STUDENT LOANS: WHAT IS THERE TO WORRY ABOUT?

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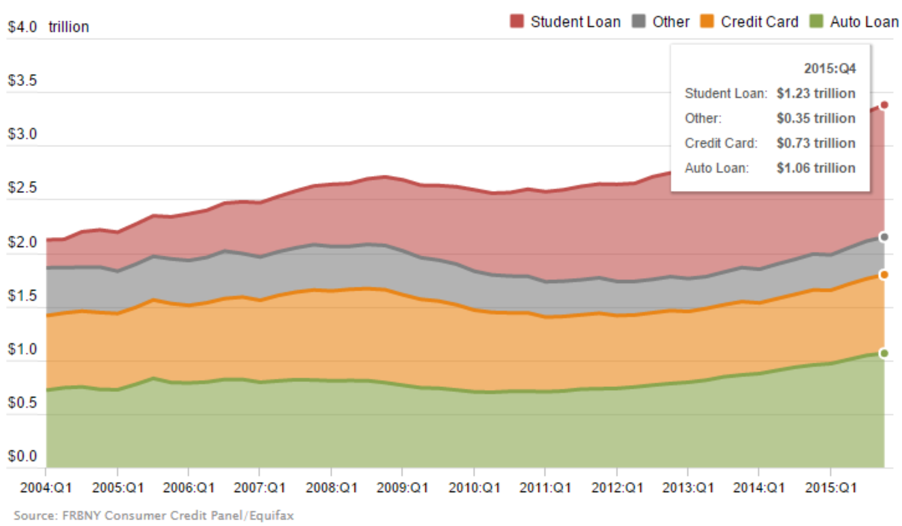
Student loans slowly began to fill the pot of household debt during the turn of the millennia. As the emphasis for higher education increased in the 1990s and 2000s, so too did the debt loads being taken on by students and their families.

Higher education spending has significantly out-paced US inflation over the last 40 years, pricing out potential students and causing others to take on burdensome loads of debt. Over the last 10 years, student loan's share of non-housing debt in the US has increased from $390 billion in 2005 to $1.2 trillion in 2015, a 207% increase (Figure 1). The amount of outstanding student loans, as of the end of Q3 2015, comprises an incredible 36% of non-housing debt.

Figure 1: Non-housing Debt Balance



Non-housing debt balances continued to increase in the fourth quarter, with a $19 billion increases each in auto loan and credit card balances respectively. Student loan balances increased by $29 billion.

Compared to the overall household, student loans in the United States total over $1.2 trillion, or 10%, of total household debt. That figure is greater than the amount of outstanding auto loans (9%) and current credit card debt (6%) (Figure 2). Surprisingly, the topic of student debt is infrequently cited by the media, particularly when compared to other more widely reported debt balances. If borrowers are not able to pay their loans, due to recession or challenging employment conditions, we expect the student loan conversation to be an everyday occurrence.

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As Figure 2 depicts, the total debt balance of US Households has increased to over $12 trillion. Not surprisingly, a majority of that $12 trillion is made up of mortgages. What is surprising, at least to some, is how large the allocation is to student loans (**red**; 10%).

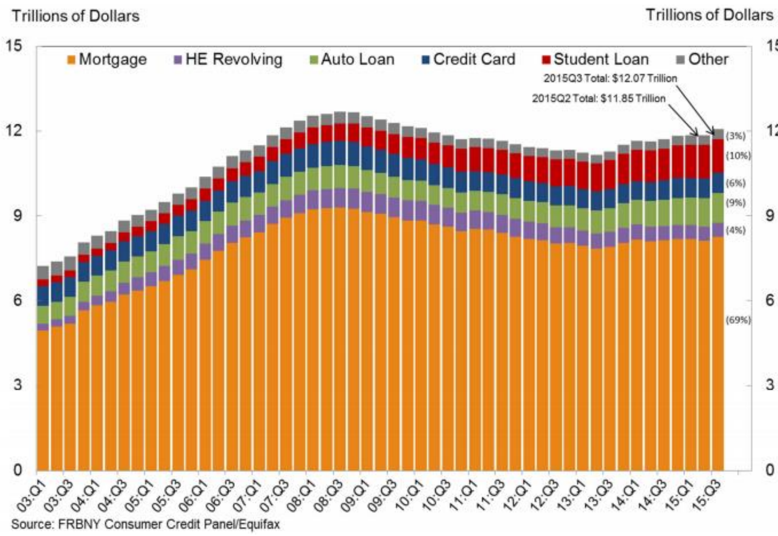

Figure 2: Total Debt Balance and Its Composition

According to data from the Bureau of Labor Statistics and the Delta Cost Project, compiled by CNBC, tuition at public 4-year colleges increased 89% from 2000-2014. If you double that timeframe and look back over the last 30 years, that number is 197%. Compare this to the CPI All Items inflation increase of 116% over the same timeframe, and you begin to connect the dots between household debt and the sharp rise in student loans. But all of this data makes us wonder, is it sustainable and for how long?

