

Date of Hearing: May 6, 2013

ASSEMBLY COMMITTEE ON BANKING AND FINANCE
Roger Dickinson, Chair
AJR 11 (Wieckowski) – As Amended: April 15, 2013

SUBJECT: Bankruptcy

SUMMARY: Urges the President and Congress of the United States to support and pass legislation that would allow the discharge of private student loan debt in bankruptcy. Specifically, this bill:

- 1) Provides for the following findings:
 - a) Existing federal law exempts from discharge in a bankruptcy case filed under Chapter 7 or Chapter 13 of the Bankruptcy Code specified educational loans made, or secured, by a lender other than the federal government, also known as private student loans, unless the debtor convinces a bankruptcy court that repayment would be an undue hardship on the debtor and the debtor's dependents, a sometimes difficult and expensive process not required to discharge other unsecured nonpriority debt; and,
 - b) Californians should have the same ability to discharge their private student loan debt as they do to discharge their unsecured nonpriority debt; and,
 - c) Californians who are not given relief from their burden of private student loan debt, even after a successful completion of a bankruptcy case, are seriously hindered from establishing personal economic stability and contributing to the economic growth of the state; and,
 - d) United States Senator Dick Durban and Representative Steve Cohen have recently introduced the following legislation in their respective congressional houses that would permit private student loan debt to be discharged in bankruptcy and are substantially similar to legislation they each introduced in 2010 and 2011:
 - i) The Fairness for Struggling Students Act of 2013, supported by eight cosponsors at the time of this resolution.
 - ii) The Private Student Loan Bankruptcy Fairness Act of 2013, supported by 24 cosponsors at the time of this resolution; and
 - e) The inability of Californians to more easily discharge private student loan debt prevents them from gaining the "fresh start" that a successful bankruptcy case is intended to provide

EXISTING FEDERAL LAW prohibits the discharge of private student loan debt in bankruptcy. (11 U.S.C. § 523(a) (8)(b)).

FISCAL EFFECT: None

COMMENTS:

According to the author this resolution is necessary for the following reasons:

Student loan debt is growing at an alarming rate in the United States. At over \$1 trillion, it has surpassed personal credit card debt.

Private loans now comprise about 24% of the nation's total education loan volume. These private student loans generally have higher interest rates and stricter repayment options than federal loans. Outstanding private student loan debt exceeded \$150 billion in 2012, held by more than 2.9 million borrowers. More than \$8 billion of this debt is in default, according to the Consumer Financial Protection Bureau.

The inability to discharge private student loan debt through bankruptcy the same way that other private debt is discharged causes debtors to postpone life-cycle events such as buying a home, getting married, or starting a family. The ability to discharge private student loan debt would release debtors that are unable to pay from their financial obligation.

Not only does the inability to discharge private loan debt affect the individual debtor, it negatively impacts the United States and California economy...

Dischargeability of private student loan debt may also induce private student loan lenders to improve their interest rates and repayment plans to prevent student loan borrowers from going bankrupt and discharging their private student loan debt.

Student Loan Debt by the Numbers.

- 1) Of the 20 million who attend college each year, close to 12 million – or 60% - borrow annually to help cover costs. (Source: Chronicle of Higher Education).
- 2) There are approximately 37 million student loan borrowers with outstanding student loans today. (Source: Federal Reserve Board of New York).
- 3) As of the first Quarter of 2012, the under 30 age group has the most borrowers at 14 million, followed by 10.6 million for the 30-39 group, 5.7 million in the 40-49 category, 4.6 million in the 50-59 age group and the over 60 category with the least number of borrowers at 2.2 million for an overall total of 37.1 million. (Source: FRBNY).
- 4) There is roughly somewhere between \$902 billion and \$1 trillion in total outstanding student loan debt in the United States today. The Federal Reserve Bank of New York reports \$902B while the Consumer Finance Protection Bureau reports \$1T.
- 5) Roughly \$864 billion is outstanding federal student loan debt while the remaining \$150 billion is in private student loans (Source: Consumer Finance Protection Bureau). Private student loans are not made or backed by the federal government.
- 6) As of Quarter 1 in 2012, the average student loan balance for all age groups is \$24,301. About one-quarter of borrowers owe more than \$28,000; 10% of borrowers owe more than

\$54,000; 3% owe more than \$100,000; and less than 1%, or 167,000 people, owe more than \$200,000. (Source: FRBNY).

