THE STUDENT LOAN BUBBLE: HOW THE MORTGAGE CRISIS CAN INFORM THE BANKRUPTCY COURTS

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Great is Bankruptcy: the great bottomless gulf into which all Falsehoods, public and private, do sink, disappearing; whither, from the first origin of them, they were all doomed.
– Robert Carlyle

INTRODUCTION

Like many great bubbles throughout history, the bubble of student loan debt currently being inflated started with an "always." For mortgages, it was the "always" of rising housing prices; for tulips, it was the "always" of their appeal and worth; for technology firms, it was the "always" of the growing potential of the Internet. Now we're faced with the "always" that a college degree will always be worth it. However, many Americans, including a vast number presently "occupying" various parks and cities across the United States, are discovering that a degree, either from a public, private, or for-profit school may not be worth it. In a country with prolonged unemployment over eight percent[1] and underemployment in the sixteen percent[2] range, many graduates are coming to the harsh realization that their degree in finance, English, marketing, or dental hygiene are not quite worth what they were advertised to be. As the classic bubble model of an increasing rate of capital being poured into a depreciating asset continues, combined with a cohort default rate that has increased steadily in the past decade, the student loan bubble and a possible collapse of the student loan becomes an even starker reality.

This paper parallels the current student loan bubble with the housing bubble of the late 1990s to early 2000s. The mortgage bubble was the quintessential example of a bubble that was destined to burst. Easy access to large amounts of capital, with few borrowing requirements, being put into an asset with grossly overstated values, created a situation where a bubble couldn't help but form. Accelerating factors, like prolonged unemployment and underemployment, and the failure of the Home Affordable Modification Program (HAMP), only hastened and enhanced the economic ramification of the burst. This paper

[1] *See Economic Data: Civilian Unemployment Rate*, ST. LOUIS FED. RES. BANK (Jan. 4, 2013), http://research.stlouisfed.org/fred2/data/UNRATE.txt.

[2] Neil Shah, *Which States Have Worst Underemployment?*, WALL ST. J. BLOGS (July 30, 2012, 1:34 PM), http://blogs.wsj.com/economics/2012/07/30/which-states-have-worst-underemployment/.

looks at the government and private sector responses to the mortgage crisis and presents a bankruptcy court solution that would be more successful than HAMP, in the event of a student loan default crisis.

I. THE EVOLUTION OF STUDENT LOANS

The modern student loan apparatus came about during the 1960s and 1970s.[3] What would become Perkins loans, Stafford loans, and Pell grants, were all part of a deliberative government policy aimed at increasing access to higher education for American students.[4] Over the past few decades, these programs have seen their funding expanded, partly adding to the rise in tuition. Federally subsidized loans, the largest program aimed at students, allowed banks to lend money to students while the United States Treasury provided a backstop in the case of default.[5] The government has made a clear policy choice to promote higher education by codifying it in policy and law. Student loans, pushed by the government, are given preferential tax treatment through credits and above-the-line interest deductions.[6] These policies have created a market that now tops $1 trillion, and is expanding at an increasing rate.[7]

II. THE MYTH

A number of bubbles start with some sort of myth about the asset.[8] The housing market started with a small myth: that

[3] *See* Daniel de Vise, *House Approves Huge Changes to Student Loan Program*, WASH. POST, Mar. 22, 2010, at A01, http://www.washingtonpost.com/wp-dyn/content/article/2010/03/21/AR2010032103548.html.

[4] *See id.*

[5] These loans are now entirely provided through the government. *Id.*

[6] *See* I.R.C. §§ 25A–25B (2006).

[7] *See* ROBERT B. ARCHIBALD, REDESIGNING THE FINANCIAL AID SYSTEM: WHY COLLEGES AND UNIVERSITIES SHOULD SWITCH ROLES WITH THE FEDERAL GOVERNMENT (2002); LAWRENCE E. GLADIEUX & ARTHUR M. HAUPTMAN, THE COLLEGE AID QUANDARY: ACCESS, QUALITY, AND THE FEDERAL ROLE (1995); DEREK V. PRICE, BORROWING INEQUALITY: RACE, CLASS, AND STUDENT LOANS (2004) (further discussion on the development of student loans); Andrew Martin & Andrew W. Lehren, *A Generation Hobbled by the Soaring Cost of College,* N.Y. TIMES, May 12, 2012, http://www.nytimes.com/2012/05/13/business/studentloans-weighing-down-a-generation-with-heavy-debt.html.

[8] It is important not to think of student loans as inseparable from the education, but as an unsecured debt instrument. In this regard they are very different from mortgages, which are secured by the domicile.

housing prices would never go down. As market data shows, this wasn't entirely speculation since housing prices between 1940 and 2000 went up dramatically.[9] The median home value in the United States quadrupled from $30,600 to $119,600.[10] More notably, housing prices in every single state increased dramatically.[11] These historic trends fueled the myth that housing prices never fall.

The real story of the housing crash begins to unfold between 2000 and 2007.[12] During that time, home prices in the United States increased 89%.[13] Several factors went into this increased price: a glut of inventory from construction, easy credit, and the idea that homes were good investments. As Greg Ip wrote in an Op-Ed for the Washington Post, few things did more to promote the housing market collapse than the notion that housing prices always go up.[14] This didn't only affect the mentality of the buyer, but also the mentality of the lender. As Ip notes, a mortgage lender is unlikely to turn down a borrower with poor credit and a bad income ratio if the value of the property securing the loan would always increase.[15]

The Siren's Song of ever-increasing housing prices was also heard by former Federal Reserve chairman Alan Greenspan, who remarked, "[a] national severe price distortion seems most unlikely."[16] Given that home prices have fallen 30% from the peak of the market, it is fair to say that housing prices do in fact go down.[17] The mortgage market provides a great lesson on how a

[9] *Historical Census of Housing Tables Home Values*, HOUS. & HOUSEHOLD ECON. STAT. DIV., U.S. CENSUS BUREAU, *available at* http://www.census.gov/hhes/www/housing/census/historic/values.html (last revised June 6, 2012).

[10] Adjusted to 2000 dollars to account for inflation. *Id.*

[11] *Id.*

[12] Based on the availability of data, all post-2000 home price numbers will come from the Case-Shiller Index. For a discussion on housing price methodology, *see* Chaitra H. Nagaraja, Lawrence D. Brown & Susan M. Wachter, *House Price Index Methodology* (Wharton U. Pa. Stat. Dep't., Working Paper, 2010) *http://www-stat.wharton.upenn.edu/~lbrown/Papers/2011e%20Housing%20Price%20 Index%20Methodology.pdf*.

[13] WENDELL COX, NAT'L CTR. FOR POLICY ANALYSIS, THE HOUSING CRASH AND SMART GROWTH 1, 7, 11(2011), http://www.ncpa.org/pdfs/st335.pdf.

[14] Greg Ip, Op-Ed., *Housing Prices Always Rise*, WASH. POST, Dec. 20, 2009, *available at* http://www.washingtonpost.com/wp-srv/special/opinions/outlook/worst-ideas/housing-bubble.html.

[15] *Id.*

[16] *Id.*

[17] Morgan Brennan, *The Best Cities to Buy a Home Right Now*, FORBES (Apr. 12, 2012, 11:36 AM), http://www.forbes.com/sites/morganbrennan/2012/04/12/the-best-cities-to-buy-a-home-right-now/.

misconceived notion can have devastating effects when it is held by a majority of the population and has an ever-increasing proportion of United States capital going into it.

The student loan market faces a very similar myth: the myth that it is always economically sound to get a college degree. Much like the idea that housing prices will always increase, this myth is backed by historical data. However, the mortgage market collapse proved the big difference between "never going to happen" and "hasn't happened yet."

Historically, each level of educational attainment has increased the earning capacity of the individual at an increasing rate. Between 1975 and 1999, an individual with a bachelor's degree went from earning 1.5 times the income of a high school graduate to earning 1.8 times the salary of a high school graduate.[18] Over the same period, those individuals with advanced degrees went from earning 1.8 times the average salary of a high school graduate to 2.6 times that of a high school graduate.[19] This represents an increase of nearly 50%.[20] These trends cut across race and gender, and on the whole, historically, advanced education has been worth it.[21]

These trends also exist in the unemployment data. Unemployment for those with a high school degree stands right near the national average of 8.1%,[22] while those with a bachelor's degree have an unemployment rate of 3.8%.[23] This 50% drop is significant as it represents 1.2 million individuals who were

[18] JENNIFER CHEESEMAN DAY & ERIC C. NEWBURGER, THE BIG PAYOFF: EDUCATIONAL ATTAINMENT AND SYNTHETIC ESTIMATES OF WORK-LIFE EARNINGS, *in* CURRENT POPULATION REPORTS 3–4 (2002), http://www.census.gov/prod/2002pubs/p23-210.pdf.

[19] *Id.* This refers to advanced degrees such as J.D., M.D., M.S., etc.

[20] *Id.* The same is true for lifetime earnings. A high school graduate can expect to make $1.2 million in the course of his or her working life, while someone with a bachelor's degree will make $2.1 million, and someone with a professional degree will make $4.4 million (all dollar values in 1999 dollars). *Id.*

[21] *See United States Census Quick Facts*, U.S. CENSUS BUREAU (last revised Jan. 17, 2012), *available at* http://quickfacts.census.gov/qfd/states/00000.html; U.S. CENSUS BUREAU, EDUCATIONAL ATTAINMENT OF THE UNITED STATES tbls.1 & 2 (last revised Jan. 17, 2012), *available at* http://quickfacts.census.gov/qfd/states/00000.html [hereinafter EDUCATIONAL ATTAINMENT OF THE UNITED STATES].

[22] *Economic Data: Unemployment Rate – High School Graduates, No College, 25 Years and Older*, ST. LOUIS FED. RES. BANK (Jan. 4, 2013), http://research.stlouisfed.org/fred2/series/LNU04027660?cid=32447.

[23] *Economic Data: Unemployment Rate – Bachelor's Degree and Higher, 25 Years and Over*, ST. LOUIS FED. RES. BANK (Jan. 4, 2013), http://research.stlouisfed.org/fred2/series/LNU04027662?cid=32447.

employed rather than unemployed.

There has been a rapid expansion in the number of bachelor's degrees awarded per year. In 1988, approximately 1 million bachelor's degrees were conferred.[24] In 1998, 1.16 million bachelor's degrees were conferred, an increase of 16%.[25] In 2008, 1.6 million bachelor's degrees were conferred, an increase of 38%, and at a rate more than double the previous ten-year increase.[26] In 2011, approximately 1.72 million students received bachelor's degrees, a nearly 10% increase that shows these trends are continuing.[27] As more individuals with bachelor's degrees are entering the workforce, fewer are leaving by means of retirement.

The Social Security Administration has begun increasing the full retirement age, keeping workers in the workforce longer and opening fewer opportunities for new graduates.[28] This could create a glut in the number of available workers with bachelor's degrees, reducing the salary being offered by employers who are presented with many more applicants. Lower initial salaries could close the gap in income between those with bachelor's degrees and those without.[29] Those without bachelor's degrees

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[24] Chad Fleetwood & Kristina Shelley, *The Outlook for College Graduates, 1998–2008: A Balancing Act*, OCCUPATIONAL OUTLOOK Q., Fall 2000, at 3, 6.

[25] *Id.*

[26] *See* SUSAN AUD ET AL., THE CONDITION OF EDUCATION 2011, at 114 (2011).

[27] LAURA G. KNAPP ET AL., U.S. DEP'T OF EDUC., NAT'L CTR. FOR EDUC. STATISTICS, POSTSECONDARY INSTITUTIONS AND PRICE OF ATTENDANCE IN 2011-12, DEGREES AND OTHER AWARDS CONFERRED 7 (2012), http://nces.ed.gov/pubs 2012/2012289.pdfhttp://nces.ed.gov/pubs2012/2012289.pdf.

[28] *See Social Security Fact Sheet: Increase in Retirement Age*, SSA PRESS OFF., http://www.ssa.gov/pressoffice/IncRetAge.html (last visited Sept. 15, 2012).

[29] There is another theory proffered by the OECD regarding late retirement and its benefits. The working paper from the OECD argues that by increasing the retirement age, employees can be wage earners longer, relying on the government for a shorter period of time, relaxing some of the pressure of current pension systems. It also argues that wage earners have higher aggregate spending, which will in turn create more opportunities in the economy. While these facts are true, it does little to assuage the issue of new entrants to the workforce, namely recent college graduates. Higher spending on consumer goods will not have the multiplier effect on jobs requiring bachelor's degrees that it will the number of blue collar jobs produced in retail sales, manufacturing, and transportation. There is also the problem of diminished capacity for a laborer versus an office worker. Take, for example, a teacher. A teacher, no matter his or her age, can teach a class of twenty students. The teacher requires a college education, and this is the type of job recent graduates look for. If the teacher works an extra five years, the rate of turnover will be lower, creating a glut in the supply of teachers. This is all assuming that there is no incredible population boom in which school enrollment doubles. Now take the maintenance person at that same school. Based on the physical rigors of the job, he or she will not be able to perform it indefinitely, and a replacement will be

account for a higher percentage of those who become unemployed, because they represent 73% of the labor force.[30] As the percentage of the work force with bachelor's degrees increases, the number of those with bachelor's degrees that could lose their job may also increase.

