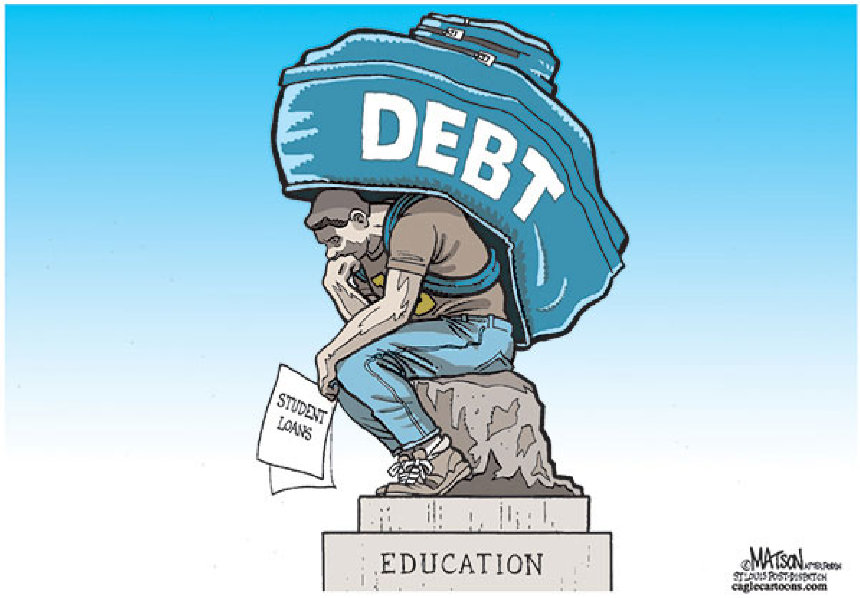

THE STUDENT LOAN "DEBT BOMB": AMERICA'S NEXT MORTGAGE-STYLE ECONOMIC CRISIS?

A Report Prepared for the
National Association of Consumer Bankruptcy Attorneys (NACBA)

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EXECUTIVE SUMMARY

Americans now owe more on student loans than on credit cards.

The amount of student borrowing crossed the $100 billion threshold for the first time in 2010 and total outstanding loans and exceeded $1 trillion for the first time last year. The reason: Students and workers seeking retraining are borrowing extraordinary amounts of money through federal and private loan programs to help cover the rising cost of college and training. In many cases, parents responsible for the student loans are in or near retirement years and facing repayment demands.

How big is the danger to the U.S. economy? "Evidence is mounting that student loans could be the next trouble spot for lenders," said Dr. Andrew Jennings, chief analytics officer at FICO and head of FICO Labs.

Consider the facts:

- Individually, college seniors who graduated with student loans in 2010 owed an average of $25,250, up five percent from the previous year.

- Borrowing has grown far more quickly for those in the 35-49 age group, with school debt burden increasing by a staggering 47 percent.

- Students are not alone in borrowing at record rates, so too are their parents. Loans to parents for the college education of children have jumped 75 percent since the 2005-2006 academic year.

- Parents have an average of $34,000 in student loans and that figure rises to about $50,000 over a standard 10-year repayment period. An estimated 17 percent of parents whose children graduated in 2010 took out loans, up from 5.6 percent in 1992-1993.

- Of the Class of 2005 borrowers who began repayments the year they graduated, one analysis found 25 percent became delinquent at some point and 15 percent defaulted. The Chronicle of Education puts the default rate on government loans at 20 percent.

With rising debt comes increased risk, both to borrowers and to the economy in general. Even in the best of economic times when jobs are plentiful, young people with considerable debt burdens end up delaying life-cycle events such as buying a car, purchasing a home, getting married and having children. Piling up student loans in middle age is even more troublesome. Aside from the simple truth that there is less time to earn back the money, it also means facing retirement years still deeply in debt. And, parents who take out loans for children or co-sign loans will find those loans more difficult to pay as they stop working and their incomes decline.

This concern is echoed by bankruptcy attorneys from across the country who report that what they are seeing at the ground level feels too much like what they saw before the foreclosure crisis crashed onto the national scene: more and consumers seeking their help with unmanageable student loan debt, and with no relief available.

