

Statement of
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Subcommittee on Administrative Oversight and the Courts

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Mr. Chairman, Senators, Ladies and Gentlemen.

My name is Marcus Cole, and I am the William Benjamin Scott and Luna M. Scott Professor of Law at Stanford University, where I teach courses in commercial and financial law and regulation. My areas of research include bankruptcy, venture capital, and banking regulation, with a focus on the law and economics of regulatory structures and institutions. I have been invited to comment upon the proposed amendment to the Bankruptcy Code that would eliminate the exemption from discharge currently enjoyed by private, for-profit student loan obligations. While I am, like most Americans, sympathetic to the plight of consumer debtors, I hope to raise, for your consideration, what I think are the likely and undesirable consequences of the removal of the exemption.

In short, I think that the removal of the exemption from discharge of privately placed student loans will result in a dramatic increase in the cost of student loans for all student borrowers, ultimately “drying up” the availability of such loans for those who need them most. If the goal is to relieve the debt burden upon student borrowers who have taken on student debt that did not result in higher productivity and earnings potential, removal of the exemption is a blunt instrument that is unlikely to address the root source of the problem, accomplishing instead a one-time, unjust transfer from innocent lenders who did nothing more than give money to people in the hopes of being repaid someday. This would be a one-time wealth transfer because, if it were to occur, the likely effect would be to chill or discourage student lending entirely, resulting in a “drying up” of student loan markets. If it is not your goal to limit access to higher education, then perhaps you might want to consider alternatives to achieve your goal. I mention some of the alternatives near the end of my statement.

To explain why removal of the exemption would have the effect of drying up the availability of student loans, I would like to break the analysis into three parts:

First, I would like to explain the three different types of lending that are available to borrowers in our economy, and how they differ from each other. Most importantly, I want to explain how student loans are fundamentally different in nature from either secured loans or other types of unsecured loans.

Second, I would like to describe the basic components of interest rates, how they are associated with various risks, and why interest rates might be higher or lower for different borrowers. Because interest rates necessarily must reflect the risk that the lender will not be repaid, the removal of the discharge exemption from privately funded student loans will necessarily increase the risk that student loan lenders will not be repaid, and this risk will, necessarily, be reflected in the risk premium component of interest rates borne by all student loan borrowers.

Finally, I would like to explore alternative ways to get at the problem I think you are trying to address, namely, the level of student debt that does not result in higher graduate incomes, but instead imposes a seemingly insurmountable debt burden on those students whose aspirations of a higher income and a better life never materialized. In particular, there are two alternatives that would be more narrowly tailored toward achieving what I think is your goal, without the harmful unintended consequences that are likely to result from a removal of the exemption for privately funded student loans.

I. The Three (Not Two) Types of Credit in Our Economy

Everyone, I think, is familiar with the two most basic forms of credit in our economy, namely, secured and unsecured credit. Most debt obligations incurred in our society are unsecured, meaning that when one person owes another person money, the person to whom the debt is owed looks to the general ability of the person owing the debt to repay it. An unsecured creditor does not have special rights associated with any one particular asset of the debtor, but has to take his or her chances that the debtor will repay either out of the debtor's current assets, or from the debtor's income. And when it comes to getting repaid, an unsecured creditor must take his or her chances alongside other unsecured creditors, hoping and expecting there is enough income or assets to pay all of them in full.

Secured creditors are different. They don't want to take their chances with respect to whether they will get repaid. They take measures to reduce the risk that they won't get paid. Instead of looking to the debtor's assets in general, a secured creditor insists upon "collateral" before extending the loan. By taking a security interest in a particular asset, a secured creditor has all the same rights of an unsecured creditor, but also acquires two rights that unsecured creditors do not enjoy.

First, in most states, a secured creditor has the right of "self-help." When a lender on a car note repossesses a car parked on the street in the middle of the night because the borrower failed to repay, the car note lender is exercising self-help. Self-help is an important right to be sure, but it is by no means the most important right of a secured creditor. That honor falls upon the secured creditor's right of priority with respect to the particular asset, or "collateral," in which the secured creditor has a security interest. This second right of secured creditors is what makes secured credit less risky for the lender, and in turn, less expensive for the borrower.

The key difference between unsecured credit and secured credit is that one type (unsecured) looks to the debtor's assets generally for repayment, while the other (secured) looks to a particular asset of the debtor to ensure repayment of the obligation. But the one thing these two types of credit have in common is that they *both look to the debtor's present ability to repay as the basis for pricing and extending the loan in the first place.*

Student loans are fundamentally different from either secured or unsecured credit. While on the surface they look indistinguishable from other forms of unsecured loans, they are extended on a completely different basis. While most other forms of unsecured credit are extended on the basis of a debtor's present ability to repay, *student loans are unique in that they are based upon the debtor's projected future ability to repay.*

The purpose of a student loan is to increase the borrower's *human* capital, and a resultant increase in the borrower's productivity and earning potential. The only asset most student borrowers can pledge to a lender in order to provide an assurance of repayment is their *future* earnings potential. A student approaching a lender in a world where there is no exemption from discharge for student loans has a problem: "How do I get a lender to believe me when I say I will repay my student loan, given that I have no other assets to pledge other than my future income?" A lender approached by this student has very little incentive to lend to the student except at an astronomically high interest rate, to reflect the risk of not being repaid. A student without means, then, faces the prospect of either not being able to access higher educational at all, or accessing it at astronomically high costs.