- 7) Among all bachelor's degree recipients, median debt was about \$7,960 at public four-year institutions, \$17,040 at private not-for-profit four-year institutions, and \$31,190 at for-profit institutions. (Source: College Board).
- 8) As of October 2012, the average amount of student loan debt for the Class of 2011 was \$26,600, a 5% increase from approximately \$25,350 in 2010. (Source: The Project on Student Debt).
- 9) The majority of borrowers still paying back their loans are in their 30s or older.
- 10) Of the 37 million Americans with outstanding student loan debt: Almost 40% of these borrowers are under the age of 30. Nearly 42% are between the ages of 30 and 50. 17% are older than 50.
- 11) Borrowers age 30-39 carry \$307 billion in student loans, followed by those under 30 at \$292 billion, \$154 billion in the 40-49 age group, 50-59 at \$106 billion and the over 60 category carrying \$43 billion, for a total outstanding debt of \$902 billion. (Source: FRBNY).
- 12) Of the 37 million borrowers who have outstanding student loan balances, 14%, or about 5.4 million borrowers, have at least one past due student loan account. Of the \$870B-\$1T in outstanding student loan debt, approximately \$85 billion is past due. (Source: FRBNY).
- 13) The official FY 2010 two-year national student loan cohort default rate rose to 9.1%, up from 8.8% in FY 2009, while the three-year rate declined slightly from 13.8% to 13.4%. (Source: U.S. Department of Education).
- 14) Only about 37% of federal student loan borrowers between 2004 and 2009 managed to make timely payments without postponing payments or becoming delinquent.
- 15) For every student loan borrower who defaults, at least two more borrowers become delinquent without default. Two out of five student loan borrowers – or 41% - are delinquent at some point in the first five years after entering repayment. (Source: Institute for Higher Education Policy).
- 16) As of 2012, there are now more than \$8 billion in defaulted private student loans, or 850,000 distinct loans in default. (Source: CFPB).
- 17) As of early 2012, borrowers in their 30s have a delinquency rate (more than 90 days past due) of about 6%, while borrowers in their 40s have a delinquency rate double that, at about 12%.
- 18) Borrowers in their 50s have a delinquency rate of 9.4% and those over 60 have a delinquency rate of 9.5%. (Source: Federal Reserve Bank of New York Consumer Credit Panel).

- 19) From 2004 to 2009, 33% of undergraduate federal student loan borrowers who left without a credential became delinquent without defaulting and 26 % defaulted, vs. 21% with a credential who became delinquent without defaulting and 16% who defaulted.(Source: IHEP).
- 20) From 2004-09, a third or less of federal student loan borrowers at four-year, public or private nonprofit institutions became delinquent or defaulted on their loans, while nearly half or more (45% and 53%, respectively) of their borrowers were making timely payments on their loans.) One-quarter to one-third of borrowers at for-profit and public two-year institutions were making timely payments on their loans, and more than half of all borrowers in these sectors were delinquent or had already defaulted.
(Source: IHEP).

Expanding market.

The yearly growth of private loans has outpaced federal loans. In 2005-06, federal loan volume equaled nearly \$69 billion while private loan volume was a little over \$16 billion. The Institute for Higher Education predicts that federal Stafford loan volume will grow by 8% while private loans will grow by 25%. In terms of recent (December 31, 2011) offerings, the CFPB reported low-end variable rates of 2.98% to 3.55% and high end rates (those paid by those with the worst credits) of 9.50% to 19.00%, with an average rate of 7.8%. These are initial rates in a very low rate environment and could increase substantially if interest rates rise generally. Fixed-rate risk-based pricing ranges from 3.4% to 13.99%. The financial institution private loan market grew rapidly over the last decade and just as rapidly receded. According to the College Board, the financial institution market grew from less than \$5 billion in 2001 to over \$20 billion in 2008, and then rapidly contracted to less than \$6 billion in 2011. A large portion of student loan volume during the boom was funded by asset-backed securities (ABS). In this respect, the private student loan market resembled the subprime mortgage market. During the boom, high investor demand for student loan ABS which allowed student loan ABS issuers to create structures with very low collateralization ratios. As a result of these factors, \$100 in student loans could generate immediate cash proceeds from securitization of \$105 or more. Generally speaking, the buyer assumed all of the risk that the borrower would fail to repay the loan after such a transaction. Therefore, a PSL lender had an incentive to increase loan volumes made for such a sale, with less incentive to assure the creditworthiness of those loans.

As developments in the asset backed securities market in mid to late 2007 negatively impacted investor demand for student loan ABS, private loan originations slowed dramatically.