UNDERSTANDING THE STUDENT LOAN "DEBT BOMB"

Most Americans see a college degree as the single most important factor for financial success and a place in the middle class. Post-secondary education and training have become essential not only to the individuals hoping to enter or remain in the middle class, but to the nation as a whole. It is widely believed that we need a well-educated workforce to create new opportunities in the United State and to remain competitive internationally.

But, as family incomes, available grant aid, and state investments in higher education have failed to keep pace with college costs, students and families increasingly are turning to student loans to help bridge the college affordability gap.

Today, students and workers seeking retraining are borrowing extraordinary amounts of money through federal and private loan programs to help cover the cost of college and training. Individually, college seniors who graduated with student loans in 2010 owed an average of $25,250, up five percent from the previous year, according to a report from the Project on Student Debt at the Institute for College Access & Success (TICAS).[1] Collectively, the amount of student borrowing crossed the $100 billion threshold for the first time in 2010 and total outstanding loans exceeded $1 trillion for the first time last year.[2] Americans now owe more on student loans than on credit cards, according to the Federal Reserve Bank of New York, the U.S. Department of Education and others. And, because there are fewer people with student loans than there are credit card holders, the debt burden on the individual borrower is considerably higher.

Although educational borrowing is up for every age group over the past three years and young people still carry the biggest student loan debt burden, borrowing has grown far more quickly for those in the 35-49 age group, according to an analysis by the credit score tracking site CreditKarma. That age group saw its school debt burden increase by a staggering 47 percent, according to the analysis.[3] Credit Karma CEO Kenneth Lin said the reason for this increase is obvious: the tough economy has pushed more people to seek mid-career training and education.

And, it is not just students who are borrowing at record rates, so too are their parents. Loans to parents for the college education of children have jumped 75 percent since the 2005-2006 academic year, according to Mark Kantrowitz, publisher of the website FinAid.org. Based on data compiled by Kantrowtiz, federally backed educational loans to parents account for roughly 10 percent – or $100 billion – of the $1 trillion in outstanding educational loans. Parents have an average of $34,000 in student loans and that payback figure rises to about $50,000 over a

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[1] *Student Debt and the Class of 2010*, The Institute for College Access & Success, November 3, 2011, http://projectonstudentdebt.org/pub_view.php?idx=791

[2] "Student Loans Outstanding will exceed $1 trillion this year," Dennis Cauchon, USA Today, October 18, 2011 and updated October 25, 2011, http://www.usatoday.com/money/perfi/college/story/2011-10-19/student-loan-debt/50818676/1

[3] "Middle-aged borrowers piling on student debt," Mitch Lipka, Reuters, December 27, 2011, http://www.reuters.com/article/2011/12/27/us-studentdebt-middleage-idUSTRE7BQ0T620111227

standard 10-year loan period. An estimated 17 percent of parents whose children graduated in 2010 took out loans, up from 5.6 percent in 1992-1993, according to Kantrowitz's estimates.[4]

With rising debt comes increased risk, both to borrowers and to the economy in general. While a college education generally is considered to be a very good investment, it does not guarantee a high paying job or freedom from financial difficulties. Even in the best of economic times when jobs are plentiful, young people with considerable debt burdens end up delaying life-cycle events such as buying a car, purchasing a home, getting married and having children. Piling up student loans in middle age is even more troublesome. Aside from the simple truth that there is less time to earn back the money, it also means facing retirement years still deeply in debt. And, parents who take out loans for children will find those loans more difficult to pay as they stop working and their incomes decline.

FICO's quarterly survey of bank risk professionals found growing concern for the stability of the student loan market. "Evidence is mounting that student loans could be the next trouble spot for lenders," said Dr. Andrew Jennings, chief analytics officer at FICO and head of FICO Labs.[5]

The Institute for Higher Education Policy (IHEP) recently examined both delinquency and default rates by studying Class of 2005 graduates five years later. Of borrowers who began repayments the year they graduated, 25 percent became delinquent at some point and 15 percent defaulted. Others took refuge in federal programs that allow students to postpone or reduce their payments. Only 40 percent of borrowers had made payments as agreed. "It really surprised me," said Alisa Cunningham, vice president of research at IHEP. "I didn't realize how many borrowers were having problems."[6] The Chronicle of Education puts the default rate of government loans at 20 percent.