The once unthinkable happened in 2006 when housing prices began to drop. This reality could also strike the skilled labor market. While presently all indicators point toward a college degree being worth the time and investment, it is not unthinkable that this could change. Manufacturing has been on the rise of late in the United States, aided by a bigger labor pool (making cheaper labor easier to find), and by increases in per-worker productivity as a result of the recession.[31] If the country were to shift back to a manufacturing-oriented economy, moving away from financial services, the current pace of bachelor degree recipients would far outstrip demand for their services.

While a college graduate may be able to get the same job as a high school educated individual, he or she will have foregone four years of earnings, and will be saddled with the debt whatever amount of money he or she borrowed to get through college. It might be unimaginable that this would happen, but the fact that Alan Greenspan saw the past five years as unimaginable doesn't change the current percentage of underwater mortgages in the market. The myth that a college education is always worth it has laid the foundation for a bubble that has been steadily inflating, mirroring the rise of the United States mortgage market.

needed based on the worker's health rather than a minimum retirement age. Faster turnover in the blue collar sector, coupled with a decreasing proportion of the United States population going into blue collar labor, will increase the wage demanded by the blue collar worker, further closing the gap between those with bachelor's degrees and those without. Organization for Economic Co-operation and Development, *Increasing Employment: The Role of Later Retirement*, 72 OECD ECON. OUTLOOK 1–2 (Dec. 2002), http://www.oecd.org/eco/economicoutlook analysisandforecasts/2487116.pdf.

[30] *See* U.S. BUREAU OF LABOR STATISTICS, HOUSEHOLD DATA ANNUAL AVERAGES: EMPLOYMENT STATUS OF THE CIVILIAN NONINSTITUTIONAL POPULATION 25 YEARS AND OVER BY EDUCATIONAL ATTAINMENT 1 (2012), http://www.bls.gov/cps/cpsaat07.pdf.

[31] Press Release, Inst. for Supply Mgmt., Mar. 2012 Mfg. ISM Report on Bus. (Apr. 2, 2012), *available at* http://www.ism.ws/news/NewsReleaseDetail.cfm?ItemNumber=22403.

III. INFLATING THE BUBBLE

Under the classic bubble model, an increasing amount of capital goes toward an asset at an increasing rate. As this rate of capital movement increases, the new asset begins to account for a significantly larger portion of the overall economy. This can happen with any asset, be it bonds, commodities, or housing.[32] These bubbles can arise when consumers are inefficient in the way they use capital and balance savings.

Dynamic inefficiencies will arise when value stores, such as real estate, are used in lieu of consumption or market investments.[33] When the bubble bursts on these value stores, neither the holder of the property nor the banker who financed the purchase can sell the property without taking a loss, and both parties lose.[34] This happens because consumers have a problem valuing assets properly, and the momentum of trading tends to send capital contributions toward popular assets, rather than toward the optimal allocation of assets.[35] The dynamic inefficiency occurs when the savings rate for a population, given a certain amount of capital, is higher than the steady state level.[36]

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[32] In the commodities world, the bubble is amplified by not only more capital going towards it, but also by more physical resources including equipment and labor. As the localized commodity boom attracts more people, it becomes marginally less profitable. It also affects other areas of the economy in which a country may have a better competitive advantage, as the resources are diverted from the competitive industry towards the commodity boom. This is commonly referred to as Dutch Disease. *See* Pablo A. Acosta, Emmanuel K.K. Lartey & Federico S. Mandelman, *Remittances and the Dutch Disease* (Atlanta Fed. Res. Bank, Working Paper No. 2007-8, 2007), http://www.frbatlanta.org/filelegacy docs/wp0708.pdf.

[33] Ricardo J. Caballero & Arvind Krishnamurthy, *Bubbles and Capital Flow Volatility: Causes and Risk Management* 2 n.1 (Nat'l Bureau of Econ. Research, Working Paper No. 11618, 2005), http://www.comisiondistorsionesdeprecios.cl/conferencias-seminarios/seminarios/pdf/caballero1.pdf. This source discusses the use of real estate as a value store in emerging markets, and the way in which this creates bubble-like conditions as the market becomes over-inflated. While the current poor market protection in emerging markets contributes to the bubble "prick," poor oversight in the United States can play the same role. *See infra* Part VII.

[34] Jean Tirole, *Asset Bubbles and Overlapping Generations*, 53 ECONOMETRICA 1499, 1499 (1985). These value store bubbles bursting also serve as intergenerational asset transfers. While this may help certain sectors of the population, because of the risk of contagion, the overall welfare of the country suffers.

[35] *Id.* at 1515–19. Inefficiencies arise when consumers prefer bubble assets rather than assets with better market fundamentals.

[36] *See generally* Sarantis Kalyvitis, The Ramsey Growth Model (unpublished

While these levels are very difficult to determine, market indicators such as net capital inflows, volatility, futures, and performance of the underlying asset class can be used to determine if the amount of savings going into the value store—for instance, housing—is greater than optimal.

The housing market in the late 1990s and the early 2000s was this type of bubble-inducing climate. Using the myth that housing prices never go down, coupled with the altruistic and government-sponsored idea that everyone should own a home,[37] real estate became a very attractive value store.[38] In a 2006 AARP survey, 16% of current workers age forty and up expected the sale or refinancing of their home to be a major contributor to their retirement income, while only 8% of actual retirees said that the sale or refinancing of their home was not a major source of retirement income.[39] The same survey found that 23% of workers and 24% of retirees have the majority of their savings in their real property.[40] This heavy proportion of savings going toward a relatively illiquid asset is the type of dynamic inefficiency that can lead to an asset bubble.

Student loans are experiencing this type of dynamic inefficiency now as the amount of student loans has risen exponentially over the past ten years. Students are investing in themselves (for lack of a better term) by taking out debt whose value is solely based on the students' own ability to perform in the marketplace. For the first time, total student loans issued

manuscript) (on file with author). The Ramsey growth model looks at the problems of households and firms compared to the socially desirable Pareto optimality.

[37] *See* Paul Krugman, Op-Ed, *Home Not-So-Sweet Home*, N.Y. TIMES, June 23, 2008, *available at* http://www.nytimes.com/2008/06/23/opinion/23krugman.html. The Community Reinvestment Act of 1977 (amended 2005), 12 U.S.C. § 2901, provided incentives for banks to create investment, lending, and banking services in poorer areas. While the reviews of the CRA are mixed, it can be seen as a government stamp of approval of the proliferation of home ownership. *See* Ben Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Address at the Community Affairs Research Conference, Washington, D.C.: The Community Reinvestment Act: Its Evolution and New Challenges (Mar. 30, 2007); *See* Roberto Quercia & Janneke Ratcliffe, *The Community Reinvestment Act: Outstanding, and Needs to Improve*, UNC CTR. FOR CMTY. CAPITAL 47, 47 (2010) (further discussion on the CRA).

[38] *See* AARP, *AARP Retirement Planning Survey Among US Adults Age 40 and Older*, AARP BULLETIN (May 2006), http://assets.aarp.org/rgcenter/econ/ret_planning.pdf.

[39] *Id.* at 28.

[40] *Id.* at 17.

passed $100 billion for a single year in 2010.[41] What is worse, total student loan debt outstanding is set to eclipse $1 trillion this year, and has already surpassed credit card debt as the number one unsecured debt held by Americans.[42]

Numbers reported by the Federal Reserve Bank of New York paint a picture similar to what we saw during the mortgage crisis. Between the first quarter of 1999 and the first quarter of 2010, student loans, as a percentage of total consumer debt, rose from 2% to 5%.[43] Over that same time period, revolving debt (primarily credit cards) fell from 10% of total consumer debt to 6%.[44] What becomes alarming about these percentages is that over this period, total consumer debt rose from $4.6 trillion to $11.4 trillion—close to a 150% increase in outstanding consumer debt over a ten-year period.[45] As consumers were borrowing an ever-increasing amount of money, an increasing proportion was going towards student loan debt. By comparison, between the first quarter of 1999 and the first quarter of 2007, mortgages rose from 69% of total outstanding debt to just below 80% of total consumer debt, representing an increase of approximately 28%.[46] While the mortgage market accounts for a significantly larger portion of United States consumer debt, even during the period leading up to the mortgage crisis, the expansion of newly issued debt was about one-sixth the rate at which student loan debt is currently expanding.[47]

The percentage change in the ratio of student loan debt to overall consumer debt is alarming, but it gets much worse when looking at the actual numbers. In Q1 1999, total student loan debt outstanding was $92 billion.[48] In eleven years, this amount

[41] Jean Chatzky, *Student Loan Debt Reached $100 Billion Mark for First Time in History; Tips to Effectively Pay*, N.Y. DAILY NEWS, Oct. 26, 2011, http://www.nydailynews.com/news/money/student-loan-debt-reached-100-billion-mark-time-history-tips-effectively-pay-article-1.968364.

[42] *See* Tamar Lewin, *Burden of College Loans on Graduates Grows*, N.Y. TIMES, Apr. 11, 2011, http://www.nytimes.com/2011/04/12/education/12college.html.

[43] N.Y. FED. RESERVE BANK, QUARTERLY REPORT ON HOUSEHOLD DEBT AND CREDIT 3 (Feb. 2011), http://www.newyorkfed.org/research/national_economy/householdcredit/DistrictReport_Q42010.pdf.

[44] *Id.*

[45] *Id.* This only tells half the story, as total consumer debt has dropped from a peak of $12.5 trillion from the first quarter of 2008 to the present level. This is due to a decrease in mortgage and revolving debt. *Id.*

[46] *Id.*

[47] *Id.* at 4.

[48] *Id.* at 3.

increased to $845 billion, an increase of $751 billion, or a near tenfold increase in total outstanding student loan debt.[49] Within two quarters, by Q3 2010, this number rose to $865 billion—a $20 billion increase that is equal to roughly 23% of the total outstanding student loan debt in 1999.[50] This is the type of accelerated borrowing and large increases in total outstanding debt that was seen in the run-up to the mortgage crisis. These trends appear to be continuing as total outstanding student loan is set to pass $1 trillion in 2012.

The flood of new borrowers is also contributing to an inflation of the student loan bubble. As the number of borrowers increases, a certain amount of degradation of the average borrower occurs as the pace of new issuances outstrips the availability of quality borrowers. This was seen in the mortgage market, as the expansion of credit to less worthy borrowers through subprime loans eroded the quality of the average borrower. The Financial Crisis Inquiry Commission noted that the rapid expansion of subprime borrowers undermined the health of the market by lowering the standard of the average borrower.[51] Subprime mortgages rose from 7.4% of the entire mortgage market in 2002, and expanded to 23.5% of the entire mortgage market by 2006, the eve of the mortgage collapse.[52]

The same thing is occurring now in the student loan market. In 1999 there were approximately 25 million student loans in the market.[53] In 2010, the number rose to almost 60 million student loans in the market.[54] Between 2003 and 2007, the number of undergraduates borrowing through private lenders jumped from

[49] *Id.* The New Federal Reserve has admitted to underestimating the amount of total outstanding student loan debt by as much as $290 billion, so all figures are subject to revision. This shows that there is an overall lack of knowledge about the size and reach of the market, similar to what was seen in the housing market prior to the mortgage crisis. Matthew Goldstein, *Bad Data II*, REUTERS, Dec. 12. 2011, http://blogs.reuters.com/unstructuredfinance/2011/12/12/bad-data-ii/.

[50] N.Y. FED. RESERVE BANK, *supra* note 43, at 3.

[51] FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES, at xxiv (2011) [hereinafter COMM'N REPORT].

[52] *Id.* at 70.

[53] N.Y. FED. RESERVE BANK, *supra* note 43, at 4.

[54] *Id.* at 4. While some of this is overlap because of the various number of loans students take out, it also represents the increased expense of college attendance that has necessitated students going into the private loan market to afford school.

5% to 14%.[55] This borrowing saw significant jumps in private non-profit and for-profit institutions. For-profit institutions accept lower-caliber students,[56] and represent a part of the "subprime student loan" market that exists. Private borrowing at for-profit institutions rose from 13% of total enrolled students to 42% of total enrolled students.[57] Additionally, more than half of the borrowers are borrowing more than $10,000 per loan.[58] As an increasing number of people borrow an increasing amount of money, this degradation of the level of borrower coupled with larger borrowed amounts looks more and more like the prelude to the student-loan version of the mortgage market crisis.

Further exacerbating the market conditions is the percentage of low-income students who are borrowing for college. While lower income students will obviously have less disposable income to pay for college, these borrowers also represent a higher risk of default—similar to what was experienced during the mortgage crisis.[59] Fifteen percent of low-income students and 21% of lower middle-income students who were dependent took out private loans.[60] In total, 54% of low-income students and 56% of lower middle-income students took out loans.[61] This compares with 52% of upper middle-income students and 40% of high-income students taking out loans.[62] One of the reasons for this use of private lending is the limits on Stafford and Perkins loans from the federal government. As the cost of attending college has gone up, the limits have not risen in a commiserate way to augment student borrowing. [63]

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[55] JENNIE H. WOO, U.S. DEP'T OF EDUC., THE EXPANSION OF PRIVATE LOANS IN POSTSECONDARY EDUCATION 3 (2011).

