



**TREATMENT OF STUDENT LOANS UNDER
CANADIAN BANKRUPTCY LAW**

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TREATMENT OF STUDENT LOANS UNDER CANADIAN BANKRUPTCY LAW

INTRODUCTION

Many Canadian high school graduates pursue some form of post-secondary education, and many of these graduates borrow from federal and provincial student loan programs to help finance their education.

In the past decade, student loan borrowings increased, as did the number of bankruptcies involving student loans. During the second half of the 1990s, changes to the *Bankruptcy and Insolvency Act* (BIA) made student loan debt non-dischargeable in a bankruptcy if the bankruptcy occurred within ten years after studies ended. This change ensures that student loan obligations will survive a bankruptcy even if other debts have been wiped out by a discharge.

This ten-year rule has been the subject of considerable debate. Lenders support the rule because it improves their chances of being repaid. Students, some insolvency practitioners and academics have questioned its soundness; as well, the Canadian Federation of Students has launched a court challenge to the rule under the *Canadian Charter of Rights and Freedoms*.

This paper:

- provides a brief overview of the history of the Canada Student Loan Program;
- outlines the provisions of the *Bankruptcy and Insolvency Act* relating to student loans;
- presents statistical data on student indebtedness; and
- highlights recent proposals to change the BIA.

CANADA STUDENT LOAN PROGRAM

The federal government instituted the Canada Student Loan Program (CSLP) in 1964. From 1964 to 1995, the CSLP made available financial assistance by way of a 100% government guarantee for student loans made by private financial institutions. The

guarantee scheme had drawbacks, however. It was costly for government, created little incentive for financial institutions to seek repayment, and did not provide suitable levels of service to borrowers.⁽¹⁾

In 1995, the Government of Canada changed the CSLP. The guarantee scheme was replaced by risk-premium financing agreements with financial institutions. Under these arrangements, participating financial institutions managed the repayment of student loans and accepted the risk of nonpayment. In return, the Government of Canada paid the financial institutions an annual risk premium of 5% of the value of the loans. The risk premium was designed to compensate financial institutions for the high number of student loan defaults. These arrangements expired at the end of July 2000.⁽²⁾

In early 2000, the federal government canvassed interested financial institutions about a new CSLP arrangement. According to a Human Resources Development Canada communiqué, too few financial institutions expressed an interest in concluding a new arrangement to make the program viable.⁽³⁾ As a result, the Government of Canada resumed issuing student loans directly through the National Student Loans Service Centre.

BANKRUPTCY LAW

The purpose of the bankruptcy process is to wipe out the outstanding debts of a bankrupt debtor and give the debtor a “fresh start.” But the bankruptcy process does not wipe out all debts – the *Bankruptcy and Insolvency Act* provides that certain kinds of debts survive a bankruptcy and remain outstanding even though all other debts are discharged. Surviving debts include:

- fines imposed by a court;
- alimony, maintenance and support payments;
- damages awards arising from civil proceedings for bodily harm, sexual assault or wrongful death; and
- debts and liabilities arising out of fraud.⁽⁴⁾

(1) Human Resources Development Canada, “The Government of Canada Ensures the Continuation of the Canada Student Loans Program,” News Release, 9 March 2000, available at <http://www.hrdc-drhc.gc.ca/common/news/hrib/00-19.shtml>.

(2) *Ibid.*

(3) *Ibid.*

(4) *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, s. 178, as amended.

In 1992, major changes to Canadian bankruptcy law took effect; one of these changes abolished preferred creditor status for debts owed to the government. This change relegated the Crown to the ranks of ordinary creditors who would share pro-rata in the bankrupt debtor's assets after secured creditors and preferred creditors. Consequently, the Crown had no priority over other creditors for student loan debts.

Amendments to the *Bankruptcy and Insolvency Act* (BIA) that took effect in September 1997 changed the status of student loan debts by making them non-dischargeable if a student filed for bankruptcy before ceasing full- or part-time studies or within two years after studies ended. A student who went bankrupt during the two-year period, however, could apply to the court at the end of the two-year period to discharge the student loan; the court could order a discharge if the student was able to demonstrate that he or she had acted in good faith and could not repay the loan due to financial difficulty. Students who filed for bankruptcy after the two-year period could have their student loans discharged as part of the normal bankruptcy process.

