No Way Out: Student Loans, Financial Distress, and the Need for Policy Reform

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Rising Debt, Increased Government Collection Powers and Inadequate Relief for Borrowers

As the cost of financing our nation's higher education system falls increasingly on students and families, student loan debt is rising at alarming rates. Most borrowers have to make some sacrifices to repay student loans. The problem, as discussed and documented in this paper, is the extent of these sacrifices. Many student loan borrowers face a lifetime of debt with little or no chance of escape.

If all goes well, college graduates earn significantly more money than those with high school degrees. However, this is not always the result. Some may find that their professions are not as lucrative as they hoped or may lose their jobs. Others will confront unexpected life traumas such as disability, divorce, or death of a family member. Still others will choose career paths where success is not measured in dollars. The problem is that borrowers are allowed very little margin for error and can easily become overwhelmed by student loan debt.

The government has extraordinary powers to collect student loans, far beyond those of most unsecured creditors. The government can garnish a borrower's wages without a judgment, seize his tax refund, even an earned income tax credit, seize portions of federal benefits such as Social Security, and deny him eligibility for new education grants or loans. Even in bankruptcy, most student loans must be paid. Unlike any other type of debt, there is no statute of limitations.

While collecting funds is important for the government and taxpayers, there comes a point of no return where the government's ceaseless efforts to collect make no sense, monetarily or otherwise. Even borrowers who are able to make affordable payments often end up defaulting because of an overly complicated system and lack of effective communication between collectors and borrowers. There is some relief available for borrowers, but this relief is generally insufficient.

The purpose of this paper is to describe the reasons why student loan borrowers get into trouble and why problems spiral so quickly. Descriptions of current policies are followed by suggestions for reform. The goal is to spark discussion among analysts, higher education and industry leaders, students and their advocates about ways to improve these policies.

Key topics and findings include:

Preventing Defaults

The adverse consequences of student loan debt are particularly acute after a borrower defaults. However, the system is not set up to focus real resources and energy into default prevention.

Recommended solutions include:

- Evaluating what works and developing effective counseling programs.

- Fixing the perverse incentive structure that rewards guaranty agencies and other entities more richly when borrowers default than when they do not.

Flexible and Affordable Repayment

Counseling and communication efforts are only as effective as the alternatives they can offer. **Struggling borrowers need accessible, affordable and flexible repayment options to avoid default.** The most flexible options are available to borrowers prior to default. However, some of these options will be eliminated after July 1, 2006.

Recommendations to improve pre-default repayment programs include:

- Extending the income contingent repayment plan (ICR) that is currently available only through the Direct Loan program to Federal Family Education guaranteed loans (FFEL) or by developing a similar formula for FFEL repayment.

- Establishing a maximum time limit after which payments are no longer required.

Post-Default Repayment

The current post-default repayment plans are helpful for some borrowers, but must be strengthened to ensure that borrowers understand their options and to best conform these options to borrower needs. There is a category of borrowers who slip in and out of default or fall into default just once due to temporary financial difficulties. These borrowers can often be restored to repayment status. Early intervention is particularly important because of the current policies that impose hefty collection fees and hand defaulted loan portfolios off to collection agencies early in the process.

There is another category of borrowers that is less likely to be able to get out of default. For these borrowers, it is critical to preserve a safety net so that people with disabilities, the elderly, victims of school fraud, and others who are in economic distress on a more permanent basis get relief.

Key recommendations and findings:

- **Rehabilitation:** Loan rehabilitation can be an important option for borrowers to get out of default and back into repayment, but it is limited by lenders and agencies improperly setting maximum amounts that borrowers must pay while in the process of rehabilitating loans. A recommended change is to allow borrowers to repay using the ICR formula during rehabilitation. In addition, all collection efforts must cease during the period that a borrower is repaying through a rehabilitation program.

- **Income Contingent Repayment:** Recommended changes to improve the income contingent repayment option include:

    - Allowing qualified borrowers in all of the main federal loan programs to access the ICR directly rather than through consolidation. Until this recommendation is put in place, borrowers should not be improperly denied access to Direct Loan Consolidation ICR.

Temporary Suspension of Payments

Deferments are essential tools for borrowers hoping to avert defaults. However, current deferment programs are in some cases overly restrictive and inconsistent across loan programs. The paper includes recommendations to restructure key deferments, such as economic hardship and unemployment deferments and to simplify the application process.

Despite the costs for borrowers, forbearances can also help reduce defaults. Among other recommendations, we suggest developing options for borrowers coming out of forbearance to restructure their loan terms.

Cancellation Programs

Currently, there are certain criteria and programs that allow borrowers to qualify for full or partial cancellation of their student loan debt. There are fraud-related cancellations including closed school, false certification, and unpaid refund; disability and death cancellations; and profession-oriented cancellations. While helpful for those who are eligible, these programs are very limited in scope and difficult for borrowers to find out about.

Recommendations include:

- Developing a cancellation that affords relief to all borrowers who attended schools that violated key Higher Education Act (HEA) provisions.

- Improving the current cancellation programs, including tying the disability standard to the standard used by the Social Security Administration or Department of Veteran's Affairs.

Bankruptcy Relief

Student loans are among the few unsecured debts that are generally not dischargeable in bankruptcy. Student loans can only be discharged if the debtor can show that payment of the loan will impose an undue hardship on the debtor and dependents. Courts have interpreted this standard very restrictively.

This section summarizes the legislative history that led to the student loan "non-dischargeability" provision and rebuts the rationales for treating student loans differently than other unsecured debts. We call on Congress to allow borrowers to discharge student loans in bankruptcy.

Relief from Collection

The widespread use of private collection agencies to pursue student loan defaulters, combined with significant expansions in the government's arsenal of collection tools, has led to abuses in student loan collection. There are also documented problems with training and oversight of third party private collectors. The use of private collectors adds substantial costs to the collection process and contributes to problems with both the amount of fees charged and when fees are imposed. This section includes detailed recommendations to ensure that borrowers are not discouraged from repaying because of uninformed and overly aggressive collectors and that all borrowers are treated fairly.

Recommendations Include:

- Developing a rigorous, public training process for collection agencies that includes information about all student loan rights as well as fair debt collection rights.

- Improving all aspects of enforcement and oversight of private collection agencies.

- Eliminating Social Security and federal benefit offsets.

- Only charging collection fees that are bona fide and reasonable and actually incurred in collecting against individuals.

- Re-imposing a reasonable statute of limitations on student loan collections. The elimination of the statute of limitations for student loans in 1991 placed borrowers in unenviable, rarified company with murderers, traitors, and only a few violators of civil laws. Even rapists are not in this category since there is a statute of limitations for rape prosecutions, at least in federal law and in most states.

Enforcing Borrower Rights

Even borrowers who are aware of their rights are often unable to enforce them. The main barrier to private enforcement is that courts have consistently held that there is no private right of enforcement under the Higher Education Act (HEA). Fair debt laws are an imperfect substitute for direct enforcement of borrower rights. Among other recommendations, we call on Congress to create an explicit private right of action to enforce the Higher Education Act. Borrowers must also have the right to appeal an adverse decision regardless of whether the decision is made by a guaranty agency, lender, or government agency.

No Way Out: Student Loans, Financial Distress, and the Need for Policy Reform

I. INTRODUCTION

As the cost of financing our nation's higher education system falls increasingly on students and families, student loan debt is rising at alarming rates. By the time they graduate, nearly two-thirds of students at four-year colleges and universities have student loan debt. In 1993, in contrast, less than one-half of four-year graduates had student loans.[1] Debt levels for graduating seniors with student loans more than doubled over the past decade, from $9,250 to $19,200.[2] With rising debt comes increased risk, both to borrowers and to taxpayers, because while a college education is generally a very good investment, it does not guarantee a high paying job or freedom from financial difficulties.

When student loan payments are more than borrowers can afford, they cannot save for retirement, buy a home, enter important fields like teaching and public service, or afford to start a family. Without meaningful alternatives, some borrowers default, which not only ruins their credit and causes long-term damage to their family's financial situation, but also means the government must pay collection fees and other costs on top of the defaulted amount.

Student loan policy involves a balancing of the government and taxpayer's interest in collecting funds against the social and economic goal of promoting equal access to higher education. If all goes well, college graduates earn significantly more money than those with high school degrees.[3] However, this is not always the result. In the current economic environment, a bachelor's degree may be just the beginning of a student's educational road. In addition, some college graduates may find that their professions are not as lucrative as they hoped or may lose their jobs as the economy changes. Others will confront unexpected life traumas such as disability, divorce, or death of a family member. Still others will choose career paths where success is not measured in dollars, but in satisfaction and promoting social good, such as teaching and social work. Others will take chances. They might start an innovative business that does not break even on the first try. Yet, while schools may fail and even lenders may fail without severe consequences, borrowers are allowed very little margin for error.

For all too many Americans seeking to advance themselves through education, the student loan programs are similar to a bait and switch scam. They are lured in at the outset, usually when they are quite young, by flexible underwriting and eligibility

[1] The Project on Student Debt, "Quick Facts About Student Debt", available at: http://projectonstudentdebt.org/files/File/Debt_Facts_and_Sources_4_4_06.pdf.
[2] Id.
[3] See, e.g., Sandy Baum, Ph.D., "The Role of Student Loans in College Access" (January 2003) (People with college degrees earn 80-90 percent more than those with only a high school education).

standards and the promise of economic rewards through education. After school ends, this aura of benevolence quickly disappears. Clearly borrowers should understand that they will likely have to make sacrifices to repay their loans. The problem is the extent of these sacrifices. Many borrowers simply find that they are facing a lifetime of debt with little or no chance of escape.

The government has collection powers far beyond those of most unsecured creditors. The government can garnish a borrower's wages without a judgment, seize his tax refund, even an earned income tax credit, seize portions of federal benefits such as Social Security, and deny him eligibility for new education grants or loans. Even in bankruptcy, most student loans must be paid. Unlike any other type of debt, there is no statute of limitations. The government can pursue borrowers to the grave.

There is a cost to pursuing these most vulnerable members of society. In human terms, a consumer who became disabled later in life may find she simply cannot continue to pay back the student loan she took out thirty or forty years ago. Offsetting a portion of her Social Security may mean that she does not get all the food or prescription drugs she needs. In financial terms, the cost of trying to collect from those who simply do not have much is often greater than the meager amounts, if any, which ultimately come back to the government.

Compounding the problem, a borrower who is faced with a temporary setback often finds himself quickly in a much deeper hole. This is because of collection fees that get added to the balance, fees that are based on an average of collection costs against all borrowers rather than the cost of collecting from that particular borrower. It is also because borrowers generally do not know about their options to defer loans, get a temporary reprieve or repay through a more affordable plan. Interest accrues, fees accrue, negative credit report notations accrue, and it is hard to escape.

There is some relief available for borrowers, but as discussed throughout this paper, this relief is generally insufficient. Further, it is difficult to find out about relief options and nearly impossible to enforce consumer rights if the relief is denied. In general, the system is so complex that it is often only through a lawyer or other advocate's intervention that a borrower can even understand his rights.

This picture is a far cry from the promise our financial aid system was created to fulfill: that no qualified student who wants to go to college should be barred by lack of money. It is precisely a lack of money that converts the promise of higher education into lifelong stress for many borrowers. The focus throughout the paper is on possible policy fixes to build a better, more equitable system for student loan borrowers who encounter financial difficulties, and to help prevent some of the most serious problems in the first place.

II. PREVENTING DEFAULTS

There is a common misconception that student loan defaults are no longer a problem. This is largely because of significant declines in the cohort default rate in recent years.[4] There has been real progress based on the cohort default rate measurement, but the problem is far from resolved.

First, the cohort rate is a misleading indicator. It tracks borrowers for just the first two years after they go into repayment. This is a mere snapshot in time that does not give a full picture of default trends.[5] The accuracy of the cohort rate is particularly critical because the Department of Education (hereafter "The Department" or "DOE") relies on these rates when assessing default-related sanctions on schools.[6]

There are problems not only with the time period, but also with the cohort rate calculation method. In addition, the default measure does not include borrowers that are current, but struggling with overly burdensome debt or borrowers that are delinquent, but not yet in default. These problems are expected to grow as interest rates rise along with borrowing levels.

Some downplay the default problem by characterizing it as an issue only in the proprietary school sector. Default rates for proprietary schools have been alarmingly high, although they have declined over the years. Despite the persistence of problems in the proprietary sector, however, it is simply not true that the default problem is confined to this sector. Looking at total dollar amounts, most of the lost money in defaulted student loans comes from four year schools (about 70%) despite their lower rates of default.[7]

Borrowers may be delinquent for up to nine months on their student loans before defaults are declared. This is a long period of time. When combined with six or nine months of grace periods, it is even longer.[8] The extended period of delinquency prior to default can be advantageous for borrowers as long as schools and other agencies develop effective programs to help anticipate and resolve problems during this time. This is a critical time because a borrower's relief options are much more limited once she goes into default.

Prevention will not work for everyone and it is not a panacea. It is, however, a tremendously important step that can save many borrowers from falling into the often inescapable default spiral. It can also save the government and its agents the higher costs of processing and trying to collect from defaulted borrowers. Helping borrowers avoid default is not only cost-effective, but also closely tied to the mission of the government,

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[4] See U.S. Department of Education, "Secretary Spellings Announces New Low Student Loan Default Rate", Press Release (September 14, 2005), available at: http://www.ed.gov/news/pressreleases/2005/09/09142005.html.