[56] *See* Suzanne Merkelson, *The For-Profit College Racket*, WHAT MATTERS TODAY (Aug. 7, 2012), http://billmoyers.com/2012/08/07/the-for-profit-college-racket/.

[57] WOO, *supra* note 55, at 6.

[58] *Id.* at 7.

[59] Robert G. Quercia, Anthony Pennington-Cross & Chao Yue Tian, *Mortgage Default Risk and Local Unemployment* 20 (Univ. of N.C. Ctr. for Cmty. Capital, Working Paper, Mar. 2011). Without a backstop from their parents, many students are simply unable to afford their loans. With low income students, this backstop is less likely to exist increasing the risk of default.

[60] WOO, *supra* note 55, at 8. The numbers don't shift dramatically for independent, low and lower middle income students.

[61] *Id.*

[62] *Id.*

[63] *See* Diana Jean Schemo, *Private Loans Deepen a Crisis in Student Debt*, N.Y. TIMES, June 10, 2007, http://www.nytimes.com/2007/06/10/us/10loans.html?pagewanted=all.

IV. PREDATORY LENDING

Predatory lending was a big problem during the lead-up to, and aftermath of the mortgage crisis. In the late 1990s and early 2000s, credit was flowing freely, and everyone from large mortgage brokers like Countrywide[64] down to local mortgage brokers wanted to get a piece of the action. The predatory practices mainly fell into three categories: failure to disclose, dangerous mortgage products, and questionable loan servicing practices. These three tactics created a $10.5 trillion mortgage market that was both unsustainable and destined to fail.[65]

There is a basic fiduciary duty present when mortgage companies are originating loans to borrowers. The assumption is that both parties are acting in good faith and disclosing material facts, including income, repayment options, loan structure, and future costs. During the mortgage crisis, a lot of these practices broke down. Mortgage brokers looking to originate loans to sell to larger mortgage servicers like Citibank and JP Morgan, misstated (or in many instances completely failed to disclose) the nature of the loans or the required repayment provisions.[66] Many borrowers failed to read the actual mortgage documents, so they were unaware of the misrepresentations made by the loan originator.[67]

Driving this problem was the fact that once the mortgage was secured, the originator sold it and then never dealt with the borrower again.[68] This, combined with a lack of knowledge about interest rates and how mortgages work, led to the perfect conditions for a mortgage meltdown.[69] Mortgage originators

[64] At its peak, Countrywide was the largest originator and servicer of consumer mortgages. *See* CTR. FOR RESPONSIBLE LENDING, UNFAIR AND UNSAFE: HOW COUNTRYWIDE'S IRRESPONSIBLE PRACTICES HAVE HURT BORROWERS AND SHAREHOLDERS (2008) [hereinafter COUNTRYWIDE].

[65] COMM'N REPORT, *supra* note 51, at 7.

[66] *See id.* at xxii.

[67] *Id.* at 90.

[68] *See* Glenn Setzer, *Mortgage Servicing Rights: Traded Like Baseball Cards?*, MORTGAGE NEWS DAILY (June 6, 2005, 7:00 AM), http://www.mortgagenewsdaily.com/662005_Mortgage_Servicing.asp.

[69] In a poll by Zillow, 57% of respondents didn't understand how adjustable rates work, 55% didn't know mortgage rates vary, 42% didn't know about the availability of Federal Housing Administration loans, and overall, 46% answered general mortgage questions incorrectly. Press Release, Zillow, Nearly Half of Home Buyers Surveyed Don't Understand Essential Information About Mortgages (May 3, 2011), *available at* http://zillow.mediaroom.com/index.php?s=159&item=227.

connected with Countrywide have been accused of loading mortgages with hidden and unauthorized fees, switching types of mortgages,[70] targeting the elderly and non-English speakers, and of negligently telling borrowers that they could afford loans by back-loading the repayment schedule to keep up-front costs lower.[71]

These practices have begun to sprout up in the student loan market.[72] They have mainly been concentrated on professional schools,[73] which have been using the same online media blitz and television advertising in low-income areas that were the hallmark of the subprime advertising regime. The tactics are the same, and the promise has only changed slightly.[74] Rather than telling a borrower they can afford a house way outside their price range, the professional schools dazzle borrowers with the promise of high-salaried professions.[75] However, much like the mortgage brokers, the professional school lenders fail to disclose key aspects of their loan programs. They tend to inflate both the average salary of the profession and the prospects of finding a

[70] COUNTRYWIDE, *supra* note 64, at 2. This included switching borrowers with good credit into costlier subprime mortgages.

[71] *Id.* In many instances, originators eliminated the need for down payments and authorized loans that went far outside the normal risk metrics for a borrower at a given income level. The process also relied heavily on credit scores rather than focusing on better measures of ability to repay. Many anecdotal examples exist about low-income individuals taking out mortgages in excess of ten times their yearly income. *Id.* at 2–3. The number of bankruptcies that received an automatic stay from state foreclosure proceedings provide us with a wealth of information on just how outrageous some of the lending practices were during the mortgage bubble. *See In re* Haburjak, 309 B.R. 170 (Bankr. W.D. Pa. 2004).

[72] These factors may also be exacerbated by the government decision to shift from FFELP to DELP loans, starving private borrowers of federally subsidized loans, and possibly pushing them to take riskier loans. *See* de Vise, *supra* note 3.

[73] Professional schools are institutes which provide degrees for professions, such as x-ray technician and dental hygienist, rather than degrees in fields such as English or Economics. They are not to be confused with professional degrees like medical and legal degrees.

[74] At a recent Bloomberg event, Vince Sampson, president of the Education Finance Council admitted that lenders are no longer pushing student loans on borrowers that cannot afford them. *Student Loans- A Freudian Slip?*, DAILY KOS (Oct. 19, 2011, 3:11 AM), http://www.dailykos.com/story/2011/10/19/1027924/-Student-Loans-a-Freudian-Slip. Unfortunately, this may be more of a reflection of tightening credit markets than a move towards altruism by the student loan industry.

[75] *See Choosing A Career or Vocational School*, FED. TRADE COMM'N (2001), http://www.ftc.gov/bcp/edu/pubs/consumer/products/pro13.pdf.

job.[76] While they don't lie, they selectively use statistics to make the job market look more favorable than it is.[77] With the nature of their advertising being more like a consumer good than a four-year university, people fail to read the fine print. The professional school lenders also fail to note that many of their programs do not qualify for government-backed student loans.[78]

The mortgage market in the 1990s quickly became an alphabet soup of acronyms for complex structured debt instruments that almost no borrower understood. Alt-A, ARM, HUD-1, LIBOR, HELOC, and PITI were some of the terms thrown around by mortgage brokers that many people did not understand and were told not to worry about. Unfortunately, TILA was the one acronym that was probably never used, and could have avoided this whole mess.[79] With more options, many of which were interest-only or had low interest rates early on to mask the actual cost of repayment, mortgage brokers were able to attract borrowers and have them take out loans for much more than they could actually afford. The rest is history. Once the economy started to turn south, borrowers began to have trouble repaying. Those already having difficulty paying their mortgages saw the rates reset, especially in adjustable rate mortgages. This led to an increase in foreclosure rates, a further tightening in credit markets, and contagion, causing the global recession of 2008.

The student loan market is a bit less complicated, but some of the same practices are also prevalent there. As the student loan market expanded, and Congress began removing interest rate caps, the proliferation of student loan asset backed securities made loan origination even more profitable. As a result, the student loan industry made access to student loans much easier.[80] The FAFSA, required for all students, is the main template for

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[76] *Id.*

[77] *See id.*

[78] *Id.* This was a common trick in the mortgage crisis whereby a mortgage broker would get the borrower through all the arduous paperwork knowing full well they didn't qualify for the loan and then suggest a quick switch to a different loan that was vastly different and significantly more costly. Many borrowers did this either to avoid going through the paperwork again or because their dream of home ownership was a signature away. With the professional school lenders, they prey on the vulnerability of people looking for a high paying job and the path to a better life, who will forego federally subsidized loans for costlier private lines for the same reasons.

[79] The Truth in Lending Act is a federal statute requiring disclosure and proper representation in mortgage lending. 15 U.S.C. § 1601 (2006).

[80] *See* Schemo, *supra* note 63.

this process,[81] and is even easier to fill out than a mortgage application. About fifteen minutes, and the student's (and sometimes the student's parents') financial information is all that is needed to qualify for federal student loans. However, this information is also used by the private student loan companies to see which students are worthy borrowers.[82] Perkins, Stafford, Grad Plus, and Parent Plus loans have all made it easier for students to obtain credit without understanding the terms of the loans.[83] Very few students read the contracts to these loans which are often sent in a .pdf file, or at a link on a website.[84]

There is little mention up front about the variable rates of many private student loans, which account for 10% of the market.[85] These rates are pegged either to the prime rate or the LIBOR,[86] both of which can go up drastically if market conditions fluctuate, creating a significantly more difficult time for the borrower entering repayment. This is priming the student loan market to have the same issues that confronted the mortgage market. The struggling borrowers trigger economic reactions that make repayment more difficult, which will worsen those economic conditions, and the wave of default will sweep more people up as its velocity grows and more borrowers, affected by tough economic conditions, struggle to repay. With the current state of the bankruptcy courts and their limited discretion to readjust student loan payments, borrowers will be forced into a situation in which all of their assets will be needed to settle a "non-dischargeable" debt.

It is unclear whether or not this has started to happen in the student loan market in a widespread manner. Because student loans are unsecured debt, they avoid the problem of not having a mortgage and note in the same owner's hands.[87] Student loans

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[81] *Steps to Federal Student Aid*, FED. STUDENT AID, http://studentaid.ed.gov/sites/default/files/steps-to-aid.pdf (last visited Jan. 23, 2013).

[82] *FAFSA: Apply for Aid*, FED. STUDENT AID, http://studentaid.ed.gov/fafsa (last visited Sept. 4, 2012).

[83] *See* Schemo, *supra* note 63.

[84] *See id.*

[85] STEPHANIE LEE & MAX EGAN, NERA ECON. CONSULTING, STUDENT LOANS AND STUDENT LOAN ASSET-BACKED SECURITIES: A PRIMER 3 (2009), http://www.nera.com/extImage/PUB_ARS_Student_Loan_0609.pdf.

[86] *Spread Between PRIME and LIBOR*, FINAID!, http://www.finaid.org/loans/prime_libor.phtml (last visited Aug. 23, 2012).

[87] Kent Anderson, *What is the Brunner Test for Dischargeability of Student Loans?*, BANKR. L. NETWORK, http://www.bankruptcylawnetwork.com/what-is-the-brunner-test-for-dischargeability-of-student-loans (last visited Aug. 31,

are also not sold in the same way, since fewer entities are in the loan servicing business. However, with the current explosion of student loan origination, and increasing tuition leading to more demand for private loans, a scenario could easily spring up where loans are sold for their servicing fees.

However, there have been allegations of violations in loan counseling at professional schools. The lenders have failed to do exit counseling for students graduating.[88] There are also allegations that the courses being taken are not properly administered, and that the grades are given out regardless of participation.[89] The student loan market certainly has not had the widespread malfeasance that plagued the mortgage industry, but much of what we now know about the mortgage market came out after the collapse. With the student loan market about to surpass $1 trillion, and the student loan asset backed securities (SLABS) market poised for a comeback as private loan origination increases, taking over the role the FFELP loans once had, the market is ripe for servicers and consumers to be turning a blind eye to what is going on. And as the per-student debt increases, fees become much harder to recognize or calculate, and late fees, which work on a percentage basis, will grow even higher.

The one positive for the student loan market versus the mortgage market is that the investigations into malfeasance have been much more proactive.[90] The main investigations into mortgage market fraud and post-2007 foreclosure fraud were mainly done in reaction to revelations that came out during the aftermath of the mortgage collapse.[91]

The student loan industry has been much more proactive in its investigations. According to the Office of the Inspector General for the Department of Education (DOE), there have been thirty-

2012).

[88] Shannon Rasberry, *Student Loan Counseling Among Violations Found During For-Profit College Probe*, STUDENT LOANS BLOG (Nov. 29, 2011), http://studentloansblog.nextstudent.com/2011/11/29/student-loan-counseling-among-violations-found-during-for-profit-college-probe.

[89] *Id.*

[90] This is due, at least in part, to the high percentage of student loans that are federally subsidized. The Department of Education has investigative powers, as a government entity, that are not available to private mortgage issuers.

