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Bankruptcy Discharge: A Second Chance

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Abstract

Student loan debt has reached astronomical numbers, currently an estimated $1.2 trillion dollars, second only to mortgage debt.[1] The high cost of a college education necessitates student loans, often several loans to finance a basic degree. The resulting debt not only prevents students from entering the middle-class, but also undermines economic growth for the nation as a whole. As a result, it is imperative to address the student debt crisis and help struggling borrowers out of financial distress. To this end, an amendment to the 1965 Higher Education Act is needed to allow for students to discharge federal and private loans in bankruptcy. Students who are not allowed to file for bankruptcy end up defaulting on their debt, creating a series of problems, including a damaged credit score and impeded future. Although bankruptcy has serious repercussions, it does allow creditors to regain their financial standing after years of careful monitoring, and provides relief albeit not easily and quickly. Student default can have the most pernicious effects not only for students, but also for institutions of higher education.

Introduction

Changing legislation over the past 40 years has eliminated discharge of educational loans through bankruptcy. Defaulting on a student loan occurs after 270 days ofno payments and, once in default, a borrowers credit is negatively affected. Bankruptcy is relief from financial distress once a borrower has no other alternative available. Currently, deferment and forbearance apply for federal loans, allowing borrowers some relief if they cannot pay their loans, but borrowers must enter these programs prior to defaulting their loans. Prior to 1976, all education loans were dischargeable in bankruptcy. However, in 1976, the bankruptcy code was changed to prevent federal loans from being discharged during the first five years of repayment. In 1984, the Bankruptcy Amendments and Federal Judgeship Act of 1984 established that all private students' loans were ineligible for discharge.[2] In 2005, Congress more recently passed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, removing all possibility for private student loan discharge, other than in extreme cases, as defined by the Brunner Test discussed later in this paper. The 2005 law passed because Congress feared that students were taking advantage of bankruptcy and too easily ridding themselves of loans. Students who are in loan default are the ones in most need of bankruptcy discharges, so the current legislation should be amended.

Research by Darolia and Ritter studied the 2005 anti-bankruptcy law.[3] They analyzed whether the change in law forced borrowers to adjust their behavior in response to the reform. They found no such change. If students had been discharging their loans unscrupulously as imagined by authors of the law, there should have been massive, declines in discharge cases after the laws enactment. This research indicates that student loan discharge did not decrease in the private loan market and that the law has no effect on the number of student loan bankruptcy cases.

Those who do gain discharge only do so after a series of steps through courts that ensure the highest level of fidelity to the process and prevent the moral hazard of bankruptcy abuse. Bankruptcy courts required the debtor to go before a judge who will adjudicate the case as is already done with a series of other bankruptcy dealings. Courts already discharge credit card, home mortgages, among many other forms of debt. No evidence exists, that the bankruptcy system is broken, nor has rampant abuse been found.

Current Barriers to Bankruptcy

Under current law, private student loans can be discharged in bankruptcy if they meet the Brunner Test. It has the following stipulations:

Poverty: Based upon your current income and expenses, you cannot maintain a minimum standard of living for yourself and your dependents if forced to repay your loans.

Persistence: Your current financial situation is likely to continue for a significant part of the repayment period.

Good Faith: You have made a good faith effort to repay your student loans.

Latino student loan default rates are double that of whites and quadruple that of Asians. This population is under severe financial distress only exacerbating current inequality. Latino students have low college attainment rates. According to the Pew Research Center, 19 percent of 18–24 year old Latinos enroll in college but only 9 percent obtain a degree.[5]

Of the three stipulations, persistence is the most difficult to prove in this case. A person needs to prove that for the indefinite future, their financial situation will not change. The burden of proof is too cumbersome and undermines even the most noble of bankruptcy claims. In addition to the Brenner Test being unwarranted due to its harsh applicability, not all courts use it. In some courts, the Totality of the Circumstances Test is used rather than the Brunner Test. This situation only adds confusion and demonstrates the onerous bankruptcy process. To further complicate matters, there are other tests used by courts in some jurisdictions.