[5] See, e.g., U.S. Department of Education, Office of Inspector General, "Final Audit Report: Audit to Determine if Cohort Default Rates Provide Sufficient Information on Defaults in the Title IV Loan Program", ED-OIG/A03-C0017 (December 2003); General Accounting Office, "Student Loans: Default Rates Need to be Computed More Appropriately", GAO/HEHS-99-135 (July 1999).

[6] 20 U.S.C. § 1085(a)(2).

[7] U.S. Department of Education, Office of Student Financial Assistance, "Ensuring Loan Repayment: A National Handbook of Best Practices" (2000).

[8] There is usually a six month period, longer for some types of loans, after graduation or withdrawal before a borrower is required to begin repayment.

guaranty agencies, and schools with respect to financial aid programs: that is, promoting equal access to higher education by helping borrowers achieve their educational goals without incurring insurmountable debt.

Most policymakers agree in theory that it is better for borrowers, taxpayers, schools, and government to prevent problems before they start. Early intervention saves both money and heartache down the road. Yet, this seemingly simple premise is hugely controversial. This is mainly because the current student loan system provides greater rewards to lenders, guaranty agencies, and others when borrowers go into default than when they avoid it. As discussed below, solving this problem will require shorter-term pilot projects and other programs that help demonstrate the effectiveness of default avoidance programs as well as elimination of the skewed incentives that can cloud the true mission of student lending.

A. Counseling and Contact Requirements

There are a number of provisions in current regulations requiring lenders or guaranty agencies to contact delinquent borrowers. There are also counseling requirements when borrowers first incur loans and after they withdraw or graduate. Initial counseling is supposed to occur prior to the release of the first loan disbursement.[9] The counseling may be in person, by audiovisual presentation, or by interactive electronic means. Schools are also supposed to ensure that an individual with expertise in financial aid is reasonably available shortly after the counseling to answer questions.

The Direct Loan program allows schools to adopt alternative approaches for initial counseling. These alternatives must be designed to target borrowers who are most likely to default on repayment and provide them more intensive counseling and support services.[10]

In addition to counseling, contacts are required at various points in the process. For example, lenders must disclose information about repayment at or prior to the beginning of the repayment period.[11] With respect to contacts during the delinquency, the regulations prescribe precisely what must be done. Not earlier than the 60th day and no later than the 120th day, lenders must request default aversion assistance from the guaranty agency.[12]

By most accounts, entrance and exit counseling is no more than a formality, one of many hoops students jump through to get their student aid checks. Further, counseling is rarely targeted at those most likely to get into trouble, even though there is ample evidence to help predict who is most likely to default.

Some guaranty agencies and schools have attempted to develop models to predict which borrowers are most at risk of defaulting and target more intensive efforts at these

[9] 34 C.F.R. § 682.604(f) (FFEL).
[10] 34 C.F.R. § 685.304(a)(4).
[11] 34 C.F.R. §682.205(c).
[12] 34 C.F.R. §682.411(i).

borrowers. Many focus on reaching borrowers immediately after drop-out since this is clearly a predictor of default.[13]

In a phone survey of student loan borrowers, the Texas Guaranty Agency found that repayers were likely to have jobs related to their training both during school and afterwards, while defaulters did not. Repayers were also more knowledgeable about their repayment options. Those who were predicted not to default but did faced the highest number of combined life traumas. They also frequently had bad experiences with loan servicers. They generally reported that the counseling they received was unclear or not helpful and most had not thought about flexible options such as deferments.[14] The importance of information and communication with borrowers is reinforced by a profile conducted by the University of Illinois, Chicago of student loan defaulters. The most commonly cited reason for defaults was lack of information.[15]

B. Perverse, Reverse Incentives

It is hard to argue against the concept of default prevention. The problem is that the student loan system is not set up to focus real resources and energy into prevention. Even more to the point, the financial incentive system rewards default collections rather than default prevention.

For lenders, delinquent loans often have less value than loans in default because the government guarantees close to full payment when default claims are filed. A 2002 GAO report described the problem in greater detail. The traditional payments for guaranty agencies, according to the GAO, make it more financially beneficial for an agency to allow borrowers to default and then to try to collect rather than prevent default.[16]

Congress responded in part by giving the Department of Education the authority to develop and sign voluntary flexible agreements (VFAs) with guaranty agencies. These agreements exempt agencies from many regulatory requirements, such as the prescribed contacts with borrowers described above. They are also encouraged to set up new types of incentive payment agreements, in many cases rewarding agencies for preventing

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[13] See Texas Guaranty Student Loan Corporation, "Predicting Which Borrowers Are Most Likely to Default" (1998), available at: http://www.tgslc.org/publications/reports/defaults_texas/ins_intro.cfm; Michael Podgursky, Mark Ehlert, Ryan Monroe, Donald Watson, John Wittstruck, "Student Loan Defaults and Enrollment Persistence" (2000), available at: http://www.missouri.edu/~econ4mp/papers_presentations/wp/Student_Loan_default.pdf#search='Michael%20Podgursky%20and%20student%20loan%20defaults; Lawrence Gladieuz and Laura Perna, The National Center for Public Policy and Higher Education, "Borrowers Who Drop Out: A Neglected Aspect of the College Student Loan Trend" (May 2005).

[14] Texas Guaranty Student Loan Corporation, "Predicting Which Borrowers Are Most Likely to Default" (1998), available at: http://www.tgslc.org/publications/reports/defaults_texas/ins_intro.cfm.

[15] U.S. Department of Education, Office of Student Financial Assistance, "Ensuring Loan Repayment: A National Handbook of Best Practices" ch. 3 (2000).

[16] U.S. General Accounting Office, "Federal Student Loans: Flexible Agreements with Guaranty Agencies Warrant Careful Evaluation", GAO-02-254 (January 2002).

defaults rather than tying compensation to collection.[17] Some agencies claim that they can pursue these goals without a VFA because their missions provide sufficient motivation to increase efforts to prevent defaults and that innovations in customer service can be accomplished under current regulations.[18]

In general, the VFA program has been encouraging, but should be evaluated further. As recommended by the GAO in a 2002 report, it is critical to develop consistent measurement standards in order to distinguish the results of the VFAs from the effects of other factors, such as general economic conditions.[19]

POSSIBLE SOLUTIONS TO HELP PREVENT DEFAULTS

1. Evaluate what works and develop effective counseling programs.

Counseling is not a substitute for strong regulation, including flexible and reasonable repayment options. However, effective counseling programs can complement these other policies by getting information out to students in a timely way and assisting them when problems arise.

It is difficult to measure and evaluate counseling programs. Key questions include when the counseling should be delivered, who should deliver it, and what the content should be. Based on the counseling experience in other areas, including credit and housing counseling, it is most likely that outcomes will vary depending on the population. This is why innovative programs should be tried and outcomes measured.

It is important not to overlook the need to train the counselors and make sure that they are objective in their presentations to students. It may be most appropriate, for example, for the school to counsel students before they take out loans or while they are in school. Students starting to experience problems after graduation or withdrawal, however, might be best served by working with objective non-profit agencies that do not work for schools, lenders or the government. Overall, the approach should be to treat the student borrowers as customers rather than as irresponsible debtors.

Counselors must be trained not only on the substantive issues related to student loan debt, but also on how to effectively counsel students. The psychological side of financial decision-making is often ignored, yet it is essential if education and counseling programs are going to achieve actual results. In addition to substantive trainings, it is important to design trainings for trainers to teach pedagogical and counseling strategies.[20]

Timing is also key. If entrance counseling is to continue, it should be given before students incur the loans. Exit counseling prior to graduation is unlikely to be a useful educable moment. Rather, counseling should be offered during grace periods and shortly after repayment begins and especially at the onset of delinquency.

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[17] Id.
[18] Id. at 15.
[19] Id.
[20] For an example of a "Train the Trainers" program, *see* the web site of the New York-based Coalition for Consumer Bankruptcy Debtor Education, http://www.nyls.edu/pages/1440.asp.

2. Fix the Perverse Incentive Structure.

Congress should require a comprehensive analysis of the current voluntary flexible agreements and other default avoidance programs.[21] Congress should also continue to promote and expand the VFA program and other innovative strategies that help prevent default. Quantifying the cost savings of preventing default is essential.

3. Communicate with Borrowers Early and Often.

Studies of characteristics of student defaulters consistently show that lack of information about options is a strong predictor of default. Yet, in discussions of this issue, many schools and agencies report that the only way they communicate with borrowers is through the often ineffective standardized presentations. Instead, schools and agencies should develop innovative programs that target at-risk borrowers and deliver information in a timely and engaging way.

It is important to develop a range of delivery options. Schools should also consider who is most effective in delivering the message. For example, contacts from loan servicers may be much more threatening than communications from a neutral, non-profit counseling agency. (See section VIII for a recommendation of a pilot project training counselors from a neutral, non-profit entity to provide assistance to borrowers).

4. Eliminate the 60 day time limit before lenders can request default aversion assistance. Default aversion should begin as early as possible.

III. FLEXIBLE AND AFFORDABLE REPAYMENT

Ultimately, counseling and communication will only be effective if there are reasonable and affordable alternatives to discuss with borrowers. Otherwise, a borrower seeking assistance may learn about the extent of his problem, but will leave the session believing that there is nothing he can do about it. These options are discussed below.

A. Pre-Default Repayment Options

Intervention prior to default is critical because many of the best repayment options are available to borrowers only during this period. Borrowers are generally placed in a ten year "standard" repayment plan. However, they have the option of choosing to repay through various flexible plans, including a "graduated plan", which allows borrowers to make smaller payments at the outset that grow over time. Extended repayment plans as well as income-sensitive repayment plans are also available in both the Federal Family Education Loan (FFEL) and Direct Loan programs.[22]

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[21] The GAO found in 2002 that the Department had not figured out a way to measure performance of the VFAs. See generally U.S. General Accounting Office, "Federal Student Loans: Flexible Agreements with Guaranty Agencies Warrant Careful Evaluation", GAO-02-254 (January 2002).

[22] Loans for the FFEL program are originated by private lenders and guaranteed by the government. Direct Loans, in contrast, are directly from the federal government to the student, with the assistance of the school

Changes to the HEA, scheduled to go into effect on July 1, 2006, take some of the flexibility out of the remaining "flexible" pre-default repayment programs. Beginning on July 1, 2006, the rules for Direct Loan repayment plans will be the same for FFEL and Direct, except for the Direct Loan Income Contingent Repayment Plan (ICR). This means that borrowers on graduated repayment plans will be required to pay over a fixed period of time not to exceed 10 years. In contrast, the Direct Loan program currently does not have a maximum time limit. Extended repayment will be available only for borrowers with loans totaling more than $30,000 and for periods not to exceed 25 years. Minimum payments are also required. In contrast, the Direct Loan program currently does not have a minimum total threshold and depending on the amount owed, allows repayment for up to 30 years.[23] The Direct Loan program also allows some discretion to create alternative plans to accommodate a borrower's "exceptional circumstances."[24]

Another under-utilized, but extremely valuable tool is the income contingent repayment (ICR) plan. This plan is currently available only through the Direct Loan Program. Under the ICR, borrowers make minimal payments if they are below poverty income, taking family size into account. Payments increase incrementally as income increases. The required payments are capped at 20% of any earnings above the poverty level.[25] If they continue making payments for 25 years, any debt that remains is forgiven.[26] However, this forgiven amount may be taxable income.

The ICR was designed to benefit borrowers in a range of circumstances. The bill that was introduced by Senator Kennedy in 1993 stated that one of its purposes was to "provide borrowers with a variety of repayment plans, including an income-contingent repayment plan, so that borrowers' ...obligations do not foreclose community service-oriented career choices."[27] The drafters believed that a payment plan linked to income could be best administered through the Direct Loan program. For various reasons, including low awareness of the option and the decline in schools participating in Direct Loans, the ICR has never caught on as expected.

Despite the great promise of the ICR, it is a little utilized tool particularly prior to default because only Direct Loan borrowers can access it without having to first consolidate their loans. Consolidating through the Direct Loan program in order to obtain an ICR, as discussed in section III.B.2, is a difficult proposition for many borrowers. One of the key recommendations below is to make the ICR more accessible prior to default by allowing FFEL borrowers to access an ICR through the FFEL program

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or other entity that originates the loan. Direct Loans have similar terms as FFELs, but when the loans become due, they are immediately owed to the United States. Participation in Direct Lending peaked at more than 1300 colleges in 1996-97, when it accounted for about one-third of the total student loan market. It has since decreased to about 25%.

[23] 34 C.F.R. § 685.208(e).

[24] 34 C.F.R. §685.208(g).

[25] 34 C.F.R. §685.209(a)(2).

[26] 34 C.F.R. §685.209(c)(4)(iv).

[27] Staff of Senate Comm. on the Budget, 103d Cong. Reconciliation Submissions of the Instructed Committee Pursuant to the Concurrent Resolution on the Budget (H. Con. Res. 64) 453 (Comm. Print 1993) (reprinting report by Senate Committee on Labor and Human Resources to accompany Title XII of the Budget Reconciliation Act).

or by developing a similar option in the FFEL program. The ICR is also an essential post-default repayment tool, as discussed in section III.B.2.

