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The Law School Bubble: Federal Loans Inflate College Budgets, But How Long Will That Last If Law Grads Can't Pay Their Bills?

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For Andrea, a past decision to ensure her future in law has left her in a stressed and distressful present.

Concerned over how it might affect her job prospects, she would not allow use of her real name. And there is reason for concern: She’s been laid off twice since her 2009 law school graduation, including from a position where she earned $20 an hour at a small firm practicing as a licensed attorney. For the 29-year-old, who’s supported herself since college, the financial repercussions of law school may amount to the worst investment of her life, despite a degree from a second-tier school and a résumé that boasts a position on law review and coveted summer associate positions.

“I deferred my loans because of economic hardship the first time,” says Andrea, who borrowed nearly $110,000 to finance her education. “After that,” she falters, “they might be in forbearance ... accruing interest ... I just don’t know.”

Andrea’s situation is far from unique. In 2010, 85 percent of law graduates from ABA-accredited schools boasted an average debt load of $98,500, according to data collected from law schools by U.S. News...
In 2010, 33 percent of law grads from ABA-accredited schools boasted an average debt load of $90,000, according to U.S. News & World Report. At 29 schools, that amount exceeded $120,000. In contrast, only 68 percent of those graduates reported employment in positions that require a JD nine months after commencement. Less than 51 percent found work in private law firms.

Heavy loans now threaten to consume the future earnings and livelihood of the nation’s young lawyers. Yet, even as the legal market contracts, more than 87,900 potential candidates vied for 60,000 seats at 200 ABA-approved law schools in 2011, according to the Law School Admission Council.

More than 78,900 have applied for 2012 spots, according to preliminary LSAC counts in November. Youthful overoptimism, bleak job prospects for college grads and the entry of several more universities and for-profit businesses into the legal education business are some of the root causes for the supply-and-demand imbalance in entry-level lawyers.

Very few critics, however, have examined the part played by the federal government through its student loan policies in creating a law school bubble that may be on the verge of bursting—one strikingly similar to the mortgage crisis that cratered the economy in 2008.

Direct federal loans have become the lifeblood of graduate education, and they shelter law schools financially from the structural changes affecting the profession. The bills are now coming due for many young lawyers, and their inability to pay will likely bring the scrutiny of lawmakers already moaning about government spending.

BUCKS BACK BOOKS
As student groups continue to lobby the federal government for increased transparency, the lawmakers are bound to ask a very simple question: Why should the U.S. government, through the Department of Education direct-lending program, continue to make billions of dollars of loans to law students when structural changes in the legal market suggest that a large portion will lack the earning power to repay those loans?

The answer to this question has potentially grave implications for legal education. Law schools—many for the first time ever—will become vulnerable to significant cuts in the amount of money available to students as Congress tries to hold the line on additional deficit spending.

"There were people warning about this 10 years ago, but a lot of people were not paying attention to it," says Phoebe A. Haddon, dean of the University of Maryland School of Law. "But debt wasn’t as great as it is now, and the likelihood that people could repay tuition was built on a different financial structure of law firms."

Haddon adds, "I’ve seen a 20 percent increase in the amount of debt that our students have experienced in the last several years, and it’s mind-boggling to me how that can continue without a better response of how to support legal education in the future."

Since the GI Bill, America has operated on the principle that higher education always delivers a return
on investment. As such, Congress created a host of programs during the Great Society era of the 1960s to expand access to colleges and universities.

Law students, along with medical and dental students, are treated generously as future professionals and able to borrow, with virtually no cap, significantly more money than undergrads. America's law students borrowed at least $3.7 billion in 2010 to pay for their legal educations. Although the majority of the funds came from the Education Department, the patchwork of mechanisms that serve higher education as a whole make it difficult to regulate how much is being lent and to whom.

For several decades, most higher education loans were made by private lenders with the federal government providing guarantees against loss—and, in some cases, interest rate subsidies. Any remaining student expenses were met by private lenders without the benefit of federal guarantees.

