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Today's News

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Senate Bill Would Allow Borrowers to Discharge Private Student Loans Through Bankruptcy

By KELLY FIELD

Fred J. Konopasek was fresh out of college and working for a car-rental company in 2003 when he was attacked in his sleep by his girlfriend's angry ex-boyfriend. The attack left him with a concussion, two black eyes, and more than $10,000 in medical bills.

Uninsured, and unable to make the payments on a $32,000 annual salary, he filed for bankruptcy, erasing his medical bills and $20,000 in credit-card debt that he had accumulated during four years at Assumption College in Worcester, Mass.

But the $51,000 in student loans that paid for his political-science degree did not disappear. That's because student loans -- like criminal fines, overdue taxes, and child-support payments -- are almost impossible to discharge through bankruptcy. Under federal law, it is far easier for a borrower to escape a car loan or a gambling debt.

That could soon change. Proposed legislation in Congress would allow borrowers to discharge their private student loans -- but not federally guaranteed loans -- after five years of repayment.

The bill, S 1561, was introduced in June by Sen. Richard J. Durbin, Democrat of Illinois, and is now pending before the Judiciary Committee. While the measure's future is uncertain, it may be attached to other legislation moving through Congress this year.

Supporters say the bill would provide much-needed relief to borrowers who find themselves in severe financial distress, while discouraging banks from making loans to students who are likely to default. They argue that it is unfair for the government to treat student loans more harshly than other forms of unsecured debt.

"We are more forgiving of the middle-aged guy who buys a Corvette and stops making payments than we are of the 22-year-old who goes to college and drops out," says Luke Swarthout, a higher-education advocate with the U.S. Public Interest Research Group. "If our laws are a reflection of our values, is that our value system?"

Lenders say that the bill would raise their financing costs and cut into their profits, forcing them to increase interest rates and trim borrower benefits to make up for lost revenue. Some say that they would have to require co-signers as assurance against default, making private loans out of reach for low-income borrowers who lack co-signers.

"Logically, if you're losing money on the one hand, you have to make up for it somewhere else," says Peter

Warren, vice president of government relations for the Education Finance Council. "If you're taking on this increased risk, something has to give."

Steaks and Cadillacs

The debate over Senator Durbin's bill comes as more and more students are turning to private loans to cover the rising cost of a college education. In 1994, private loans made up only 5 percent of educational-loan volume. Today they make up roughly 20 percent, according to the College Board. Such loans almost invariably carry worse terms and conditions than loans backed by the federal government, with some carrying interest rates as high as 18 percent.

For most private-loan borrowers, the investment in a college degree pays off in increased earnings. But when debtors drop out before graduating, are unable to find work in their chosen field, or, like Mr. Konopasek, are hit with unexpected medical bills, they often struggle to make their loan payments. Those who default may find themselves hounded by collection agencies, receiving dozens of phone calls a day. Their wages can be garnisheed, and late fees may be added to their loan balance.

For such borrowers, the only way out is through bankruptcy court, where they must prove to a judge that repaying the loans would "impose an undue hardship" on them or their dependents. Courts have tended to interpret this standard very restrictively, and often reject appeals in cases where the borrower chose a low-paying profession, such as teaching or the ministry, says Deanne Loonin, a staff lawyer at the National Consumer Law Center.

In many cases, a borrower's success or failure comes down to luck: A 2005 study published in the *University of Cincinnati Law Review* found little statistical difference between filers who were granted a discharge and those who were denied one.

It wasn't always so difficult for borrowers to get relief from their student loans. Thirty years ago, educational debt was completely dischargeable through bankruptcy. But in 1976, spurred by a series of news articles about young doctors and lawyers who had used bankruptcy to escape their loan obligations, Congress passed a law that made it harder for borrowers to erase their federal student loans. At the time, the restrictions were seen as a way to safeguard the fledgling federal loan program against deadbeat debtors.

But there was little evidence, even then, that hordes of borrowers were abusing the system. While default rates in the 1970s were much higher than they are today, less than 1 percent of all educational loans made at the time were discharged through bankruptcy, according to a General Accounting Office report published in 1976.

Ms. Loonin says lawmakers conflated default rates and bankruptcy rates and overreacted to a handful of news articles.

"This really is a myth that took on a life of its own based on anecdotal media reports, much like the stories of welfare mothers driving Cadillacs and buying steaks," she said.

Lenders Divided

Private loans remained dischargeable until 2005, when Congress, at the urging of Sallie Mae and other for-profit lenders, added language to bankruptcy-reform legislation that made it just as difficult for students to discharge private loans as federal loans. At the time, lenders argued that the change would enable them to make private loans to borrowers with lower credit scores.

