Warren Plan to Discharge Student Loan Debt in Bankruptcy Misguided

May 13, 2019 - This past week, Sen. Elizabeth Warren and Rep. Jerry Nadler made a proposal to allow borrowers to discharge their debts in bankruptcy filings. That's currently against the law; the reasons for which we'll get into a little later in this piece. There is no doubt that student loan debt is out of control with more than $1.3 Trillion in outstanding loans currently. But simply allowing these debts to be eliminated in bankruptcy proceedings wouldn't address the core problems associated with student debt, and in a worst-case scenario, could leave every American citizen on the hook for around $4,500.

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The real issue with student loan debt isn't the amount of money borrowed. It's actually that cost of tuition and the ease with which colleges and universities have been able to gain access to money to pay their exorbitant charges. That easy money comes to them in the form of federally backed student loans. These loans can be taken out by pretty much anyone who is simply breathing and who wants to attend a university.

Unlike most other loans, the underwriting process for student loans is almost nonexistent. Studentâ€¦ and even their parentsâ€¦ simply need to show that they are enrolled in a university. They fill out the application for federal student aid on line (knows as FAFSA) and in a few minutes, they get approved. Ironically, the lower your household income, the better your chances are for approval. Payday lenders have more stringent lending guidelines.

Borrowers aren't limited in how much they can borrow based on their major or job prospects after graduation either. Want to get a degree in something obscure like Eastern Philosophy? Never mind the fact that your job prospects after graduation would likely be very limited.

Somehow or another though, colleges have done a pretty good job of bamboozling students and their parents into thinking that their degrees are worth what may amount to a lifetime of debt. That's pretty clear when you look at the earnings expectations of college students.

In a 2017 LendEDU survey, more than 20% of respondents stated that they expected to make between $60,000 and $80,000 per year after graduation. Roughly 17% said they expected to make over $80,000 a year once they were in the job market. But a separate employer survey last year by Kornferry paints a different picture. It showed the highest paying jobs were in software development, engineering and science and those were the only job segments in the survey that

exceeded $60,000 in earnings at the time of entry. Someone coming out of school taking a job as a customer service representative could expect to make around $35,000.

Students and parents also need to be aware that job salaries were highly dependent upon location. $60,000 may sound like a great entry salary but if you live in a high cost city like San Francisco or New York, you're likely to need a roommate or two if you want to live in something other than a tent.

But these hard realities don't seem to be making it into college marketing literature. And why would they. For years colleges and universities have viewed student loans as a gravy train. The more money the government makes available, the higher they can raise their tuition costs. Take for instance the University of Colorado at Boulder. Out of state students can expect a total annual cost - including room and board - of just over $54,000 for an arts and sciences degree. That means you're going to spend $216,000 over four years. If you graduate and have to take a customer service job, you are unlikely to ever be able to pay that money back.

Some may think that bankruptcies should allow for the discharge of student loan debts - after all, who wouldn't be angry after getting stuck with a huge bill only to find out that you were sold a bill of goods? But there are some real issues with allowing this. First of all, the money borrowed actually belongs to taxpayers. Allowing it to be discharged in bankruptcy would add to the already massive federal debt. And since the amount currently owed comes out to around $4,500 per American man, woman and child, allowing this would cost each of us individually.

More importantly, Warren's proposal doesn't address the real issue; tuition charges. The underwriting process for student loans needs to tie the amount of money being borrowed to the expected earnings of new graduates. Those with undeclared majors shouldn't be able to borrow any more money than those who would be earning the lowest amount with a declared major. And when you change your major, the amount you can borrow going forward should also be changed.

There is also no reason that we can see to foist the cost of college loans onto the backs of taxpayers. Upon graduation, students already have options if their debt is too high. They can elect to make income-based payments for up to 25 years. There are also options to take jobs in government sponsored programs that will discharge a portion or all of their debt over time. Granted, these may not be a part of the future that these students dreamed of when starting their college experience. But another hard reality of life is that we don't always get what we want.

The Warren proposal could also create another issue; strategic default. Using the University of Colorado example above, let's say that you graduate with more than $200,000 in debt and you can only get a lower salaried job. Your best financial option could be to declare bankruptcy immediately upon graduation and then live on your parents' couch for the next couple of years. Over the next seven years, your credit score will suffer but at the same time, you'll have fewer bills to pay.

Now, you may think that people wouldn't strategically default on loans like this, but this is precisely the scenario that may property investors found themselves debating when real estate prices dropped through the floor in 2008. The more sophisticated investors decided that defaulting was in their best personal interest.

If you take this same model to student loans, there is another factor that would likely get added to the mix. Unlike the real estate investors of 2008 who didn't have parents there acting as a safety net, a lot of new college grads are likely to be telling their kids to default and use their family for that safety net. It may not be ethical, but it is a reality.

The bottom line here is that we do believe that student loan debt is out of control and needs to be reigned in. But this particular proposal creates more problems for both taxpayers and students. Congress would be better served addressing issues having to do with tuition and truth in advertising to students than by passing this piece of legislation.
byJim Malmberg
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