When U.S. credit markets seized in 2008, there was worry that there would be insufficient federal or private loan funds to meet the financing needs of all students enrolled in U.S. colleges and universities. So the Education Department, under the authority of a new federal law passed in the spring of 2008, began buying up the federally guaranteed loans, making them direct loans from the U.S. government. In 2010 Congress passed the Student Aid and Fiscal Responsibility Act, part of President Barack Obama's final health care overhaul, which ended when U.S. credit markets seized in 2008, there was worry that there would be insufficient federal or private loan funds to meet the financing needs of all students enrolled in U.S. colleges and universities. So the Education Department, under the authority of a new federal law passed in the spring of 2008, began buying up the federally guaranteed loans, making them direct loans from the U.S. government. In 2010 Congress passed the Student Aid and Fiscal Responsibility Act, part of President Barack Obama's final health care overhaul, which ended when U.S. credit markets seized in 2008, there was worry that there would be insufficient federal or private loan funds to meet the financing needs of all students enrolled in U.S. colleges and universities. So the Education Department, under the authority of a new federal law passed in the spring of 2008, began buying up the federally guaranteed loans, making them direct loans from the U.S. government. In 2010 Congress passed the Student Aid and Fiscal Responsibility Act, part of President Barack Obama's final health care overhaul, which ended when U.S. credit markets seized in 2008, there was worry that there would be insufficient federal or private loan funds to meet the financing needs of all students enrolled in U.S. colleges and universities. So the Education Department, under the authority of a new federal law passed in the spring of 2008, began buying up the federally guaranteed loans, making them direct loans from the U.S. government. In 2010 Congress passed the Student Aid and Fiscal Responsibility Act, part of President Barack Obama's final health care overhaul, which ended when U.S. credit markets seized in 2008, there was worry that there would be insufficient federal or private loan funds to meet the financing needs of all students enrolled in U.S. colleges and universities. So the Education Department, under the authority of a new federal law passed in the spring of 2008, began buying up the federally guaranteed loans, making them direct loans from the U.S. government. In 2010 Congress passed the Student Aid and Fiscal Responsibility Act, part of President Barack Obama's final health care overhaul, which ended

In 2010 Congress passed the Student Aid and Fiscal Responsibility Act, part of President Barack Obama's final health care overhaul, which ended federal guaranteed student loans and replaced them with direct loans made through the Education Department. In effect, by converting the loan guarantees into an income-producing asset, the federal budget was reduced by $61 billion over 10 years.

Some of that savings was earmarked for additional educational grants and funding for community colleges. But some was allocated to help fund the national health care plan, hence its inclusion as part of the health care bill.

In the short term, the student loan overhaul may have been brilliant political maneuvering. But in the longer term, if a large portion of students don't repay their full loans, the perceived benefits of interest income on direct federal student loans will become an enormous financial liability. And there are good reasons to believe this might happen.

THE GOVERNMENTAL GAMBLE

The Education Department does not make lending decisions based on credit scores, at least for Stafford loans, the primary funding mechanism for both undergraduate and professional schools. Nor does it conduct a rigorous analysis on how graduation from particular institutions affects an individual's income or earning power. The protections for the U.S. Treasury are largely on the back end: Changes to the federal bankruptcy code over the last 15 years have made it extremely difficult to discharge student debt.

But sheltering loans from bankruptcy does not guarantee that the government will receive steady repayment, as several layers of loss apply. Though the latest loan default rates are far below the 22.4 percent peak in 1990, according to Education Department figures, they have been rising since 2003. While direct-lending program budget projections seem to preclude any possibility of loss, future budgets based on historical default rates can be upended as the legal market constrains. The default rates could be higher than the historical average as anticipated gains in earning power fail to materialize and lost jobs do not come back.

Likewise, the Congressional Budget Office may have underestimated the extent to which students will be eligible for the federal Income-Based Repayment plan, a relatively new innovation. IBR caps student loan repayment at 15 percent of adjusted gross income. Extensive use of that plan would both reduce revenues and create a shortfall in program funding for new loans. With approximately $200 billion in student loans each year, and high amounts projected in years to come, a 10 percent shortfall in repayments under IBR could amount to $20 billion to $30 billion lost.

By failing to make rigorous, realistic actuarial assumptions in deciding who to lend money to and how much to lend, the federal government avoids politically uncomfortable trade-offs. Everyone can go to college. And if you can get accepted into law school, the government will finance that, too.