This concern is echoed by the anecdotal experiences of bankruptcy attorneys from across the country who report that what they are seeing at the ground level feels too much like what they saw before the foreclosure crisis crashed onto the national scene: more and consumers seeking their help with unmanageable student loan debt, and with no relief available.

And, as with the mortgage foreclosure crisis, the staggering amounts owed on student loans also will have repercussions for the broader economy. Just as the housing bubble created a mortgage debt "overhang" that absorbs the income of consumers and renders them unable to afford to engage in the consumer spending that sustains a growing economy, so too are student loans beginning to have the same effect, which will be a drag on the economy for the foreseeable future.

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[4] "Parents Snared in $100 Billion College Debt Trap Risk Retirement," Janet Lorin, Bloomberg, February 2, 2012 http://bloomberg.com/news/2012-02-02/parents-snared-in-100-billion-u-s-college-debt-trap-risking-retirement.html

[5] "Student Loans Seen as Next Casualty of Sluggish Economy, FICO Quarterly Survey Finds," FICO.com, January 11, 2012, http://www.fico.com/en/Company/News/Pages/01-11-2012a.aspx

[6] "Delinquency: The Untold Story of Student Loan Borrowing," Alisa Cunningham and Gregory S. Kienzl, Ph.D., Institute for Higher Education Policy, March 2011, http://www.ihep.org/Publications/publications-detail.cfm?id=142

WHAT IS FUELING THE STUDENT LOAN "DEBT BOMB"?

If all goes well, college graduates earn significantly more than those with high school degrees. However, this is not always the case. Some may find their chosen professions are not as lucrative as they thought. Some may find few jobs are available or may lose their job in the current economic environment. Yet others will confront unexpected life traumas such as disability, divorce or death of a family member. Whatever the circumstance, student loan borrowers are allowed very little margin for error and easily can find themselves with unmanageable student loan debt. These borrowers face a lifetime of debt with little or no chance for escape.

Missing just one student loan payment puts a borrower in delinquent status. After nine months of delinquency a borrower is in default. As younger college students, middle aged borrowers and parents all have taken on bigger student loan burdens, the level of defaults has risen. Although the Department of Education's official default rate for 2009 was 8.8 percent, the figure reflects only those debtors who began repayment in fiscal year 2009 and failed to meet the obligation by September 30, 2010, not all the people who defaulted over time.[7]

While any default hurts a borrower's credit, the consequences of a default on a student loan is particularly onerous. Once a default occurs, the full amount of the loan is due immediately. The government also cuts off any future federal financial aid and strips the borrower's eligibility for loan forgiveness.

For those with federal student loans, the government has collection powers far beyond those of most creditors. The government can garnish a borrower's wages without a judgment, seize a tax refund (including an earned income tax credit) or portions of federal benefits such as Social Security, and deny eligibility for new education grants or loans. The government can sue the borrower to place liens on bank accounts and property, and can tack on collection fees of 30 percent of the amount due. There is no discharge in bankruptcy for federal loans except in extremely limited circumstances that require a borrower to file a lawsuit that few bankruptcy debtors can afford, especially because student loan servicers aggressively litigate such cases. Unlike any other type of debt, there is no statute of limitations. The government can pursue borrowers to the grave. And, for those with professional licenses, failure to pay student loan debt can result in the loss of the state-issued license.[8]

Compounding the problem is that a borrower faced with a temporary setback often finds himself quickly in a much deeper hole. Interest accrues, collection fees accrue, and negative credit report notations accrue making it difficult to get out from under the growing loan balance or to find a decent job.