[91] Brady Dennis & Sari Horwitz, *Settlement Launches Foreclosure Reckoning*, WASH. POST, Feb. 10, 2012, http://www.washingtonpost.com/business/economy/settlement-launches-foreclosure-reckoning/2012/02/09/gIQAxGoE3Q_story.html.

two investigative reports filed regarding student loan fraud.[92] The DOE has not wasted time going after all perpetrators of fraud in the student loan industry.[93] A man in Quincy, Massachusetts was arrested and jailed for lying on a student loan application.[94] The man failed to disclose that, at the time of applying for a promissory note for a new student loan, he was already in default for other student loans.[95] A Sacramento, California woman was arrested for leading a student loan fraud ring that filed student loan applications using identities they had stolen.[96] In total, the woman and her co-conspirators cashed fraudulently obtained student loan checks totaling more than $200,000.[97] In Newark, New Jersey, a woman pled guilty to stealing and conspiring to launder over $500,000 in federally subsidized student aid through a student government organization.[98] Over the course of three years, the woman wrote unauthorized checks to herself, drawing from accounts funded by federal student aid.[99]

While the DOE has been vigilant about stopping fraud in the student loan market, this gives some idea of the various ways individuals are trying to scam the system.[100] It is difficult to ascertain the total amount of student loan fraud that occurs, however, and some larger scams give a window into how widespread this fraud might be. A group called the CSC Institute

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92 Office of Inspector Gen., *Investigative Reports*, U.S. DEP'T OF EDUC., http://www2.ed.gov/about/offices/list/oig/ireports.html (last modified Aug. 15, 2012).

93 *Id.*

94 Press Release, U.S. Dep't of Justice, Quincy Man Jailed for Lying on Student Loan Application (May 2, 2011), *available at* http://www2.ed.gov/about/offices/list/oig/invtreports/ma052011.html.

95 *Id.*

96 Press Release, U.S. Dep't of Justice, Leader of Federal Student Loan Fraud Ring Pleads Guilty to Mail Fraud and Aggravated Identity Theft (Feb. 28, 2011), *available at* http://www2.ed.gov/about/offices/list/oig/invtreports/ca032011.html.

97 *Id.*

98 Press Release, U.S. Dep't of Justice, New Jersey City University Employee Pleads Guilty to Stealing, Laundering Over $500,000 from Student Government Organization (Dec. 9, 2010), *available at* http://www2.ed.gov/about/offices/list/oig/invtreports/nj122010.html.

99 *Id.*

100 The police have also treated these suspected frauds like any other frauds, even utilizing SWAT teams to enter homes of suspected fraud rings. *See* Elizabeth Flock, *Education Department Agents Raids California Home*, WASH. POST BLOG (June 8, 2011, 3:40 PM), http://www.washingtonpost.com/blogs/blogspot/post/education-department-swat-team-raids-california-home/2011/06/08/AGUx1KMH_blog.html.

stole $4.3 million of the $13 million in Pell grants it was awarded.[101] Put another way, the group was stealing one out of every three dollars coming in. With the rate of debt issuance increasing rapidly, it is fair to assume that the amount of fraud is increasing as well.

While this is happening at for-profit institutions which, much like subprime mortgage brokers, prey on lower income and less educated individuals, there is no telling what other schools may be utilizing similar practices. College is big money in the United States. In the school year 2008–2009, $180 billion was spent on college tuition.[102] This reflected an increase of 6.5% in tuition at public institutions and a 4.4% increase in tuition at private institutions.[103] As tuition goes up, the profit to be made off each additional student increases, leading to potential fraud. Non-profit institutions are not exempt from fraudulent behavior. A paper for the Hauser Center for Nonprofit Organizations at Harvard University found many examples of non-profit fraud.[104]

Because of the charitable intent of the organizations, they are not given the same amount of scrutiny often reserved for for-profit institutions.[105] While many universities are run more like corporations, with dedicated professional boards, outside trustees, and internal business units, there still remains a large number of small universities that do not have the money necessary to hire and retain that level of leadership. Even the large universities run by professional boards are slaves to enrollment figures, and need to do everything they can to attract applicants. Recently, a lawsuit was filed against a number of law schools over deceptive practices in disclosing their post-graduation employment figures.[106] This goes to illustrate the realities of the new higher

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[101] Chris Edwards & Tad DeHaven, *Fraud and Abuse in Federal Programs*, CATO INST. (Aug. 2009), http://www.downsizinggovernment.org/fraud-and-abuse.

[102] Justin Pope, *College Tuition Costs Rise AGAIN*, HUFFINGTON POST, Oct. 20, 2009, http://www.huffingtonpost.com/2009/10/20/college-tuition-costs-ris_n_327398.html.

[103] *Id.*

[104] *See* Janet Greenlee et al., *An Investigation of Fraud in Nonprofit Organizations: Occurrences and Deterrents* (The Hauser Ctr. For Nonprofit Orgs., Harvard Univ., Working Paper No. 35, 2006), http://www.hks.harvard.edu/hauser/PDF_XLS/workingpapers/workingpaper_35.pdf.

[105] Stuart Douglas & Kim Mills, *Nonprofit Fraud: What Are the Key Indicators?*, CHARITY VILLAGE (Aug. 16, 2000), https://charityvillage.com/Content.aspx?topic=nonprofit_fraud_what_are_the_key_indicators_&last=547.

[106] Sylvia Wood, *Law Schools Face Lawsuits Over Job-Placement Claims*, NBCNEWS.COM (Feb. 2, 2012, 3:31 PM), http://usnews.msnbc.msn.com/_news/

education model: higher costs, supplemented at 65% by federal subsidies,[107] can lead to fraud as a matter of surviving in a more cutthroat environment.

V. SECURITIZATION AND LEVERAGING

Securitization has become a dirty word since the mortgage crisis. Asset-backed securities, mortgage-backed securities, and residential mortgage-backed securities played a key role in turning a crisis of defaulting mortgages into a global credit shutdown and near depression level recession. By looking at the mortgage securitization market, we can discern where the problem areas were, and use this information to more closely monitor SLABS. Some of the key areas addressed in the United States Senate Financial Crisis Report as issues that led to the MBS meltdown are loan origination, ratings, disclosure, motivation, design, and contagion. Many of these factors mirror what is now seen in the rise of the student loan industry over the past decade and the explosion of SLABS. This section of the paper discusses the similarities, and shows that while a large decline in student loan repayment in its primary market would be bad, the decline coupled with SLABS exposure (and to a more uncertain extent, credit default swap exposure) could lead to another global credit freeze.

While the complexity of MBS is staggering, the basic building block is not. The whole MBS process starts with a single mortgage. That single mortgage is then pooled with other mortgages in a trust, which then securitizes them and sells them in the open market.[108] When a mortgage is bought by the trust for the purposes of securitization, the trust relies heavily on the initial rating that comes from the mortgage broker's intake and origination.[109] With close to fifty million mortgages in the United States, it would be a near impossible task for these trusts purchasing the mortgages to do a credit check on every mortgage.[110] The problem with the ratings used for mortgages is

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2012/02/02/10302339-law-schools-face-lawsuits-over-job-placement-claims?lite. As of the time of this writing, no judgment has been rendered on these suits.

[107] Pope, *supra* note 102.

[108] *Understanding the Markets*, MBS QUOTELINE, http://www.mbsquoteline.com/understanding.php (last visited Aug. 31, 2012).

[109] *Id.*

[110] U.S. CENSUS BUREAU, TABLE 998 MORTGAGE CHARACTERISTICS (2012), http://www.census.gov/compendia/statab/2012/tables/12s0998.pdf.

that they relied heavily on the borrower's credit score rather than his or her ability to repay.[111] Focusing on credit score spoke to the person's past but not their future. The borrower's future ability to repay is what the MBSs were based on, and once the economy started to stall and borrowers lost all ability to repay, it became readily apparent that these mortgages were not AAA, but rather junk.

SLABS are setup the same way as MBS. They start with a single student loan, which is then pooled with other student loans.[112] The SLABS is then created and sold to investors.[113] However, a look at the SLABS's underlying securities shows a picture quite similar to the mortgage market. The student loans backing the SLABS are based on credit score rather than a borrower's ability to repay. SLABS are also based on the false notion that student loans cannot be discharged in bankruptcy.[114] The credit score issue becomes much more complicated with the rise of co-signors. Since 2002, the number of student loans featuring a co-signor has risen from about 38% to nearly 70%.[115] These co-signors, generally parents, have significantly higher credit scores than their children, which can mask the relative inability of the actual borrower to repay the debt.[116]

Since co-signors are released from the loan after a period of timely payments, the actual rating of the student loan is skewed.[117] Looking at sample SLABS, the overwhelming majority of the student loans backing them are of AA rating or better.[118] Given the nature of student loans, the present economic downturn, and the increased average loan amount per borrower, these ratings based on an amalgamation of the borrower and co-

[111] DR, *How Your Credit Score Affects Your Mortgage*, U.S. NEWS (Mar. 2, 2011), http://money.usnews.com/money/blogs/my-money/2011/03/02/how-your-credit-score-affects-your-mortgage.

[112] LEE & EGAN, *supra* note 85, at 12.

[113] *Id.*

[114] MARK KANTROWITZ, LIMITATIONS ON EXCEPTION TO DISCHARGE OF PRIVATE STUDENT LOANS 1 (2007), http://www.finaid.org/questions/bankruptcylimitations.pdf.

[115] Kelly Greene, *New Peril for Parents: Their Kids' Student Loans*, WALL ST. J., Oct. 26, 2012.

[116] *Id.*

[117] SALLIE MAE, SALLIE MAE SMART OPTION STUDENT LOAN 5 (2009), http://www.csbnow.com/StudentLoanProgram.pdf.

[118] NOMURA FIXED INCOME RESEARCH, STUDENT LOAN ABS 101: AN INTRODUCTION TO STUDENT LOAN ABS 3 (2005) [hereinafter NOMURA]; *See also* BD. OF GOVERNORS OF THE FED. RESERVE SYS., REPORT TO THE CONGRESS ON RISK RETENTION 61–62 (2010) [hereinafter BD. OF GOVERNORS].

signor credit score bear a striking resemblance to the high rated mortgages that were backing MBS. With most oversight going to MBS rather than SLABS, this is a place of potential hazard.

As was just briefly touched on, the ratings agencies played a large role in the proliferation of the mortgage backed securities market. Thomas Friedman once noted that "[t]here are two superpowers in the world . . . . There's the United States and there's Moody's Bond Rating Service . . . . And believe me, it's not clear sometimes who's more powerful."[119] The rating agencies were not in charge of rating the individual mortgages underlying the MBS but rather, looking at the entire pool, evaluating how risk was spread throughout the tranches, and then giving it a rating.[120] Moody's was not concerned with the individual borrower, but rather the one thousand borrowers which, based on historic trends, could have their default rate predicted quite closely.[121] The only problem was that Moody's did not have the original loan documentation, and was simply going on the type of loan, the amount, and repayment metrics like interest rate and balance.[122] In the peak years between 2005 and 2007, ratings became progressively less conservative, and MBS underperformed their ratings more frequently.[123] These ratings were then relied upon by Wall Street, as MBS, swaps, and credit swaps were all being driven by a diminished ratings regime.

Eventually, the market turned south, and the borrowers whose AAA mortgages were in upper tranches of MBS began to default.[124] This led to a glut of MBS on the market, causing the market to freeze.[125] Without MBS, new capital was not being generated to further lend to borrowers, and thereby create new MBS, and the government was eventually forced to step in and

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[119] *PBS NewsHour: Free Market Society* (PBS television broadcast Feb. 13, 1996).

[120] ADAM ASHCRAFT, PAUL GOLDSMITH-PINKHAM & JAMES VICKERY, MBS RATINGS AND THE MORTGAGE CREDIT BOOM 11 (2009), http://www.stern.nyu.edu/cons/groups/content/documents/webasset/uat_024504.pdf.

[121] *See* Ben Protess, *Crisis Testimony of Former Moody's Executive Proves Vague*, N.Y. TIMES (Feb. 24, 2011, 12:50 PM), http://dealbook.nytimes.com/2011/02/24/crisis-testimony-of-former-moodys-executive-proves-vague.

[122] Using special-purpose vehicles, ghost corporations that solely existed to buy mortgages, securitize and sell them, and then collect mortgage payments made the rating agencies job even more difficult. By 2006, they were no longer evaluating the mortgages but the bonds issued by the SPV and whether incoming cash flow was enough to payout on the bonds.

[123] ASHCRAFT, GOLDSMITH-PINKHAM, VICKERY, *supra* note 120, at 4.

[124] *Id.* at 1.