But as the economist Herbert Stein once said, "If something cannot go on forever, it won't." The federal government's gamble that higher education will continue to result in higher personal incomes eerily echoes Wall Street's risky assumption that historical patterns in real estate values would carry forward forever and enable many sliced-and-diced mortgage-backed securities to attain AAA ratings.

While it may be politic, even patriotic, to assume that the higher-education-equals-higher-income equation is fact, for investors it remains, at best, aspirational. Since 2008, private investment in nearly any market has been reluctant. The capitalists aren't taking this education-equals-high income bet; if they did, the terms they would demand would likely change the choices that student borrowers are now making.

Unless the government's actuarial assumptions on student loan repayments turn out to be correct, federal funding of higher education is on a collision course with the federal deficit. Optimistic assumptions of future growth and earning power, however, are completely at odds with the financial landscape that has given rise to the so-called scamblodger movement and some recent lawsuits by graduates alleging their schools committed fraud and
Direct loans to students will increase from \$3 billion in 2009 to \$7 trillion in 2020, according to estimates by the Office of Management and Budget. Between 7 and 4 percent—\$30 billion to \$72 billion—will be for law school graduates.

other deceptive practices regarding portrayals of job prospects.

COUNTING THE DISCOUNTS
The cost of legal education is more complicated than tuition, books and living expenses. Although published tuition is usually very high (Harvard's 2010-11 rate was \$47,600), more than half of all enrolled students receive some sort of discount.

The vast majority of these discounts come in the form of merit-based scholarships based on undergraduate grades and LSAT scores. Merit scholarships are not guaranteed over the three years of schooling. Recent news media coverage has noted that scholarships based on beating the law-class grade curve can leave many students without scholarships and several semesters left to complete degrees, often paid for by more federal loans.

And while some scholarships are financed through law school endowments, most are cross-subsidies by incoming students: Student A pays full tuition—largely financed through loans—so that student B can receive a discount.

The cross-subsidy is fueled by competition among schools to maximize prestige as measured by U.S. News rankings. The credentials of entering classes represent a significant component of the ranking formula—a combined 22.5 percent, as described by U.S. News.

Because of this system of variable tuition, some students graduate with little or no debt. A much larger group graduates with considerable debt.

For law students who have not defaulted on prior federal student loans, the first \$20,500 per year in loan funding is typically a federal Stafford loan at an annual interest rate of 6.8 percent. Because the yearly cost of law school attendance often far exceeds \$20,500, a large proportion of students take out federal Direct PLUS loans, which carry a 7.9 percent yearly interest rate plus a 4 percent one-time charge at the time of disbursal. The only limit imposed is the cost of attendance minus any other financial assistance.

Students who choose the highest-ranked school to accept them tend to be the biggest borrowers because their LSAT scores and undergraduate GPAs are more likely to be below the school's median statistics. As a result, these students get less merit scholarship aid, which pushes their cost of attendance to \$40,000-\$65,000 per year. After three years, the cumulative debt is \$120,000-\$195,000, with a blended interest rate of roughly 7.3 percent.

Assuming a total debt of \$150,000 (the amount currently carried by several thousand law graduates), the total monthly payment is \$1,743.46 a month for 10 years, according to the Education Department's repayment calculator. For law graduates who opt for the 25-year graduated payment plan, which starts at about \$930 a month and increases over time, that amortizes to \$357,229, more than double the original amount.

According to NALP, the association for legal career professionals, the median starting salary for a lawyer who graduated from law school in 2010 is \$63,000. For a recent, unmarried law school graduate making \$63,000 and getting single-digit-percent annual pay increases, the chasm between income and prospective repayment is impractical for both the student and the government.

This combination of high debt and moderate income makes this all-too-typical law graduate eligible for the federal government's income-based repayment program. According to FinAid's IBR calculator, used by many law school financial aid counselors, the student will make monthly payments of \$584 the first year and \$1,605 in year 25. After 25 years, the loan is forgiven.

At that time, more than half of the principal, \$76,000, will not have been repaid, along with \$26,000 in capitalized interest.