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[7] "Student loan debt now exceeds $1 trillion; more than credit cards," Bartholomew Sullivan, Scripps Howard News Service, January 14, 2012,

[8] For an excellent and comprehensive discussion of the challenges faced by student loan borrowers see "No Way Out: Student Loans, Financial Distress, and the Need for Policy Reform," Deanne Loonin, National Consumer Law Center, June 2006, http://www.studentloanborrowerassistance.org/blogs/wp-content/www.studentloanborrowerassistance.org/uploads/File/nowayout.pdf.

As challenging as government student loans may be for students and parents facing financial hardship, there are at least some protections. Borrowers can count on fixed, affordable interest rates, generally low fees, repayment options, and limited forgiveness programs backed by the federal government. Federal loan terms and conditions are set by Congress, and are the same for all borrowers regardless of their income, credit score, or where they go to school. The same cannot be said for private student loans.

Private student loans are made by lenders to students and families outside of the federal student loan program. They are not subsidized or insured by the federal government and may be provided by banks, non-profits, or other financial institutions. The borrowing limits in the federal loan programs, the skyrocketing cost of higher education and aggressive lender marketing fueled the growth of private student loans. Although still just a portion of the overall volume of student loans, the percentage of undergraduates with private student loans rose from five percent in 2003-04 to 14 percent in 2007-08. During that same period, the volume of student loans rose from $6.5 billion to $17.l billion.[9]

Despite some similarities, there are a number of very important differences between federal and private loans, including:[10]

Underwriting. With the exception of PLUS loans for parents and graduate/professional students, federal loan borrowers do not have to meet creditworthiness standards. Private loans, in contrast, are priced according to credit worthiness standards.

Pricing. All federal loans have interest rate caps. In contrast, nearly all private loans have variable interest rates with no upper limits. Many of these loans are very expensive, with predatory interest rates 15 percent or higher.

Loan Limits. There are loan limits for the various federal loan programs. The only exception is PLUS loans for parents and graduate/professional students. For private loans, there are no regulations setting a maximum dollar amount on how much a student can borrow. Generally, lenders allow students to borrow up to the cost of attendance minus other aid.

Borrower Protections. Federal loans come with a range of borrower protections that are mandated in the federal Higher Education Act, including income-based repayment, deferment and cancellation rights. In contrast, private lenders are not required to offer any particular relief.

Regulation. Federal loans are regulated through the Higher Education Act (HEA). Private loans, in contrast, are regulated (or not) in much the same way as other types of private credit, such as credit card installments or mortgage loans. Oversight largely falls within the jurisdiction of federal regulators. As in the mortgage market, federal enforcement actions to curb problems in the private student loan market have been virtually nonexistent.

Collection. Both federal and private lenders use third party collection agencies to pursue delinquent and defaulted borrowers. Private student lenders have fewer collection powers than

[9] The Project on Student Debt, The Institute for College Access & Success,
[10] "No Way Out: Student Loans, Financial Distress, and the Need for Policy Reform," NCLC.

federal collectors. This gap is closing, however, as private lenders have fought to obtain many of the same collection rights as the government. They succeeded in persuading Congress in 2005 to make private loans as difficult to discharge in bankruptcy as federal loans.

Despite the disparities in terms and protections for federal government loans and private loans, the private student loan market grew rapidly throughout the 1990's and early 2000's. During this time, many borrowers sought private loans even if they were eligible for federal student loans. There are signs that this rapid growth tapered off with the advent of the credit crisis, but many borrowers hold debt extended by private lenders during the peak years.

<u>RECOMMENDATIONS FOR REFORM: DEFUSING THE DEBT BOMB</u>

It is a widely held view that no qualified student who wants to earn a college degree should be barred due to a lack of money. However, it is precisely this lack of money that converts the promise of higher education into a lifetime of stress and financial hardship. The policy reforms offered here are intended to help build a better and more equitable system for student loan borrowers who encounter financial difficulties.

Restore the bankruptcy discharge for student loans

Student loans are among the few types of debts that generally are not dischargeable in bankruptcy. In contrast to student loans, most other debts are dischargeable in either a Chapter 7 liquidation process or Chapter 13 debt adjustment plan. Other debts singled out as non-dischargeable include child support, alimony, court restitution orders, criminal fines and some taxes.

