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The Basics

3 ways to avoid the student-loan trap

Lenders and collectors increasingly play hardball with students who load up on debt they can't pay yet can't escape. Here's what to know about student loans – before you borrow.

By Liz Pulliam Weston

Debtors' prisons were abolished more than 160 years ago, but Lori Siler of Westfield, Ind., insists she's living in one -- thanks to massive student-loan debt.

Siler dropped out of Purdue University in 1999 after borrowing the maximum amount of federal student loans, about $46,000. Today, the single mother of two boys earns $32,000 a year as an administrative assistant, while her unpaid student-loan debt has ballooned to more than $100,000.

Her lender wants her to repay $650 a month -- one-quarter of her gross income -- for the next 35 years. By the time Siler made the last payment, she would be 78.

"If I had charged up $100,000 worth of stuff (on credit cards) I could file bankruptcy, spend seven to 10 years rebuilding my credit and have a future," said Siler, 43. "But because I chose to attempt to get an education ... I am effectively consigned to corporate servitude for the rest of my life."

As tuitions soar, borrowing rises and interest rates march higher, consumer advocates fear millions more will face unpayable student-loan debt.

Unforeseen consequences

Hundreds of thousands of student borrowers are discovering what Siler has learned: that student loans are increasingly difficult to escape, regardless of the burden repayment might be.

Student lenders and collectors say their tough policies help keep the cost of college loans low and are a necessary antidote to earlier years when even well-paid borrowers could walk away from their education debt.

But many consumer advocates and bankruptcy attorneys say the pendulum has swung too far in favor of lenders. Students with little grasp of financial matters are encouraged to load up on loans, they say, and aren't warned that this borrowing could haunt the rest of their lives.

How student loans differ from other debt

The situation is a far cry from the early 1990s, when one out of five student borrowers defaulted on their loans with few consequences. Public outrage at the idea of doctors and lawyers reneging on federally subsidized loans helped bring about sweeping changes:

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Unlike most other unsecured debt, student loans can no longer be erased in bankruptcy court. Student-loan lenders won a 1998 change in federal law that made their loans almost impossible to discharge. The courts have rejected virtually every argument even the poorest borrowers have made that repayment would constitute an "undue hardship," bankruptcy attorneys said. Only borrowers who are "totally, permanently disabled" have much hope of discharging their debt, said Los Angeles bankruptcy attorney Leon Bayer.

Bankruptcy judges that do grant discharges are often reversed on appeal. Patricia Brightful, for example, convinced a Pennsylvania bankruptcy court in 1999 that repaying the $52,000 she owed in student loans would be an undue hardship for herself and her daughter, who was then 14. Brightful, 46, earned about $8,500 a year as a part-time legal secretary, had recently been evicted from her home, and according to the court suffered from "glaring psychiatric problems."

The Third Circuit Court of Appeals ruled in 2001, however, that Brightful hadn't proved her situation would never improve. The court held that bankrupts can't erase student loans just by showing they can't make the payments, but must also prove their financial outlook is so hopeless that repayment is impossible in the future.

Related student-loan resources

- How to find free money for college
- The insider's guide to student loans
- How to blitz your college debts
- Good debt vs. bad debt: both are tough in your 20s
- Top 10 shocks for college grads

Private collection agencies now pursue student borrowers. The U. S. Department of Education turns to a stable of 12 private collection companies to pursue most of its seriously overdue student loans, and collections soared to a record $5 billion last year. (The Education Department's success in using private companies helped lead to a law change that will allow the IRS to begin employing private collectors next year for its past-due debt.)

Meanwhile, Sallie Mae, the nation's largest student lender and, as of December 2004, a private company, recently became the nation's largest debt collector, said Patrick Lunsford, editor of CollectionIndustry.com, a Web site and newsletter for collectors. Sallie Mae purchased three collection agencies in recent years and owns a controlling interest in a fourth, Arrow Financial, said spokesman Tom Joyce.