Since the end of the Great Recession, the consumer has not been stronger. The number of individuals quitting their jobs (Figure 3) has continued to increase and is now in-line with pre-2008 highs, signaling confidence in the labor market as individuals typically do not quit one job unless they are about to begin a new one. And, the number of initial jobless claims (Figure 4) is nearing lows not seen in decades.

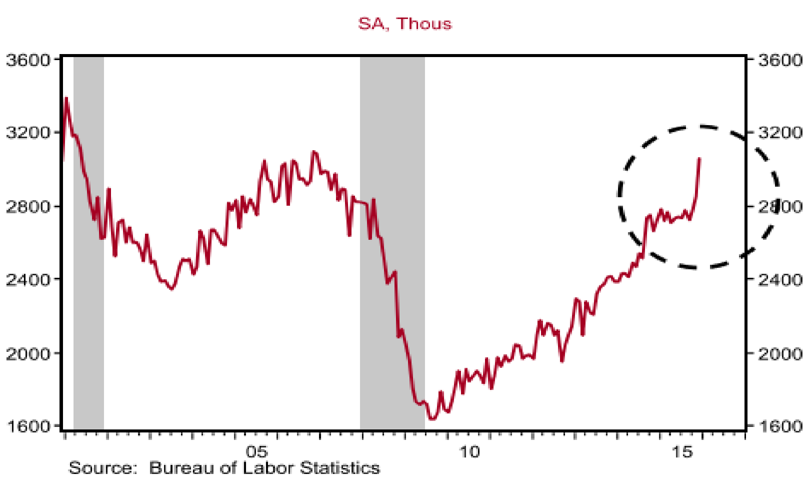

Figure 3: JOLTS: Quits: Total

So again, after reviewing all of this information, is there really a problem brewing?

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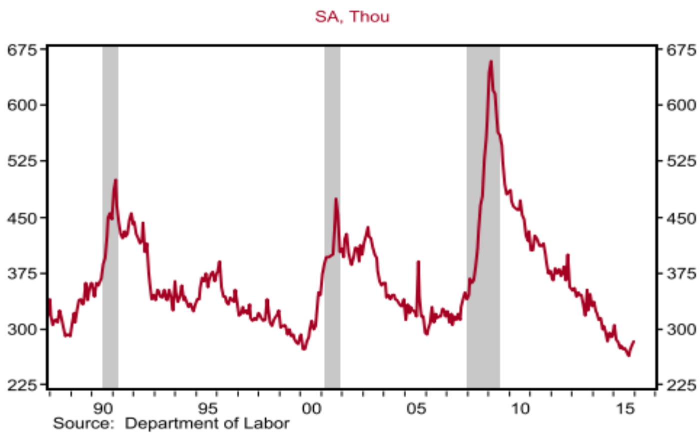
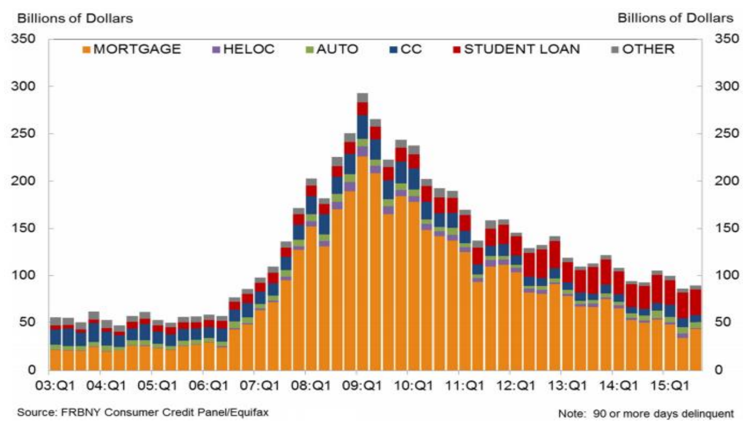
Figure 4: Initial Claims for Unemployment Insurance, State Programs, Weekly Avg.