It wasn't always this way. Prior to 1976, all student loan debt was dischargeable in bankruptcy, just as if it were any other type of unsecured debt. That year, Congress added an exception to the bankruptcy discharge by prohibiting the discharge of education loans made by the government or a non-profit college or university, unless those loans had been in repayment for five years. That exception was continued in the 1978 Bankruptcy Act, but debtors who completed a chapter 13 plan, paying all they could afford over three to five years, were not subject to the five year waiting period. Since 1978, there have been three significant legislative changes in the treatment of student loans in bankruptcy.

First, in 1990, the five year repayment period was extended to seven years and the differential treatment of chapter 13 was eliminated. In 1998, the temporal ground (the seven years) for discharge was eliminated. And finally, in 2005, Congress included most private student loans in the nondischargeability category as part of a comprehensive rewrite of the bankruptcy code.

The only exception to the nondischargeability of student loan debt is if the debtor can persuade the bankruptcy court that repayment of the loan would result in "undue hardship." There is no statutory definition of "undue hardship." This is a court-defined term, usually satisfied only if the debtor can meet the three-pronged test set forth in *Brunner v. New York State Higher Education*

Services Corp.,[11] under which the debtor must demonstrate: (1) she cannot maintain a minimal standard of living for herself or her dependents if forced to repay the loan, (2) circumstances exist indicating this state of affairs is likely to persist for a significant portion of the repayment period, and (3) the debtor has made a good faith effort to repay the loan. In certain courts, a somewhat more flexible ”totality of the circumstances” test has been applied.

Regardless of which test is used, most courts are very restrictive in determining which borrowers qualify for discharge. Often only borrowers very close to the poverty level with little or no hope for improvement are considered eligible. And few debtors are able to avail themselves of the opportunity to seek a discharge, because they cannot pay to fund the litigation that is required to prove undue hardship, litigation that has become much more expensive because student loan creditors aggressively defend such cases.

These statutory changes to the bankruptcy discharge for student loans were made despite the lack of any hard evidence that there were abuses of the system. In fact, in 1977, after the original bankruptcy amendments had been adopted but before they went into effect, the House Judiciary Committee issued a report concluding that the nondischargeability provision should be repealed. The Committee found that there was no real problem and that fewer than one percent of all federally insured and guaranteed educational loans were discharged in bankruptcy.[12]

Furthermore, the extension of the preferential treatment for student loans in bankruptcy to private student loans came during the credit industry’s feeding frenzy – the 2005 comprehensive rewrite of the bankruptcy code. Amid the chaos of credit card lenders, car financiers and rent-to-own oufits all advancing their self interests in a long and complex series of amendments, an unidentified lawmaker slipped in a provision making private student loans non-dischargable. There were no hearings or public discussion of such a fundamental change in policy on private student loans during the several years the bankruptcy bill was under discussion. Now, private student lenders, despite their lack of protections afforded by government lenders, enjoy the same protection from default.[13]

NACBA agrees with the comments submitted by the National Consumer Law Center to the Consumer Financial Protection Bureau that “bankruptcy is not and should not be the entire safety net, but it is the most organized, recognized, and effective system available offering relief to those who most need it. It is never an easy decision for a consumer to choose bankruptcy. This choice comes with many costs and consequences, including damaged credit that lasts for

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[11] 831 F.2d 395 [2d Cir. 1987]

[12] H. Rept. 95-595, at 132-33 (1977).

[13] Private student loans, on the other hand, are one of the riskiest and most expensive ways to pay for college. These loans are offered by a variety of banks and other lenders and can generate tremendous profits through high variable rates and fees. Private student loans lack the fixed rates, consumer protections, flexible repayment options of federal student loans and generally are extended base on creditworthiness. Indeed, some have observed that these loans are “not financial aid any more than a credit card is when used to pay for textbooks or tuition.” See for example, the testimony of Lauren Asher, President, the Institute for College Access & Success, before the Subcommittee on Commercial and Administrative Law, Committee on the Judiciary, U.S. House of Representatives, oversight hearing, “An Undue Hardship? Discharging Educational Debt in Bankruptcy,” September 23, 2009, found at http://judiciary.house.gov/hearings/pdf/Asher090923.pdf

years."[14] However, it is now available only through the random, unfair, and costly "undue hardship" system. Effectively, it has become no choice at all for those who most need it.

