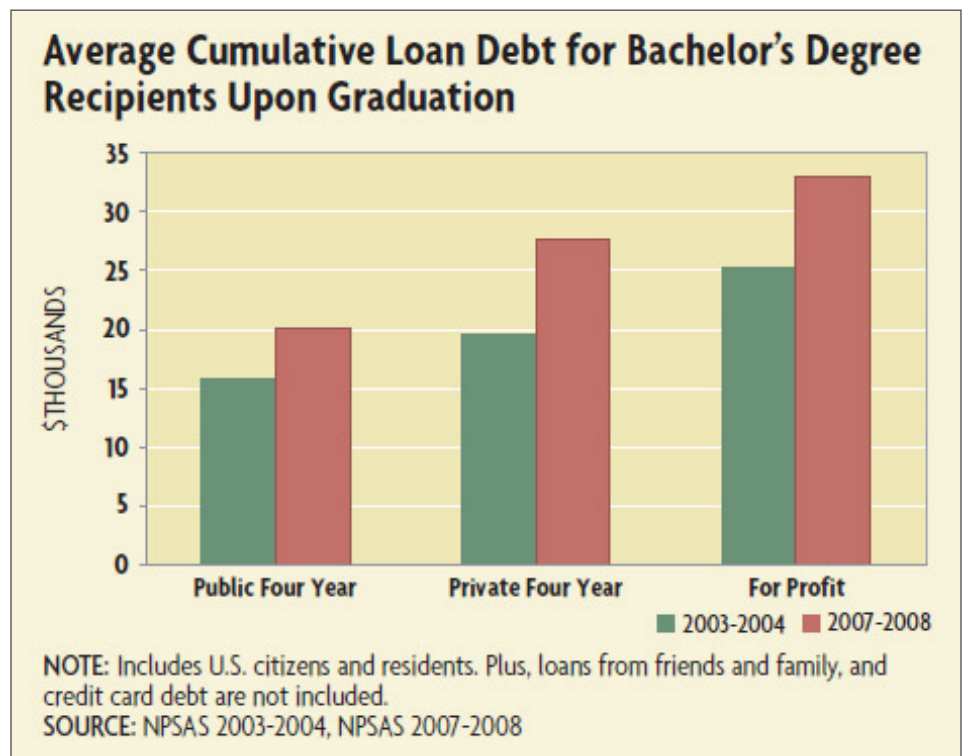
The official cohort default rate counts only people who default within two years of beginning repayment. (A cohort is composed of borrowers who enter repayment within the same fiscal year.) Because many people default in later years, the actual number of defaults is much greater. Beginning in 2012, the official rate will cover a three-year window, and preliminary data put the rate nearly 70 percent higher.

These figures point to a growing problem with postsecondary student debt on a national scale. In the Fifth District, students in Washington, D.C., graduated with an average debt of \$29,793 per student, versus the national average of

\$23,200. (The data are based on where the student attends college, not on home state; Washington, D.C., has only one public university.) In West Virginia, 73 percent of students graduating from college had debt, compared with 67 percent nationally. According to the NPSAS, however, the rest of the District had both lower average student debt levels and a lower proportion of students with debt in 2008 (the most recent data available).

What's Behind the Increase?

Several factors are driving the increase in student borrowing. On the demand side, increased emphasis on the importance of higher education has coincided with an increase in college costs: More students want to attend college, and they need more money to do it. In the last 10 years, prices for undergraduate tuition and fees have risen between 34 percent and 46 percent at public institutions and 31 percent at private institutions (adjusted for inflation). College costs have outpaced overall inflation, and room and board has increased more for students living on campus than off campus, which





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suggests that college costs have also outpaced the cost of living. Still, a \$20,000-plus debt may be a rational investment. A report by Georgetown University's Center on Education and the Workforce estimates that 63 percent of jobs will require a four-year degree by 2018, and the College Board calculates that four-year college graduates earn on average almost \$20,000 more per year than high school graduates.