This change in the status of student loan debt was intended to alleviate the impact of the loss of preferred creditor status for debts owed to the Crown in the face of: mounting numbers of loan defaults; increasing loan losses; and perceptions that students were abusing the bankruptcy process to rid themselves of their loan obligations.

Less than one year after the two-year rule became effective, however, the Minister of Finance introduced a number of changes to the student loan program. The 1998 federal Budget contained measures aimed at reducing student loan defaults and helping students deal with their mounting debts, including:

- Canada Millennium Scholarships;
- Canada Study Grants for Students with Dependents;
- interest relief;
- extended loan repayment periods;
- loan principal reductions; and
- interest deductibility.

At the same time, the Minister announced a change in the student loan non-dischargeable period under the BIA from two years to ten years. This provision became effective on 18 June 1998. As a result, student loan debt is not discharged by a bankruptcy if the bankruptcy occurs within ten years after a person ceases being a student. As with the two-year rule, the court can, however, order the discharge of a student loan debt after the ten-year period expires if the debtor is able to satisfy the court that he or she acted in good faith and cannot repay the loan due to financial difficulty.⁽⁵⁾

STUDENT LOAN DEBT AND BANKRUPTCY LEVELS

Statistics Canada data confirm that the number of bankruptcies involving loans under the Canada Student Loans Program rose during the 1990s. Data on student debt from 1990-1991 to 1995-1996 also reveal:

- in the 1990s, the level of student loan debt increased;
- more students encountered problems repaying their loans shortly after leaving school – in 1995-1996, 30.9% of students had difficulty repaying their loans in the first year after leaving school compared to 21.7% in 1990-1991; and

(5) Sections 178(1)(g) and (h) and 178(1.1) of the *Bankruptcy and Insolvency Act* provide as follows:

(g) any debt or obligation in respect of a loan made under the *Canada Student Loans Act*, the *Canada Student Financial Assistance Act* or any enactment of a province that provides for loans or guarantees of loans to students where the date of bankruptcy of the bankrupt occurred

(i) before the date on which the bankrupt ceased to be a full- or part-time student, as the case may be, under the applicable Act or enactment, or

(ii) within ten years after the date on which the bankrupt ceased to be a full- or part-time student; or

(h) any debt for interest owed in relation to an amount referred to in any of paragraphs (a) to (g).

(1.1) At any time after ten years after a bankrupt who has a debt referred to in paragraph (1)(g) ceases to be a full- or part-time student, as the case may be, under the applicable Act or enactment, the court may, on application, order that subsection (1) does not apply to the debt if the court is satisfied that

(a) the bankrupt has acted in good faith in connection with the bankrupt's liabilities under the loan; and

(b) the bankrupt has and will continue to experience financial difficulty to such an extent that the bankrupt will be unable to pay the liabilities under the loan.

- students who studied at private career colleges and training institutions had the most difficulty repaying their student loans – approximately one-third defaulted during the first year of repayment.⁽⁶⁾

An analysis of student loan borrowing (using National Graduates Survey databases of students graduating from Canadian colleges and universities in 1982, 1986, 1990 and 1995) indicates higher rates of borrowing and increased levels of repayment problems:

- by 1995, slightly under 50% of all post-secondary graduates had student loans;
- among the 1995 graduates, the average total borrowing amounted to approximately \$9,500 for college graduates and \$12,500 to \$14,000 at the Bachelor's, Master's, and Ph.D. university levels;
- approximately 24% of 1995 graduates had student loans amounting to \$20,000 or more, and a maximum of 7% had student loan debt in the order of \$30,000 – a significant increase from earlier groups;
- among the 1995 group of graduates, between 20% and 40% of those with loans had repaid their debts in full by two years after graduation, while others had repaid nothing or only small amounts;
- the average payback rates for the 1995 group were in the 40%-55% range, a reduction from previous groups;
- the number of self-reported repayment problems increased as time progressed – for the 1995 group, the range was 21% to 33% of those who owed money two years after graduation; and
- after accounting for graduates who had no loans and those who paid off their loans entirely, loan repayment problems were reported for 10% to 15% of the 1995 graduates.⁽⁷⁾

(6) Statistics Canada, "Student debt from 1990-91 to 1995-96: An analysis of Canada Student Loans Data," *Education Quarterly Review*, Summer 1999, vol. 5, no. 4, Article Highlights, available at <http://www.statcan.ca/english/indepth/81-003/feature/eqhi1999005004s2a01.htm>.