NACBA calls on Congress to act immediately to eliminate the nondischargeability of private student loans. There simply is no reason to allow private student loans to be treated differently from other types of unsecured credit. In fact, exempting these loans from discharge is likely to cause even more harm for borrowers since there are no interest rate limit or limits on fees charged for private student loans. Furthermore, there are limited repayment options for those borrowers facing financial hardship. Legislation pending in both the House (H.R. 2028, the "Private Student Loan Bankruptcy Fairness Act,") and Senate (S. 1102, the "Fairness for Struggling Students Act,") will restore bankruptcy relief for private student loans.

Congress also should extend greater relief to student loan borrowers by restoring the right to discharge federal student loans in bankruptcy. Congress should retain the undue hardship standard and restore the original five year repayment provision. In this way, borrowers could prove undue hardship at any time to discharge their loans. All borrowers, regardless of hardship, would be allowed to discharge student loans five years after those loans first became due.

Restoring bankruptcy protection for student loan debt is not the same thing as simply forgiving these loans. The 2005 changes to the Bankruptcy Code ensure that debtors who enter bankruptcy with funds to repay debts are not able to simply liquidate them through Chapter 7. For example, there is now a means test to determine if a debtor can repay creditors. In addition, there are significant new barriers to access, including higher filing fees and mandatory counseling and education requirements. Any question about the existence or extent of past abuse of the bankruptcy system should be put to rest by the new system. The discharge should be restored for students who truly need the bankruptcy safety net.

Re-impose a reasonable statute of limitations on student loan collections

Just as student loans are among the few unsecured debts that generally are not dischargeable in bankruptcy, student loan borrowers have the unenviable distinction of holding debt with no statute of limitations. The Higher Education Act Amendments of 1991 eliminated the statute of limitations within which suits could be filed, judgments enforced or offset, garnishment or other actions initiated to collect federal student loans. This lumps student borrowers with very small number of law violations, such as murder and treason. Despite the governmental and societal interest in pursuing criminals, statutes of limitation apply to nearly all federal criminal actions. The rare exceptions exist for those crimes that are punishable by death, including espionage and treason, and now, student loan defaults.

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[14] Comments to the Consumer Financial Protection Bureau on Request for Information Regarding Private Education Loans and Private Educational Lenders, 76 Fed. Reg. 71329 (November 17, 2011), Docket # CFPB 2011-0037, National Consumer Law Center, January 17, 2012, http://www.studentloanborrowerassistance.org/blogs/wp-content/www.studentloanborrowerassistance.org/uploads/2007/03/comments-cfpb-jan2012.pdf

Statutes of limitation are the norm in civil and criminal cases. The primary justifications for statutes of limitation fall into two general categories: those relating to the benefits of repose and finality and those advocating against the adjudication of stale claims. Statutes of limitation recognize that there are very serious problems associated with adjudicating old claims. In the case of student loans, it means loan holders must keep records of government student loans for a borrower's entire life. Borrowers' records must likewise be kept for a lifetime. The limitless pursuit of vulnerable student loan borrowers has serious costs. Disabled and older consumers face collection for loans they may have taken out 30 or 40 years earlier. If they have no other assets or property, the government is permitted to take a portion of their Social Security benefits. There truly is "no way out" for student loan borrowers.

Improve oversight of private collection agencies

The widespread use of private collection agencies to pursue student loan defaulters, combined with a significant expansion in the government's collection tools has led to abuses in student loan collection. There are documented problems with training and oversight of third party private collectors. The use of private collectors adds substantial costs to the collection process and contributes to problems with both the amount of fees charged and when fees are imposed.

NACBA recommends that a rigorous training process for collection agencies instituted; that all aspects of oversight of private collection agencies be improved; and that collection fees meet a test of reasonableness.