Fortunately, Congress rescued millions of students like this (and like me, once) by making it difficult to discharge student loans in bankruptcy. Because student loans are difficult to discharge, a student borrower can credibly commit to repay the student loan. Furthermore, the lender, confronting a lowered risk of default, can charge a drastically lower rate of interest for the loan. This lower interest rate, in turn, makes the loan, and the education for which it pays, much more affordable for the student borrower.

II. The Increased Interest Rate Resulting From Removal of the Discharge Exemption for Private Student Loans

The next question may be "why does the dischargeability of a loan affect the interest rate associated with it?" The answer stems from the fact that money is fungible. If we put two twenty-dollar bills next to each other, no one would be able to tell which was mine and which belonged to you. In fact, money is the most fungible commodity in the world. Like all fungible commodities, the buyers and sellers all exist in a competitive market. Money from one supplier is just as good as money from any other supplier. And any borrower who needs that money is just as happy, if the terms are equivalent, to get that money from one supplier as from any other.

The question that follows is "but if it is true that money (credit) markets are competitive markets, then why do different borrowers face different terms from

lenders?” The answer is that while there is a competitive “market” price for money, there is also an “insurance premium” that must cover the risks that a lender will not be repaid. In fact, there are essentially two risks associated with any one borrower’s willingness and ability to repay a loan, namely, “industry risk” and “borrower-specific risk.”

Industry risk is the risk associated with the type of business, trade, or industry in which a particular borrower earns his or her income. A smart-phone manufacturer, for example, has a different industry risk profile than a manufacturer of VHS video recorder machines. Both companies may be “creditworthy,” in that they always pay their bills on time, and that they do not borrow more than they can feasibly repay. Nevertheless, a lender approached by these two manufacturers would charge a higher interest rate to the VHS machine manufacturer to reflect the risk that there may be no VHS industry a year from now.

Borrower-specific risk is the risk that *this particular borrower* brings to the credit relationship. You may have two borrowers with identical job titles or in the same industry, but one has a history of paying his or her bills on time, while the other does not. For this reason, the more creditworthy borrower will be confronted with lower borrowing costs than the less creditworthy borrower.

The interest rate associated with any loan, then, can be said to consist of at least three simple components, namely, (1) the “natural” interest rate (the market price for or time value of money); (2) the industry specific risk associated with this particular borrower; and (3) the borrower-specific risk associated with this particular borrower. There is virtually nothing a lender or borrower can do to reduce or eliminate the “natural” interest rate component of the interest associated with their loan. But there are some things that can be done to lower or eliminate industry risk, and even more that can be done to lower borrower-specific risk.

To lower industry risk, the economic uncertainties associated with particular *types* of borrowers in a particular industry must be addressed somehow. This is *precisely* what Congress did to lower student loan interest rates when it exempted them from discharge in bankruptcy. This meant that any student seeking a student loan, without regard to his or her own, personal creditworthiness, could credibly commit to a lender that he or she would repay the loan. Since the loan could not be discharged in bankruptcy (without great difficulty and uncertainty), the risk of loss to the lender is dramatically lowered, and the lender, like all competing lenders, would be able to reduce the risk premium and resultant interest rate associated with all student loans.

The next question must be, “Does this mean that repealing the exemption from discharge from student loans will cause their interest rates to rise?” All else being held equal, the answer is, emphatically, “yes.” Without the assurance of repayment afforded by the exemption from discharge, there is little a student can use to assure a lender of repayment. Removal of the exemption removes every student’s ability to make a *credible* commitment regarding their willingness and ability to repay from their future earnings. The resultant increase in the risk premium could make student loan interest rates usurious. In other words, interest

rates on student loans can go so high that no lender could legally offer student loans, even if there existed rational lenders willing to take on the new risks.

But repeal of the exemption from discharge would do far more than just increase interest rates and dry up the availability of student loans. It would also change the rules in the middle of the game for lenders who lent with the expectation that they would get repaid without fear of discharge in bankruptcy. The effect of a repeal upon these lenders would be an instantaneous transfer of wealth from the lenders to the borrowers, without the lenders having done anything wrong to be deprived of their right to repayment.

Even if Congress was to attempt to reverse the repeal after witnessing the inevitable effects upon student loan markets, the damage will have been done to the confidence of potential lenders. Any potential lender considering lending to students will price into their loan a risk premium associated with the behavior of Congress. The knowledge that Congress changed the rules of the game before “half-time” bears the risk that it might do so again, and again.