[125] *Id.* at 20.

remove so-called toxic assets.[126] The failure to properly rate the MBS had led major investment banks to hold exorbitant amounts of MBS on their balance sheets under the impression that they were AAA, that senior tranches would never be affected, and that housing prices and mortgage origination would keep up their unnatural pace.[127]

The same thing appears to be happening in the SLABS market. Of 151 tranches that were originally rated AAA, all but two are still A3 or higher, with the majority (ninety-four) still qualifying as AAA.[128] Only thirteen total tranches were rated below A3 initially, and thirty-nine are rated below A3 at the time the matrix was created.[129] Looking to specific SLABS and DBRS, a credit research firm has only three rated A, with the majority rated AAA.[130] According to the Federal Reserve report on risk retention, SLABS are typically structured with 97% AAA notes that are almost entirely subsidized by the federal government.[131] Before FFELP was scrapped in favor of a government-centric DELP program, private originators used the FFELP loans they were allowed to service in SLABS.[132] With private borrowing increasing each year,[133] the private originators are quickly finding an unsubsidized substitute for the FFELP loans they no longer originate. Many are still AAA based on the co-signors credit score, but without government subsidization serving as a backstop, they are far riskier, especially in a scenario of widespread default. The SLABS market is propped up the same

[126] Edmund L. Andrews, Eric Dash & Graham Bowley, *Toxic Asset Plan Foresees Big Subsidies for Investors*, N.Y. TIMES, Mar. 21, 2009, http://www.nytimes.com/2009/03/21/business/21bank.html?_r=1&pagewanted=print.

[127] Kerri Ann Panchuk, *Federal Reserve's Balance Sheet Grows on MBS, Treasury Securities*, HOUSINGWIRE (Mar. 22, 2011, 12:01 PM), http://www.housingwire.com/news/federal-reserves-balance-sheet-grows-mbs-treasury-securities.

[128] *See* NOMURA, *supra* note 118.

[129] *Id.*

[130] *Id.* at 3.

[131] BD. OF GOVERNORS, *supra* note 118, at 46.

[132] Michael Binz, Erkan Erturk, Frank J. Trick & John Anglim, *U.S. Student Loan ABS Issuance Is Ticking Up, But the Future's Uncertain, Say Conference Speakers*, STANDARD & POOR'S RATING SERVICES (June 26, 2012), http://www.standardandpoors.com/spf/upload/Events_US/US_SF_Event_619abs10.pdf.

[133] *Private Loans: Facts and Trends*, PROJECT ON STUDENT DEBT, http://projectonstudentdebt.org/files/pub/private_loan_facts_trends.pdf (last updated July 2011).

way the MBS market was propped up. Poorly rated underlying securities that have not been properly vetted by an actual rating agency are being pooled, rated on their aggregate versus historic trends, and then being sold and traded.

The SLABS market could head much in the same direction. The market has exploded in the last decade. Since 2003, $5.7 billion have been issued with much still outstanding.[134] Some of these deals were in the $100 billion range, backed by numerous banks that were looking to continue generating income from the ABS market while mortgages were untouchable.[135]

The disclosure issues are also similar to those in the housing market. Banks are unable to disclose necessary information about the underlying student loans, because they simply do not have it. Taking a credit score for a student who is about to enter the work force with 8.3% unemployment and even worse unemployment numbers for eighteen to twenty-five year olds simply does not reflect the risk inherent in these securities.[136] They fall back on the idea that they cannot be discharged in debt, but that doesn't mean that money is flowing into the SLABS. If there is no co-signor and the borrower is unemployed, the borrower has no means to pay back the loan and no assets to seize, either because the borrower is a recent graduate, or because other creditors with more aggressive early default procedures have stripped the borrower of his or her assets. Investors are heading into the same problems they had with MBS. While the market is not the $7 trillion that MBS was, the SLABS market, at its peak, topped $2.6 trillion, which is more than enough to rock a fragile economy recovery.[137]

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[134] *See* CONSUMER FIN. PROTECTION BUREAU, PRIVATE STUDENT LOANS: REPORT TO THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, (2012); *see also* Erkan Erturk & Michael J. Binz, *Mounting Student Debt Is Reshaping the U.S. Student Loan Market*, STANDARD & POOR'S RATING SERVICES (Aug. 13, 2012), http://www.standardandpoors.com/spf/upload/Ratings_US/Mounting_Student_Debt.pdf.

[135] *See* NOMURA, *supra* note 118, at 9.

[136] *Economic Data: Civilian Unemployment Rate*, *supra* note 1; *Economic Data: 20 to 24 Years*, ST. LOUIS FED. RES. BANK (Jan. 4, 2013), http://research.stlouisfed.org/fred2/series/LNS14000036?cid=32447; *Economic Data: 16 to 19 Years*, ST. LOUIS FED. RES. BANK (Jan. 4, 2013), http://research.stlouisfed.org/fred2/series/LNU04000012?cid=32447.

[137] *See* Malcolm Harris, *Rising Tuition + Student Loans = Education* Bubble, FISCAL TIMES (May 9, 2011) http://www.thefiscaltimes.com/Articles/2011/05/09/Rising-Tuition-Student-Loans-Education-Bubble.aspx#page1; *see also* Erturk & Binz, *supra* note 120.

VI. CONTAGION

The crash of mortgage-backed securities, which was prompted by an increase in foreclosure rates for supposed AAA loans, was amplified by the contagion that it caused. Contagion is the idea that shocks in one market may spill over into other markets.[138] Papers describe the mechanisms in which "negative shocks in one market represent the arrival of economic news that directly affects the collateral values or cash flows associated with securities in other markets."[139] There were two instances of contagion: across domestic markets, and across international markets. For reasons of simplicity, this paper combines the two, since a shock to the credit market in a country the size of the United States will necessarily affect global credit markets.[140]

There are three types of market mechanisms that can be seen as contagion. The first is the correlated-information channel where "a shock to one financial market signals economic news that is directly or indirectly relevant for security prices in other markets."[141] The second mechanism is the liquidity channel where "a shock to one financial market results in a decrease in the overall liquidity of all financial markets."[142] The third channel is the risk premium channel, where "the willingness of market participants to bear risk in any market" after a shock to one market is affected.[143] This causes the equilibrium risk premium to go up for all securities, putting a strain on market

[138] Graciela L. Kaminsky, Carmen M. Reinhart & Carlos A. Vegh, *The Unholy Trinity of Financial Contagion*, 17 J. ECON. PERSP. 51, 55 (2003).

[139] Francis A. Longstaff, *The Subprime Credit Crisis and Contagion in Financial Markets*, 97 J. FIN. ECON. 436, 437 (2008).

[140] SLABS are also now being originated in Canada and Europe. *See Select Commentaries: Student Loan Asset-Backed Securities*, REPRINTS OF DBRS U.S. STRUCTURED FIN. NEWSLETTER (DBRS), Jan. 2008, at 12–13.

[141] Longstaff, *supra* note 139, at 438; *see also* Laura E. Kodres & Matthew Pritsker, *A Rational Expectations Model of Financial Contagion*, 57 J. FIN. 769, 770 (2002). Kodres and Pristker have developed a model that shows a shock to a market affects the banks by forcing them to liquidate leveraged positions or rebalance their portfolios in a way that protects the company but is not optimal. This leads to a decrease in liquidity as capital is being used to sure up balance sheets, rather than being put back into the market.

[142] Longstaff, *supra* note 139, at 438; *see also* Marcus K. Brunnermeier & Lasse H. Pedersen, *Predatory Trading*, 60 J. FIN. 1825, 1825 (2005) (discussing the idea that the inability to get liquidity in one market will make it harder for a firm to get liquidity in another market provided both parties know of the firm's trouble).

[143] Longstaff, *supra* note 139, at 438.

participants looking to sell any securities.[144] The mortgage crisis experienced all three of these channels.

The correlated-information channel was one of the most prominent contagion mechanisms early in the crisis. Once news started coming out that homeowners could no longer afford their mortgages, it signaled to the market that there were other economic indicators at play. First, the inability to pay a mortgage is directly correlated to income, and if the ability to pay was dropping, it was reasonable to suspect that incomes were dropping. This was in fact the case, as unemployment started to pick up. Between the end of 2007 and the end of 2008, when the recession really started to gain traction, the unemployment rate rose from 5.0% to 7.3%.[145]

Second, with the level of MBS that had been issued from 2000 to 2007, the wave of foreclosures signaled that the housing market might be weaker than expected, causing the MBS market to seize up.[146] This began to affect new home starts and the construction industry. It also affected the banking industry from both sides; both loan origination and servicing, and MBS.[147] Investors became wary of anything related to mortgages, especially of MBS.

Third, this negative news then spread to the corporate bond market where investors became aware of banks that had large holdings in MBS, and began to divest in them.[148] Paper couldn't be rolled over, and this, with other contributing factors, would lead to the collapse of storied investing houses, Bear Stearns and Lehman Brothers.[149]

It is tough to predict what the news of a large number of student loan defaults would mean for the other markets.

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[144] Dimitri Vayanos, *Flight to Quality, Flight to Liquidity, and the Pricing of Risk* (Nat'l Bureau of Econ. Research, Working Paper No. 10327, 2004).

[145] BUREAU OF LABOR STATISTICS, LABOR FORCE STATISTICS FROM THE CURRENT POPULATION SURVEY (2012), http://data.bls.gov/pdq/SurveyOutputServlet?request_action=wh&graph_name=LN_cpsbref3.

[146] *See Number of Foreclosures Soared in 2007*, NBC NEWS.COM (Jan. 29, 2008), http://www.msnbc.msn.com/id/22893703/ns/business-us_business/t/number-foreclosures-soared/#.UD_ertaPU25.

[147] Dean Baker, *The Housing Bubble and the Financial Crisis*, 46 REAL-WORLD ECON. REV. 73, 77 (2008).

[148] Matthew Silfee, *Commercial Banks Increase Agency MBS Holdings by $51.4 Billion*, STRUCTURED FIN. NEWS (Aug. 2, 2010), www.structuredfinancenews.com/news/-209256-1.html.

[149] Andrew Ross Sorkin, *Lehman Files for Bankruptcy; Merrill Is Sold*, N.Y. TIMES, Sept. 15, 2008, http://www.nytimes.com/2008/09/15/business/15lehman.html?_r=1&pagewanted=print.

Certainly, if there were a large number of defaults in the student loan market, it would signal the same type of inability to repay that the foreclosure wave signaled in the mortgage market. While the student loan market is just under 10% of the size of the mortgage market, it is growing rapidly, especially as a share of total consumer debt.[150] This would most likely be a signal that employment is down for twenty-one to thirty year olds, who hold a significant portion of the total student loan debt.[151] This will necessarily impact consumer spending, leading to an inventory contraction in the retail sector in preparation for decreased demand.

It is possible that employers could also see a decrease in employment coming, and begin to curb hiring in anticipation of lower wages as the supply of available labor would increase.[152] The college industry would also be affected if schools anticipated a contraction in student loan origination that would mirror the contraction in mortgage origination. The problem with bad economic news is that it spreads and intensifies. If student loan defaults lead retailers to cut inventories, investors now see two pieces of bad news. This spiral could lead to another recession, as all players in the economy see the student loan defaults as a symptom of larger economic problems.

The second mechanism, liquidity channels, can have a far-reaching impact in the global economy, and can move very quickly. When the foreclosure rate went up between 2006 and 2007,[153] credit began to tighten for the average borrowers in response to a decrease in the inflow of capital. This led to fewer new mortgage originations, the necessary component for feeding the beast of MBS. Without new MBS, combined with falling values and relatively illiquid MBS created before the crisis, banks were incapable of creating new capital flows to fix the holes in their balance sheets left from over-leveraging during the mid-

[150] *See* Leach Schnurr & David Gregorio, *Consumer Debt Eases in Second Quarter: NY Fed*, REUTERS (Aug. 29, 2012), http://www.reuters.com/article/2012/08/29/us-usa-fed-consumerdebt-idUSBRE87S0R020120829.

[151] Danielle Kurtzleben, *Student Debt Woes Could Magnify Economic Problems*, U.S. NEWS (Aug. 29, 2012), http://www.usnews.com/news/articles/2012/08/29/student-debt-woes-could-magnify-economic-problems.

[152] *See* Ricardo Llaudes, *The Phillips Curve and Long-Term Unemployment* (European Cent. Bank, Working Paper No. 441, 2005), http://www.ecb.int/pub/pdf/scpwps/ecbwp441.pdf.

[153] *More Than 1.2 Million Foreclosure Filings Reported in 2006*, REALTYTRAC (Feb. 8, 2007), http://www.realtytrac.com/content/press-releases/more-than-12-million-foreclosure-filings-reported-in-2006-2234.

2000's boom.[154]

The short-term credit markets froze in response to $7.3 trillion in MBS now being illiquid.[155] This tightened consumer credit markets even further as banks were hesitant to lend to anyone without collateral to back the loan.[156] From the short-term credit markets, it spread to the auction rate securities market. Already aware of how bad MBS had become, investors no longer bid on auction rate securities, creating yet another illiquid market for previously originated securities. It reached its peak when on February 13, 2008, 80% of auctions failed.[157] On February 20, another 395 of 641 auctions failed; a 62% failure rate.[158] Contagion had spread from foreclosures of home mortgages all the way to auction rate securities and short-term credit markets, two markets generally considered to be stable, and relatively liquid.

When the MBS market tanked, so did the SLABS market. Looking at origination and liquidity during the period of 2007 to 2011, there was a decrease in the volume of new SLABS as well as the movement of previously originated SLABS.[159] Fewer swaps were written, as investors were scared of anything they didn't know.

