U.S. House of Representatives

Committee on the Judiciary

Subcommittee on Commercial and Administrative Law

Hearing on Undue Hardship: Discharging Educational Debt in Bankruptcy

Wednesday, September 23, 2009

Statement by

American Association of Collegiate Registrars and Admissions Officers (AACRAO)

American Association of State Colleges and Universities (AASCU)

National Association for College Admission Counseling (NACAC)

Mr. Chairman and members of the Subcommittee,

The undersigned organizations, representing institutions of higher education, are pleased to provide written testimony on treatment of private educational loans in bankruptcy. Our members have long been committed to promoting institutional integrity and protecting students, and we submit this testimony to voice their concerns about the manner in which the peculiar treatment of "educational loans" is undermining both of these important priorities.

As the members of the subcommittee are well aware, bankruptcy law has restricted the ability of borrowers to discharge their federal student loans since the mid-1970s. For more than a decade, federal student loans have been non-dischargeable altogether, except for cases of undue hardship. While this exceptional treatment of federal student loans under bankruptcy law is harsh, federal student loans do provide basic consumer protections, their own specific discharge provisions, and flexible repayment options that serve as meaningful alternatives to bankruptcy discharge for borrowers. The undersigned, therefore, seek no change to the treatment of federal student loans in bankruptcy.

Our concerns focus on the treatment of private educational loans in bankruptcy. Beginning in the early 1990s, for reasons that were never articulated or debated, Congress began to extend the bankruptcy code's exceptionally harsh treatment of federal loans to private educational loans. Until the 2005 bankruptcy reform act, this identical treatment was limited to private loans that were funded or guaranteed by states or non-profits. This ill-advised expansion rendered a large number of non-federal loans non-dischargeable in bankruptcy, even if they had none of the important attributes that justified that treatment for federal loans.

In making this change, Congress appears to have assumed that states and non-profits would voluntarily configure their educational loan offerings in a manner that would eliminate the need for bankruptcy discharge for their borrowers. It should come as no surprise to any observer of the student lending industry that the exact opposite occurred. Non-dischargeability of educational loans provided eligible lenders with a carte-blanche to impose ever harsher conditions on borrowers. Many of these borrowers were unaware that unlike with federal loans, the promissory notes they were signing would obligate them to repay the loans even in cases of school fraud, school closure, or total and permanent disability.

The primary benefit to eligible issuers of these loans was that the bankruptcy code's unorthodox treatment of their loans insulated them from the economic consequences of otherwise untenable lending practices. Predictably, these lenders were at the forefront of predatory educational lending practices, and began to provide high-dollar private-label loans to borrowers without much concern about the latter's ability to repay the loans. Low-income students, particularly those attending expensive for-profit career schools, were targeted through collaborative marketing and origination relationships between

schools and lenders, who in some cases jointly forecasted future default rates of more than 50 percent on the sub-prime loans that they aggressively promoted.
The comparative advantage that the "non-profit" issuers of such private-label loans enjoyed was quickly seized upon by other predatory providers, who sought a similar advantage for their products. In 2005, again without hearings or debate, Congress extended the exceptional bankruptcy treatment initially afforded only to federal loans to all educational loans. That unfortunate change, in turn, led to an explosion in sub-prime educational lending practices, which this ill-thought-through federal incentive unwittingly facilitated. Predatory lending targeting low-income and minority communities expanded, while an entire new line of "direct-to-consumer" programs targeted middle- and upper-middle-income families with easy, but punitively harsh educational credit offerings. The most salient feature of these programs is that their issuers were substantially shielded from the consequences of their high-risk products by the fact that borrowers could not discharge these predictably unaffordable loans even in bankruptcy, and that the promissory notes were really a modern indenture instrument.

In addition to its fundamentally negative consequences of promoting irresponsible lending practices, the vagueness and imprecision of the actual language of the 2005 amendment has created loopholes for additional fraudulent and abusive practices. For example, the statutory language fails to define the "educational loans" that it excludes from eligibility for ordinary bankruptcy discharge. This lack of precision allows virtually any credit transaction with families with students in school to be arguably non-dischargeable. This same imprecision makes it impossible to track and analyze the scale and scope of the private-label educational loan market, since institutions may well be entirely unaware of credit that might be marketed to their students and their families. This same lack of institutional awareness makes it quite likely that families and students may be induced to borrow more than their actual unmet need.

Mr. Chairman, the subcommittee's hearings today are a very important first step in documenting and addressing the problems associated with the highly unorthodox special treatment that Congress opted to extend to private educational loans. As stated above, the unconditional extension of non-dischargeability to private loans has created a perverse incentive for risky lending practices that victimize borrowers and reward the most irresponsible lenders at the expense of other creditors. This fundamental distortion of the bankruptcy code also rewards shoddy schools by enabling them to arrange for inappropriately large private-label loans for their students through collusion with sub-prime lenders. We find it particularly offensive that entities profiting from these predatory practices justify their special treatment in the bankruptcy code by claiming that non-dischargeability lowers the cost of all private educational loans. There is no evidence that the enactment of the 2005 changes lowered the cost of loans, and therefore, no reason to believe that its repeal would increase the cost.

Legitimate private educational loan programs are subject to underwriting criteria to ensure reasonable prospect of repayment. Bankruptcy, let alone dischargeability in bankruptcy, is not even remotely probable factors for such programs. As previously stated, we believe that non-dischargeability of loans has facilitated the marketing of sub-

prime loans to more vulnerable populations, and that their unorthodox treatment has served as a powerful incentive to promote over-borrowing. We urge the subcommittee to examine a complete exclusion of private educational loans from the special bankruptcy treatment previously reserved only for federal loans.

Mr. Chairman, we thank you for your leadership on this important issue, and stand ready to work with you and your colleagues as you act on the findings of today's hearing.