Because private collectors are paid a percentage of the debts they retrieve, they're seen as much more motivated and effective in tracking down defaulters than public agencies would be. But private collectors working for public agencies also benefit from debt-collection weapons not available to other private collectors. The Education Department, for example, has been granted the ability to garnishee wages and seize tax refunds or Social Security checks without a court order.

If Sallie Mae or another collector is unsuccessful in getting a borrower to pay a federal student loan, Joyce said, the debt is often turned over to the Education Department so it can pursue those options.

Only the IRS, which pursues tax debt, and the Department of Health and Human Services, which goes after unpaid child support, regularly wield similar powers. In addition:

There is no statute of limitations on unpaid student-loan debt, and collectors have become increasingly skilled at tracking down defaulters even decades later.

With most other kinds of debt, the period in which creditors can sue is limited to three to 15 years, depending on the type of borrowing and on state law. No such restriction exists on student-loan debt.

Massive databases like those maintained by ChoicePoint and LexisNexis make it easier for collectors to find defaulted borrowers years after they've skipped, Lunsford said. Collectors for the Education Department can also tap into government databases that track newly hired employees.

Most collectors monitor debtors' credit histories, looking for those whose improving credit records indicate they're more likely to pay.

"Credit scoring is a big deal" among collectors, Lunsford said. "They're all doing some type of analytic scoring process."

One of the reasons Sallie Mae bought into collector Arrow Financial, Joyce said, was its success in using credit history to track likely targets for repayment.

"They have an interesting proprietary model," Joyce said, "that's going to help (Sallie Mae collections) across the board."

The most consumer-friendly debt?

Not everyone is pleased with the private debt collectors' success rate. Some collectors harass debtors, charge outrageous collection fees and force borrowers into unaffordable payment plans, said Deanne Loonin, a staff attorney for the National Consumer Law Center.

Student lenders and collectors point out that borrowers usually have plenty of options to prevent or cure their defaults. Indeed, student-loan debt is typically far more flexible than other types of debt. Federal student-loan programs typically offer:

- Long repayment periods that can lower monthly costs (although the longer the loan term, the higher the loan's overall cost).
- The ability to defer payments or pay less than the full amount owed if the borrower becomes unemployed or suffers financial hardship.
- A variety of repayment options, including "income sensitive" payments that depend on salary, or graduated payments that start small and rise over time.

- The possibility of "rehabilitating" a defaulted loan, so that some or all negative information about the loan is expunged from the borrower's credit report after 12 consecutive monthly payments are made.

Even private student loans, which now make up about 20% of new loans granted to students, allow forbearance, deferment and consolidation that can lower monthly costs, Joyce said.

Student-loan debt in general "is the most consumer-friendly debt that's out there," Joyce said. "It's also the only debt that ... enhances your ability to repay the loan, by helping you get a degree that increases your income."

Unless, of course, it doesn't, or you don't get the degree you expect. Siler said her job prospects are limited because she failed to get her degree, and her problems paying her student loans have precluded borrowing more money to finish. Student-loan experts say those who fail to get their degrees are much more likely to default than those who cross the finish line.

3 borrowing tips

If you're thinking of borrowing money for school, or already have, keep in mind the following:

- **Don't take on too much debt**. Most students would be smart to limit their total borrowing to no more than two-thirds of the annual salary they expect to make in their first year after college. If you're at or near that limit and haven't finished your schooling, consider transferring to a cheaper college or taking a year off to work and pay down your loans. (For more details, see "How much college debt is too much?")

- **Lock in low rates now**. Student-loan rates will jump significantly July 1, and Congress is considering abolishing fixed-rate consolidation loans in the future. (See "Act fast to cut your student loan costs.")
- **Talk to your lenders if there's a chance you may default**. As you've just read, ignoring student loans won't make them go away, and your options for dealing with the debt may wither the longer you fail to pay.

Liz Pulliam Weston's column appears every Monday and Thursday, exclusively on MSN Money. She also answers reader questions in the Your Money message board.

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- Teach your teen to handle credit cards
- Phishing scams -- avoid getting hooked
- 3 ways you can go broke in real estate
- How that huge credit limit can hurt you

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