If the foreclosure crisis, by way of MBS, can cause the SLABS market to contract, then it is reasonable to assume the reverse is true. Liquidity in the primary student loan market would decrease, as a higher default rate[160] meant fewer available funds

[154] Ultimately, many banks would be found to have leveraged their assets up to 20 or 30 times their actual value. *See* Kate Kelly, *Lost Opportunities Haunt Final Days of Bear Stearns*, WALL ST. J., May 27, 2008, http://online.wsj.com/article/SB121184521826521301.html#printMode.

[155] ROBERT POZEN, TOO BIG TO SAVE? HOW TO FIX THE U.S. FINANCIAL SYSTEM 5 (2009).

[156] This is in stark contrast to the earlier practices of relaxing even typical down payment policies. Ilyce R. Glink, *Mortgage Loan Now Requires Higher Down Payment, Credit Score*, CHI. TRIB., Apr. 16, 2009, http://www.chicagotribune.com/classified/realestate/chi-mortgage-loan-down-payment-credit-score,0,830375.story.

[157] Between 1984 and 2007, a total of 44 auctions had ever failed. Song Han & Dan Li, Liquidity, *Runs, & Security Design: Lessons from the Collapse of the Auction Rate Municipal Bond Market* 6, 45 (Oct. 15, 2008) (presented at the Federal Reserve "Day Ahead" Conference on Financial Markets in 2009), http://www.frbsf.org/economics/conferences/0901/Han-Li.pdf.

[158] *Id.* at 6.

[159] STANDARD & POOR'S RATING SERVS., STUDENT LOAN ABS TRENDS, OUTLOOK AND PANEL DISCUSSIONS 22 (2012) (on file with author).

[160] *See* Collin Eaton, *Student-Loan Default-Rate Climbs as Economy Falters*, CHRONICLE OF HIGHER EDUC. (Sept. 12, 2011), http://chronicle.com/article/

for new students seeking loans. This would be mitigated in part, because the federal government issues the majority of new loans, and they are not as affected by short-term fluctuations in repayment.[161] However, they are affected by long-term trends, and if there were a prolonged, pervasive, high default rate on student loans, it could also affect the availability of federal funding.

This would immediately affect the college market, as student loans represent the majority of money flowing into universities. Depending upon their balance sheets, some universities may simply no longer be able to operate. Once the student loan market begins to dry up, the fuel for the SLABS engine also dries up. I believe that this will cause an even bigger seizing of liquidity in markets across the spectrum. SLABS are somewhere in the $1 trillion range, so they represent a much smaller piece of the ABS pie than MBS did.[162]

However, this is now the second go-around with an asset-backed securities freeze. Investors know how it ends. Swaps and issuance of ABS may stop almost immediately, with auction rate securities failing at 2008 rates again. Short-term credit markets will dry up as investors prepare for another global recession and deem no one creditworthy. While the banks don't have the leverage problems to the extent they had them four years ago, they still do have leverage problems, and rely on short-term credit and corporate bonds to stay afloat. These markets may completely evaporate as investors see this more as a second domino in the ABS fall, rather than as a stand-alone shock.

The third mechanism is the risk premium channel. Logically, once the mortgage market started seeing an increase in foreclosures due to subprime mortgages, investors began increasing their risk premium for purchasing MBS. In light of the fact that MBS is primarily used to generate new capital for mortgages, and since mortgages were now being viewed as much riskier than they were only a few years before, investors required a bigger payoff for their investment. However, this wasn't just true in the mortgage market. Risk premiums went up in a

Student-Loan-Default-Rate/128964/.

[161] *Government Student Loans*, STAFFORDLOAN.COM, http://www.staffordloan.com/stafford-loan-info/government-student-loan.php (last visited Sept. 3, 2012).

[162] *U.S. Student Loan ABS Resistant to Default Rates,* FITCHRATINGS (Mar. 22, 2012), http://www.fitchratings.com/web/en/dynamic/articles/U.S.-Student-Loan-ABS-Resistant-to-Default-Rates.jsp.

number of markets, including auction rate securities markets, short-term credit markets, corporate bond markets, and ABS markets generally.[163] This compounded the problem of decreased marketability as the investors with capital offered liquidity, but only at rates that banks were ill-advised to take.[164] The equity markets were hit especially hard. Investors fled these markets as high-profile bankruptcies caused by the mortgage crisis scared them away. Investors waited for stocks to finish plummeting before they would invest. Citibank went well below $1.00 before investors saw it as a sound investment again.[165]

A meltdown in the student loan market could have a similar impact on the risk premium of investors in other markets. As the SLABS market ratings have indicated, the market is seen as a very liquid, very safe market in which to trade. SLABS have by far the highest ratio of AAA ratings to overall ratings. Much of this is based on the false notion that student loans are non-dischargeable, and thus will always be paid.[166] There will be an effect on equity markets as the investors see signs that the economy is worsening, leading to these defaults.

Banks (like Citibank and JP Morgan) with large portfolios of SLABS will see an increased risk premium for their corporate bonds. Their stock prices may drop as investors see those stocks overvalued compared to the risk on the companies' balance sheets. Investors, having been through this before, will immediately grow more hesitant about the entire ABS market, and will demand a higher risk premium on ABS offerings. Auction rate securities will have to lower their offered prices to reflect investors' fear of another significant downturn. Credit Default Swap (CDS) issuance could also see a dramatic shift. CDS lost some $20 trillion in market size during the mortgage crisis, so the market will not be willing to write or swap CDS for anything that does not include a premium reflecting another possible recession.[167]

The SLABS market is what makes the student loan market so

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[163] Han & Li, *supra* note 157, at 1.

[164] *See Buffett Lends a Shoulder to Goldman*, ECON. TIMES, Sep. 25, 2008, http://articles.economictimes.indiatimes.com/2008-09-25/news/27716970_1_goldman-sachs-group-warren-buffett-lloyd-blankfein. Warren Buffet famously loaned Goldman Sachs a large amount of money but for the unheard of rate of 10%.

[165] *See* COMM'N REPORT, *supra* note 51, at 23.

[166] *See* Naranjo, *infra* note 202, at 252–53 (review of why this is false).

[167] COMM'N REPORT, *supra* note 51, at 299.

deadly to the overall economy. While the student loan market is big, and growing steadily, a student loan default without SLABS is just one default. Student loan credit markets would seize up, but they are very independent, and are backed heavily by the federal government, so the impact would be mainly on potential students.[168] However, SLABS inject student loans into the overall financial market. They represent liabilities on balance sheets, and are a harbinger of another round of ABS default.

There is every reason to believe that a student loan default crisis, by way of SLABS, could have the same impact the mortgage crisis had. But we can expect this to happen more quickly, because we already know how the market reacts. The unknown number of CDS that are written on SLABS further complicates this. Ultimately, one student loan default triggers two other debt instruments, creating three credit events in the market for every one person who defaults.[169] The MBS meltdown and contagion gave an expert lesson in what exactly can happen and why it is so imperative that it be stopped before it starts.

VII. GOVERNMENT RESPONSE TO THE MORTGAGE CRISIS

In the same way that understanding the build-up and bursting of the mortgage bubble can help us understand the student loan bubble and its weaknesses, looking back on the government response to the mortgage crisis can help us identify what worked and what did not work. This analysis can help us create a proactive solution rather than the delayed reactive solution we witnessed after the mortgage crisis.

One problem with the response to the mortgage market was that the full breadth of the collapse was not known. A failure of market oversight and a lack of knowledge of systematic risk made the bottom hard to tell. As discussed earlier, contagion takes what would normally be a single-sector downturn and spreads it into every aspect of the economy, compounding the problem.[170] The government did have an expansive response to the mortgage crisis specifically, and the broader economy generally; however, this section addresses just those actions that could have an

[168] *See* LEE & EGAN, *supra* note 85, at 12.

[169] Obviously many student loan defaults would have to happen in order for there to be a large impact but this illustrates how the process starts. *See id.*

[170] LONGSTAFF, *supra* note 139, at 2.

analogous structure in the event of a student loan collapse.[171] It is important to note that the government's response was multi-faceted, targeting mortgage borrowers, lenders, and financial institutions involved in MBS and CDS.

The Troubled Asset Relief Program (TARP)[172] was created to address the after-effect of the mortgage crisis: toxic debt on the balance sheets of the largest banks in the world that, if left unchecked, could create systematic risk to the entire financial sector. The original TARP, authorized to be $700 billion,[173] was meant to prop up banks by removing MBS that consisted of defaulting mortgages from banks balance sheets while simultaneously boosting banks' liquidity in the market. This was not the case however, as many banks saw TARP as a windfall to help stabilize their balance sheets without increasing borrowing to consumers.[174] The banks did need the capital infusion as years of overleveraging[175] had left their balance sheets with significantly more assets than net equity.

One of the first victims of the crisis, Bear Stearns, gave the most poignant example of this problem. At the end of 2007, Bear Stearns had $395 billion in assets being propped up by $11.8 billion in net equity, a leverage ratio of thirty-three to one.[176]

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[171] For a broad discussion, *see* Alan S. Blinder & Mark Zandi, How the Great Recession Was Brought to an End (July 27, 2010) (unpublished manuscript), http://www.princeton.edu/~blinder/End-of-Great-Recession.pdf.

[172] TARP also had a component called the Capital Purchase Program (CPP). This was replaced in February 2009 by the Capital Assistance Program. Both programs targeted a capital infusion into troubled financial institutions whose failure represented a systematic risk to the entire financial sector. For purposes of clarity and consistency, TARP will be used to mean the program to purchase failing MBS and the program to inject capital into banks through the purchase of warrants and preferred stock. *See* Paul Glasserman & Zhenyu Wang, *Valuing the Treasury's Capital Assistance Program*, 57 Management Sci. 1195 (2011) (discussing CAP).

[173] This would later be reduced to $465 billion under President Obama. Neil Barofsky, Special Inspector Gen., Troubled Asset Relief Program, Statement Before the U.S. H.R. Comm. on Ways and Means Subcomm. on Oversight (Mar. 19, 2009).

[174] Mike McIntire, *Bailout Is a Windfall to Banks, if Not to Borrowers*, N.Y. Times, Jan. 17, 2009, http://www.nytimes.com/2009/01/18/business/18bank.html?pagewanted=all.

[175] *See* Sheran Deng, *SIVs, Bank Leverage and Subprime Mortgage Crisis* (Dec. 22, 2008) (unpublished), *available at* http://ssrn.com/abstract=1319431.

[176] Class Action Complaint at 20, *In re* Bear Stearns Cos., 763 F. Supp.2d 423 (S.D.N.Y. 2011). While Bear Stearns was not a recipient of TARP as it was sold for $10 a share to JP Morgan, it served as a stark example of a practice that was going on throughout the financial sector. *See* Adam Shell, *JPMorgan Boosts Offer for Bear Stearns to $10 a Share*, USA Today, http://abcnews.go.

After the collapse of Bear Stearns, Lehman Brothers, Fannie Mae, and Freddie Mac, the US Treasury Department, under Henry Paulsen, knew that stabilizing banks to avoid any further collapses would be the first step in righting the economic ship that was quickly taking on water.[177] TARP also had the added feature of being an investment through capital infusion rather than an interest loan.[178] TARP has been seen as effective, and audits have also borne out this fact.[179] While TARP funds have not yet been repaid, the Congressional Budget Office calculates that the actual cost of TARP to taxpayers will be significantly less than the $700 billion originally authorized.

The government didn't only intervene to prop up banks and GSEs. The federal government was very active in the consumer mortgage market, trying to help borrowers stay in their homes, while a combination of rising unemployment, recession, rates adjusting, and foreclosure actions all exerted negative pressure on the borrowers. As noted earlier, the federal government created HAMP to help those borrowers in arrears or underwater by giving them a means to modify their loans so the banks could keep collecting some mortgage payments, and so that borrowers could stay in their homes.[180]

As was also previously noted, this has been, by and large, a failure. Without a judicial decree forcing the modifications, and without close government oversight, banks weren't eager to promote HAMP, and many borrowers were precluded by overly stringent requirements.[181] Senate Bill S.61, which would have allowed homeowners to seek a modification in a Chapter 13 proceeding in Bankruptcy Court, failed to pass the Senate, though a similar bill did pass the House of Representatives in 2009. The Senate also voted against a Cram-Down bill that would have allowed for judicial modification of mortgages.[182]

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com/Business/story?id=4516500&page=1#.UD_zNI7thaE (last visited Aug. 28, 2012).

[177] This includes the Maiden Lane Transactions used with Bear Sterns and AIG. *See Maiden Lane Transactions*, FED. RES. BANK OF N.Y., http://www.newyorkfed.org/markets/maidenlane.html (last visited Aug. 28, 2012).

[178] Barofsky, *supra* note 173.

[179] Jackie Calmes, *Audit Finds TARP Program Effective*, N.Y. TIMES, Dec. 10, 2009, http://www.nytimes.com/2009/12/10/business/economy/10audit.html.

[180] COMM'N REPORT, *supra* note 51, at 405.