Some economists, including Andrew Gillen of the Center for College Affordability and Productivity, a nonprofit research organization in Washington, D.C., argue that tuition hikes are an effect, rather than a cause, of increased student borrowing. In a 2008 policy paper titled *A Tuition Bubble? Lessons from the Housing Bubble*, Gillen details a vicious cycle. Because the government views postsecondary education as a public good, it provides subsidies (relatively cheap and plentiful student loans) to pay for it. The subsidies increase the ability of more students to pay for school, which leads universities to raise their prices, which then leads the government to provide

greater subsidies, and so on. Normally, the price would settle at a point where the ability and willingness of students to pay for an education matches the ability and willingness of a school to supply that education. But because the subsidy artificially increases the ability of students to pay, and because the supply of higher education is relatively inelastic, the normal laws of supply and demand may be distorted.

Implications

The rise in student debt poses several challenges to the increasing number of students striving for a degree. Student debt can linger for decades, preventing graduates from making important decisions such as buying a house, getting married, or having children. Parents who co-sign their children's loans also share this burden, and it may prevent them from making their own life decisions, such as retiring.

For borrowers who fall into delinquency, their lenders can exact several harsh penalties. In addition to harmed credit scores and higher payments, further financial

aid is denied, academic transcripts may be withheld, tax refunds may be withheld to repay the student loan, and federal payments like Social Security may be reduced. The longer a borrower remains delinquent, the less likely he or she will be to resume control of the debt.

There are strategies that borrowers can use to delay or reduce their payments, but they require thorough research and strict adherence to the terms set by the lenders...

The consequences of accumulating student debt illustrate how important it is for borrowers to understand the terms of their student loans. And as tuition and incidental schooling costs increase, the next wave of hopeful college applicants must decide whether student loans are a strategy that leads to worthwhile investments in education – or to cumbersome obligations.

For complete article:

www.richmondfed.org/publications/research/region_focus/2010/q4/pdf/feature1.pdf



Snacks

Student Loan Financing 101 Consider sharing the previous full article directly with your students.

To generate discussion, try using the discussion questions below along with the reinforcement and closure activities. As an anticipatory set, link to a short video from the Richmond Fed's *Share the Wealth* contest, specifically, the one minute program titled "Mission Possible." http://www.richmondfed.org/education/for_teachers/academic_competitions/index.cfm

National JumpStart Standards

Overall Competency:

Maintain creditworthiness, borrow at favorable terms, and manage debt.

Standard 1: Identify the costs and

benefits of various types of credit.

Standard 3: Describe ways to avoid or correct debt problems.

Audience: Grades 9-12

Depending on your students' content knowledge, you may wish to have them identify the following terms prior to class discussion. Terms are defined on page 4. Or, have students highlight unfamiliar terms for teacher clarification.

Vocabulary Terms

Loan Origination	Loan Discharge
Loan Principal	FAFSA Form
Loan Default	Public Good
Loan Deferment	Subsidy

Discussion Guide Questions

Directions: Students are to read the article, "Debts and Defaults: The growing market – and tab – for student loans," and answer the following questions in complete sentences. Questions are to be used as a framework to help guide class discussion. Please share with students that student loans are also used to finance accredited two-year degrees and professional or trade certificate programs. For more information about school or program eligibility requirements, follow this link: studentaid.ed.gov/PORTALSWebApp/students/english/aideligibility.jsp

1. What happened in June 2010 for the first time in U.S. history and why is this significant?

2. What is the average four-year undergraduate debt for public institutions, private nonprofit institutions, and private for-profit institutions?
3. The authors indicated that college students appeared to be less able to manage student loan debt. What evidence suggests this conclusion?
4. What does it mean to default on a loan?
5. Are student loans dischargeable under current bankruptcy law?
6. What are the primary types of student loans and how are they different?
7. What is the difference between students that are dependent versus independent?
8. What is the cost of attendance on average for public and private institutions?
9. What are some of the advantages of federal loans?
10. List some of the advantages of private loans and how they are used.
11. List some of the challenges associated with the rise of student loan debt.
12. Identify some strategies used to lessen the burden of student loan debt.

Reinforcement Activity

To enhance student understanding of the topic, have students critically assess and synthesize the information in the form of a newspaper article.