We may not have to wait long to answer that question. Figure 5 depicts the amount of "New Seriously Delinquent Balances by Loan Type." In other words, it shows loans that are more than 90 days delinquent. At first glance, you notice a low, but stable, amount of delinquent balances running up to the Financial Crisis, followed by an immediate uptick in the amount of delinquent mortgage balances (**orange**) beginning in 2007. What takes a moment to realize is the almost incessant increase of student loans (**red**) that became delinquent over the time period.

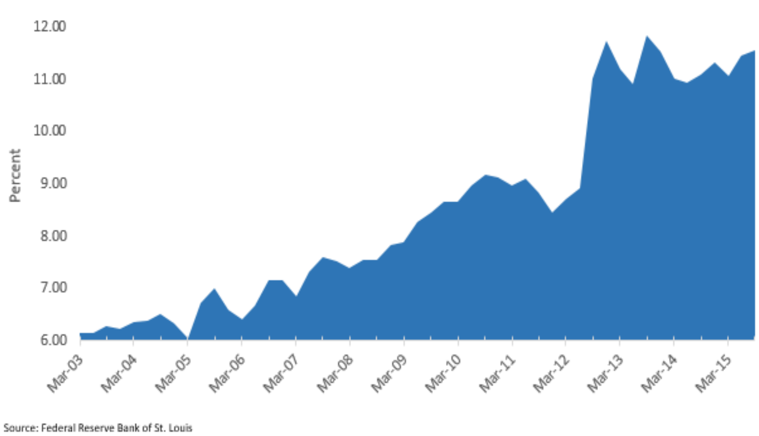
During the Financial Crisis, from 2007-2009, delinquency rates across all forms of household debt spiked, including mortgages, auto loans, and credit card debt. As we all remember, government intervention and time created a long healing process that slowly normalized defaults – except for student loans. Student loan delinquency rates have never recovered their downward trajectory after 2007. In fact, the delinquency rate for student loans has continued to increase since the financial crisis, with billions of dollars in student loan debt not being repaid.

Figure 5: New Seriously Delinquent Balances by Loan Type



According to data provided by the Federal Reserve Bank of New York (FRBNY) (Figure 6), approximately 11.5% of aggregate student loans are 90+ days delinquent or in default. To say that another way, $149.5 billion of student loans are delinquent. This FRBNY report, however, reminds us why it is vitally important to read the footnotes; the devil is always in the details. "***As explained in a [recent report](), delinquency rates for student loans are likely to understate actual delinquency rates because almost half of these loans are currently in deferment, in grace periods or in forbearance and therefore temporarily not in the repayment cycle. This implies***

Figure 6: Percent of Student Debt 90+ Days Delinquent



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that among loans in the repayment cycle, delinquency rates are roughly twice as high." In other words, the 11.5% figure quoted could be above 20% in reality.

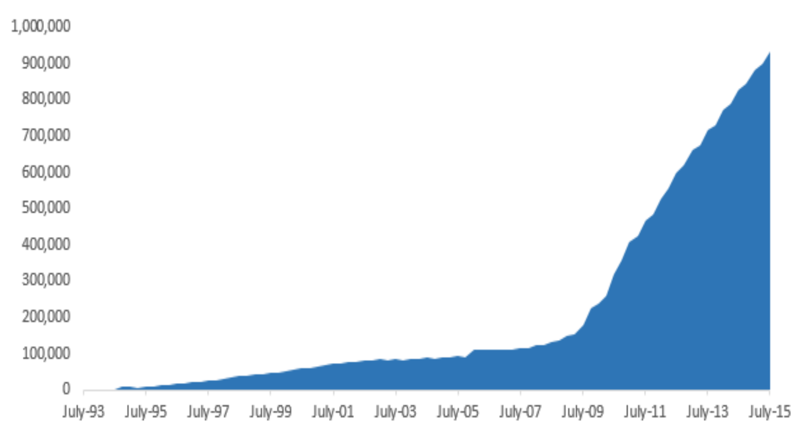
With all of this said, the question of how this affects consumers, educational institutions and investors is just begging to be answered.

For consumers, the direct effects of increased delinquency and default rates on student loans is fairly obvious. Failing to pay any type of debt leads to negative credit scores, financial insecurity, emotional distress, and dampens overall consumer spending – the lifeblood of the American economy. Bankruptcy may or may not solve the problem. Debts are generally forgiven in court, either partially or totally, but the courts have taken a much less forgiving stance on educational loans (see: Tetzlaff v. Educational Credit Management Corporation, a case which has followed former student Mark Tetzlaff for years: read **here**).