It is unclear whether that has occurred, since lenders rarely disclose their underwriting criteria. But one recent analysis suggests that Sallie Mae, at least, is not lending to riskier borrowers today than it was two

years ago. The study, by Mark Kantrowitz, the publisher of FinAid, a Web site about student aid, found that only 7.5 percent of Sallie Mae's private-loan borrowers had credit scores equal to or below 650 (on a scale of 300 to 850) before the law was enacted, and only 7.7 percent did afterward. The average weighted score both before and after the change was 718. Anything over 700 is considered a good credit score.

Sallie Mae officials say they are not fighting Senator Durbin's bill, and an aide to the lawmaker said that several large lenders have signed off on the legislation, including JP Morgan Chase & Company, Wells Fargo, and Citibank. J.C. Flowers & Company, a private equity firm that will become the majority owner of Sallie Mae if a $25-billion buyout deal goes through, has also given the bill the go-ahead, the aide said.

John Dean, special counsel to the Consumer Bankers Association, said that many for-profit lenders continue to believe that the changes made in 2005 made private loans cheaper and more widely available. But he said the industry was not fighting efforts to undo those changes "because doing so would be misinterpreted by some as working against the interest of borrowers."

Instead, he said, for-profit lenders were working with Mr. Durbin "to craft a workable amendment." To make his measure more palatable to lenders, Mr. Durbin agreed to limit it to loans made after the enactment date and to require borrowers who file for bankruptcy to wait five years before discharging their loans.

But nonprofit lenders, who have been protected from bankruptcy discharges for more than two decades, oppose the bill. That's because in addition to reversing the 2005 changes in bankruptcy law, the bill would repeal an exception added to the law in 1984 for loans made under any program "funded in whole or in part" by a nonprofit institution. An aide to Mr. Durbin said that the senator was trying to discourage for-profit lenders from setting up "shell nonprofit entities" and running their lending through that shell.

Jamie M. Wolfe, chief financial officer of NorthStar, a nonprofit lender based in St. Paul, Minn., said his "gut reaction" to the change was that "we will need a lot more creditworthy co-signers to be able to make loans -- especially when the dust settles from the current subprime mortgage mess."

Uncertain Outlook

Other groups have also voiced concerns about the bill. The American Securitization Forum, which represents various players in the securitization industry, says making private loans dischargeable could dampen the market for student-loan asset-backed securities and drive up the cost of future deals. In securitization, banks bundle student loans, transfer them to trusts, and sell securities in the trusts with the loans as collateral. The process allows lenders to transfer some of the risk of making loans to investors, who in turn profit if the loan repayments exceed the asset's purchase price.

Another trade group, the American Bankers Association, says it is reluctant to reopen federal bankruptcy law to another round of revisions, particularly since Congress just finished updating the law in 2005. That process took four years and was highly contentious.

"Once anything dealing with bankruptcy is on the Senate floor as a stand-alone bill, it can become a magnet for all sorts of bankruptcy amendments dealing with credit cards, mortgages, anything," says Philip S. Corwin, counsel to the association.

One way lawmakers could prevent that from happening would be to attach Senator Durbin's bill to legislation already moving through Congress. An aide to Mr. Durbin said the senator was looking for an appropriate bill to serve as a vehicle for getting his measure through.

But it is unclear how aggressively Mr. Durbin, the Senate's assistant majority leader, will push his bill. He has already passed up an opportunity to attach his bill to the Senate's reauthorization of the Higher Education

Act, opting instead to offer an amendment to expand loan forgiveness for public prosecutors and defenders, and some supporters of the bill say privately that they fear the senator may be quietly abandoning it.

If Mr. Durbin does decide to push the bill, his biggest challenge may be changing his colleagues' perceptions of bankruptcy filers. Thirty years after Congress made federal student loans nondischargeable, many lawmakers continue to see bankruptcy not as a "safety net for honest but unfortunate debtors" but as a "financial planning tool" for unscrupulous debtors seeking a free ride, Ms. Loonin said.

Alan Collinge, founder of StudentLoanJustice.org, an advocacy group for borrowers, knows firsthand how hard it can be to sell bankruptcy reform to Congress. He recently crossed the country in a motor home, speaking to the staffs of 60 out of 70 Congressional education-committee members about restoring consumer protections to student loans. "They sounded receptive" when he spoke to them, he says, "but at the end of the day, it doesn't appear that they were really taking the issue seriously."

"It seems like it was kind of a waste of gas and five flat tires," he said.

Meanwhile, Mr. Konopasek is still struggling to make ends meet. While he makes $50,000 a year now as an account manager for a Boston financial-services firm, he says it is barely enough to cover his private student-loan payment and the cost of housing in South Boston. He has no savings, he is living in a group house with four college students, and he says he stays up most nights worrying about how he will pay off his student loans. He says that if he were able to discharge his private student loans through a second bankruptcy declaration, he would do so "in a heartbeat."

"You grow up with everyone telling you you need to go to college, it's a good investment," he said. "It is a good investment, but at what cost?"

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