During the lending boom, private loan lenders sought to increase volume through a new marketing channel and processing protocol: Direct-to-Consumer (DTC). DTC lending circumvented the school's financial aid office, marketing instead through mass media, online advertising, and direct media. Funds were generally disbursed directly to the student, instead of to the school. The school did not certify the borrower's financial need, and the lender instead imposed a cap of the lesser of total cost of attendance or a fixed amount, such as \$30,000. This new technique could simultaneously increase the number of borrowers and the amount each one borrowed. It also created an opportunity for the student to borrow more than the actual costs of education.

Borrower challenges.

The private student loan market is structured in the same way as the mortgage market, where loans are held by investors and serviced by intermediaries, often other financial institutions. Not surprising the challenges faced by student loan borrowers often reflect the issue faced by mortgage borrowers. CFPB has highlighted the following borrower issues:

- 1) Inability to speak with personnel empowered to negotiate a repayment plan.
- 2) Inability to refinance.
- 3) Inability to access repayment plans previously advertised.
- 4) "Good faith" partial payments leading to default.
- 5) Bankruptcy –triggered defaults.
- 6) Unexpected checking account transactions.
- 7) Handling of payments.
- 8) Confusion when loans and servicing rights are bought and sold.
- 9) Crediting of overpayments.
- 10) Limited access to account information.
- 11) Loss of benefits due to servicer personnel-suggested action.
- 12) Debt collection practices.

Student loans and bankruptcy.

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 nondischargeable include child support, alimony, court restitution orders, criminal fines and some taxes.

Prior to 1976, all student loan debt was dischargeable in bankruptcy. 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.

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.* under which the debtor must demonstrate: (1) they cannot maintain a minimal standard of living for themselves or their 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.

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 House Judiciary Committee found that there was no real problem and that fewer than 1% of all federally insured and guaranteed educational loans were discharged in bankruptcy. An unidentified lawmaker slipped in a provision making private student loans non-dischargeable. There is no evidence that this policy change was discussed or otherwise analyzed.

A study in the *American Bankruptcy Law Journal*, *An Empirical Assessment of Student Loan Discharges and the Undue Hardship Standard*, by Jason Iuliano analyzed the result of bankruptcy cases and the interaction of the hardship standards in *Brunner*. That study concluded:

For years, commentators have derided the undue hardship requirement as too burdensome and attacked courts for applying the standard in an inconsistent manner. The real problem, it turns out, is that debtors simply are not pursuing student loan discharges. So few discharges are granted, not because judges set the bar too high, but rather, because so few people request relief. This study showed that only 0.1 % of student loan debtors in bankruptcy file an adversary proceeding in an attempt to discharge their educational debts. This statistic is surprising for three main reasons. First, many debtors who do not try to discharge their loans are in dire financial positions. Second, courts grant discharges to nearly forty % of discharge seekers. Third, many debtors are successful without the aid of an attorney.

This study also showed that courts are not granting relief in an indiscriminate manner. People who received discharges differed from people who were denied discharges in three respects: successful debtors (1) were more likely to have a medical hardship, (2) were less likely to be employed, and (3) had lower annual incomes the year before they filed bankruptcy. Rather than condemn the undue hardship requirement, members of the bankruptcy community should encourage debtors with legitimate need to file adversary proceedings even if they cannot hire an attorney. Courts are willing to grant discharges. The problem is that few people are asking for them.

Staff notes that in spite of the evidence that student loan debt does get discharged in bankruptcy in some cases, the standards that the debtor must meet in order to receive discharge of student loan are far more onerous than the standards for other types of debt. Instead student loan debt is held on par with other debts that cannot be discharged, such as taxes and tax liens, alimony and child support, debts obtained through fraud, false pretenses or false representation, debts for fraud while you were acting in a fiduciary capacity, or for embezzlement or larceny, debts for willful and malicious injury, debts for fines or penalties to governmental units, debts for judgments in wrongful death or personal injury lawsuits resulting from motor vehicle, vessel or aircraft accidents while you were intoxicated and condominium or cooperative association fees or assessments. Furthermore, the fact that a debtor lacks knowledge about their rights during bankruptcy that could otherwise change the outcome of their cases should not prevent placing student loan debt on the same level as other types of debt that is discharged.

Technical amendments.

- 1) Page 1, line 3, strike "excepts" and insert "exempts"
- 2) Page 2, line 7, Strike "their."
- 3) Page 2, lines 15-16 strike, "supported by eight cosponsors at the time of this resolution."
- 4) Page 2, line 18, strike, "supported by 24 cosponsors at the time of this resolution;"

REGISTERED SUPPORT / OPPOSITION:

Support

California Council on Economic Education (CCEE)
California State Student Association (CSSA)
Children's Advocacy Institute at the University of San Diego School of Law

Opposition

None on file.

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