POSSIBLE FIXES TO PRE-DEFAULT REPAYMENT PROGRAMS:

1. **Extend the ICR to FFEL loans or develop a similar formula for FFEL repayment.**

2. **Establish a maximum time limit for repayment of student loans.**

   At a minimum, borrowers demonstrating hardship circumstances should have to pay back loans for no more than 20 years and should only have to pay amounts that are affordable based on their incomes, family size, and residual expenses. The ICR is an excellent, already existing tool, to implement this policy. However, borrowers facing hardship should be able to repay using other flexible repayment options, such as graduated and extended repayment plans. Those payments should also count toward the total repayment time limit. Once this time limit is reached, any remaining balance should be forgiven. The forgiven amount should be exempted from the definition of income for income tax purposes. [28]

3. **Until #2 is adopted, Congress should ensure that borrowers have the flexibility to repay over an extended period of time.** While it is generally preferable to pay in the least amount of time possible in order to limit the amount of interest charged, many borrowers simply cannot afford to repay through these shorter-term plans. Congress should extend the repayment period for pre-default flexible repayment plans.

4. **Require both FFEL and Direct lenders to offer alternative payment plans to accommodate a borrower's "exceptional circumstances."** For example, after the hurricane disasters in the South in 2005, the Department of Education and Congress reached out to affected borrowers, offering various flexible repayment, deferment, and other options.

B. Post-Default Repayment

Even with strong default prevention programs in place, many borrowers will end up in default at some point. There is a category of borrowers who slip in and out of default or fall into default just once due to temporary financial difficulties. These borrowers can often be restored to repayment status. Early intervention is particularly important because of the current policies that impose hefty collection fees and send defaulted loan portfolios out to collection agencies early in the process.

There is another category of borrowers that is less likely to be able to get out of default. For these borrowers, it is critical to preserve a safety net so that people with

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[28] See The Project on Student Debt, "White Paper: Addressing Student Loan Repayment Burdens" (February 2006). Available at: http://projectonstudentdebt.org/files/pub/WHITE_PAPER_FINAL_PDF.pdf.

disabilities, the elderly, victims of school fraud, and others who are in economic distress on a more permanent basis get relief.

1. Rehabilitation

The FFEL and Perkins loans programs offer borrowers in default the opportunity to rehabilitate their loans. Borrowers are entitled to pay only what is reasonable and affordable for them in order to rehabilitate their loans.[29] The payment amount is determined by the guaranty agency or by the Department of Education if it is holding the loan. Currently borrowers must make 12 timely payments in order to qualify. Beginning July 1, 2006, borrowers will be required to make nine timely payments in a period of ten consecutive months.

Rehabilitation relief is secured only if after the borrower makes the required payments, the loan holder is able to find a lender to purchase the loan. An eligible lender purchasing a rehabilitated loan must establish a repayment schedule that meets the same requirements that are applicable to other FFEL program loans made under the same loan type and that provides for the borrower to make monthly payments at least as great as the average of the 12 monthly payments received by the agency.[30]

Based on years of representing clients and numerous reports from student loan borrowers, we have found that there is a great deal of inconsistency in the administration of the rehabilitation program. On one hand, many loan holders insist that the borrowers make minimum payments during the rehabilitation period. In fact, borrowers are required to pay only what is reasonable and affordable for them and required minimum payments are explicitly prohibited.[31] The problem is that there is no standard formula to determine the affordable monthly amount, and the Department has stated that borrowers are not eligible for an ICR while their loans are in rehabilitation.

Even those borrowers who obtain reasonable and affordable plans are often kicked into the standard ten year plan after the loan is rehabilitated. Department staff told NCLC in 2004 that resolving this problem was likely as straightforward as fixing the Department's computers so that borrowers have the option of choosing which plan to continue with after the official rehabilitation period is over. Yet, reports of borrowers not being given this choice and not even understanding that they have this choice persist. As a result, too many borrowers just recently lifted out of default fall right back in during the transition period when the rehabilitated loan is sold.

Another problem is that collection does not necessarily cease during the rehabilitation period. The Department has explained in response to questions from NCLC and other advocates that collection will stop only if the rehabilitation agreement specifically provides for a cessation. Otherwise, borrowers will continue to face the usual range of collection tactics, including tax offset, even though they have made a repayment

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[29] 34 C.F.R. § 682.405(b) (FFEL).
[30] 34 C.F.R. § 682.405(b)(3).
[31] 34 C.F.R. § 682.405(b)(1)(i)(B). See, e.g., Arroyo v. Solomon and Solomon, 2001 WL 1590520 (E.D.N.Y. Nov. 16, 2001) (Plaintiffs allowed to proceed with claims that collector violated fair debt laws by demanding payments beyond what plaintiff could reasonably afford).

commitment and are in the process of rehabilitating their loans. This seems particularly counterproductive since borrowers are likely to quickly get discouraged from making payments if they continue to face collection efforts.

Rehabilitation can be preferable to consolidation because successful rehabilitation wipes out the borrower's past history of default on credit reports and the borrower is not at risk of losing rights through consolidation (see Section III.B.2 below). However, because rehabilitation is a business proposition—requiring that a lender purchase the rehabilitated loan—the program is not always an accessible or useful tool for the lowest income borrowers who can pay only relatively small monthly amounts. In addition, collection fees of up to 18.5% of the unpaid principal and accrued interest at the time of sale are added to the new loan.[32]

POSSIBLE FIXES TO REHABILITATION:

1. **Increase oversight and enforcement.**

   Oversight and enforcement are needed to ensure that borrowers are not required to pay more than what is reasonable and affordable during the rehabilitation period and during the transition when the loan is sold. The regulations already provide this right, but are often not enforced. **One efficient solution would be to allow borrowers to repay using the ICR formula during the rehabilitation period.** Further, as described in section IX, borrowers have few remedies if a lender violates the HEA and refuses to rehabilitate a loan or demands high monthly payments beyond what is affordable. (See § IX for recommendations to strengthen borrower remedies in these circumstances).

2. **Collection efforts should automatically cease while the borrower is repaying through a rehabilitation agreement.**

3. **Only reasonable and actually incurred collection fees should be charged, as discussed in greater detail below.** In addition, the collection fee charge should be a one-time fee that is not capitalized.

2. Income Contingent Repayment

The prior section highlighted the importance of the ICR as a flexible repayment tool prior to default. The ICR plan is also one of the few flexible repayment options available after default. However, it is underutilized due to lack of outreach and because of program rules that require FFEL borrowers to consolidate through Direct in order to obtain an ICR.

Even though a FFEL borrower's sole purpose may be to repay through the ICR, she is subject to complex consolidation rules and additional barriers imposed by FFEL lenders.

[32] 34 C.F.R. § 682.405(b)(1)(iv).

Barriers created by current regulations include:

- Borrowers who do not have FFEL or Direct loans are not eligible to consolidate their loans. This might include, for example, borrowers with only Perkins loans.

- Borrowers who have previously received consolidation loans and defaulted on those loans are generally not eligible to consolidate again with Direct. The FFEL program currently allows borrowers to consolidate just once.

Probably the most serious barrier to accessing the Direct Loan consolidation program and the ICR is not written in the rules. Instead, it occurs because many FFEL lenders will not release their borrowers into the Direct Consolidation program. This would not be such a problem if a similar program were available through FFEL. However, FFEL lenders may offer only an income-sensitive repayment plan, which is generally less advantageous for borrowers in financial distress. The FFEL income-sensitive plan requires that borrowers at least pay the monthly interest. In addition, there is no standardized formula to determine the monthly payment amount and to ensure that the borrower's total debt burden is limited.

If an eligible borrower in the FFEL programs applies for a Direct loan, the borrower is entitled to receive that loan in the event that the borrower is unable to obtain a consolidation loan from a FFEL lender *or* is unable to obtain a consolidation loan with income-sensitive repayment terms acceptable to the borrower. This is a self-certification process. Yet, many FFEL lenders claim that borrowers cannot self-certify and must get a rejection from the FFEL lender. Some will not grant such rejections, leaving the borrowers in limbo.[33]

A key problem, as documented in a 2005 report by the Department of Education's Inspector General (IG), is that many FFEL lenders either intentionally or unintentionally prevent borrowers from consolidating with Direct or unduly delay the process.[34] After receiving an application for a Direct Loan consolidation, the Department through its contractor sends a loan verification certificate (LVC) to each of the borrower's loan holders. Holders are required to return the request within 10 business days of receipt.[35] The IG determined that loan holders either failed to return LVCs timely or returned incomplete certifications for about 10% of the loans. Further, when a holder fails to return the LVC, according to the IG, the Department does not take effective action to ensure that the applicant's loan is consolidated. In some cases, as noted by the IG, FFEL lenders improperly claim that they do not have to "release" the loan because of the single holder rule.[36] This is a distortion of that rule, which is not at all relevant in these

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[33] The Deficit Reduction Act amended this provision, instead requiring FFEL lenders to deny the consolidation application or deny an application for a consolidation loan with income-sensitive repayment terms before FFEL borrowers would be eligible to consolidate with Direct. However, in June 2006, Congress passed an emergency supplemental spending package, H.R. 4939, which restored the original language. See P.L. 109-234.

[34] U.S. Department of Education, Office of the Inspector General, Final Audit Report ED-OIG/A07-D0027 (February 10, 2005).

[35] 34 C.F.R. § 685.220(f)(1)(i).

[36] 34 C.F.R. §682.201(c).

circumstances. In any case, this excuse should be completely moot when Congress repealed the single holder rule in June 2006.[37]

As discussed above, extending the ICR (or a similar program) to FFEL will ensure that borrowers do not have to jump through the consolidation hoops just to repay through ICR.

Overall, there are some useful repayment options available both before and after default. The problem is that the system is overly complex and creates often insurmountable barriers for borrowers. One of these key barriers, discussed in section VIII, is that many borrowers do not even know about these options.

Take the example of a borrower who is temporarily disabled due to a work accident. He already used up his eligibility for deferments due to previous economic and unemployment problems. Unaware of other options such as forbearance, this borrower's loans go into default. He is not eligible for loan cancellation. After a few years, he is able to work part-time and would like to try to make some repayments. The problem is that he has FFEL loans. His FFEL lender insists that he must consolidate his loans with that lender and repay through the standard repayment plan. Alternatively, they tell him that he can rehabilitate his defaulted loans, but again must make monthly payments beyond what he can afford. The FFEL lender does not tell him about the income-sensitive repayment option. The borrower also does not know and is not told that he can consolidate with Direct Loans and choose the ICR option.

As a result, the borrower does nothing. He continues to face the stresses associated with defaulted loans. His credit is ruined, making it more difficult for him to afford to buy a car so that he can get to work. Ironically, the government gets nothing from him because his wages are too low to garnish and his income is too low to get a tax refund. Perhaps the government will wait for this borrower to start collecting Social Security and then try to get some money from him. This is a waste for taxpayers and for this borrower. He could be back in repayment, making affordable payments if he only knew that there were viable choices.

POSSIBLE FIXES TO INCOME CONTINGENT REPAYMENT AND CONSOLIDATION:

1. **Allow qualified borrowers in all of the main federal loan programs to access the ICR directly rather than through the consolidation program. This option should be available before and after default.**

2. **Until recommendation #1 is put in place, ensure that qualified borrowers with FFEL loans are not improperly denied access to Direct Loan Consolidation ICR.** One possible solution is for Department to obtain a loan

[37] P.L. 109-234.

payoff amount from another source and then consolidate the loan without waiting for a FFEL lender to return the loan verification certificate (LVC).[38]

C. Compromise and Write-Offs

The Department has authority to compromise FFEL or Perkins loans of any amount or to suspend or terminate collection.[39] The Department has issued Standardized Compromise and Write-Off Procedures for use by all guaranty agencies.[40]

According to these Procedures, allowable compromises include:

1. Collection costs can be waived to obtain payment of all principal and interest in full.

2. Thirty percent of principal and interest owing also can be waived to recover the remaining 70%.

3. Compromises involving more than 30% of principal and interest will bind only the guaranty agency, and not the U.S. government. Guaranty agencies cannot waive the Secretary's right to collect the remaining balance.

The Department has described the types of borrowers who might qualify, including those who are chronically ill, partially disabled, or of an age that results in inability to work or where potential for future earnings is limited or non-existent.

Although these programs may work for some borrowers, it is difficult to obtain information about write-offs. The Department does not openly publicize these programs. Further, the guidelines discussed above are outdated (from 1993) and technically apply only to guaranty agencies.

Further, anecdotal reports indicate that the Department and its agents generally require a large lump sum before they will even consider a write-off. Once again, the balance between the government's interest in collecting funds and ensuring that borrowers honor their obligations must be weighed against the burdens on borrowers and the costs of perpetual collection efforts.

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[38] This is one of the recommendations in the IG report. U.S. Department of Education, Office of the Inspector General, Final Audit Report ED-OIG/A07-D0027 (February 10, 2005).

[39] 34 C.F.R. § 30.70(h).

[40] See Letter from Jean Frohlicher, President of the Council of Higher Education Loan Programs, Inc., re: Compromise and Write-Off Procedures (Nov. 7, 1993), with attached approval by Robert W. Evans, Director, Division of Policy Development (Nov. 24, 1993), and attached Standardized Compromise and Write-Off Procedures. There are also general write-off and compromise rules promulgated by the Department of Treasury. See 31 C.F.R. §902.2.

POSSIBLE FIXES TO COMPROMISES AND WRITE-OFFS:

We recommend at a minimum that:

1. The Department should clarify and update its standards for compromise and write-off. The existing guidelines were developed for guaranty agencies in 1993.

