Response to Harvard Law Review Note:

Ending Student Loan Exceptionalism: The Case for Risk-Based Pricing and Dischargeability

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Recently, The Harvard Law Review published a piece arguing for the repeal of USC 523 (a)(8), the student loan exception to dischargeability under the US. Bankruptcy code. The piece makes the standard argument, made previously by John Pottow and others, for repeal, and also proposes an alternative pricing scheme for student loans going forward. This was encouraging. The author (Peter Zuckerman- Wachtell, Lipton, Rosen & Katz, New York), to his credit, decouples this argument from the argument for risk-based pricing also made. This response, similarly, pertains only to the note as it pertains to the repeal of 523(a)(8).

There is little to disagree with in the authors argument for repeal. However, there is evidence not mentioned by Zuckerman that should be considered, here: Namely; that the insertion of 523(a)(8) caused a true reversal in the fiscal incentives of all functional elements of the lending system, including the lenders, guarantors, and most importantly, the Department of Education.

By removing the threat of bankruptcy (as well as statutes of limitations, usury laws, and other consumer protections that exist for all other loans), and establishing a very lucrative compensation system for the collection of defaulted loans, the largest lenders, all of the guarantors, and even the Department of Education make more revenue from defaulted loans than loans that remain in good stead.

A government controlled, systemically predatory lending system is an unprecedented event to my knowledge, and an extremely serious matter. One that provides rationale for the swift repeal of 523(a)(8) at least as compelling as that put forth by the author.

The financial incentive to default loans, and examples

The majority of current outstanding student loans were made under the Federal Family Education Loan Program (FFELP). The following applies to these loans, which are administered using private lenders, state sponsored guarantors, private collection companies, and the Department of Education. The financial motivations of the four functional elements of the lending system are discussed separately below.

Lenders

Large FFELP lenders like Sallie Mae and Nelnet own collection subsidiaries, who are allowed to keep up to 20% of every payment on a defaulted loan before applying the payment to principal or interest. When an FFELP loan held by these companies defaults, they are reimbursed nearly full book value through the federal guaranty on the loans. The defaulted loans can then be collected upon by their collection assets, while the money received from the guaranty is used to fund new loans. So it is clearly evident that a defaulted loan is typically a greater source of wealth to the large lenders than loans that remain in good stead. Sallie Mae, the largest lender/collector in the industry with over 30% market share, disputes this claim. The company cites collection costs on these loans prior to defaulting as the reason they would prefer a loan not default. But this claim is weak, given that interest continues to accrue on the loans during this period, and in view of the very significant revenue that can be had through default collection fees- an amount that surely justifies the expense of sending warning letters out, and placing phone calls to the delinquent borrower.

Indeed, after the Higher Education Act of 1965 was amended in 1998, rendering bankruptcy impossible for all intents and purposes, Sallie Mae acquired several of the largest student loan collection companies in the nation, and also purchased the nation's largest guarantor, The USA Group. This is strong evidence that defaults were attractive to the company.

The company also paid several million dollars in fines after the 1998 amendments for submitting default claims for loans on which they never attempted to contact the borrower during repayment. Other lenders have also been found to be similarly attempting to cash out defaulted loans where the borrower was never contacted, and no effort was made to contact the borrower. This should almost never happen for a loan where default is an outcome that the lender wishes to avoid. In fact, it should never happen.