In 2006, the average student borrower who filed for bankruptcy had $13,456 in debt. In 2013, the average student loan debt for bankruptcy petitions was $32,096. This increase correlates with the overall student loan debt, irrespective of bankruptcy petitions. In other words, the increasing costs of higher education are highly correlated to increased bankruptcy charges.

A report by the Association for Community College Trustees, "A Closer Look at the Trillion," demonstrates that most students who are in default owe debts between $5,000 to $10,000,[4] which fuels considerably below the average student debt bankruptcy petition of $32,908. In other words, most of those who are in financial distress borrowed small amounts and do not make up the majority of those who actually file for bankruptcy. These students are not abusing the system. Yet, it is these borrowers that need the most help and for whom a revision of the current bankruptcy law must address. The Association for Community College Trustees' research also demonstrated that 90 percent of all defaulters left college with debt but no credential. They are saddled with debt but not a degree, which typically leads to higher income potential in the long-term, enhancing their ability to repay.

Impact on Latino Community

Latino student loan default rates are double that of whites and quadruple that of Asians. This population is under severe financial distress only exacerbating current inequality. Latino students have low college attainment rates. According to the Pew Research Center, 19 percent of 18–24 year old Latinos enroll in college but only 9 percent obtain a degree.[5] A 10 percent discrepancy is nothing short of a crisis. Coupled with the degree attainment problem is the fact that students who do not complete a degree are most likely to default on their debts. This situation creates a negative feedback mechanism exists where Latino students take out loans, do not complete college, and default on their debts with no degree. As a consequence, credit scores are ruined and these Latinos face a future burdened with a disastrous financial cycle. Alleviating the burden of debt, for students who did not complete a degree but are left with thousands of dollars in loans is crucial to the Latino community's success and vibrancy.

Literature Review

Literature related to student default has focused on two distinct narratives—student demographics or institutional shortfalls. The student demographics narrative argues that certain kinds of students, those poor and of color, come with a high risk of default even before entering their institution of higher education. This is mainly due to their low economic backgrounds. This line of thinking concludes that institutions have little interaction whether a student defaults, because there exists students who by virtue of their neighborhoods and economic position, will default on their debts. This argument lies in removing blame from institutions of higher education and onto the populations they serve.

This argument is not substantiated with empirical evidence. Historically Black Colleges and Universities (HBCUs) have managed to lower their default rates without changing the admission process.[6] HBCU's have implemented consistent and rigorous counseling along with strong exit interview strategies for students upon graduation. This demonstrates that institutions can, in fact, create policies that help mitigate their students' default rates after graduation regardless of the makeup of their student population.

On the other side of the debate lies the focus on institutional shortfall and responsibility. Research has demonstrated that institutions have a role to play in preventing student default rates. Institutional policies ranging from admissions policies to university expenditures all have a role impacting student loan default rates. Macy and Terry show that institutions' decisions on tuitions and fees have the most significant impact on average student debt.[7] James Monk's research demonstrates that four-year public universities, unlike private four-year schools that adhere to need-blind admission policies, have a higher proportion of low-income students.[8] As a result, public institutions may change policies around admission and financial aid to limit the number of low-income students. Since low-income students have a higher chance of defaulting, institutions will re-

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duce the number of low-income students so that they are not adversely affected by higher cohort default rates, which acts as a perverse incentive. This argument demonstrates the need for institutions of higher education to address their policies that can help mitigate the amount of debt students have once they leave. Although, mitigation may help students leave school with less debt, it will not prevent default altogether. There are some students who will default on their debt despite the cost of attendance; for these students not even institutional policies will help.

Implications

High levels of debt and default create repercussions for students will be felt for years. Borrowers who default on their debt get barred from future loan programs with no recourse. Beyond the immediate ramifications, default burdens borrowers for a lifetime—preventing them from accessing middle class benefits such as a home mortgage or car loan.[9] If one of the goals of college is to sustain a vibrant middle class, then barring students from a home or car loan is just as damaging as never attending college. These circumstances defeat the purpose of a college degree and only furthers some students' already dire financial conditions. Allowing for students to file bankruptcy would clear them of debt and give them a clean slate. Of course, this is not an easy trajectory. Bankruptcy burdens debtors with severe consequences, but minimally it allows for the debtor to start anew. Bankruptcy affects a person's credit rating for 7 to 10 years limiting access to credit and loans. Nevertheless, a 10-year credit suspension is better than a life of default with no end in sight. Student borrowers need a second chance to restart their lives should they find themselves in difficult circumstances.