Directions: Imagine you are writing an advice column for the school newspaper. Outline your recommendations in a one- to two-page article for students considering financing an advanced degree, professional or trade certificate program. Students should write in complete sentences, paragraph format, and use evidence contained in the article to support recommendations.

Assessment

Interested in testing student subject

retention? Consider using this brief quiz to assess student content understanding. Alternative approaches to this assessment include having the students work in pairs, or breaking the class into teams to compete for the Student Loan Knowledge Achievement Cup!

Directions: Identify whether or not the following statements are true or false. Place your response in the space provided.

- _____ 1. For the first time in history, credit card debt exceeded student loan debt by \$850 billion.
- _____ 2. In the *2007-2008 National Postsecondary Student Aid Study*, data showed that student loan debt for both public and private institutions increased.
- _____ 3. The default rate for student loans has decreased for public, private and for-profit institutions.
- _____ 4. Student loan limits are different depending on whether you are an undergraduate or graduate student.
- _____ 5. Financial aid experts counsel students to take out private loans because they offer certain advantages such as fixed interest rates and more flexible repayment terms.
- _____ 6. Private loans can often close the gap between federal aid and college tuition.
- _____ 7. More than 10 percent of college students have neglected to apply for federal aid.
- _____ 8. Private lenders do not offer low introductory rates, instant credit approval and an easy application process.
- _____ 9. Student loans can be discharged under current bankruptcy laws without exception.
- _____ 10. Student loan debt may delay graduates from making important decisions such as buying a house, getting married, or having children.

Vocabulary Terms Defined

Loan Origination– The process of making a loan, including the loan

application and approval.

Loan Principal– The original amount of money borrowed or the amount currently owed on a loan.

Loan Default– Failure to repay a loan according to the terms of the loan contract.

Loan Deferment– A postponement of payment on a loan that is allowed under certain conditions such as reenrollment in school, unemployment, or economic hardship.

Loan Discharge– The release of a borrower from the obligation to repay a loan.

FAFSA Form– A required U.S. government form for students seeking federal financial assistance for post high school education and training. *FAFSA* is an acronym for *Free Application for Federal Student Aid*.

Public Good– A good that people cannot be prevented from using, and for which one person's use does not reduce another person's ability to use it. Examples of public goods include national parks, defense, and law enforcement.

Subsidy– A grant or monetary contribution by the government to assist an individual or company with offsetting the cost of consumption or production of a given product or service.

References:

www.direct.ed.gov/glos.html;
Mankiw, N. Gregory. (2009). *Principles of Economics (5th ed.)*. Mason, OH: South-Western.

Assessment Key

- | | |
|----------|----------|
| 1. False | 6. True |
| 2. True | 7. True |
| 3. False | 8. False |
| 4. True | 9. False |
| 5. False | 10. True |



Class in Session

Interested in enhancing your content knowledge of financial literacy public policy? Check out this excerpt of the March 2009 edition of the Federal Reserve Bank of Richmond Economic Brief!

Rationalizing Financial Literacy Policy

by Kartik Athreya, Senior Economist and Anne Stilwell, Research Associate.

The views in this article are those of the authors and do not necessarily reflect the opinions of the Bank or its management.

Recent events in mortgage markets have placed front and center the issue of the financial literacy of households, and whether there is a public imperative to improve the level of such decision making. By financial literacy, we mean the ability of individuals to understand the nature of the financial contracts they enter. Specifically, for those who enter contracts to save resources for their own futures, such as savings accounts, retirement plans, mutual funds, and stocks, financial literacy means they understand the rules governing the payoffs on their investments. Similarly, for borrowers, financial literacy means they have a clear understanding of their options and obligations in various situations that may arise in both the near and distant future. Put this way, it is hard to argue against greater financial literacy. Therefore, in this *Economic Brief*, we take it as given that it would be better, all else equal, for households to be “more financially literate.” There are two questions, then, that one must answer prior to the implementation of any policy: How do we achieve greater literacy? And to what extent is this a public policy imperative? The remainder of this essay addresses these questions via a series of somewhat more specific queries.