(7) Ross Finnie, *Student Loans: Is It Getting Harder? Borrowing, Burdens and Repayment*, March 2000, pp. 11-12, available at <http://www.cmec.ca/stats/pcera/symposium2000/finnie.en.pdf>. See also: Ross Finnie and Gaétan Garneau, *Student Loans in Canada: A Cross-Cohort Micro Analysis of Student Borrowing for Post-Secondary Education*, R-96-16E, July 1996, Applied Research Branch Strategic Policy, Human Resources Development Canada; Ross Finnie and Saul Schwartz, *Student Loans in Canada: An Economic Analysis of Borrowing and Repayment Using the National Graduate Surveys*, W-96-3E, January 1996, Applied Research Branch Strategic Policy, Human Resources Development Canada.

Other studies also shed light on the student bankruptcy issue. *An Empirical Study of Canadians Seeking Personal Bankruptcy Protection* (1998) by Saul Schwartz and Leigh Anderson confirms the importance of student loans as a factor in the bankruptcy of younger Canadians. Schwartz and Anderson report:

For young people seeking bankruptcy, student loans were very likely to comprise a large share of overall debt. For 28 per cent of the young people, student loans were 50 per cent or more of the overall debt and, for 10 per cent, student loans were more than 90 per cent of total debt.

Over the past decade, on the order of \$10 billion ... has been lent to hundreds of thousands of Canadian post-secondary students (Finnie and Schwartz, 1996). Some of these borrowers were university students with relatively strong post-schooling job prospects. A large proportion of student loans, however, were issued to students enrolled in short-term courses whose vocational value was much less certain.

Most importantly, however, student loans are issued without any assessment of the borrower's potential to repay; instead, they are based on student financial need. That practice may encourage post-secondary access, but it also leads to situations where some young people have relatively large debts and no means to repay them.⁽⁸⁾

In a 1999 paper, Saul Schwartz notes that approximately 9% of Canada student loan borrowers had defaulted on their loan obligations in 1980, but by 1990, the Auditor General of Canada had put the default rate at "one in six."⁽⁹⁾ As the number of student bankruptcies rose, so did the cost to government. In 1996-1997, for example, student loans in bankruptcy reportedly cost the federal government \$70 million, up from \$30 million in 1990-1991.⁽¹⁰⁾

Using data pertaining to more than 1,000 debtors who filed for bankruptcy in 1997, Schwartz examined the situation of bankrupt individuals with student loan debts. Comparing the economic status of those individuals with the overall sample, Schwartz concluded:

(8) Saul Schwartz and Leigh Anderson, *An Empirical Study of Canadians Seeking Personal Bankruptcy Protection*, January 1998, available at <http://strategis.ic.gc.ca/SSG/ca00893e.html>.

(9) Saul Schwartz, "The Dark Side of Student Loans: Debt Burden, Default, and Bankruptcy," *Osgoode Hall Law Journal*, vol. 37, nos. 1 & 2, 1999, p. 317, available at <http://www.yorku.ca/ohlj/PDFs/37.1.2/schwartz.ds.pdf>.

(10) *Ibid.*, p. 318.