Guarantors

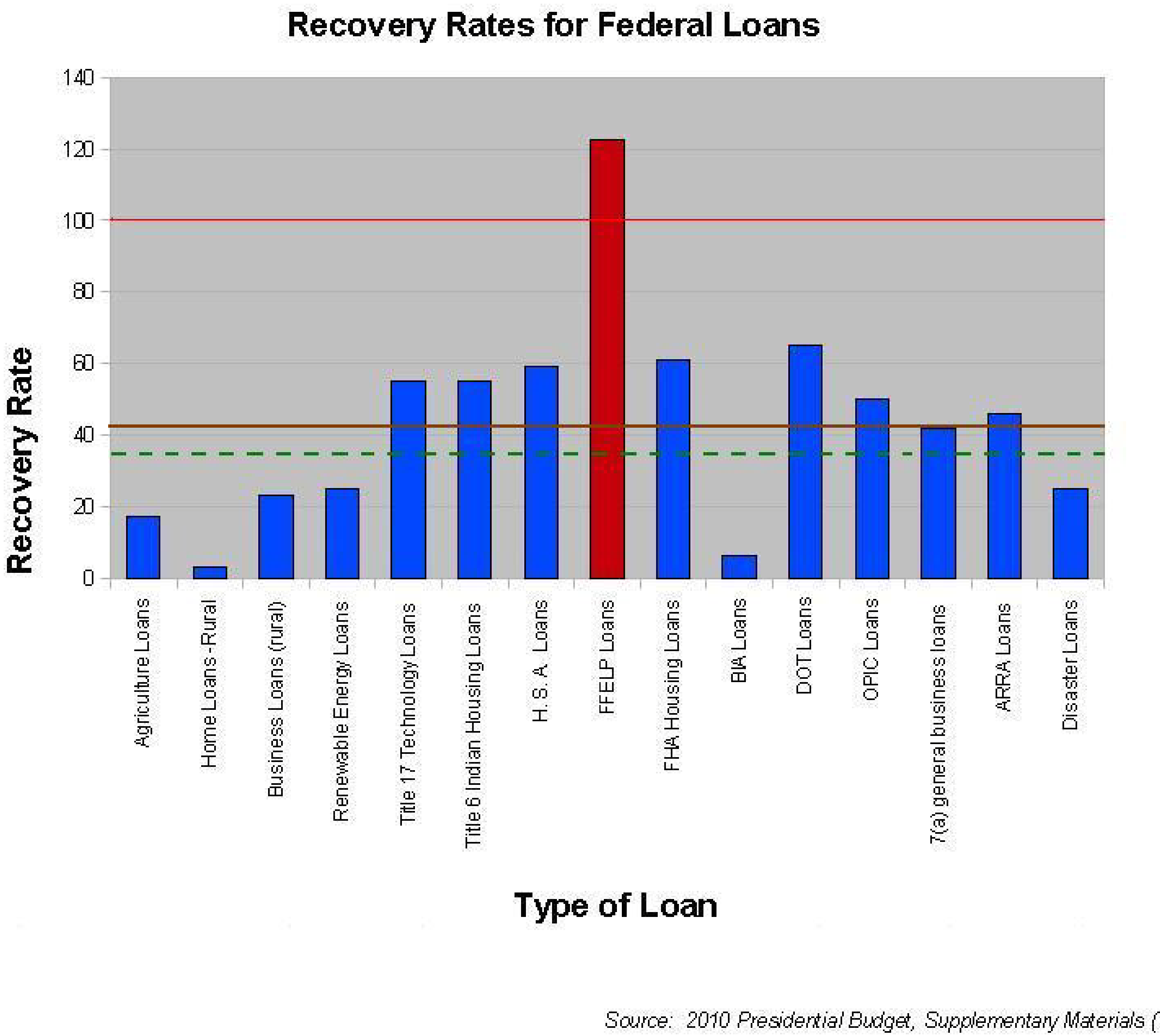
It has been shown that guarantors derive, on average, about 60% of their income from penalties and fees from defaulted loans. Therefore it is even less controversial to claim that guarantors have financial preference for defaults, than the analogous claim for lenders.

Collection companies

Collection companies derive 100% of their revenue from defaults.

The Department of Education

Supplemental materials in the president's 2009, 2010, 2011 budgets (and prior) show that for every dollar paid out by the federal government for defaulted Federal Family Education Loan Program (FFELP) student loans (which comprise a large majority of all outstanding student loans), the Department of Education recovers $1.22 (we assume this is before collection costs, and the government's "cost of money") .



Consider the case of generalized defaulted bank loans. Dermine and Neto de Carvalho (2006) found that these loans incurred, on average, a recovery cost of about 2.6% of the amount recovered. So for example: to recover $122,000 in defaulted bank loan debt would cost about $3,500.

It is important to note that for general bank loans (ie home loans, car loans, property loans, etc), recovery typically involves the seizure of physical property pledged against the loan- property that must be handled, stored, and ultimately liquidated by the bank. This, combined with the various legal and administrative costs that accompany such recovery action is a significant cost that does not exist for unsecured debts, such as student loans or credit cards.

Consider that student loans are not dischargeable in bankruptcy. Nor are they subject to statutes of limitations, state usury laws, or even Fair Debt Collection Practices when the collection entity is a non-profit, government-sponsored (or government) entity. Consider further that the student lending system can take a borrowers wages, income tax returns, Social Security and Disability income, and can also put pressures on a borrower that no credit card company could bring to bear, such as termination/exclusion from public employment, denial of security clearances, exclusion from practicing in a state licensed profession through administrative suspension, and others. Credit card recovery is probably far more expensive than recovery of defaulted student loans, yet apologists for the student lending system would have us believe that the reverse its true.

Comparing defaulted FFELP loans to non-defaulted loans

To be thorough, let us consider this question from a slightly different basis, and consider narrowly whether a rational decision maker in the role of FSA would prefer a loan to default, or not. In other words, let's compare a defaulted loan to a non-defaulted loan, and see if there is a clear financial incentive to prefer one over the other from the standpoint of the Department of Education.