2. The Department should build additional flexibility into the system. It is often preferable for both borrowers and taxpayers to accept a lump sum and close the books on a particular loan rather than stretch out collection for an extended period. This is particularly true in cases where the costs of pursuing collection are likely to be greater over time than the amounts collected.

3. Publicly disclose information about compromise and write-off options.

IV. TEMPORARY SUSPENSION OF PAYMENTS

A. Deferments

Deferments are essential tools for borrowers hoping to avert default. Since they are only available prior to default, it is particularly critical to make borrowers aware of these options before they fall into the default trap.

For subsidized student loans (where the U.S. pays the interest while the student is enrolled in school), a deferment not only postpones when a student must make payments, but interest obligations do not accrue during the deferment period. Instead, the government pays the interest portion of the loan and the student's payments on the principal are postponed until after the deferment expires. For unsubsidized loans, where borrowers are responsible for interest accrued while they are in school, borrowers remain obligated for accrued interest during the deferment period. In this situation, lenders may forbear and capitalize interest payments after the deferment period.[41]

Each of the main federal loan programs offers a different mix of deferment programs. For example, the Perkins program offers a broad array of deferment options, including many tied to particular professions and to military service. Congress recently expanded the deferment programs related to military service to the other loan programs as well.

The current programs are essential, but the implementing regulations are often overly restrictive. In addition, many borrowers do not find out about their deferment options. Those who do seek deferments often experience difficulties with the burdensome application process.

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[41] 34 C.F.R. §682.211(a)(4).

Another major problem is that the deferments related to hardship conditions have strict time limits. For example, economic hardship and unemployment deferments are available for periods that collectively do not exceed three years.[42] Borrowers facing longer-term hardship conditions are not entitled to relief. The same problem applies to borrowers who use up the three years of "eligibility", return to repayment, but later experience another period of hardship.

Another gap is that there is no longer a specific deferment program for borrowers who are temporarily disabled. This deferment is available only for borrowers with very old loans. The problem is that borrowers who have been repaying their loans, but then experience short-term disabilities, are often ineligible for any type of deferment. These borrowers are not eligible for disability-based loan cancellations which require proof that disabilities are permanent and expected to continue indefinitely or result in death.

POSSIBLE FIXES TO DEFERMENTS:

1. **Restructure the economic hardship deferment by:**

   a) Eliminating the three year limit on economic hardship assistance since those most in need of the benefit are often in long-term hardship situations;

   b) Making interest subsidies available to borrowers with "unsubsidized" loans;

   c) Encouraging borrowers to make payments to reduce principal even when they receive interest subsidies;

   d) Including some consideration of family size in determining economic hardship, and

   e) Establishing procedures for borrowers to apply online for economic hardship.[43]

2. **Time limits should also be extended for the unemployment deferment and other hardship-related deferments. The extended limits should apply to each period of hardship instead of cumulatively.**

3. **Restore the temporary total disability deferment.**

4. **Provide timely information about deferments.**

5. **Simplify the application process for all deferments.**

[42] 34 C.F.R. §682.210(s)(5), (6).

[43] These recommendations are derived from The Project on Student Debt, "White Paper: Addressing Student Loan Repayment Burdens" (February 9, 2006), available at: http://projectonstudentdebt.org/files/pub/WHITE_PAPER_FINAL_PDF.pdf.

B. Forbearances

Forbearances allow borrowers to postpone payments. However, unlike deferments for subsidized loans, interest continues to accrue during the postponement. Despite the costs for borrowers, there is evidence that forbearances can help reduce defaults.[44] Forbearances are intended to help prevent a borrower from defaulting or to permit the borrower to resume repayment after default.[45]

Currently there is an economic hardship forbearance that is mandatory for up to five years in cases where the borrower is not able to repay the loan within the maximum repayment term.[46] In addition, there is a mandatory forbearance in increments of up to one year for periods that collectively do not exceed three years if the amount of the borrower's monthly student loan payments collectively is equal to or greater than 20% of the borrower's total monthly income.[47]

Forbearances are also required in other circumstances, including when:

1. The borrower is serving in a national service position;

2. During exceptional circumstances, such as a local or national emergency or military mobilization, or

3. If the geographical area in which the borrower resides has been designated a disaster area.[48]

Forbearances for borrowers in poor health or with other personal problems are available at the lender's discretion.[49] Discretionary forbearances are also critical during periods when borrowers are waiting for processing of consolidation or cancellation applications.

Other forbearances available at the discretion of the lender include:

1. Forbearances prior to filing bankruptcy;

2. Forbearances while the lender is determining the borrower's eligibility for discharge of the loan;

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[44] See, e.g., Derek V. Price, "Student Loan Forbearance and Its Relationship to Default", Lumina Foundation (November 2004). Available at: http://www.luminafoundation.org/publications/synopsis/loanforbearance01.pdf.
[45] 34 C.F.R. §682.211(a)(1).
[46] 34 C.F.R. §682.211(i)(5)(ii).
[47] 34 C.F.R. §682.211(h)(2)(i) (FFEL). Analyses of student debt have generally relied on the idea that students should not devote more than 8% of their gross income to repayment of student loans. Thus, the 20% limit here is significantly higher than this generally accepted maximum. See generally Sandy Baum, "How Much Debt is Too Much? Defining Benchmarks for Manageable Student Debt" (November 2005).
[48] 34 C.F.R. §682.211(i).
[49] 34 C.F.R. §682.211(a)(2)(i).

3. Forbearances while the lender is processing and collecting documentation to support deferment and change in repayment plan requests, or

4. Forbearances not to exceed three months for borrowers who are affected by natural disasters.

Forbearances can be very useful tools, particularly for borrowers facing temporary problems that have caused them to go into default. They should first explore eligibility for other options, including affordable repayment, but some borrowers will benefit from a forbearance during relatively short periods of distress.

POSSIBLE FIXES TO FORBEARANCES:

It is generally appropriate to retain the time limits on forbearances since interest accrues during the forbearance period and any interest costs not paid during this period are capitalized (added to the loan principal). The recommendations below first address ways to make the forbearance program less costly for borrowers. The second set of recommendations highlight the need to make information about forbearance more readily available.

1. Using the existing categories of forbearance eligibility, establish options for borrowers coming out of forbearance to restructure their loan terms. This program could be modeled on existing programs in the housing area such as the special forbearance program for homeowners with HUD, V.A., and Rural Housing Service (RHS) loans.[50] Among other options, these programs allow homeowners to reduce or suspend payments for a defined period of time so long as the arrearage does not exceed the equivalent of twelve monthly mortgage payments. At the end of the forbearance period, the homeowner must typically begin paying at least the full amount of the monthly mortgage payment. Similar programs should be established for student loan borrowers.

2. Prohibit or limit the capitalizing of interest accrued during the forbearance period. There is precedent for setting a limit on capitalization in the Direct Loan ICR program. In this case, unpaid interest is capitalized until the outstanding principal amount is ten percent greater than the original principal amount. At that point, interest continues to accrue but is not capitalized.[51]

3. Provide timely information about forbearances using counseling and other communication methods discussed above. This information should explain in detail the costs of forbearance as well as other non-forbearance related options to help borrowers in financial distress.

[50] See generally National Consumer Law Center, Foreclosures §2.7 (2005).
[51] 34 C.F.R. §685.209(c)(5).

V. CANCELLATION PROGRAMS

There are a few, limited programs that allow borrowers to fully or partially cancel their student loan debt. The current programs are discussed below, focusing on gaps in the rules as well as problems with oversight. This discussion is followed by recommendations for change.

These cancellations, as well as deferments and forbearances, are often pointed to approvingly by policymakers seeking to retain the elimination of the statute of limitations or the restrictions on discharging student loans in bankruptcy (see section VI below for more on bankruptcy). Senator Jeffords, for example, in supporting the elimination of the temporal grounds for discharging student loans in bankruptcy noted that there are options such as deferment, forbearance and cancellation available to help borrowers.[52] In recent arguments before the Supreme Court, the government in part justified its argument against a time limit for Social Security offsets by pointing to the supposedly accessible disability cancellation program.

The reality is that each cancellation, as discussed below, is very limited in scope. Further, it is extremely difficult for borrowers to find out about these cancellations. The information is available on the Department's web site for those who dig around a little, but it is not included in routine collection letters. Many collectors either do not know about the programs or do not inform borrowers about them. It is not in the economic interests of the typical collector to discuss cancellations when they could potentially pressure a borrower into making unaffordable payments, even for a short while, or pressure her into consolidation. This is how they can ensure that they get paid.

A. Fraud-Related Cancellations

There are three cancellation programs that are geared mainly toward borrowers who are victims of school abuses. These were enacted in response to the tragic abuses, mainly in the proprietary school sector, that flourished in the late 1980's through the mid-1990's. These problems persist today. In fact, new abuses are now emerging, in many cases, more serious than ever. Department of Education Inspector General John P. Higgins testified in May 2005 that the student financial assistance program is a high risk area that remains vulnerable.[53] Further, the Inspector General has concluded that the Department's institutional assessment model is an ineffective tool for identifying "at risk" institutions.[54]

The three cancellations intended mainly to address fraud are closed school, false certification, and unpaid refunds. It is important to emphasize that not one of these

[52] 144 Cong. Reg. S11069-06, 1998 WL 667510 (September 19, 1998).
[53] Statement of John P. Higgins, Jr., Inspector General, Department of Education, Before the House Committee on Government Reform, May 26, 2005. Available on-line at: http://reform.house.gov/UploadedFiles/Dept%20of%20Ed%20IG%20-%20Higgins%20Testimony.pdf (Last visited June 2005).
[54] United States Department of Education, Office of Inspector General, Final Audit Report: Case Management and Oversight's Monitoring of Postsecondary Institutions," Control No. ED-OIG/A04-D0014 (Sept. 30, 2004).

programs provides general remedies for borrowers who attended a fraudulent school. For example, a school may routinely pay admissions officers by commission in violation of incentive compensation rules, fail to provide educational materials or qualified teachers, and admit unqualified students on a regular basis. None of these violations is a ground for cancellation. Instead, each cancellation offers relief for a narrow set of circumstances.

1. Closed School

The closed school cancellation is available to borrowers who took out loans after 1986 and who were in attendance at a school that closed or withdrew from the school within 90 days of closure. The 90 day period may be extended in exceptional circumstances. Students are not eligible for this discharge if they completed the program through a "teach-out" at another school or through transfer of credits.

2. False Certification

The false certification cancellation is available if 1) the borrower did not have a high school diploma when she went to school and was not given a proper "ability to benefit" test or was otherwise falsely certified for admission; 2) there was a state law at the time of enrollment that would have disqualified the student from getting a job in the area for which she was being trained; or 3) the school forged the loan papers. Congress also added a false certification discharge in cases of identity theft, effective July 1, 2006.

Based on experiences representing clients for many years and reports of advocates and borrowers nationwide, we have found that the Department routinely denies cancellations in cases where there is no record of findings or reports of fraud at the borrower's school. This places most borrowers in an impossible bind. It is extremely difficult for borrowers to gather this information on their own and in many cases, there are no such reports, even for the most unscrupulous schools. As revealed at Congressional hearings during the 1990's, the Department of Education failed to properly enforce regulations against many offenders. The absence of an investigation does not mean that fraud never occurred.

3. Unpaid Refund

The unpaid refund cancellation offers a full or partial discharge if a borrower left school and the school failed to pay an owed refund.

While these cancellation programs have been important in providing relief for many borrowers, there are huge cracks in remedies for victims of fraud. A typical scenario of a borrower left with no remedies: Joe had only a G.E.D. and was aggressively recruited by trade school X while waiting in line for his unemployment check. The "admissions officer" (really salesperson) misrepresented the course of study as well as the likelihood that Joe would get a job and a high starting salary. This school employee also misrepresented the school's completion and job placement rates. Joe started school and realized after a few months that the school was a scam. He complained and was told that he would have to pay the loan back no matter what, so he might as well stick it out. He stayed beyond the period where he was owed a refund, but then finally decided it was hopeless and left. The school stayed in business for another six months. Joe got nothing of value from the "education", but was left with student loans totaling over $3,000. Joe injured himself at the construction job he got while attending the school and was unable to make payments on his student loans. The $3,000 debt has since ballooned due to collection fees and interest. Joe is not eligible for any of the three school-related cancellations. As discussed in section IX, his other remedies are also severely limited.

B. Disability and Death

Another set of cancellations is available for borrowers who are disabled or die. The disability cancellation is extremely restrictive. Only borrowers who are unable to work and earn money because of an illness or injury that is expected to continue indefinitely or result in death are eligible.[55] This is more restrictive than the disability standard used by the Social Security Administration and Department of Veterans Affairs. To make matters worse for borrowers , the Department, through a unilateral sub-regulatory process, has published even stricter standards, including required "second guessing" of medical professionals by guaranty agencies and other holders of loans.[56]

We recommend below that borrowers who have been qualified as disabled by the Social Security Administration or V.A. be presumptively eligible for the DOE discharge. This is a more equitable and efficient way to administer the disability discharge program. This change would also help encourage disabled individuals to try to work and earn money without penalizing them if these efforts fail.