III. Possible Alternative Approaches to Address Underproductive Student Loan Debt

The final question might be, “if Congress does not remove the exemption for private, for-profit student loans from discharge in bankruptcy, then how can overburdened student borrowers find relief from their debt burdens?” The answer to this depends upon whether we are concerned with past or future borrowers.

For borrowers who have already taken on student debt for which they find themselves unable to repay, there exists a “hardship” test that will allow, in exceptional cases, the discharge of student loan debt in bankruptcy. The test for hardship is not spelled out with clarity in the bankruptcy code, and as a result, varies from district to district across the country.¹ Whether Congress wishes to make this test uniform is not a matter about which I have a strong opinion. From my discussion above, regarding the need for student borrowers to have the ability to make credible commitments, it stands to reason that the hardship test should not be made easier to satisfy.

A more just solution than simply punishing lenders for giving money to people would be to place the burdens of student borrowers upon all taxpayers.

¹ Different courts use different tests to determine whether a particular student loan borrower has shown an undue hardship. One frequently-used standard is the *Brunner* test, which requires a debtor to show that 1) the debtor is unable to maintain, with current income and expenses, a “minimal” standard of living for the debtor and the debtor’s dependents if forced to repay the student loans; 2) additional circumstances exist indicating that this state of affairs is likely to persist for much if not all of the repayment period remaining on the student loans; and 3) the debtor has made a good faith effort to repay the student loans. (*Brunner v. New York State Higher Educ. Servs. Corp.*, 831 F. 2d 395 (2d Cir. 1987).

Whether the lenders, who did nothing wrong, or the taxpayers, who did nothing wrong, shoulder this burden, the goal of relieving debtors from the burden of student loan debt would be achieved, but without the economic consequences of discouraging lenders from lending in the future.

A more targeted approach to the problem of student borrowers with more debt than acquired human capital would be to look at *why* their borrowing did not result in increased human capital sufficient to repay the loan. Did their institutions of higher learning, trade schools or other educational institutions defraud them, making false promises of a better future? Or did they find their studies too difficult, or change their minds about their goals and aspirations? An inquiry like this might be more fine-tuned to the problem to be addressed than the blunt instrument of a sweeping amendment to the bankruptcy code.

In addition to the aforementioned approaches, there are two other, more novel approaches that might be entertained by Congress. The first would be to internalize the cost of “bad” educational lending upon the lenders themselves by forcing them to do what all lenders do in the contexts of secured and unsecured lending alike. All mortgage lenders, for example, insist upon a home appraisal before making a home loan. Similarly, all car note lenders insist upon a valuation of the car securing the note. Even unsecured lenders will seek information about assets and income before lending on an unsecured basis.

In the context of student loans, Congress may wish to require private student lenders to assess the earnings potential of any student borrower associated with any particular educational institution. If the student loan is to be used to pay for an education that has proven in the past to be of little value in the market place, then perhaps the lenders themselves ought to bear the cost of helping such institutions remain open. Toward this end, a hardship test that revolved around the quality of the educational institution and its track record might target the problem of fraudulent schools.

A different, more creative approach can be borrowed from Europe. Although there are very few private universities in Europe, there are some, and many of these have helped students finance their education in ways we might find quite novel. For example, Bucerius Law School in Hamburg, Germany, is the first and only private law school in Germany. Since performance on the German state examination is public record, the reputation of Bucerius has been catapulted to the very top of the German legal academy due to the performance of Bucerius graduates on these examinations. And since there are few charitable foundations in Germany supporting Bucerius and its mission, much of Bucerius’ operations are financed through tuition.

But not all Bucerius students can afford the steep annual cost of tuition at the school. For those who cannot, Bucerius makes a deal: instead of paying annual tuition now, agree to pay a fixed percentage of your future income over a capped period of time after graduation. The more money a Bucerius graduate earns, the more money the school receives from its graduates. The reverse is also true. If a Bucerius graduate struggles financially after graduation, Bucerius will receive that same fixed percentage of the graduate’s income, however low it might be.

The one thing that makes the Bucerius “future income arrangement” work, of course, is that the obligation to repay the school is not dischargeable in bankruptcy.

Universities and colleges in the United States, including the chancellors of the University of California, are reportedly exploring similar arrangements. One hurdle they will confront, however, is the question of whether such arrangements are dischargeable in bankruptcy. To the extent that they are, there is little chance that these creative solutions to the problem of investing in human capital will ever take root.

In summary, I am very sympathetic with the plight of debtors overburdened by student loans that did not do what the loans were supposed to do, namely, to make the students lives better and more productive. I myself grew up in the Terrace Village Housing Projects of Pittsburgh, Pennsylvania, and I could not have imagined going to college without the help of student loans. But I would never have had access to student loans, or the college education they made possible, if my lenders did not have the assurance that they would be repaid from my future income. Although I was completely unaware of it at the time, Congress gave me the power to make a credible commitment to my student loan originators, and I would not be here before you today if it were not for the education my country made possible for me through student loans.

Thank you very much for this opportunity to testify before you.