Policy Recommendation

The many barriers that impede student borrowers from getting a second chance can be addressed with federal policy recommendations. First, is to allow student borrowers to discharge their private and federal loans in bankruptcy cases. *The Higher Education Act needs to be amended to permit federal students loans to be discharged in bankruptcy.* Essential guardrails are needed to ensure borrowers use the process effectively. The HEA amendment should include a five-year time ban once in repayment when the borrower cannot file bankruptcy, only after the five years in repayment will borrowers qualify for bankruptcy. The Higher Education Act should be amended to include the following:

(a) IN GENERAL.—Section 523 of title 11, UnitedStates Code, is amended—
(1) in subsection (a)(8)—
(A) in the matter preceding subparagraph (A), by inserting ''a loan made, issued, or guaranteed 14 under part B, D, or E of title IV of theHigher Education Act of 1965 (20 U.S.C. 1071 et seq., 1087a et seq., 1087aa et seq.), if'' after ''debtor's dependents, for''; and (B) by striking subparagraphs (A) and (B) and inserting the following:
''(A) the loan has been in repayment for a total period of less than 5 years; or
''(B) on the date on which the petition under this title is filed, the loan is being repaid using an income-based repayment plan under section 493C of the Higher Education Act of 1965 (20 U.S.C. 1098e);''; and (2) in subsection (b), by striking ''(a)(1), (a)(3), or (a)(8) of this section'' and inserting ''paragraph (1) or (3) of subsection (a) of this section, 6 under subsection (a)(8) of this section (as such subsection was in effect on the day before the date of enactment of the Student Borrower Relief Act)''.

This amendment enables bankruptcy courts to adjudicate the merit of the petition using current bankruptcy statute laws that exist for many other forms of debt. This policy change would face a series of pushbacks. One would mainly be from private lenders who argue that in allowing bankruptcy, lenders will have an increased risk and will therefore raise interest rates to protect themselves against the risk. While plausible, there is no empirical evidence to suggest this would be the case.

On the federal loan side, some argue that allowing federal loans to be discharged would further burdens the taxpayer and threatens the solvency of the loan program. This argument assumes that bankruptcy courts are quick to accept discharge petitions without due process, which is not the case. Bankruptcy courts have enough guardrails to protect against the moral hazard of unscrupulous debtors. Others argue that federal loans offer generous enough benefits like forbearance and deferment along with income driven repayment. Despite these benefits, students continue to default, often because of poor exit counseling or an extraneous life circumstance. For these students, even deferment does not help, once a student receives deferment, accrued interest increases the total amount owed once they enter repayment. [10]

Some student loan borrowers are in dire financial distress. Often with no degree, these students are saddled with debt they can never repay. Students who entered default can never go back to school, at least not with federal loan support. This only further complicates their situation preventing them from ever getting ahead.

Conclusion

Some student loan borrowers face dire financial distress. Often with no degree, these students are saddled with debt they can never repay. Students who entered default can never go back to school, at least not with federal loan support. This situation only further prevents them from ever getting ahead. Allowing federal and private student loans to be discharged in bankruptcy would provide extremely distressed borrowers with the ability to start over, gain their credential to get a better paying job, and enter the middle class. Latino students are defaulting in high numbers, thus posing a serious challenge to this community. Defaulting on student loans only further complicates a second change at fixing credit scores and finishing their degrees. Without bankruptcy, some students are sentenced to a life of financial unpredictably and distress.

Bankruptcy courts already discharge many kinds of debt and have sufficient standards that need to be met for petitions to be granted. Allowing federal and private loans to be discharged allows student loans to be considered like many other forms of debt rather than treated as a special category. The student loan debt crisis is impacts millions of students burdening them with debt when they leave college and begin their careers. Many borrowers,can make adequate monthly payments. For some borrowers, however, repayment proves difficult and default becomes the only solution. For this increasingly Latino and poor population, bankruptcy is a last resort. To this end, amending the Higher Education Act would provide necessary relief to thousands of struggling borrowers.

Endnotes

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