This change will not lead to new abuses in the discharge program because adequate safeguards are already in place in the Higher Education Act and Department regulations, including:

- Conditional Cancellations: Borrowers must wait three years from the date of onset of disability before they can receive a final discharge. During this period, the Department monitors borrowers, looking for "excess" earnings (defined as earnings above the poverty level for a two person household). Borrowers are also prohibited from incurring new federal student loans (except for new consolidation loans) during this period.

- Limited Eligibility: Only borrowers who were not disabled at the time they incurred student loans are eligible for the cancellation unless the borrower had a condition that substantially deteriorated after incurring the loan.

It is extremely difficult for borrowers to find out about the disability cancellation, let alone get one. Those borrowers that are able to apply are often denied with notices that do not spell out the reasons for denial. In some cases, they are deemed ineligible because they may have worked at some point in the past. Even when borrowers submit

[55] 34 C.F.R. § 682.200 (FFEL).
[56] See Department of Education, Dear Colleague Letter No. GEN-02-03 (May 2002).

signed statements from their doctors that they meet the disability standard, the generally non-medical personnel at guaranty agencies and other entities often second guess these determinations.[57]

C. Profession-Specific Cancellations

A final set of full and partial cancellations is available for members of certain professions, such as teaching. The small Perkins program offers the most extensive series of profession-related cancellation options. Numerous proposals appear in Congress each year to extend the scope of the existing profession-oriented cancellations and to add new ones.

These programs are intended to address the concern that if the cost of education continues to grow at its current pace, lower and middle income students will simply be unable to work as teachers, social workers or as doctors or lawyers serving under-privileged communities. This is a very serious issue. However, most of these borrowers are receiving some income and are able to make some payments. The problem is that their monthly payments are often too high and the total amount to be repaid is unaffordable. The State PIRGs found, for example, that 23% of public college and 38% of private college graduates would have unmanageable debt as starting teachers. The percentages are even higher for social workers, with 37% of public college and 55% of private college graduates facing unmanageable debt.[58]

Instead of expanding these profession-oriented cancellations, the most effective way to deal with this problem is to allow borrowers to make payments based on their incomes, generally through the ICR program as discussed above in section III, and to limit the total number of years of repayment. Schools should also be encouraged to develop loan forgiveness programs for graduates who work in key professions for a required number of years.

One other cancellation program is the current provision that forgives a borrower's outstanding debt after she has repaid through an ICR plan for 25 years. See section III for recommendations in this area and further information.

POSSIBLE FIXES TO IMPROVE CANCELLATIONS:

1. **Develop a cancellation that affords relief to all borrowers who attended schools that violated key HEA regulations.** This will ensure appropriate relief for victims of fraud instead of the current piecemeal process.

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[57] A 2005 report by the Department's Inspector General contains different estimates of the percentage of physicians contacted after disability applications are received. A nurse in the Conditional Disability Discharge Unit reported that physicians are contacted for approximately half of the disability discharge applications the Unit receives. The Department responded that its contractor follows up with physicians for approximately 70 percent of cancellation applications received. United States Department of Education, Office of Inspector General, "Final Audit Report: Death and Total and Permanent Disability Discharges of FFEL and Direct Loan Program Loans", Control Number ED-OIG/A04E006 at 15 (November 14, 2005).

[58] The State PIRGS' Higher Education Project, "Paying Back, Not Giving Back: Student Debt's Negative Impact on Public Service Career Opportunities" (April 2006), available at: http://pirg.org/highered/payingback.pdf.

2. **If borrowers have secured judgments against a school based on violations of the HEA and have been unable to collect from the school or from any other source, they should be entitled to relief to pay off all student loans owed or to directly cancel these loans.**

3. **With respect to the existing programs:**

   a. Closed School: Expand and clarify the extenuating circumstances that allow borrowers to obtain closed school discharges even if they do not meet the 90 day standard.

   b. False Certification Cancellations: The Department should specify that borrowers that submit a sworn statement establishing their eligibility for a false certification discharge and any available corroborating evidence are presumptively eligible for the discharge. Once presumptive eligibility is established, the burden would shift to the Department to disprove the borrower's eligibility.

   c. Disability Cancellations: Tie the disability standard to the standard used by the Social Security Administration or V.A. Initiate a public rulemaking process with respect to the evaluation and processing of disability cancellation applications.

4. **Respond promptly to cancellation applications.** Denials must be sufficiently detailed so that the borrower can determine whether she has grounds for appeal. (See section IX for additional due process concerns).

5. **Provide public information about cancellation application and approval rates.**

6. **Notify borrowers of cancellation rights at various points in the repayment and collection process.**

VI. BANKRUPTCY RELIEF

Just as student loan borrowers have the unenviable distinction of holding debt with no statute of limitations, student loans are also among the few unsecured debts that are generally not dischargeable in bankruptcy. Student loans can only be discharged if the debtor can show that payment of the debt will "impose an undue hardship on the debtor and the debtor's dependents."[59] Courts have interpreted this standard very restrictively, making it extremely difficult for even the most vulnerable and desperate borrowers to discharge their loans. Further, it is very difficult procedurally for student loan borrowers to prove undue hardship. The borrower must affirmatively seek this determination in bankruptcy court and prove her case.

[59] 11 U.S.C. § 523(a)(8).

In contrast to student loans, most other unsecured debts are dischargeable either through the Chapter 7 liquidation process or Chapter 13 reorganization. Other debts singled out as non-dischargeable include child support, alimony, court restitution orders, criminal fines and some taxes.

A. History of Student Loans and Bankruptcy

The Department of Health, Education and Welfare initiated the movement to close the supposed student loan "loophole" in the 1970's.[60] The agency brought the issue to the attention of the 1973 Congressional Commission on Bankruptcy Laws. This Commission admitted there was no hard numerical evidence suggesting a serious problem, but concluded nevertheless that even a small percentage of discharges created a negative public image that discredited the system.[61] The student loan program was relatively new at that time and policymakers seemed especially concerned that bad publicity might kill the young program. The Commission heeded the advice of HEW and recommended that a discharge limitation be established. They suggested either prohibiting discharge for five years after default or imposing an undue hardship standard.

Although these recommendations were not passed immediately, press reports about hoards of "deadbeat" student loan debtors continued to appear throughout the 1970's.[62] By 1976, these concerns had gained sufficient momentum to push Congress to consider the limitations. Congress codified the Commission's recommendations in the Education Amendments of 1976. This change made student loans generally non-dischargeable except five years after default or if the borrower could prove "undue hardship."

Congress faced the question again in 1978 with the Bankruptcy Reform Act. This time, the Senate and House split on the issue. The original Senate bill contained the 1976 standard. The original House bill, in contrast, proposed restoring the pre-1976 standards, making student loans dischargeable once again. Congress eventually settled on the Senate version as a compromise.

Since 1978, there have been three significant legislative changes. First, in 1990, the five year period was extended to seven years. In 1998, the temporal ground for discharge (the seven years) was eliminated. The 1998 move was described by many traditional student supporters as a "budget compromise." Senator Jeffords, for example, described the need to make a number of difficult decisions in order to bring the bill into balance.[63] A number of legislators described their discomfort with the bankruptcy

[60] See generally Thad Collins, "Forging Middle Ground: Revision of Student Loan Debts in Bankruptcy As An Impetus to Amend 11 U.S.C. § 523 (A)(8)", 75 Iowa L. Rev. 733 (March 1990); Frank T. Bayuk, "The Superiority of Partial Discharge for Student Loans Under 11 U.S.C. § 523(A)(8): Ensuring a Meaningful Existence for the Undue Hardship Exception", 31 Fla. S. U. L. Rev. 1091 (Summer 2004).

[61] Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 137, 93rd Cong., 1st Sess., Pt. I at 11, 170, 176 (1973).

[62] See, e.g., Time of Reckoning for Student Loan Deadbeats, U.S. News & World Rep., July 18, 1977 at 21; Study Now, Pay Never, Newsweek, March 7, 1977 at 95; Student Loan Mess, Time, December 8, 1975 at 8.

[63] 144 Cong. Rec. S11069-06, S11071, 1998 WL 667510.

provision, but rationalized that they had passed significant benefits for students, including lower interest rates. It is important to note that many of these benefits for students have been eroded since 1998. Finally, in 2005, Congress included most private loans in the non-dischargeability category as part of comprehensive bankruptcy amendments.[64]

B. Myths and Facts Behind the History

The impetus for this extraordinary treatment of student loans appears mainly to have come from panic over the high default rates in the student loan programs. Somewhat like the stories of mothers on public assistance riding in Cadillacs to buy steaks with food stamps, stories of doctors making big bucks discharging their hefty student loans caught the attention of Congress, the media, and the public. Unfortunately, public policy was developed in spite of studies, many of which came out at that time, discrediting the reports of abuse.

Congress acknowledged the pressure from the anecdotal reports of abuse. For example, a 1977 House Report on this issue stated that:

> The sentiment for an exception to discharge for educational loans does not derive solely from the increase in the number of bankruptcies. Instead, a few serious abuses of the bankruptcy laws by debtors with large amounts of educational loans, few other debts, and well-paying jobs, who have filed bankruptcy shortly after leaving school and before any loans became due, have generated the movement for an exception to discharge. In addition, a high default rate has been confused with a high bankruptcy rate, and has mistakenly led to calls for changes in the bankruptcy laws.[65]

Congress asked the GAO to study this issue in 1976. The GAO found that there was a high rate of student loan defaults, but only a small percentage were discharged in bankruptcy. The House report summarized the GAO's findings:

> First, the general default rate on educational loans is approximately 18%. Of that 18%, approximately 3-4% of the amounts involved are discharged in bankruptcy cases. Thus, approximately ½ to ¾ of 1% of all matured educational loans are discharged in bankruptcy. This compares favorably with the consumer finance industry. [66]

Another argument that arose in the Congressional debate was that student loans are different from most loans and should be treated differently. According to this view, student loans are made without business considerations, without security, without cosigners, and rely for repayment solely on the debtor's future income. In this sense, the loan is viewed as a mortgage on the debtor's future. The argument is that those with a college degree have an asset which should deny them access to bankruptcy relief for loans used to finance that degree.

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[64] P.L. No. 109-8, §220.

[65] H.R. Rep. 95-595, 1st Sess. 1977, 1978, 1978 U.S.C.C.A.N. 5963, 6094, 1977 WL 9628.
[66] Id.

Opponents countered that it was not their intent to hold skills and education against the person who is forced to seek relief. These bankruptcies, they argued, are no less legitimate than other bankruptcies which allow debtors a fresh start.[67] This counter-argument is directly related to the balance discussed at the outset of this paper between the government's interests in collecting debts versus expanding access to education. In fact, the lack of credit worthiness standards has been deemed appropriate because these are generally young people taking a chance that education will be financially rewarding. In some ways, at the outset, student loans are more like social welfare programs. It is unfairly punitive to treat them this way at the outset, but then to focus mostly on the business interest if the borrower gets into trouble.

Many in Congress noted this issue. The program, they argued, should either be tightened or collection efforts should be increased. However, if neither of these alternatives is acceptable, then student loans should be viewed as general social legislation that has costs. Most succinctly, according to the 1977 House Report, "It is inappropriate to view the programs as social legislation when granting the loans, but strictly as business when attempting to collect."[68]

Others spoke about the problems with challenging the bankruptcy principles of a fresh start and equality of treatment for all debts and creditors. Any exception, they argued, must be justified by the strongest showing of need and of sound policy.

In many ways, the action taken in the 1970's was an overreaction based on fears that negative reports about defaulters might undermine the fledgling student loan programs. Some even noted that it was inappropriate to debate this issue in the Education committees and as part of the education authorization process. Yet, the exception remains and was even expanded, inexplicably, to private student loans in 2005.

The private loan provision was added to comprehensive bankruptcy amendments with little discussion. This is especially troubling. Even those who believe that government student loans should be treated differently should have a hard time explaining why this logic extends to private loans. Private borrowers do not have the protections that government borrowers enjoy, including caps on interest rates, flexible repayment options, and limited cancellation rights. There are reports of private loans with interest rates of at least 15% and often much higher.[69] To compound the problem, many private lenders claim that they are not subject to any claims and defenses the borrower might have against the closed school. This is discussed in greater detail in section IX.

It is time to directly address this history and rebut the rationales for treating student loans differently than other unsecured debts. Each of these arguments can be addressed in turn:

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[67] See, e.g., H.R. Rep. 95-595, 1st Sess. 1977, 1978, 1978 U.S.C.C.A.N. 5963, 6122, 1997 WL 9628 (Statement of Hon. Don Edwards, Chairman Subcommittee on Civil and Constitutional Rights, Committee on the Judiciary, July 13, 1977).
[68] Id. at 6094, 6095.
[69] See, e.g., Sam Kennedy, "School Steers Students to Backbreaking Loans," The Morning Call at A1 (May 22, 2005).

1. **Alleged excessive use of the bankruptcy system by student loan borrowers.**

   These accounts were never substantiated at the time. Putting aside the history, the reality is that Congress has just passed comprehensive bankruptcy reform amendments intended primarily to ensure that debtors who enter bankruptcy with funds to repay debts are not able to simply liquidate debts through Chapter 7. For example, there is now a means test to determine whether there is a presumption of abuse based on the debtor's ability to repay creditors.[70] In addition, there are significant new barriers to access, including higher filing fees and mandatory counseling and education requirements.

   Even those who disagree about the existence or extent of past abuse should be able to agree that the new system should address this issue. This leaves the student loan debtors who truly need bankruptcy as a safety net. The discharge should be restored for them.

