Student Loan Debt and Bankruptcy - White House Supports a Change

July 23, 2012 - Last week, the White House went on record supporting a change to bankruptcy law that would allow the discharge of limited amounts of student loan debt in bankruptcy cases. While the proposal would only impact a small amount of current student loan debt, it would almost certainly introduce a slippery slope to student lending which would result in further calls for more leniencies by the courts. And that slope would, in turn, leave taxpayers on the hook in the end for unpaid student loan debt. It would also likely result in higher interest rates for future student loans. Before heading down this path, a real examination of how student loans are awarded really needs to take place.

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Under current law, student loan debts can't be discharged in bankruptcy. There is a simple reason for this. Student loans are federally guaranteed. When Congress passed the laws regarding student loans, they wanted to make sure that taxpayers were repaid. Exempting them from the review of bankruptcy judges was just one of the things they did to insure this.

Unfortunately, student loans have also become the fastest growing segment of consumer debt. Current and former students now owe more than $1 trillion for education loans. Student loans have also increased the demand for higher education; placing colleges and universities in the position of being able to increase tuition rates much faster than inflation. In fact, the "easy money" that is available from student loans has had a perverse affect on the educational market. Rather than making education affordable, it has actually driven costs much higher.

And those increased educational costs have taken place without much rhyme or reason. There is no evidence to suggest that the cost of getting an engineering degree has gone up any faster than the cost of getting one in physical education. And the costs of both degrees at the same university are usually comparable. But the ability to repay loans for both of those degrees is not. Engineers are in short supply in the United States. At the same time, school districts around the country often cut their budget for physical education when times are tight. That usually means laying off PhysEd teachers.

The proposal being backed by the White House would allow bankruptcy judges to dismiss private student loan debt incurred through banks and through Sallie Mae. While those loans may be private, they also have federal guarantees. Those federal guarantees ultimately need to honored by taxpayers.

The initial proposal would only impact around $150 Billion in outstanding student debt. That's about 15% of the overall market. Sallie Mae backs the proposal but most banks do not. And those banks are also warning that by making these debts subject to discharge in bankruptcy court, the federal government would actually drive up interest rates on student loans. Given the fact that those interest rates are already fairly high, they could actually make it more difficult for some people to get the education they are seeking. Thatâ€™s exactly opposite of what Congress intended when it passed the current law in 2005.

Rather than going down this particular path, the amount of student loans that any student can get should be directly tied to his or her ability to repay the loan. Making this determination isn't exactly rocket science. It can be based the major field of study, the institution awarding the degree and employment & salary statistics for both of these things. If you are a student majoring in a subject that has a median income of $30,000 and a 15% unemployment rate, then the risks are certainly higher that you will default on your loan than someone whose major has a median income of $60,000 and a 5% unemployment rate. The interest rate paid by each of these students, and the amount of money available to them should be very different.

Such a change would do a couple of things. First, it would mean that colleges would have to be realistic about tuition. In some cases it would probably drive tuition up. But in many cases, it would drive it down.

Secondly, it would better insure that student loans were actually repaid. Those with lower paying jobs should wind up with lower amounts of debt; making their payments more affordable even with higher interest rates. And those interest rates could even be adjusted down over time for those with good payment histories.

The point of all of this is that student loan debt definitely deserves the some attention by Congress and the White House. But making student loan debt dischargeable in bankruptcy is more likely to cause new problems than anything else. The focus really needs to start out on making changes to the current system that will better insure that borrowers are able to pay back their debt, and force colleges and universities to be accountable for what they charge. A college education is really only worth something if employers are willing to pay for it in the form of higher pay. If they are not willing to pay more, then it is just another bad investment.

byJim Malmberg
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