- Although there are no apparent gender differences in student loan lending, more than 60% of the bankrupts with student loan debt were women, compared to 40% of the entire sample of bankrupt individuals. Schwartz attributes the higher level of female bankrupts with student loans to the fact that women earn less than men and therefore have more difficulty meeting their loan obligations.⁽¹¹⁾
- Bankrupts with student loans had lower incomes than the full sample of bankrupts – the median income of bankrupt individuals with student loans was \$14,000, the median income for those who stated that student loans had triggered their bankruptcy or comprised more than 50% of their debt load was \$12,000, while the median income of the entire sample was \$24,000.⁽¹²⁾
- A large portion of bankrupts with student loans worked in unskilled occupations – 37.6% of individuals with student loan debt and 34.8% of those whose student loans had triggered their bankruptcy or comprised more than 50% of their debt. This compares to 33.4% of the entire sample who had unskilled jobs.⁽¹³⁾
- In the two years prior to filing for bankruptcy, 47.6% of the entire sample had received either income assistance or unemployment benefits; for bankrupts with student loans, the percentage was higher – 56.5% for those with student loan debt and 61.7% for individuals whose student loans had triggered their bankruptcy or were more than 50% of their debt load.⁽¹⁴⁾

Schwartz summarized his findings this way:

The economic situation of all those declaring bankruptcy suggests that bankruptcy is used primarily as a last resort. The economic situation of those seeking bankruptcy protection with student loans among their debts, or whose student loans were critical in their bankruptcy, is even worse than the already desperate situation of the whole group. To be sure, they are younger and have more education, but they have lower annual household income and lower monthly income at the time of filing for bankruptcy. More than 40 per cent had received income assistance in the two years previous to filing, and about 30 per cent had received unemployment insurance. A surprisingly large proportion – more than one-third – had occupations that were unskilled.⁽¹⁵⁾

(11) *Ibid.*, p. 326.

(12) *Ibid.*, p. 327.

(13) *Ibid.*, p. 328.

(14) *Ibid.*, p. 329.

(15) *Ibid.*

STUDENT LOANS AND BANKRUPTCY: ISSUES AND PROPOSALS FOR CHANGE

Whether student loan debt should be treated differently in a bankruptcy from debts owed to ordinary creditors is a subject of considerable debate. When the two-year rule was introduced in Bill C-5 (First Reading, 6 March 1996), the Standing Senate Committee on Banking, Trade and Commerce questioned whether student loans should be singled out for special treatment. Stories abounded about students completing their studies and then going bankrupt to erase their student loan debts, but the Committee wanted to know if evidence existed to demonstrate that students were blatantly manipulating the bankruptcy system to simply avoid paying their loan obligations.⁽¹⁶⁾

Industry Canada officials told the Committee that the number of student loan defaults had increased from “\$20 million to \$60 million over the last two or three years”⁽¹⁷⁾ and that 65% to 70% of bankruptcies involving student loans occur within the first two to three years after graduation. They suggested that students in financial difficulty should be seeking assistance under the debt relief provisions of the student loan program before resorting to bankruptcy.⁽¹⁸⁾ In fact, the two-year non-dischargeable period was chosen to coincide with the grace period offered under the then student loan program.

We picked the two-year period because, under the student loans arrangements, there is a six-month period where there is no requirement to pay back that loan. Then there is a further 18-month period where there is assistance on the interest payments. It coincides with that 24-month period in which the student is already given [a] period of grace to deal with the repayment of the loan.⁽¹⁹⁾

Although the Committee heard no direct evidence to suggest that large numbers of students were abusing the bankruptcy process, the fact that a significant percentage of student bankruptcies occurred during a period when, according to government officials, some form of

(16) *Twelfth Report of the Standing Senate Committee on Banking, Trade and Commerce*, Issue 17, 11 February 1997, p. 7, available at <http://www.parl.gc.ca/english/senate/com-e/bank-e/17ap-e.htm>.

(17) Proceedings of the Standing Senate Committee on Banking, Trade and Commerce, Issue 13, 4 November 1996, available at <http://www.parl.gc.ca/english/senate/com-e/bank-e/13evb-e.htm>.

(18) *Ibid.*

(19) *Ibid.*

debt relief was available, indicates that the two-year rule was instituted to steer students away from bankruptcy.