Does the market for “expert advice” work most poorly for the poor, and if so, why?

One impetus for promoting financial literacy is that many people do not have the expertise to differentiate between a “good” and a “bad” financial product. However, there are many products that we buy each day whose mechanism we do not understand. In fact, the majority of consumer durables (for instance, refrigerators, cars, and televisions) are both expensive and rather mysterious in their inner workings. Moreover, refrigerators have only a short warranty, and yet, households seem to routinely make good choices about them.

So, to rationalize financial literacy schemes by appealing to the complexity of most such contracts, we need to be able to answer the question: “What exactly makes a loan or insurance product different than a car or plumbing, and why can’t – or why don’t some people get good advice?” One reason that consumer durables differ from consumer financial contracts is that concerns by sellers about their reputation may be relatively powerful in consumer durables because people repeatedly purchase these items and they may communicate with others. Financial contracts, by contrast, are infrequent and often private. For example, we may plan to stay in mortgage contracts for many years, and may not tell our friends and neighbors about the precise nature of terms, or about any subsequent problems we face. As a result, lenders may not invest a societally optimal level of effort in communicating product attributes in a clear way to potential purchasers. Indeed, this is the view of many critics in the wake of high default rates on recently issued subprime mortgages.

Will the potential lack of incentives for financial intermediaries to invest in the long-term financial health of borrowers inevitably lead to harm? After all, financial literacy efforts are often targeted at the

poor; a presumption is that those with high income “know better.” But is this really true, or is it rather that the set of “reputable” financial intermediaries simply chooses not to deal with the high-risk (low-income) population? For example, a major financial institution may simply be wary of making high-risk loans, as it will fear being evaluated in the court of public opinion following the high-delinquency and default rates that high-risk loans necessarily create. Resolving the extent to which reputational mechanisms elicit good behavior from financial intermediaries is vital to constructing a coherent strategy for financial literacy...

Follow the link below to read more about Rationalizing Financial Literacy Policy, which addresses additional questions such as...

1. *Do we really know “bad” financial choices when we see them?*
2. *What should be the scope of financial literacy efforts?*
3. *What about a “financial driver’s license,” and can we improve disclosure?*
4. *Do we really know a successful financial literacy effort when we see it?*
5. *How do we engage the unengaged?*
6. *What is the relationship between economic and financial literacy?*

www.richmondfed.org/publications/research/economic_brief/2009/pdf/eb_09-03.pdf



Beyond the Textbook

Consider using the following resources to supplement your personal finance curriculum for middle and high school students.

Lesson Plan Ideas: High School and Middle School

To Get the Right Answers about College: Ask the Right Questions Grade Level: 9-12

This lesson, published by the Federal Reserve Bank of St. Louis, asks students to survey college students about college expenses. Students learn about the various options available for educational assistance. Students also weigh the costs and benefits associated with financing their education. As part of the exercise, students complete a FAFSA form. www.stlouisfed.org/education_resources/assets/lesson_plans/09ITV_CollegeQuestions.pdf

Just Sign Here: Bottom-Line Personal Finance Myths Grade Level: 8-12

This lesson provides a general introduction to the importance of financial literacy, credit, and credit history. www.stlouisfed.org/education_resources/assets/lesson_plans/06ITVPersonalFinanceMyths.pdf

Katrina's Classroom, Lesson #4: Back to School Video Segment and Lesson Plan Grade Level: 7-12

Published by the Federal Reserve Bank of Atlanta, this lesson features video clips that describe the impact of Hurricane Katrina on three high school students and their families. Specifically, the *Back to School* video segment and lesson plan discusses a student's college savings efforts. The lesson highlights the importance of budgeting and investing in education and training. www.frbatlanta.org/forms/katrina.cfm

College: Where am I going to go? Grade Level: 9-12

Featured on *Econ Ed Link*, an online lesson plan resource center for teachers, courtesy of the Council for Economic Education, this lesson uses the PACED decision guide to assess and evaluate potential income versus the tuition costs associated with prospective academic or professional training institutions. www.econedlink.org/lessons/index.php?lid=463&type=educator