The government write-down for this student is about \$103,000, which may be offset by an eventual tax pay-
future student loans. Loan balances reduce the federal funds available for current and future law school graduates. And their unpaid based repayment is surely the fate that awaits many would have to collect it from someone near enough for the debt forgiveness. Of course, the government law school grad would have $103,000 in imputed income
ment: Under the current Internal Revenue Code, the law school grad would have $103,000 in imputed income for the debt forgiveness. Of course, the government would have to collect it from someone near enough to retirement to be eligible for membership in AARP.
Surveying the current landscape for law jobs, income-based repayment is surely the fate that awaits many current and future law school grads. And their unpaid loan balances reduce the federal funds available for future student loans.

ENDGAME
Given the likelihood of some form of curb in federal student lending, there are gut-wrenching times ahead for law schools—even those that continue to enjoy a surplus of applicants. Until we get to that point, however, the lawyer production machine will continue to churn out more lawyers.

For those trying to get through this fiscal year, a government write-down of student debt may seem far away and speculative. Within a few years, however, the government will gain more experience on the IBR program, permitting a more accurate calculation of what its loan assets are really worth.

All the while, the stakes are growing larger. The volume of direct loans to students is estimated to increase from $489 billion in 2009 to $1.8 trillion in 2020, according to the Office of Management and Budget. Between 2 and 4 percent—$36 billion to $72 billion—will be for law school graduates.

Besides rising defaults and heavy use of income-based repayment, federal student lending is vulnerable to other attacks. Although IBR may be viewed as a boon to law students, law school graduates may view it differently—15 percent of their monthly income paid over more than half of their career span is a severe burden, especially if the sought-after gains in earning power fail to materialize.

For federal education loans, law students are grouped together with doctors and dentists, even as the U.S. Bureau of Labor Statistics acknowledges a shortage of those professionals and a growing glut of lawyers. Further, the bureau projects that these shortages and surpluses will continue over the next decade.

Does the right hand of government know what the left hand is doing? If too many law school graduates are forced to invoke IBR, the Education Department will eventually have to justify writing checks to law schools. Mark Grunewald, interim dean of the law school at Washington and Lee University, thinks any blanket restrictions on federal student lending would be disastrous and unfair. "There are real differences among prospective law students’ economic circumstances, and new blanket restrictions on lending could hurt those most in need of financial support," he says. "It’s also unclear what the legal employment market might look like after a general economic recovery. Market forces may ultimately prove to be a better corrective."

Still, scrutiny by the scamblogger movement and legal and mainstream media may speed up the process. One plausible outcome has the Education Department using its accreditation authority to force law schools to demonstrate, as a condition of receiving federal loan money, a minimum threshold of employability and income upon graduation.

As today’s prospective law students survey their options, they see few career paths that are affordable and intellectually challenging, and that offer secure economic returns and the potential to be socially meaningful. Based on the other alternatives, many still argue that a law degree is as good a bet as any. This may be true. But the more vexing question is why a gambling metaphor now seems so apt for legal education.

Six figures of debt, a heavy interest burden and poor job prospects—this is no way to begin a legal career. Some graduates will no doubt hang their own shingles and build successful practices, but many others will start practicing law without proper capital or mentorship. This is dangerous territory for the profession.

During the 1990s, research on lawyers has shown a strong link between lawyer misconduct and the economic stress of too many lawyers chasing too little, unsophisticated legal work.

The easy credit that feeds legal education will eventually exact costs that go beyond recent law school graduates. Andrea is one who knows that personally.

"The face of the law profession has changed. Even the ones who don’t have jobs think it will bounce back and be the same, but it won’t. This is a totally different game." "The last few years were the hardest of my life. I’ve essentially lost my dream. ... It’s like I’ve failed at everything. If I’d known what would happen, I would have gone another way. I would have stayed at my firm, became a paralegal. I wouldn’t have taken on this debt. I don’t have anything or anyone else to fall back on."

The U.S. legal profession is in the midst of a broad structural transformation. Meeting the challenge to compete in a global economy requires a higher-education policy that honestly addresses issues of access, cost containment and national interest.

Legal education may soon provide an object lesson of what happens when we do nothing: Bad things happen when lawyers and law professors stick their heads in the sand. The republic may be in need of some world-class lawyerly judgment. And maybe soon. ■

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