The introduction of the ten-year non-dischargeable rule in 1998 less than a year after the two-year rule took effect came as a surprise to many. Insolvency practitioners criticized the lack of consultation about the rule change, particularly in light of the extensive consultations that had preceded previous bankruptcy amendments. They argued that the ten-year period was too long and failed to strike the appropriate balance between allowing bankrupt students to rehabilitate themselves with a fresh start and combating alleged abuse of the bankruptcy system.⁽²⁰⁾

One critic of the concept of a non-dischargeable period for student loan debt argued:

Regardless of the government's rationale for introducing the ten-year waiting period, the empirical evidence ... suggests that most of those seeking bankruptcy protection with student loans among their debts have very low incomes and no guarantee of higher future incomes. Waiting ten years is not only unlikely to change their economic situation, but will deny them the "fresh start" that is one of the aims of the BIA.⁽²¹⁾

The Canadian Federation of Students has also been highly critical of the ten-year rule. In late 2000, the Federation took legal action to challenge the rule under the equality provisions of the *Canadian Charter of Rights and Freedoms*. The case is expected to proceed to trial in late 2002.

Others have called for a reduction of the ten-year period. In 2001, the Personal Insolvency Committee of the Insolvency Institute of Canada recommended that:

- the rule be abolished and reduced to five years from the date that the last student loan was obtained;
- courts have the discretion to grant a discharge in appropriate circumstances before loan relief measures expire;

(20) See proceedings of the Standing Senate Committee on National Finance on Bill C-36. Evidence by the Canadian Bar Association and the Canadian Insolvency Practitioners Association, Issue 15, 11 June 1998, available at http://www.parl.gc.ca/36/1/parlbus/commbus/senate/Com-e/fina-e/15cv-e.htm?Language=E&Parl=36&Ses=1&comm_id=13

(21) Schwartz, "The Dark Side of Student Loans" (1999), p. 332.

- more open, accessible and transparent loan relief measures be established under the Canada Student Loan Program; and
- a review of the criteria for granting loans under the CSLP be carried out.⁽²²⁾

In addition, the ten-year rule has been scrutinized by the Personal Insolvency Task Force (PITF)⁽²³⁾ established by the Office of the Superintendent of Bankruptcy to review the BIA's provisions relating to personal bankruptcy. Sub Group 5 of the PITF, examining student loan bankruptcies, made two recommendations: change the ten-year non-dischargeable period to five years; and permit bankrupt student loan debtors to apply to the court for relief on the basis of financial hardship after one year instead of after the current ten-year waiting period. The specific recommendations call for:

- reducing the length of time before student loans can be discharged from ten years to five years after studies end;
- allowing the discharge of student loans, on the basis of a court-administrated hardship hearing, one year after studies cease, upon application by the bankrupt;
- amending the BIA to allow for the partial discharge of student loans, when approved at a "hardship" hearing; and
- allowing for conditional discharges subject to payment plans that could include paying a certain percentage of income for a specified number of years.⁽²⁴⁾

CONCLUSION

The BIA is to be referred to a parliamentary committee for review after April 2002. The status of student loan debt and the ten-year rule are expected to be raised in the course of the review.

(22) Report of the Personal Insolvency Committee of the Insolvency Institute of Canada, *Recommendations for Reform and Further Amendments to the Bankruptcy and Insolvency Act – Personal Insolvency*, January 2001, pp. 8-9, available at <http://www.insolvency.ca/papers/PICReport.pdf>.

(23) PITF is comprised of stakeholders interested in bankruptcy such as creditors and/or creditor representatives, debtor representatives, members of the judiciary, trustees, a member of the Canadian Insolvency Practitioners Association as well as a number of academic scholars in the field of bankruptcy law.

(24) Personal Insolvency Task Force, Sub Group 5 Issues, Summary of PITF Issues and Proposed Recommendations, available at <http://strategis.ic.gc.ca/SSG/br01178e.html>.

Students would prefer to have student loan debt fully dischargeable. Lenders, on the other hand, want to have their interests protected and remain concerned that increased levels of student borrowing and higher student debt loads will lead to more bankruptcies and greater loan losses. Insolvency practitioners and the Personal Insolvency Task Force have put forward a compromise that would reduce the ten-year non-dischargeable period to five years and allow for a discharge in cases of financial hardship.

The student loan issue is likely to provoke lively discussion as the debate continues over how such loans should be treated under Canadian bankruptcy law.