What are the Factors behind a Foreclosure? Grade Level: 9-12

This is a lesson plan offered by Public Broadcasting Service (PBS). Although the initial content focuses on foreclosures, it includes an activity that considers future earnings versus debt. http://www.pbs.org/newshour/extra/teachers/lessonplans/economics/july-dec10/foreclosure_10-28.html

My Side of the Mountain Grade Level: 6-8

This lesson plan is designed to highlight the economic and financial education concepts found in the book, *My Side of the Mountain*. Students examine how investments in human capital can enhance job opportunities and skills. By using a KWLH chart, students draft a plan to develop their human capital potential. www.stlouisfed.org/education_resources/assets/lesson_plans/MySideMountain.pdf

Professor Finance and Fed Boy Meet the Catastrophe Clan Grade Level: 7-10

Published by the Federal Reserve Bank of Kansas City, this lesson offers students a fun way to learn about the

wise use of credit. Students act out a play that demonstrates the importance of informed financial decision-making. www.kansascityfed.org/publicat/education/teachingresources/fed_boy_lesson_plan.pdf

Additional Resources *The Economist, The Runaway Cost of College* www.economist.com/blogs/democracyinamerica/2010/03/student_loans

Bureau of Labor Statistics, *Education Pays* This site offers descriptions and charts detailing the impact of education on future earnings. www.bls.gov/opub/ooq/2010/summer/oochart.pdf

Working in the 21st Century This site offers an overview of current trends in the labor market. Included is a slide deck packed with descriptions and charts. www.bls.gov/opub/working/home.htm

2009 Economic Video Short Takes feature the topic, "Opportunity Costs," Federal Reserve Bank of St. Louis, www.stlouisfed.org/education_resources/NEEVC/2009/jondduckworth-2.cfm

Student Aid For specific information about the FAFSA form, check out the following web site: www.fafsa.ed.gov/

To obtain more specific information about student loans, consider using this link titled "Student Aid on the Web," studentaid.ed.gov/PORTALSWebApp/students/english/index.jsp.



Heard over the P.A.

The *5E Educator* features information on upcoming workshops, competitions, and other events that may be of interest to secondary educators. To register or review these and other opportunities, please visit www.richmondfed.org/conferences_and_events/education/.

The Fed Experience

Wondering how to teach economics and personal finance in a way that will excite your students and re-energize your teaching?

Register today to bring your class to visit *The Fed Experience*, located at the Federal Reserve Bank of Richmond. *The Fed Experience* is a free educational exhibit that compliments state and national standards for economics and personal finance. Here students learn how they are an important part of our economy, and that everyday choices about what you buy and how

Event	Date	Location
Roanoke Valley Financial Literacy Fair	4/5/2011	Salem, VA
North Carolina Economics Challenge	4/6/2011	Charlotte, NC
VCEE Teacher Institute	4/6/2011	Fairfax, VA
Maryland Personal Finance Challenge	4/7/2011	Towson, MD
Maryland Department of Education Social Studies Coordinators Meeting	4/14/2011	Baltimore, MD
Virginia Jump\$tart Coalition Meeting	4/26/2011	Richmond, VA
Personal Finance Workshop for North Carolina Civics & Economics Teachers	4/27/2011	Charlotte, NC
Maryland Financial Literacy Summit	6/23/2011	Timonium, MD
South Carolina Education & Business Summit	6/26/2011 - 6/30/2011	Greenville, SC

you save affect you, the economy, and the prices of goods and services. Students also examine how the Fed is instrumental in helping keep prices stable. Stable prices make it easier to make financial choices and promote economic growth.

Visit us online to schedule a field trip today at www.thefedexperience.org. Our website features an overview of the exhibit, visitor information, teacher resources and much more!

The Branch Tour Experience

The Baltimore and Charlotte Branches of the Federal Reserve Bank of Richmond also offer tours for high school students. Teachers may contact the individual branches to obtain specific tour information. To book a tour today, contact your Branch's Economic Education Specialist (cited on page 1). We look forward to hosting your tour!