From the Department's perspective, an FFEL loan can either default, or remain in good stead. Given no specific details about the loan, the borrower characteristics, etc., the Department has a very simple choice to make:

1. The loan remains in good stead.

This is the simplest case, The Department pays subsidies if required during the life of the loan, and also either pays or receives "spread income" to or from the lender (this is a complicated mechanism, but generally these payments are made by the Department to the lenders). So the Department pays no default claim, and may incur interest subsidy, and generally pays a small "spread cost". To be overly generous, we will simply ignore these costs for the purpose of this analysis. So the Department, essentially, just "watches the loans go by", and there are no costs involved, nor income gained.

2. The loan defaults.

The Department must pay out principal and interest of the loan at the time of default. Assuming the government's "cost of money" is small we know that ultimately the Department recovers 122% of this original payout amount. Even if collection costs were twice that of general bank loans, this would still leave a hefty profit for the Department of Education. If the loan was subsidized, there is likely an additional savings in interest expense that the Department is obligated to pay if the loan goes into deferment status.

So essentially, the Department is given a choice: Either do nothing and get nothing, or outlay cash with the knowledge that this outlay will realize a 22 percent return, ultimately (minus the governments cost of money and collection costs). From this perspective, it is clear that based solely on financial motivations, and without specific detailed knowledge of the loan (i.e. borrower characteristics, etc.), the chooser would clearly favor the default scenario, for not only the return, but perhaps the potential savings in subsidy payment as well.

Conclusion

It should be clear from this analysis that for many years, the Department of Education MUST have looked upon defaulted FFELP loans as a source of revenue, rather than a cost to the agency. Given a current defaulted loan portfolio of approximately $70 billion(this does not include interest post default), the amount of revenue this represents to the Department of Education is in the tens of billions of dollars.

Some dispute this claim, and assert that the government should be able to claim a much higher “cost of money” that their actual cost (ie an opportunity cost based on higher return loans they could have made had the loan not defaulted, but this is not a sound or valid claim to make, institutionally, since no loans are not made due to the default payment (ie the government is not forced to make fewer loans for lack of capacity). Experts including Mark Kantrowitz have acknowledged that for FFELP loans, the government does, indeed earn more revenue on defaults than for loans that remain in good stead.

A lending environment where a default is more lucrative to the lender than a healthy loan is a defining characteristic of a predatory lending arrangement, where the lender will be inclined to administer the loan in such a way as to promote defaults, not prevent them. And in this specific case where the Department of Education is involved, the evidence appears to bear this on a number of fronts, including omission or misrepresentation of important lending statistics, like the true default rate to Congress and the public, failure to adequately inform the borrowers about the absence of fundamental consumer protections, and other gross oversight failures in direct opposition to the interest of the borrowers. These are described briefly below.

The true default rate

Despite repeated claims by the Department of Education, the student lending industry, their lobbyists, and the universities that default rates are relatively low, a 2003 IG report estimated that between 19% and 31% of 1st and 2nd year students would be put into default during the life of their loans. For community colleges, the range was between 30% and 42%, and for for-profit schools, was between 38% and 51% . Simple averaging gives a default rate of more than 1-in-three. Completely ignoring for-profit schools gives a 4-year university/ community college average of about 30%...These are perhaps high estimates, given the IG's predilection towards conservative estimates for budgeting purposes, but if even close (ie within 10 percent), paint a far different picture than what has been portrayed.

More recently, the Chronicle of Higher Education reported that of borrowers leaving school in 1995, fully 20% had defaulted on their loans as of 2010. This guarantees a "lifetime" (i.e. 20 year) default rate of something higher than that, and this is for borrowers who left school with a far smaller debt load, adjusting for inflation, and also describes borrowers entering the workforce during a far better economy. Therefore, to say that the true, lifetime default rate is likely to be 17% (this is the federal lifetime default rate projection) is grossly understating the case.

In fact, given these data, one could argue with justification that perhaps 1 In 3 undergraduate student loan borrowers leaving school in recent years will default, or have defaulted on their loans, and could even be higher. This default rate is higher, likely, than the subprime home mortgage default rate, and has been for years. This is a fact that the Department of Education, lenders, and universities are loathe to acknowledge.

That the Department of Education, the Schools, and the lenders all failed to inform the general public about the actual default rate for federal student loans is troubling, and provides further evidence that it was not in any of these entities interests to disclose this information, although at least for the Department of Education, there is a clear public benefit mission that should compel the loud, and unambiguous disclosure of this information. That the public was not warned of the true likelihood of default for these loans cries out for explanation. In the absence of any explanation from the Department for this omission, and in view of the financial return on these loans, one can make a compelling case that this information was concealed from the public due to Institutional concerns that trumped the public interest...and one can only imagine the harm this caused unwitting borrowers and their families who made very significant borrowing decisions unaware of the true risks they were entering into.