Will the mounting student debt problem change the way educational institutions think about tuition? Should education inflation continue to rise, the effects on institutions, both public and private, could loom large. While colleges and universities have already received the tuition owed once a student steps foot in the classroom, it is future attendance that raises concerns. As the cost to receive an education continues to climb, the cost-benefit analysis performed by would-be students will narrow. At some point, with all else being equal, the number of students willing and able to pay for an education will decline, forcing the higher education institutions to slash budgets as revenues fall. Something has to give.

Lastly, we would not be properly analyzing the situation if we did not look at the consequences that student loans can have on investors and the markets. When the words delinquency and default begin to surface in mainstream media, the natural questions are: who has exposure and how much?

Figure 7: Student Loans Held by the Federal Government



Source: Federal Reserve Bank of St. Louis

Of the $1.3 trillion of student loans outstanding, the United States Government has put themselves (i.e. taxpayers) on the hook for over $930 billion worth of the loans (Figure 7). The remaining amount has been either issued by the private sector or rolled up into Student Loan Asset-backed Securities. In other words, for every $1.00 of student loans outstanding in the US, the Federal Government (technically the US Education Department) is the creditor for $0.71 of it. The other $0.29 is held by private investors. At the end of the day, individual and private investors have very little control over the Government's 71% ownership of student loans, but they do maintain control of the remaining market share.

The answer of who owns the remaining 29% of outstanding private student loans is a hazy one. SLM Corporation, commonly referred to as Sallie Mae and traded on the NASDAQ under the ticker SLM, is generally the first name to surface. The former government entity gone private, gone public company provides and offers private student loans, among other ventures. In 2015, the company originated $4.3bn in private education loans, up 6% year-over-year,

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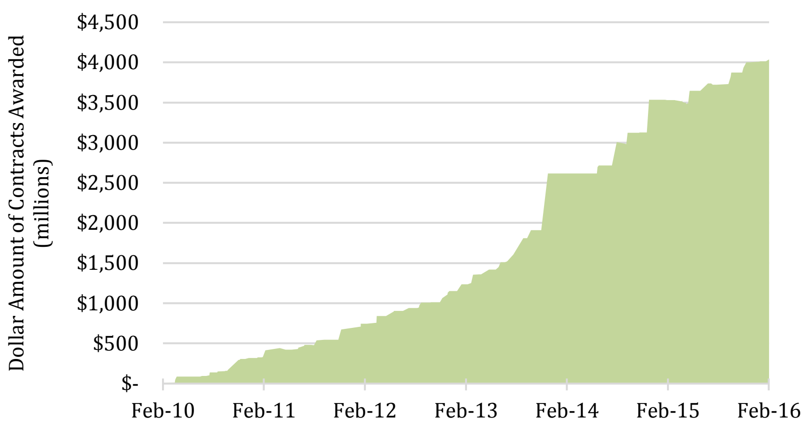
increasing the company's private loan exposure to $11bn. The company continuously securitizes its loan portfolio for Wall Street banks and investors to purchase.

Another public company that deals in the space is Navient Corporation (ticker: NAVI), which was spun-off from Sallie Mae in 2014. Navient deals in the student loan servicing and collections market. According to their website, Navient "offers a variety of loan management, servicing and asset recovery services to clients in higher education, and federal, state and local governments." According to a press release from Navient in 2014, they service nearly $300 billion in student loans. Because they have also won contracts from the Education Department, the exact makeup of loans (Government vs. Private) that they service is not immediately clear. The stocks of both companies have been under pressure in recent quarters.

Figure 8: Education Department Debt Collection Contracts Awarded



Source: Bloomberg

Other headlines to watch over the coming months (and likely years) from an investor's point of view are threefold. The first headline to watch is the delinquency rate that the Federal Reserve Bank releases on student loans. Secondly, watch the performance of both SLM and NAVI, as their records are perhaps the best public barometer that we have of the student loan market. The third, and arguably the most critical headline to watch is one that hardly makes a ripple in mainstream media: Rolling Debt Collection Contracts Awarded by the Education Department (Figure 8). The Education Department budgeted back in 2009 for $6 billion to be spent on student loan collection services. So far, just over $4 billion has been awarded, however, we suspect this will increase over time.

In the end, student loans and the programs offered by both the public and private sector are an incredibly important facet of education in America. Through grants, scholarships and loans, millions of Americans have had the ability to earn an education. As we have noted, there is a large opportunity cost with two side effects: education inflation, as institutions increasingly spend more to accommodate the uptick in students, and delinquencies/bankruptcies, as some consumers simply cannot afford to repay the debt. While none of these facts alone are a surprise, the voracious appetite for student loans in recent years, coupled with the subsequent increase in defaults, could accelerate the media spotlight. Only time will tell if this topic will create stress on the broader economy, or be bailed out by improving wages and job growth.