2. **Student loan borrowers gain an asset (education) that should bar them from discharging the debt. A related argument is that buying an education is less risky than most other investments and should be harder to discharge.**

   There is no guarantee that student loans will lead to economic success. In some cases, borrowers choose to work in careers that are less lucrative and often for the public good. In any case, many borrowers run into unexpected life traumas and should be allowed to discharge those debts when they have no other recourse. Some attend fraudulent schools.

3. **Student loans are easier to get than most other credit and should not be dischargeable.**

   It is difficult to see the logic to this argument and in any case, credit cards are quite easy to get as well these days. In fact, credit card companies are notorious for marketing to students. Most important, Congress has decided to make it easier to incur student loan debt because of the social policy goals of advancing access to education and because it is unrealistic to expect younger adults to have significant credit records. As noted above, it does not do students any favors to treat the program as a social program at the outset, but as a cut-throat business if they are unable to meet their obligations.

   Further, the program that Congress has set up is in many ways a substitute for greater public funding of higher education, including grants. Congress has essentially transferred much of the burden from the public to individual students.

   It is important that students realize that they are required to meet their obligations. Before they go into debt, they should also be counseled about the typical salaries in the career they hope to pursue and the costs of servicing their debt. However,

[70] 11 U.S.C. § 707(b)(2).

even with counseling, as discussed throughout this paper, some will be unable to repay their loans. These are the borrowers who can benefit from the fresh start that is afforded other debtors.

4. **Significant safeguards exist in the student loan programs as substitutes for bankruptcy protection.**

   The ways in which many of these safeguards are incomplete or unfairly administered are discussed throughout this paper. In any case, the only other "safeguards" that provide complete relief are the non-bankruptcy cancellations and these are extremely limited in scope (See § V) and mainly intended to deal with fraudulent schools.

Student Loan Discharges in Practice

The dischargeability restriction has been generally applied to most loans, but not to a student's nonpayment of tuition or room and board, where the charges are not incurred as an extension of credit or under a governmental or non-profit program.[71] There is also some, but likely very limited, wiggle room, as discussed below, in the new provision that makes most private loans non-dischargeable.

There is no statutory definition of "undue hardship." Courts have used different standards ranging from a test established in Brunner v. New York State Higher Education Servs. Corp.[72] to a more flexible "totality of the circumstances" test. [73] The Brunner test requires that 1) the debtor cannot maintain, based on current income and expenses, a "minimal" standard of living for the debtor and dependents if forced to repay the loans; 2) additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment period and 3) the debtor has made good faith efforts to repay.

Regardless of which test is used, most courts are quite restrictive in determining which borrowers qualify for discharge. Often, only borrowers very close to poverty level with little or no hope for improvement are considered eligible. It is also common for courts to reject the discharge in cases where a borrower chose a "low paying" occupation, such as a musician or even a minister, and even if the loan was incurred to pay for relevant education.

At least some judges have expressed discomfort with this restrictive standard. Some have granted partial discharges. In these cases, the courts discharge only part of the debt and require the balance to be repaid over time. The recent trend is for courts that allow partial discharges to require consumers to show undue hardship for the portion of the loans to be discharged.[74] Another approach taken by some courts is to discharge

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[71] See generally National Consumer Law Center, Student Loan Law §7.2.1 (2d ed. 2002 and Supp.).
[72] 831 F. 2d 395 (2d Cir. 1987). This test has been adopted by the Third, Fourth, Fifth, Sixth, Seventh, Ninth, Tenth and Eleventh Circuits.
[73] For a good summary of this test, see Tennessee Student Assistance Corp. v. Hornsby (In re Hornsby), 144 F. 3d 433 (6th Cir. 1998). However, the Sixth Circuit later adopted the Brunner test.
[74] See generally National Consumer Law Center, Student Loan Law ch. 7 (2d ed. 2002 and Supp.).

some, but not all, of the consumer's individual loans. Still others have used the bankruptcy proceeding to restructure the loan, reducing the amount owed and establishing a modified repayment schedule. For example, courts have discharged collection fees and accrued interest, and delayed the obligation to make payments for several years.

Although the judges' sympathy for these debtors is understandable, this partial discharge approach undermines the "fresh start" philosophy of bankruptcy, which is intended to allow consumers to start over again financially. The statutory language requires that courts determine simply whether the debt is or is not dischargeable. In addition, the new bankruptcy amendments require most borrowers with incomes above their state median incomes to file through the Chapter 13 bankruptcy process and develop a repayment plan for most debts. If a borrower cannot prove "undue hardship," she can still make payments on her student loans during the course of the Chapter 13 repayment plan. At the end of the plan, she could seek a determination that repayment of the balance would cause an undue hardship.

It is very difficult, however, for most borrowers to understand these complexities. Consumers filing for bankruptcy *pro se* are at a particular disadvantage. Even many bankruptcy attorneys are reluctant to represent clients in cases where they must file affirmative complaints to prove undue hardship. A better solution, discussed below, is to restore bankruptcy relief for student loan borrowers.

The private loan non-dischargeabilty provision is new and it is still too early to analyze how it will be interpreted. In fact, the statute includes a few limits to the new private loan provisions. These limits are derived from the Internal Revenue Code definition of a "qualified education loan," which is explicitly referenced in the bankruptcy law.[75] Only "qualified education loans" will be nondischargeable under this new category.

The Internal Revenue Code defines qualified education loans as any indebtedness incurred by the taxpayer <u>solely</u> to pay qualified higher education expenses.[76] This may allow borrowers that incur debt for education that is mingled with other types of debt to argue that the debt was not incurred <u>solely</u> to pay higher education expenses and is thus dischargeable.

In order to be considered a qualified education loan, the loan must also be incurred to pay expenses for education furnished during a period in which the recipient was an eligible student.[77] There are circumstances in which a student may take out a loan to attend school, but not necessarily be an eligible student. For example, aggressive proprietary schools in some cases enroll non-high school graduates without properly

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[75] 26 U.S.C. §221(d).

[76] 26 U.S.C. §221(d)(1).

[77] 26 U.S.C. §221(d)(1)(C).

administering the required "ability to benefit test." Students improperly enrolled in this way are eligible to administratively cancel their loans and should also be categorized as "ineligible" students.

There may also be some wiggle room in the definition of qualified higher education expenses. There are two parts to this definition. First, the expenses must fit within the federal Higher Education Act (HEA) category of items and services considered to be "the cost of attendance." Second, the expenses must be for attendance at an "eligible education institution."[78]

The HEA definition of cost of attendance is quite broad, including tuition and fees and costs for rental or purchase of equipment, materials and supplies.[79] It also includes room and board. Most education-related expenses will likely be covered.

The requirement that expenses must be for attendance at an "eligible education institution" may be more helpful for borrowers. Eligible institutions are defined as institutions that are eligible to participate in a Title IV program.[80] Title IV refers to the title of the HEA that governs federal financial assistance programs. Most, but not all schools, are eligible to participate in these programs. For example, numerous unaccredited schools have gone in and out of business in recent years. These unaccredited schools are not eligible to participate in the Title IV programs. Other scam programs such as "diploma mills" are also not eligible to participate in Title IV programs. Borrowers with student loans from these schools should be able to discharge the loans without having to prove hardship.

POSSIBLE FIXES TO BANKRUPTCY:

1. **At a minimum, Congress should act immediately to eliminate the non-dischargeability provision for private student loans.[81]** If the rationale is shaky for discharging government loans, it is hard to fathom any reason to allow private student loans to be treated differently from other types of unsecured credit. In fact, exempting these loans from discharge is likely to cause even more harm for borrowers since there are no interest rate limits or limits on fees charged for private student loans or limits on the amount of credit that can be extended.

2. **Congress should also extend greater relief to student loan borrowers by once again allowing these borrowers to discharge federal student loans in bankruptcy.** Alternatively, Congress should retain the undue hardship standard <u>and</u> restore the seven year provision.[82] In this way, borrowers could prove undue

[78] 26 U.S.C. §221(d)(2).

[79] 20 U.S.C. §1087ll.

[80] 26 U.S.C. §221(d)(2), referring to 26 U.S.C. §25A(f)(2)(B).

[81] This recommendation is included in S. 3255, introduced by Sen. Clinton (D-NY) on May 26, 2006.
[82] Restoring the seven year grounds for discharges is included in S. 3255, introduced by Sen. Clinton (D-NY) on May 26, 2006.

hardship at any time in order to discharge their loans. However, all borrowers, regardless of hardship, would be allowed to discharge student loans seven years after those loans first became due. As was the case before, the seven year period should not include any applicable suspension of the repayment period.

VII. RELIEF FROM COLLECTION

The government recognizes that there are times when the costs of collection will outweigh the likely benefits. Department of Treasury regulations, for example, give federal agencies discretion to compromise debts if they cannot collect the full amount because the debtor is unable to pay in a reasonable time, the government is unable to collect the debt in full within a reasonable time, the cost of collecting does not justify the enforced collection of the full amount, or there is significant doubt concerning the government's ability to prove its case in court.[83] These regulations were written for a reason. There comes a point of no return where the government's ceaseless efforts to collect make no sense, monetarily or otherwise.

A. Problems with Private Collection Agencies

The widespread use of private collection agencies to pursue student loan defaulters, combined with significant expansions in the government's arsenal of collection tools, has completely changed the landscape of student loan collections. Because the Department and its agents routinely hand defaulted loan portfolios off to these agencies, many borrowers seeking to get out of default or otherwise address student loan problems end up dealing with the least sympathetic of all actors, a private collection agency.

Ultimately, collection agencies will work first and foremost in their own interests. One need go no farther to illustrate this point than the web site of the Great Lakes Guaranty Corporation. They say what most everybody thinks, but not everyone admits: "The collection agency has one agenda: to collect the amount due."[84] The site warns borrowers that once their file is sent to a collection agency, they will no longer be able to postpone payments. This should not be the case. A borrower's rights should not disappear when a private collector holds his file.

Some have said that the Department's privatization of collection is a success story. On the positive side, there have been significant improvements in the amounts of funds collected. However, much of this improvement occurred because loan consolidations are counted as recoveries. Records of "recoveries" from guaranty agencies and the Department, for example, are broken out by consolidation and non-consolidation collections. The former category has generally made up the bulk of guaranty agency collection in recent years. Data from 2003, for example, show that the Department reported about 16% of its collections from consolidations. Guaranty agencies, in contrast, reported nearly 57% of total recoveries from consolidations. Reporting a consolidation in the "recovery" category is misleading because it is really

[83] 31 C.F.R. §902.2(a).
[84] https://www.mygreatlakes.com/ind/staticForwardFAP.do?staticpath=/guaranty/leaf/consequences.html. (Last checked June 2006).

just a matter of paying off one loan through consolidation and originating a new loan. This is more like shuffling debt around.

Regardless of whether funds were recovered through consolidation, there have been significant costs to the aggressive and nearly limitless collection efforts. The impact on vulnerable borrowers has been highlighted throughout this paper. To compound the problem, even borrowers that wish to repay or exercise other rights are often shut out because of problems with overly aggressive and often abusive collection agencies. Private collectors have in some cases deliberately deceived consumers by misrepresenting themselves as the Department of Education. They have overcharged consumers for collection fees, used misleading tactics to track borrowers, browbeaten borrowers into unaffordable payment plans, threatened them with actions that they cannot legally take, and pressured consumers to borrow from relatives.[85]

Some of these abuses have arisen because of the fact that a federal government program is involved. Student loan borrowers have many important rights, discussed throughout this paper. Yet many private collectors do not have enough knowledge about these rights. As a result, consumers are deprived of important options to which they are legally entitled. Even worse, some collectors misrepresent these rights or steer consumers into options more profitable for the collector.

There are many explanations for this abuse, including:

- The fact that millions of student loan obligations are handled in huge volumes, with little or no attention paid to the circumstances of individual borrowers.

- Remedies available to collect on student loans are both unique and easily misunderstood, and collectors often misrepresent the exact nature of these remedies.

- The complexity of the student loan program leads to confusion about who is collecting on a debt and makes it easy for a collector to misrepresent itself as the government.

- Private collection agencies are delegated complex responsibilities such as determining the monthly payments for reasonable and affordable payment plans. These collection agencies also help determine if borrowers have defenses to collection procedures, even though the collection agencies' financial incentive is not to offer reasonable and affordable plans or to acknowledge defenses.

A December 2003 report by the IG presents a very troubling picture of the Department's oversight of private collection agencies.[86] The IG found that the Department did not effectively track complaints, perform desk audits, conduct site visits for technical assistance and training, review deliverables, or maintain contract files.

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[85] See generally National Consumer Law Center, Student Loan Law ch. 4 (2d ed. 2002 and Supp.).

[86] U.S. Department of Education, Office of Inspector General, Final Audit Report, Control Number ED-OIG/A19-D0002 (December 23, 2003).

An additional, serious problem is that borrowers who are aware of their rights and express those rights to collection agencies are often unable to persuade the collectors to return their files to the Department or other loan holder so that the borrower can deal more directly with the actual holder of the loan rather than a hostile agent.