Disclosure about the lack of Consumer protections

The majority of citizens with outstanding student loan debt were never informed that bankruptcy protections, statutes of limitations, Truth in lending requirements, and other fundamental consumer protections were uniquely absent from federal student loans prior to taking out the loans. Because these protections exist for every other type of loan in the nation, they had no reason to suspect or ask about this possibility.

How the lack of consumer protections causes inflation

There are many negative systemic consequences that have occurred in the oversight of the FFELP program, and appear to be related to the Department of Education's misdirected financial motivations. One very significant result is that during the legislative process, when the schools, lenders, and their lobbyists pressure Congress to raise the allowable loan limits, the Department of Education is one of the only entities available and obligated to act in the interest of the students if the default rate grows too high, academic quality decreases, etc.. Instead of voicing concern, or even objections to such proposals year after year, the Department of Education has instead remained largely silent, despite their knowledge about the true default rates, and the widespread misleading of students and their families about them. Therefore, Congress continues to rubberstamp these legislative efforts, and the schools quickly raise their tuitions to reach the new lending ceilings.

This, again, is a key failure in oversight that effectively causes Congress to make decisions without the interests of the borrowers being represented (Of course the lenders and schools claim to have the interests of the students at heart, but their obvious financial motivations obviously discount their credibility on this claim).

If the Department of Education were seeing a material, financial loss with loan defaults, they likely would have raised objections to attempts to raise the lending limits many years ago. This would provided a critical check on the process. But they have been largely absent from these debates, and their perverted financial interest is an obvious and plausible explanation for this gross oversight failure.

So it must be agreed that lack of Department oversight contributes directly to Congress's repeated decisions to raise the loan limits, and we've already established the link between this poor oversight, and the removal of consumer protections. Therefore, the removal of standard consumer protections- bankruptcy protections chief among them- has effectively enabled the schools to raise their tuition at unreasonably accelerated rates.

Of course, the loud debate on the cost issue results in finger pointing in all directions..."like a scarecrow in the wind" between lenders, schools, the Department of Education, the student advocates, and Congress. But of these five entities, four were behaving as expected (i,e, schools pushing for raising the limits, advocates wringing their hands in the absence of defensible proof that things were going awry, lenders playing their part as the selfish, amoral entities they are understood to be, Congress debating what they are told, and ultimately voting based upon this debate).

The Department of Education, however, failed to fulfill its role, and did not disclose to the group the true magnitude of the default problem, as one would expect it to both during the legislative process and to the public generally. Nor did the Department ever issue warning or notice to the public any information about the true default rate, or that fact that bankruptcy, Statutes of limitations, and other protections that exist for every other type of loan were gone for student loans. This is information that the public needed to know to make informed lending decisions, and that would have surely resulted in a lower default rate had they been told. The Department of Education is clearly the party whose behavior can ultimately be questioned with strong justification. Citizens also have just cause to be angered by the collective failure of ALL the system elements that resulted in the problem we now face, but strictly speaking, the Department's failure is the only one with no defense.

This is a critical, unambiguous link that is never pointed out, but which is key- probably *the* key- to explaining the rampant inflation we have seen in higher education over the years.

There are additional, related failures in oversight at the Department of Education indicating that the Office of Federal Student Aid is, for all intents, a captured agency. These lies outside the scope of the current argument, however.

Conclusion:

Congress, and the President, must assume the immediate responsibility of fixing this systemically predatory system by, at a minimum, returning the standard consumer protections that should have never been taken away in the first place. This begins with the repeal of 523(a)(8). Insodoing, The federal government will, once again, have a financial interest that student loans not default- a necessary condition for a fair lending system.

This corrected environment will ultimately compel the government to use its considerable influence to encourage the universities- in a serious and meaningful way- to both provide a quality education that gives the student the best chance for success, and also to do this at a reasonable cost. Instead of looking the other way as Congress deliberates upon whether to raise the loan limits yet again, the Department of Education will be compelled to object, and perhaps embrace a rational pricing system such as what the author of this note proposes, and/or other tools for ensuring academic excellence, low cost, less indebtedness, fewer defaults, and ultimately, student success.

Zuckerman, and other bankruptcy experts need to inculcate this additional evidence so that the issue of bankruptcy protections and student loans can be fully informed.

Thanks to the Irascible Professor (Mark Shapiro) for giving consideration to this important issue.