[181] *See* Loren Berlin, *HAMP Loan Program Expands, Too Little Too Late*, HUFFINGTON POST, Jan. 27, 2012, http://www.huffingtonpost.com/2012/01/27/hamp-loan-modification-expands_n_1237169.html.

[182] Unfortunately, while HAMP had the right idea in terms of keeping people

The failure of both bills was not the end of bankruptcy courts' involvement in the mortgage crisis. Borrowers who are under-secured on their mortgages, meaning they owe more than their house is worth, can still file for bankruptcy, and the mortgage and note are included in the bankruptcy estate.[183] Once the debtor files his or her bankruptcy petition,[184] an automatic stay is put on all state court actions, including foreclosure proceedings.[185] Under Chapter 13 plans, the debtor is able to pay off his or her arrearage over the course of the plan, usually three or five years.[186] This allows a person who has the money to meet his or her mortgage obligations to keep his or her house while slowly becoming current.

The process of reaffirmation adds another wrinkle to the bankruptcy proceedings. With a normal bankruptcy, once the discharge is granted, the mortgage stays, but the note is discharged. However, if the note is discharged, the debtor cannot seek a modification of the loan under a program such as HAMP.[187] The process of reaffirmation allows the person to seek a modification, because they are reaffirming their personal liability for the house. Without a reaffirmation, the bank, prompted by missed payments, could foreclose on the mortgage but would only be able to collect whatever the house sells for. With a reaffirmation, the debtor could seek a modification but would also be personally liable for the unsecured deficiency, that is, the difference between the amount owed and the amount the house sells for. This is a glaring hole in the bankruptcy process, as two methods meant to work towards keeping a borrower in their home, cannot seem to be reconciled without the borrower taking on personal liability.[188]

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paying and in their homes, better solutions for its administration existed but could not pass the Senate. *See* Peter J. Leo, *The Case for "Cramdown": Eliminating the Practical and Ideological Barriers to Pure Mortgage Modification* (Jan. 2010), http://works.bepress.com/peter_leo/1.

[183] H.R. 200, 111th Cong. (2009).

[184] If the debtor wishes to keep their house they will need to file a Chapter 13. *Chapter 13, Individual Debt Adjustment*, U.S. COURTS, http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Chapter13.aspx (last visited Sept. 9, 2012) [hereinafter U.S. COURTS].

[185] 11 U.S.C. § 362(a)(2) (2006).

[186] U.S. COURTS, *supra* note 184.

[187] The debtor can refinance but given that there will be a bankruptcy on their credit report, the prospect is grim.

[188] While DRBS has stated that some bankruptcy judges are doing mortgage cram downs without a bill from Congress giving them this authority, there appear to be no instances of judges modifying loan terms. *See* DBRS, *First*

Since the introduction of HAMP, results have been mixed, but a consensus is growing that the program did not achieve its objectives. HAMP proposed that lenders actively seek out eligible borrowers for modifications, determine whether it is more beneficial to foreclose or modify the loan, and in some instances, attend mediation before a foreclosure went through.[189] The program was intended to help nearly 8 million struggling homeowners, but, as of 2010, 728,686 borrowers had been kicked out of the program and only 640,300 remained, less than half of those originally enrolled.[190] HAMP can be costly, and in late 2010, the number of people choosing to enter the program fell from 55,000 in the early part of the year, to 33,000.[191] Public perception that the program was poorly designed and had been rushed out to the public to address the housing crisis, and the pervasive stories but the modification taking longer than the foreclosure process even for qualifying homeowners, also fueled mistrust in the program.[192] The Special Inspector General for the TARP, SIGTARP, and the US Treasury Department both have come out and said that HAMP missed the mark.[193]

In assessing the failures of HAMP, we can better inform the discretion of the bankruptcy courts who will be tasked with handling student loan defaults. The first problem is that it was not mandatory for lenders. Because the lenders were outside of the court system for modifications, and foreclosures take place in state court, the federal government was unable to force lenders to partake in HAMP, both for political and legal reasons.

Second, because of the voluntary nature of the program,

Mortgage Cram-Downs Have Begun, U.S. STRUCTURED FIN. NEWSL., May 2, 2011, at 1.

[189] Administrative Order *In re* Final Report & Recommendations on Residential Mortg. Foreclosure Cases, No. AOSC09-54, 2009 WL 5227471 (Fla. Mar. 19, 2009) (ruling that all foreclosures must go through mediation first to see if modification is possible).

[190] Arthur Delaney & Shahien Nasiripour, *Federal Auditor Says Obama's Anti-Foreclosure Effort Risks 'Generating Public Anger and Mistrust'*, HUFFINGTON POST, Oct. 25, 2010, http://www.huffingtonpost.com/2010/10/25/false-hope-federal-audito_n_773681.html.

[191] *Id.* This has also led to a number of scams where people promising mortgage modifications are actually just taking peoples' money.

[192] *See id.*

[193] The Special Inspector General stated "[d]espite frequent retooling, [it] continues to fall dramatically short of any meaningful standard of success." Karen Datko, *HAMP is a Failure: Here's Why*, MSN MONEY (Feb. 3, 2011, 8:25 PM), http://money.msn.com/saving-money-tips/post.aspx?post=c124f733-e80a-4582-b236-0128df523ab4.

modifications were still performed in-house by lenders, but their performance was significantly weaker.[194] HAMP modifications performed better, because the structure of the modification wasn't the problem, the eligibility requirements were. Under HAMP, the average borrower's monthly payment was reduced by $608 compared to $307 for in-house modifications.[195]

Lastly, there was very little oversight done on lenders. Lenders were put in the driver's seat for these modifications, and a United States Treasury report found that lenders were using an incorrect version of the United States Treasury eligibility formula on potential modification participants.[196] Because of the nature of the crisis, the United States Treasury was unwilling to levy penalties against the banks.[197]

Lenders were much more capable of handling a smaller workload, and were more responsive when there wasn't an epidemic of default occurring. In 2009 and 2010, over $12 billion in loan modifications were done, and this was only in the commercial real estate sector.[198] Similar large spikes are also seen in the residential mortgage market.[199] While these were, initially, primarily HAMP occurrences, lenders are now seeking modifications because of the expense and time of foreclosures, the increased attention from state attorneys general, and because state courts are no longer rubber-stamping foreclosures. These hindrances can help create a model for the courts to implement in the event that a student loan default epidemic occurs.

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[194] Ruth Simon, *For Lender, Foreclosure Has Become Dirty Word*, WALL ST. J., Sept. 8, 2011, http://online.wsj.com/article/SB10001424053111904103404576556744110012216.html.

[195] Datko, *supra* note 193.

[196] SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, THE NET PRESENT VALUE TEST'S IMPACT ON THE HOME AFFORDABLE MODIFICATION PROGRAM 19 (2012).

[197] Paul Kiel & Olga Pierce, *Govt's Loan Mod Program Crippled by Lax Oversight and Deference to Banks*, PRO PUBLICA (Jan. 27, 2011), http://www.propublica.org/article/loan-mod-program-crippled-by-lax-oversight-and-deference-to-banks.

[198] RICHARD PARKUS & HARRIS TRIFON, DEUTSCHE BANK SEC., CMBS RESEARCH: LOAN MODIFICATIONS IN CMBS STEP INTO THE SPOTLIGHT 4 (2010).

[199] Tim Massad, *Expanding our Efforts to Help More Homeowners and Strengthen Hard-Hit Communities*, U.S. DEP'T OF THE TREASURY (Jan. 27, 2012), http://www.treasury.gov/connect/blog/Pages/Expanding-our-efforts-to-help-more-homeowners-and-strengthen-hard-hit-communities.aspx.

VIII. THE ROLE OF BANKRUPTCY COURTS

The reforms laid out in the previous section are a prophylactic measure aimed at preventing the type of widespread defaults that were seen in the mortgage crisis. However, no system is perfect, and it would be irresponsible to not prepare a contingency plan for that possibility. Once again, looking to the successes and failures of the mortgage crisis provides a road map for ways in which the government can respond to a student loan default crisis. The bankruptcy courts, already savvy in restructuring debts, bringing borrowers current, and working intimately as an intermediary between creditors and debtors, are a logical place to vest the authority of responding to a student loan default crisis.[200] However, the way the courts are now set up would further exacerbate the problem of a student loan default crisis rather than fix it. Reforms must be initiated to inform the discretion of the bankruptcy courts and vest broader power in the bankruptcy courts to address the potential problem.

As explained earlier, HAMP was the main program targeted directly at the problem of borrowers being unable to meet their debt obligations. Of the several problems that HAMP ran into, the most important to address are the lack of force of law behind the program, and stringent standards that caused many borrowers to not qualify or quickly be kicked out of the program. If discretion were vested in the bankruptcy courts, a judicial edict would be behind all modifications, making them binding on all parties. Second, bankruptcy judges, more than any other part of the government, are keenly aware of the solutions and pitfalls that accompany restructuring debt, and of bringing borrowers current on debts.[201] Using the bankruptcy courts also eliminates any conflict of interest that would arise by having the lender dictate terms of a modification to their own borrower.

Bankruptcy courts are given great discretion with student loans.[202] This discretion, when faced with a student loan default

[200] Bills were presented to Congress to give this same power for mortgages but failed to pass. Bankruptcy courts would also take judicial notice of any actions going after defaulted loans which would avoid any robo-signing type scams from coming up.

[201] N. Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 U.S. 50, 71 (1982).

[202] Congress intended for § 523(a)(8) to be read strictly so any changes to discretion would need to be done through Congress to avoid overturning on appeal and slowing down the recovery process. *In re* Naranjo, 261 B.R. 248, 253, 258 (Bankr. E.D. Cal. 2001).

crisis, could quickly cause the markets to seize if bankruptcy judges began to more broadly interpret case law and grant discharges to large swathes of student loan borrowers. A debtor filing for Chapter 7 bankruptcy[203] must meet the undue hardship test.[204] 11 U.S.C. § 523(a)(8) reads in pertinent part:

> a discharge under section 727, 1141, 1228 (a), 1228 (b), or 1328 (b) of this title does not discharge an individual debtor from any debt— . . .
> (8) unless excepting such debt from discharge under this paragraph would impose an undue hardship on the debtor and the debtor's dependents, for—
> (A)(i) an educational benefit overpayment or loan made, insured, or guaranteed by a government unit, or made under any program funded in whole or in part by a governmental unit or nonprofit institution. . . .[205]

The Second Circuit Court of Appeals defined the undue hardship test in *Brunner v. New York State Higher Education Services Corp*.[206] The Court laid out a three-pronged test to determine if there was an undue hardship.[207] It must be established:

> (1) that the debtor cannot maintain, based on current income and expenses, a "minimal" standard of living for herself and her dependents if forced to repay the loans;
> (2) that additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment period of the student loans; and
> (3) that the debtor has made good faith efforts to repay the loans.[208]

This test, though refined through many bankruptcy court decisions, gives great discretion to the bankruptcy courts.[209] First, the question of what a minimum standard of living entails is debatable. While some courts see this as the federal poverty

[203] A debtor filing under Chapter 13 must meet the same standards to get a discharge under § 1325. 11 U.S.C. § 1328 (2006).

[204] Interestingly, undue hardship was also a key provision of HAMP. Ideally, seasoned federal judges will be better equipped to determine undue hardship than lenders with a vested interest in the outcome.

[205] 11 U.S.C. § 523 (2006).

[206] 831 F.2d 395, 396 (2d Cir. 1987).

[207] *United Student Aid Funds, Inc. v. Espinosa* complicates this matter as the Supreme Court found that a failure of the Bankruptcy Court to apply the undue hardship test would not void a discharge. 559 U.S. 260 (2010).

[208] Brunner, 831 F.2d at 396.

[209] *See In re* Thoms, 257 B.R. 144, 150 (Bankr. S.D.N.Y. 2001); *In re* Fowler, 250 B.R. 828, 830–31 (Bankr. D. Conn. 2000).

line, Kent Anderson points out that in an urban area those with "income . . . below 150% of [the] poverty level requires government subsidies . . . to satisfy the most elementary needs of human existence."[210] Additionally, Anderson notes that the good faith basis to pay is subject to court discretion, and in some instances a new eyeglass prescription and life insurance have been found to be unnecessary expenses.[211]

The real crux of the Brunner test comes in the second prong, which requires the cause of the hardship to repay to be a persistent issue over the life of the loan. Most bankruptcy court rulings have viewed this through the lens of a physical or medical ailment that makes it impossible for the debtor to work.[212] No published case to date has viewed long term, persistent unemployment as fulfilling the second prong of the Brunner test and the courts have not treated long term unemployment as an undue hardship.[213] These cases were decided before the mortgage crisis and the results created the longest stretch of high unemployment since the Great Depression.[214]

Official unemployment is 8.3%; labor force participation is 63.9%, one of the lowest levels in eighty years; and the United States real unemployment rate is 14.9%,[215] nearly twice the level it was in 2007. In light of this it is not hard to see why bankruptcy judges could start changing their minds about what constitutes a persistent malady creating an inability to repay student loans. Further, there is reason to think that in the coming years, as student loans increase and the labor market for

[210] Anderson, *supra* note 87.