Here is one recent real-life example. An attorney in California had financial trouble earlier in his career. He ended up defaulting on his student loans. He is now making money and wants to get out of default and repay his loans. Although he is a trained lawyer, he has been unable to work with the collection agency, which has repeatedly threatened him and harassed him. Finally, the collection agency said that they would agree to set up a rehabilitation plan with him. However, they claimed that he would be required to make monthly payments that were unaffordable for him. They also refused to send him any paperwork ahead of time. The attorney requested that the agency return the file to his guarantor so that he could work with them. Both the collection and guaranty agency said that the attorney must work with the collection agency and that they would not return the file to the guarantor. The case is still pending because the collection agency refuses to return the file to the guarantor and the guarantor insists that the attorney must deal with the collection agency. Yet, the agency is still refusing to send a copy of the rehabilitation agreement to the lawyer ahead of time and the lawyer will not sign anything until he can read it first. It is possible that the use of an aggressive collection agency with little or no knowledge of student loan law will mean that this attorney decides not to repay at all. This comes at a great cost to him and to the government and taxpayers.

B. Collection Fees

The use of private collectors also adds substantial charges to the collection process. There are problems with both the amount of fees charged and when fees are imposed.

There is still some ambiguity regarding the amount of allowable collection fees. Fees are limited to 18.5% at the time of sale for rehabilitation and the same limit applies to consolidated loans. Otherwise, the limit is that fees must be "reasonable."[87] The Department states on its web site that it will charge no more than 25% of outstanding principal and interest.[88] This is not a limit set by statute, but a result of a settlement in a case where the Department was sued for charging fees beyond those stated in promissory notes.[89] The Department has also said that 25% is their market rate and so this is presumptively reasonable.

The regulations allow the Department to compensate collection agencies based on the average cost per borrower rather than the actual fees incurred in collecting from any particular borrower.[90] This percentage or average approach often leads to unfair results since the small number of defaulting consumers from whom recovery is made bear the

[87] 34 C.F.R. §682.410(b)(2).
[88] See http://www.ed.gov/offices/OSFAP/DCS/collection.costs.html. (Last checked June 2006).
[89] Gibbons v. Riley, (E.D.N.Y. Nov. 9, 1994) (complaint filed).
[90] 34 C.F.R. §30.60(d).

brunt of all of a creditor's collection expenses.[91] The Department has argued that the "make whole" approach is fair because it allows agencies to charge enough to sustain both successful and unsuccessful collections.

A number of states prohibit or limit this type of "make whole" approach.[92] For example, Iowa allows a collection agency to collect a fee from the debtor only if the fee is reasonably related to the actions taken by the collector and the collector is legally authorized to collect it.[93] These laws do not necessarily apply in the student loan context but are useful for comparison.

Another problem is that collection fees are often added to the balance immediately, before any costs are actually incurred. In an effort to prevent this type of up-front loading of collection costs, the Department has clarified that the borrower is not legally obligated to pay costs which have not been incurred. The Department has recognized that this can actually discourage repayment and in any case does not reflect actual costs.[94]

Unfortunately, largely due to the lack of oversight of the collection agencies, abusive practices continue. Here is one real-life example: An elderly consumer in Oklahoma (Mr. A) has defaulted student loan debt of about $5,000. In 2005, the Department began offsetting his Social Security payments, as authorized by the Debt Collection Improvement Act. This consumer receives no other income. His only assets, including an old car, are exempt from collection. Although he advised the Department that he was "collection proof" other than his Social Security income, the Department still sent his file out to a collection agency. As a result, Mr. A has continued to get collection letters from the agency that stated a balance owed in principal and interest <u>and</u> collection fees, even though the agency is doing nothing other than sending out letters to someone from whom they cannot collect. These fees are presumably the "standard" 25%. This is extremely discouraging to an older consumer who sacrifices a significant portion of his Social Security income each month only to see that it does not reduce his balance and in fact his balance keeps growing.

POSSIBLE FIXES TO EXPAND COLLECTION RELIEF:

1. **The Department should limit the files it sends to collection agencies.** At a minimum, borrowers that are already subject to extreme collection programs such as offset and have no other assets should not be pursued by collection agencies and should not be charged collection fees.

2. **The Department and its agents must develop a system to ensure that when borrowers ask a collection agency to return their files to the Department or guaranty agency, the agencies are required to do so immediately.** If a

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[91] A bankruptcy trustee unsuccessfully challenged this method in a student loan case. Educational Credit Management Corp. v. Barnes, 318 B.R. 482 (S.D. Ind. 2004).
[92] These are discussed in detail in National Consumer Law Center, Fair Debt Collection §15.2.1 (5th ed. 2004 and Supp.).
[93] Iowa Code §537.7103(5)(c).
[94] See 61 Fed. Reg. 60482 (Nov. 27, 1996).

borrower informs a collector that he believes he has a defense to the debt, that the amount is wrong, or that he wants to request a hardship reduction, the file should be immediately sent back to the agency.

3. **The Department must immediately develop a rigorous, public training program for collection agencies that includes information about all student loan rights as well as fair debt collection rights. An independent legal observer should be appointed to evaluate these programs and conduct follow up with collectors.**

4. **As part of the training process described above, the Department should develop a handbook for collectors that outlines in detail the main borrower rights and responsibilities.** This handbook should include specific information about returning files to the loan holders when requested by borrowers. The handbook should be reviewed by independent consultants, updated regularly, and be publicly available.

5. **As recommended in the IG report, the Department must improve all aspects of enforcement and oversight of private collection agencies.** In addition, Congress should establish a set of mandatory penalties, including elimination from the government's program, for offenders.

6. **The Department and its agents should make publicly available its process for handling complaints against collection agencies and any disciplinary actions taken against those agencies.**

7. **All collection letters must include information about exemptions and other rights.**

8. **The Department should only charge fees that are bona fide and reasonable and actually incurred in collecting against individuals. The amount of fees to be charged must be clearly written in the promissory note. In no event should fees be capitalized.**

9. **Reasonable collection fees should only be charged when actual costs are incurred and in no case for government offsets or wage garnishments.**

10. **To better understand the true costs of collection, Congress should commission a study of all collection costs incurred in pursuing student loan debtors, including fees paid to collection agencies and paperwork costs.** Special attention should be paid to collection efforts against borrowers with little or no assets or income, including those living solely on Social Security payments. The results of this study should be used in developing exemptions from collection, as discussed in section VII.D.

C. Restore a Statute of Limitations

The Higher Education Act Amendments of 1991 eliminated the statute of limitations within which suits could be filed, judgments enforced, or offset, garnishment or other actions initiated to collect federal student loans.[95] This places student borrowers in unenviable, rarified company with murderers, traitors and only a few violators of civil laws. Even rapists are not in this category since there is a statute of limitation for rape prosecutions, at least in federal law and in most state laws.

Despite the governmental and social interest in pursuing criminals, statutes of limitation apply to nearly all federal criminal actions. The rare exceptions exist for those crimes that are punishable by death, including espionage and treason.[96] Other exceptions apply to the prosecution of persons charged with absence without leave or missing in time of war and for individuals fleeing from justice.[97]

Statutes of limitations are the norm in civil and criminal cases. The Supreme Court has repeatedly emphasized their importance, stating, for example that "Statutes of limitations are vital to the welfare of society and are favored in the law. They are found and approved in all systems of enlightened jurisprudence."[98] The primary justifications for statutes of limitations fall into two categories; those relating to the benefits of repose and finality and those advocating against the adjudication of stale claims.

With respect to civil claims, federal district courts have found that civil actions are subject to statutes of limitations in all but a few rare instances, including patent infringement actions not involving damages,[99] citizen suits brought under environmental protection laws such as the Federal Water Pollution Control Act[100] and suits for injunctive relief brought by the Attorney General under the Fair Housing Act.[101] These exceptions do not include any other debt collection related areas.

The legislative history for this unprecedented retroactive elimination of the statute of limitations is sparse, but it appears to have been derived at least in part from the unsubstantiated premise that student loan defaulter's ability to repay increases over time.[102] Further, because student loans are made without credit worthiness considerations, some in Congress argued that the benefit for the borrower far outweighs any burden resulting from the government's right to collect *forever*. Savings in the student loan program were also mentioned.

POSSIBLE FIXES TO STATUTE OF LIMITATIONS:

Restore a reasonable statute of limitation for student loan collections.

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[95] 20 U.S.C. § 1091a.
[96] 18 U.S.C. §3281; 18 U.S.C. §794(a), 2381.
[97] 10 U.S.C. §843; 18 U.S.C. §3290.
[98] Wood v. Carpenter, 101 U.S. 135, 139 (1879).
[99] Giese v. Pierce Chemical Co., 29 F. Supp. 2d 33 (D. Mass. 1998).
[100] Public Interest Research Group of New Jersey v. U.S. Metals Ref. Co., 681 F. Supp. 237 (D.N.J. 1987).
[101] U.S. v. Incorporated Village of Island Park, 791 F. Supp. 354 (E.D.N.Y. 1992).
[102] 137 Cong. Reg. S7291-02, 1991 WL 95486 (June 6, 1991).

The clock should begin to tick at the time the borrower defaults. General common law rules regarding reinstating and tolling of the time limit should also apply. At a minimum, a ten year statute of limitations should be adopted. This would coincide with the ten year limit on other federal debt collections through the benefits offset program.[103]

D. Exemptions from Collection

Congress has steadily increased the government's collection powers over the past decade. The government can now collect student loans through tax refund offsets, administrative wage garnishment, and offset of federal payments. All of these collection efforts have no time limit. The Department can also litigate to collect student loans, but law suits are rarely used given the government's tremendous extra-judicial powers.

There are limited safeguards built into the various collection methods. Unfortunately, in some cases, these safeguards are simply insufficient to protect the most vulnerable borrowers. In other cases, the safeguards are not being enforced.

There are a number of problems in this area, including:

1. The Debt Collection Improvement Act of 1996 allows borrowers facing Social Security offsets to keep the first $750/month ($9,000/year) of their payments.[104] This amount is too low, even below the 2005 poverty level for persons under 65. Even worse, there is no provision in the law to increase this amount. It is stuck at $9,000/year even as the cost of living goes up every year.

2. A 2005 Supreme Court decision held that the ten year time limit in the Debt Collection Improvement Act that generally applies to offset of federal payments does not apply to student loan collections.[105] This leads to the extreme result of an 80 or 90 year old Social Security recipient facing offset of a portion of her Social Security payments for loans that may be 30 or 40 or even 50 years old.

3. There is a patchwork of inconsistent "hardship" programs for borrowers facing collection. In some cases, as in administrative wage garnishment, hardship is listed as a defense on the hearing notice form. In other cases, borrowers have almost no way of finding out that the Department or guaranty agency might reduce the amount collected due to hardship.

4. Some collectors have argued that the 15% limit on the amount that can be collected through administrative wage garnishment applies to each loan individually rather than cumulatively.

[103] 31 U.S.C. §3716. See discussion in section (D) below.
[104] 31 U.S.C. §3716(c)(3)(A)(ii).
[105] Lockhart v. U.S., 126 S. Ct. 699 (2005).

5. Collectors use the tax intercept program to seize earned income tax credits (EITCs). The EITC is based on income and household size and is only available to lower income working families with children.

These examples show that the unprecedented expansion of government collection powers conflicts at some point with other social goals. For example, it is counter to the goals of Social Security to allow the government to seize a person's Social Security payments, her lifeline, to repay old loans. The same problem arises with the EITC, one of the most highly touted anti-poverty programs.

POSSIBLE FIXES TO IMPROVE EXEMPTIONS:

1. **Eliminate offset of Social Security and other federal payments to collect federal debts.** This program undermines the social interest in preserving the health and well-being of elder and individuals with disabilities.

2. **Until #1 is adopted, Congress should at a minimum do the following:**

   a. Increase the amount of Social Security benefits exempted from offset to equal at least 150% of poverty and provide for annual cost of living increases.

   b. Clarify that the ten year limit applies to student loan collections.

   c. Exempt the most vulnerable Social Security recipients from the offset program, including those over an advanced age such as 75 or those who are severely disabled.

3. **Exempt the EITC from the tax refund offset program.**

4. **Clarify that the 15% limit on administrative wage garnishment is a maximum regardless of the number of loans being collected.**

5. **Establish consistent standards for hardship defenses for all of the collection programs.** Publicize these standards in collection notices, hearing notices, and on the Department's web site. These notices should not only set out the criteria to establish hardship and the available relief, but also include detailed instructions on how to apply for this relief.

VIII. INFORMATION AND OUTREACH

The default prevention section above highlighted the importance of communicating information to borrowers prior to default. It is equally critical that borrowers in default receive accurate and adequate notice about their options. It is also essential that this information be communicated by objective, non-profit, third party counselors who are trained on the unique rights available through the student loan programs.

One problem is that even well-intentioned agencies often give out erroneous information. For example, one guaranty agency states on its web site that borrowers lose forbearance rights after default.[106] In fact, the regulations clearly state that forbearance is intended to prevent defaults <u>or</u> permit borrowers to resume honoring their obligations after default.[107]

This is presumably an honest error, but in other cases, collection agencies have been sued and challenged for intentionally misleading borrowers in order to pressure them into choices that benefit the collectors, rather than the borrowers.[108] The same problem occurs in the credit counseling world, which although non-profit, is largely funded by creditors. As a result, many credit counselors are reluctant to advise consumers about their full range of loss mitigation options, including bankruptcy.

Ombudsman offices established at guaranty agencies and government agencies can be helpful as long as they are properly supported and as long as there is rigorous oversight of their activities. There are a number of innovative programs at guaranty agencies and at the federal Department of Education. Anecdotally, we have found that the federal Ombudsman and her staff are often very helpful in resolving borrower complaints. However, these cases involve borrowers with legal representatives. It is unclear to what extent unrepresented borrowers are aware of the ombudsman office and able to successfully access these services.

In one case, for example, an attorney representing a low-income borrower in Minnesota called the federal ombudsman office. The borrower had defaulted on her loans and was facing wage garnishment. The attorney was referred to a borrower services office in Chicago. This office contacted the collection agency, which had refused to work out an affordable repayment plan with the borrower and her attorney. The collection agency was insisting on a minimum monthly repayment of over $800/month. Ultimately, the consumer and the Department agreed to a voluntary repayment plan of $125/month. The plan was part of a loan rehabilitation.

Further evaluation is needed to assess the effectiveness of these various ombudsman and borrower assistance programs. There are a number of key issues to consider. First, many programs are affiliated with lenders, guaranty agencies, or government agencies. Although they are generally well-intentioned, these agencies are not necessarily working first and foremost in borrowers' interests. The agencies generally claim to be both borrower advocates and impartial mediators. In fact, these roles may conflict. For example, a counselor affiliated with a lender or guaranty agency is unlikely to give unbiased advice about loan cancellation or bankruptcy. A second question is whether the counselors are sufficiently trained to understand the full rights available to borrowers. Are they also trained to understand how student loan debt fits into a borrower's overall budget?

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[106] https://www.mygreatlakes.com/ind/staticForwardFAP.do?staticpath=/guaranty/leaf/consequences.html (last checked June 2006).
[107] 34 C.F.R. §682.211(a)(1). In this case, the forbearance agreement must include a new signed agreement to repay the debt.
[108] See generally National Consumer Law Center, Student Loan Law ch. 4 (2d ed. 2002 and Supp.).

In the meantime, the private sector is beginning to step in to fill the void. Companies that sell other types of "debt relief" are now selling their services to student loan borrowers. The danger is that these companies will engage in the types of abusive practices that have been prevalent in the debt relief, debt settlement, and credit repair industries.[109] There is evidence that these problems have already begun. One of these companies recently sent a contract to a student loan borrower that required fees of $325 up-front and $325 within one month just to initiate the "fact finding" portion of their services. They also require customers to sign a power of attorney, granting authority to the company to act on the consumer's behalf. It appears that the promised services consist mainly of helping the borrower apply for loan consolidation--a service that the consumer can do for free on her own.

It is deeply troubling that consumers are so overwhelmed and feel that they have nowhere to turn except to pay outrageous fees to companies that are not necessarily well-trained on student loan issues. As recommended below, it is critical to begin building a network of non-profit, objective counselors to help these borrowers. To the extent some of these programs already exist, greater evaluation and outreach is needed to make sure that the programs are unbiased, high-quality and effective and that borrowers know about them. At the same time, the various recommendations in this paper will help to simplify the relief process so that more borrowers can achieve results on their own.

POSSIBLE FIXES TO IMPROVE INFORMATION AND OUTREACH:

In addition to improving the substance of the student loan safety net, it is essential to alert borrowers about it and ensure that there are neutral, objective counselors available to help with follow-up. In addition to strengthening effective existing programs, Congress should fund a pilot project that sets up a neutral, non-profit entity to provide assistance to borrowers in trouble. Private funders could also offer assistance.

Counselors should be under the supervision of a lawyer or other professional who is knowledgeable about student loan law and keeps up with new developments. This is because, as discussed above, even well-intentioned counselors may give erroneous advice about the often complex student loan programs. The pilot project is a first step toward building a strong network of student loan counselors.

It may be possible to give funding to already existing borrower assistance, counseling or legal services agencies. However, these agencies must be truly non-profit and should not receive high levels of funding from creditors or collectors. In addition, the difference between agencies that act as mediators and agencies that act as borrower advocates must be clearly delineated. These are different types of services that overlap and complement each other, but also come into conflict at times.

A critical first step in building an adequate borrower assistance network is to evaluate the existing federal, state and guaranty agency ombudsman programs and other borrower assistance services to assess which programs are effective and why.

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[109] See, e.g., Deanne Loonin, National Consumer Law Center, "An Investigation of Debt Settlement Companies: An Unsettling Business for Consumers" (March 2005), available at: http://www.nclc.org/action_agenda/credit_counseling/content/DebtSettleFINALREPORT.pdf.

IX. ENFORCING BORROWER RIGHTS

A. Private Enforcement

At some point, the Department and/or Congress may implement some of the suggestions in this paper in an effort to better protect borrowers. Although this is a useful first step, a critical second step would still be missing. For example, what if the lender, guaranty agency, or school refuses to discuss loan rehabilitation even when a borrower clearly has a right to such a plan? Currently, the borrower can complain to the Department of Education. Given documented problems with the Department's oversight, this is less than a complete solution even for those borrowers who persist and manage to speak to someone at the Department. Beyond complaining to the Department, it is virtually impossible for a borrower to enforce her rights.

The main barrier is that courts have consistently held that there is no private right of enforcement under the Higher Education Act (HEA). Borrowers may access the courts in some cases only when appealing adverse decisions. Even here, as discussed below, a technicality allows review of Department decisions, but not guaranty agency or lender decisions. In addition, in some cases, borrowers can attempt to bring private cases by asserting violations of the HEA under state unfair and deceptive practices laws. There has been mixed success in this area.[110]

Largely by default, most private enforcement of student loan violations, to the extent it occurs at all, is through the federal and state debt collection laws. The federal law is the Fair Debt Collection Practices Act (FDCPA).[111] This type of enforcement is most appropriate and useful when abusive and harassing debt collection agency conduct is involved. However, there are severe limitations to using this law to enforce borrower rights. First, the laws do not apply to all collectors. It applies to third party debt collectors, but not to the Department. It is unclear whether the law applies to guaranty agencies.

Further, the FDCPA is an indirect way of obtaining relief. It is intended to address collection abuses. A collection agency's failure to offer a particular repayment plan or otherwise comply with the HEA is a violation. However, the available remedies are monetary damages. These can be extremely useful, but they do not help borrowers get the repayment plans or discharges to which they are entitled. It is also unclear whether injunctive relief is available through the FDCPA.[112]

Another impediment to enforcement of rights occurs when schools violate the law, but then file for bankruptcy or close. The question is to what extent creditors should be liable for the violations of schools.

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[110] See generally National Consumer Law Center, Unfair and Deceptive Acts and Practices §3.2.7 (6th ed. 2004 and Supp.).
[111] 15 U.S.C. § 1692.
[112] See generally National Consumer Law Center, Fair Debt Collection §6.9 (5th ed. 2004 and Supp.).

One key enforcement mechanism to extend liability to certain creditors is through the Federal Trade Commission (FTC) Holder Rule.[113] The rule operates by a notice being placed in consumer credit agreements stating that the consumer can raise seller-related claims and defenses against the holder of the note or contract. In general, the notice must be inserted when the seller finances a sale or when a creditor has a relationship with the seller and that creditor finances the sale. The notice is a simple statement that any claim or defense the consumer has against the seller constitutes a claim or defense against the loan.

Truly nonprofit schools fall outside the FTC's jurisdiction and are not covered by this Rule. In contrast, for-profit schools are covered when they extend credit themselves or refer the consumer to a particular lender. The FTC and the Department of Education have affirmed that the Holder Rule applies to government loans. As of January 1, 1994, all FFELs use a common promissory note which includes an adaptation of the FTC Holder Notice.

Despite the inclusion of this notice in government loans, borrowers have been required to jump through numerous hoops and initiate time-consuming complex lawsuits in their efforts to hold lenders responsible for school level abuses. This problem is alleviated to some extent by Department regulations that provide at least some of the protections of the Holder Notice. For example, Direct Loan regulations state that in any collection proceeding, the borrower may assert as a defense against repayment any act or omission of the school that would give rise to a cause of action against the school under applicable state law.[114] It is less clear whether FFEL borrowers have similar rights.

Borrowers with private loans are less protected and can be especially disadvantaged when trying to hold lenders liable for abuses of unscrupulous schools. In this context, there is ample evidence that many lenders use the schools to solicit loans. The lenders coordinate the process and provide the loan documents to the schools. They are working together. Given these relationships, schools should be including the FTC Holder Notice, but they do not always do so. In other cases, they include the notice, but negate it with a clause that states that loans are always enforceable by the lender. Lenders have been creative in attempting to evade this law, including arguing that they are not subject to FTC jurisdiction if they are national banks.[115]

POSSIBLE FIXES TO IMPROVE PRIVATE ENFORCEMENT OF BORROWER RIGHTS:

1. **Congress should specify that borrowers and other parties with standing have a private right of action to enforce the HEA.**

2. **The Department and other relevant state and federal agencies, including the Federal Trade Commission (FTC), must ensure that lenders and schools that are required to do so are complying with the FTC Holder**

[113] 16 C.F.R. §433.2.
[114] 34 C.F.R. §685.206(c)(1); 20 U.S.C. §1087e(h).
[115] See Tom Domonoske, The Finance Industry Fuels Revival of Trade School Scams, The Consumer Advocate (Oct/Nov/Dec 2003).

Rule. Enforcement and oversight is especially important in the private student loan context.

3. **Ensure that borrowers in all of the loan programs have the same rights as Direct Loan borrowers to assert defenses against repayment based on school abuses.**

B. **Appellate Rights and Due Process**

Borrowers must be allowed to exercise their due process rights to raise defenses and appeal collection actions. The problem is that many rights that exist in the regulations do not exist in practice. The typical student loan debtor will usually get a notice of government collection action. Obtaining more information, however, can be a monumental task. Getting through by phone to the Department of Education (or Treasury) and speaking to a live person is a difficult process at best. In all too many cases, the contact is with a collection agent who knows nothing about borrower rights and is most interested in getting the borrower to pay as soon as possible.

In those cases where a hearing does occur, it is usually held before an employee of the collection agency or possibly an employee with the Department's collection department. These are hardly neutral forums. In general, only the savviest of consumers can figure out how to navigate the Department's website and perhaps figure out how to challenge a particular collection process. Everyone else ends up mired in a process that is inconsistent and difficult to navigate. The consumer will certainly have trouble trying to learn the full range of rights and defenses by reading the form collection notices sent by the Departments of Education and Treasury. At worst, these notices focus on options that are most advantageous for the debt collectors--such as loan consolidation--rather than providing information about all available defenses and repayment options.

Further, borrower rights to appeal vary depending on which entity makes the decision. For example, in one case, a borrower facing wage garnishment requested a hearing to raise, among other defenses, problems with the calculation of collection fees. The guaranty agency conducted the hearing pursuant to authority granted by the Higher Education Act. Since the decision was issued by the guaranty agency, the borrower was denied further review. However, if the decision had been issued by the Department, the borrower would have been able to seek judicial review.

POSSIBLE FIXES TO IMPROVE APPELLATE RIGHTS:

Appeal Rights

1. **Congress should require all student loan collectors to report not only on dollars collected, but also on how they are complying with the notice and hearing provisions of the Debt Collection Improvement Act (DCIA).**

2. **All agencies must develop and enforce regulations that meet constitutional and statutory due process standards.** At a minimum, collection notices should inform consumers that they might have defenses to payment of the

debt, that they have a right to set up reasonable and affordable payment plans, and that they may request a hearing.

3. **All collection notices and the Department's web site and other information sent to borrowers should include a toll-free phone number that borrowers can use to find out about their rights.** This program could be developed in coordination with the existing Student Loan Ombudsman office. In addition to the government program, we advocate developing a pilot project that sets up a neutral, non-profit entity to provide assistance to borrowers in trouble. (See § VIII).

4. **Each agency must establish fair hearing procedures that are truly fair.** Fair hearing includes the opportunity for consumers to choose from a list of neutral arbiters, easy access to records and reports related to their case and the opportunity to present testimony by phone if the closest agency forum is inconvenient. Agencies must require hearing officers to tape proceedings and to make transcripts available when requested by borrowers. These minimal due process standards have been routine for many years at most government agencies.

5. **The Department must not delegate inherently governmental functions, such as conducting fair hearings, to third party debt collectors.** Private debt collectors are not trained to understand and stay current on the latest agency rules and regulations. They are trained to collect money. If a borrower informs a collector that he believes he has a defense to the debt, that the amount is wrong, or that he wants to request a hardship waiver, the file should be immediately sent back to the agency.

6. **Amend the law so that it is clear that borrowers are able to appeal adverse actions taken by guaranty agencies and other entities as well as actions taken by the Department.**

CONCLUSION

The student loan programs work well for many students who are able to complete their educations and earn sufficient income after graduation to repay their debts within a reasonable period of time. Unfortunately, this scenario is becoming less common as borrowers get deeper into debt earlier in the process and do not know about available, if limited, options that could help them avoid problems down the road. Once these problems begin, collection costs and fees accrue so rapidly and aggressive collection efforts hit so hard that many borrowers never recover.

This paper describes these problems and points out the ways in which current policies fail to offer sufficient relief for borrowers. Suggested policy reforms are included throughout the paper. These recommendations are intended to ensure that borrowers who are able to repay are encouraged to do so and given the flexibility to repay at affordable rates. The proposed policy changes would also provide more adequate relief for borrowers who are temporarily or permanently unable to repay.

While the student loan programs are here to stay, there are ways to alleviate the burden for the most vulnerable and lower income borrowers. Our higher education system and economic productivity depend on how we resolve these issues.