[211] *Id.*

[212] *See In re* Crawley*,* 460 B.R. 421, 438 (Bankr. E.D. Pa. 2011); *In re* Marcotte, 455 B.R. 460, 470–71 (Bankr. D.S.C. 2011); *In re* Wallace, 443 B.R. 781, 789 (Bankr. S.D. Ohio 2010).

[213] The bankruptcy courts look to education, health, and future earning capacity to see if a persistent hardship is likely to continue. *Crawley*, 460 B.R. at 438–39 n.20.

[214] CONG. BUDGET OFFICE, U.S. CONG., UNDERSTANDING AND RESPONDING TO PERSISTENTLY HIGH UNEMPLOYMENT, at viii (2012). The publication goes on to say that the stigma of long-term unemployment actually perpetuates itself, causing the labor market to sag.

[215] The real unemployment rate includes those who are looking for work but, for various reasons, have not searched for a job during the four weeks that are being counted, as well as those who are looking for full-time work, but are currently only working part-time. *See* Bart Hobijn, Colin Gardiner & Theodore Wiles, *Recent College Graduates and the Job Market*, FRBSF ECON. LETTER, Mar. 21, 2011, at 3.

new graduates stagnates,[216] a weak recovery will create a swarm of students facing long-term, persistent unemployment, barely able to stay above the poverty line with no way of paying their student loans.[217] These students could eventually seek the protection of the bankruptcy courts, and without proper reform, the courts, in their capacity as courts of equity, could create a student loan default crisis, rather than prevent one.

IX. REFORMS TO THE BANKRUPTCY COURT PROCESS OF HANDLING STUDENT LOANS

The first step toward reformation is drawing a bright line distinction between student loan borrowers seeking discharge because of high unemployment and economic factors, and those that are seeking discharge because of medical or disability reasons. The easiest way to do this is to create a program through the courts that helps out borrowers seeking discharge of their student loans, but who could not meet the undue hardship test. The program would look at the education of the borrower, prevailing market conditions generally, market conditions with respect to skill-set and geography of the debtor, the length of unemployment, the chances of finding gainful employment over a ten-year period, and the proportion to expected future income that the student loans represent.

This program would not discharge the loans, but would create a plan under the framework of Chapter 13 that would keep the borrower paying a nominal amount, and give the lender more money over time. A balance must be struck between fairness and equity to the borrower, and between the reality of how repaid student loans fund new student loans and the consequences, as listed earlier, of a widespread student loan default. It would basically be a HAMP program for student loans under the aegis of the bankruptcy courts.

The second step is bifurcating debt. Student loans represent a very unique type of debt in the bankruptcy context, since it is unsecured, but also non-dischargeable.[218] Many students seeking

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[216] *Id.* at 2–3 (finding that the unemployment rate of new college graduates has doubled to nearly 16%).

[217] News Release, Bureau of Econ. Analysis, National Income and Product Accounts (Jan. 27, 2012), http://www.bea.gov/newsreleases/national/gdp/2012/gdp4q11_adv.htm (showing a 1.8% increase in real GDP in 2011).

[218] Julie Swedback & Kelly Prettner, *Discharge or No Discharge? An Overview of Eighth Circuit Jurisprudence in Student Loan Discharge Cases*, 36

the protections of a student loan bankruptcy plan may also have dischargeable debt in the form of credit cards, medical expenses, taxes, or other liens to secured property. Under this plan, debtors would be allowed to seek Chapter 7 discharge of debts if they choose, and if they meet the standards that are already in place, and then would put their student loans into a modified Chapter 13 plan.

Congress, in enacting Chapter 13, intended to encourage its use, and intentionally made discharge provisions under § 1328 more liberal than those under Chapter 7.[219] This intent was seen in the courts decisions in *In re McAloon* that allowed for a debtor to discharge student loans in a Chapter 13 plan even though those loans could not be discharged in a Chapter 7 plan.[220] While Congress has certainly narrowed the ability to discharge student loans through several amendments to the bankruptcy code since *McAloon*, increasing the number of years before a debtor could file for discharge and making it impossible to discharge through Chapter 13,[221] Congress's original intent for Chapter 13 perfectly suits the needs of the governments faced with a mounting student loan default crisis.[222] Forcing student loan debtors into a Chapter 13 plan keeps them paying while giving the debtor the necessary breathing room to find employment without worrying about wage garnishment, tax refund garnishment, or state court actions.[223]

Next, the court must address any arrearage that exists. It is fair to assume that if a student is filing bankruptcy due to student loans, then there is most likely an outstanding balance. Under § 1322, interest must be paid on any pre-petition arrearage that is paid during the life of the loan in a Chapter 13 plan.[224] This would apply to student loans, since they are non-

WM. MITCHELL L. REV. 1679, 1681,1683 n.16 (2010).

[219] *In re* McAloon, 44 B.R. 831, 835 (Bankr. E.D. Va. 1984).

[220] *Id.* at 832.

[221] Student Loan Default Prevention Initiative Act of 1990, 20 U.S.C. § 1001 (2006).

[222] *See* Peter B. Barlow, *Nondischargeability of Educational Debts Under Section 523(A)(8) of the Bankruptcy Code; Equitable Treatment of Cosigners and Guarantors?*, 11 BANKR. DEV. J. 481, 488–89 (1994–95) (further discussion on section 523(a)(8) and its interaction with Chapter 13).

[223] These reforms, which negatively affect lenders in some regards, if enacted, would hopefully change the lending behavior, since it is in the student loan lenders best interest to avoid default, something much more easily done with a lower debt burden.

[224] 11 U.S.C. § 1322 (2006), *superseding* Rake v. Wade, 508 U.S. 464 (1993).

dischargeable under § 1328(a).[225] In order to expedite the debtors' ability to find employment and maintain a standard of living, the arrearage must be paid off over the life of the plan, but any interest that is accrued will be added to the outstanding principal balance. Once out of bankruptcy protection, the interest accrued during the plan will begin accruing interest as a normal part of the loan. The lenders will be getting paid back some of what they've lent, borrowers will be given some breathing room, but most importantly, student loan lenders will end up in a position no worse than they would be otherwise, and will possibly be better off, a factor which will be necessary in getting their support for the reform legislation.[226]

Next, the Chapter 13 student loan plan would need to be extended to one hundred twenty months. Assuming the mortgage crisis started in earnest in 2007, the United States is now sixty months, or a full Chapter 13 plan later, and there is still a problem of persistent long-term unemployment. If the idea is to give debtors breathing room to find employment, get current on student loans, and be able to pay them back over the life of the loan, then we must look at the most immediate history of unemployment and adjust accordingly. These goals would most easily be achieved by adding 120 months to 11 U.S.C. § 1325. To avoid prejudicing lenders any further, the arrearages from pre-petition debt would need to be paid off over a five-year period, with the bankruptcy judge having discretion to extend the period in the event of an extreme situation, e.g. a disability or sickness.

The bankruptcy courts also need to be given the ability to cram-down student loans. This proposal gained some traction during the mortgage crisis, but was never able to pass through Congress.[227] Under a cram-down, the judge would dictate new loan terms to a lender in order to help the borrower be able to repay the debt. In a mortgage context, it often meant reducing the outstanding mortgage to the fair market value of the house.[228]

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[225] 11 U.S.C. §1328 (2006).

[226] Based on myriad bankruptcy court cases, lenders, and the United States government, banks are very aggressive in going after student loan payments and making sure they are not discharged in bankruptcy. It would be ill-advised not to find a solution that benefits both parties.

[227] Rafael I. Pardo & Michelle R. Lacey, *The Real Student-Loan Scandal: Undue Hardship Discharge Litigation*, 83 AM. BANKR. L.J. 179, 180 (2009).

[228] *Saving American Homes 101*, CENTER FOR AM. PROGRESS (Mar. 3, 2009), http://www.americanprogress.org/issues/housing/report/2009/03/03/5718/saving-american-homes-101/.

Because student loans are much harder to value, a cram-down of the principal would need to be done as a function of the potential earnings that the debtor can expect over the life of the loan. The burden would be on the debtor to show that there is no way that his or her earnings could support the student loan. Using the government's metrics for the income contingent repayment plan, a debtor would have to show that over the course of his or her life, paying the entirety of the outstanding student loan would be more than 20% of discretionary income.[229] If this burden is met, the judge would have the discretion, based on the totality of circumstances, to reduce the student loan debt to an amount equal to 20% of discretionary income paid over the life of the debt.

The judge would also have the ability, through the cram down process, to extend the life of the loan.[230] This is especially important, given that young borrowers represent a disproportionate amount of student loan debt relative to their representation in the population. The maximum repayment period for a student loan is twenty-five years. A debtor who is thirty, without extending the length of the loan, would only have to repay until he or she is fifty-five, a full seven years before any social security benefits can be obtained[231] and twelve years before full retirement age. By extending the length of the loan, a debtor would be faced with lower payments, making it more manageable to pay back outstanding student loans.

It would also make the burden of showing a need for a principal reduction harder. For example, employing a thirty- or forty-year student loan drastically reduces the average monthly payments. Under a twenty-five year $100,000 loan at 6.8%, the average monthly payment is $694.07. Increasing the loan to thirty years reduces the monthly payment to $651.93 per month, and extending it further to forty years yields a monthly payment of $606.96, a reduction of 10% per month. This also benefits the student loans companies since they collect $82,000 more in interest payments. Judges would also have the discretion to adjust the interest rate, including switching from a variable to a fixed rate, in five year increments, to backload payments when debtors are at their highest income.

229 Discretionary income is the difference between Adjusted Gross Income and 100% of the federal poverty line.

230 *Saving American Homes 101*, *supra* note 228.

231 42 U.S.C. § 415 (2006).

During the Chapter 13 student loan plan, monthly payments would be floating, set to 5% of disposable income with an interest rate determined by the judge based on prevailing market conditions. One critique of HAMP, and the mortgage crisis in general, was large rate adjustments at a time when rates were falling towards historic lows. This strikes a balance between the low income that the debtor will have, and the need for lenders to receive payments to originate new student loans. Because the aim of this program is not to discharge debt, but to relieve the pressure of student loan debt during times of national economic strife, it is important to make sure the payments reflect the employment status of the debtor. This would also include a check every three years to make sure that a good faith effort has been made to find employment that adequately reflects the debtor's future potential earnings. Unlike HAMP, the judge would have the discretion to decide whether or not the effort was in good faith, eliminating the harsh and draconian standards of HAMP participation.

Lastly, the Chapter 13 student loan plan would have to have a provision by which a borrower could exit the plan and resume the student loan terms that were originally set forth when he or she borrowed, without prejudicing the lender. As the plan stands now, a borrower who gets a job early on in the program would have the benefit of a lower interest rate during the Chapter 13 student loan plan, a capped contribution at 5% of income, while potentially being able to squirrel away savings to pay off the entire loan as soon as the plan ends. This would be very beneficial to the borrower, but at a great economic cost to the lender.

In order to avoid that outcome, the judge would be allowed to setup a prepayment penalty commiserate with the loan that attaches to the end of the plan. It would be a percentage of the interest that the lender was due to collect over the life of the loan. This balances the lender's disadvantage of early payment with the benefit of having new funds to distribute. The plan would allow the borrower to opt out, provided he or she pays a balloon payment commensurate with the foregone interest the lender would have collected, all arrearage interest, the difference between the original payments due and the modified payments made, and a penalty to compensate the lost economic opportunity of the lender. The optional nature of the balloon opt-out avoids the feasibility issues that a mandatory opt-out provision would have.[232]

CONCLUSION

It is impossible to tell whether or not there will be a student loan default crisis. Certainly, the student loan market has all the early signs of a bubble, and they don't appear to be abating anytime soon. The mortgage crisis showed the global economy just how interconnected all the financial markets are, and the long lasting damage that collapsing bubbles can cause. With unemployment still above 8% five years later, it would be foolish to diminish the affect that these bubbles can have on the economy.

Fortunately, we can learn lessons from past bubbles (especially the most recent mortgage bubble, which is possibly the most well-documented bubble from a data standpoint), and adjust our future behavior. In order to prevent the student loan bubble from collapsing and ravaging the economy, reforms to oversight, SLABS origination, market transparency, and student loan lending must happen as quickly as possible. Additionally, empowering the bankruptcy courts to deal with a student loan debt collapse, if it does happen, will avoid the protracted mortgage fiasco that has marked the past four years.

There is no market elixir that is certain to stop a student loan default from happening, nor are reforms necessarily going to prevent the damage from being as bad as, or even worse than the past five years. However, by preparing in advance, we at least give the economy, and those seeking higher education, a fighting chance.

[232] *See* Richard N. Gottlieb, *Up, Up and Away: Considering "Balloon Payment" Plans in Chapter 13 Cases,* 16–3 AM. BANKR. INST. J *1, *5 (1997) (discussing using balloon payments in Chapter 13 plans); *see also In re* McClaflin, 13 B.R. 530, 533 (Bankr. N.D. Ill. 1981) (stating that no provision allows or disallows balloon payments in Chapter 13 plans).