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## **Federal Student Loans: Terms and Conditions for Borrowers**

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# Federal Student Loans: Terms and Conditions for Borrowers

## Summary

The federal government operates two major student loan programs: the **Federal Family Education Loan (FFEL)** program, authorized by Part B of Title IV of the Higher Education Act (HEA), and the **William D. Ford Direct Loan (DL)** program, authorized by Part D of Title IV of the HEA. These programs provide loans to undergraduate and graduate students and the parents of undergraduate students to help them meet the costs of postsecondary education.

Together, these federal student loan programs provide more direct aid to support students' postsecondary educational pursuits than any other single source. In FY2003, these programs provided \$45.8 billion in new loans to students and their parents.

Under the FFEL program, loan capital is provided by private lenders, and the federal government guarantees lenders against loss through borrower default, death, permanent disability, or, in limited instances, bankruptcy. Under the DL program, the federal government provides the loans to students and their families, using federal capital (i.e., funds from the U.S. Treasury). The two programs rely on different sources of capital and different administrative structures, but essentially disburse the same set of loans: subsidized and unsubsidized Stafford loans for undergraduate and graduate students; PLUS loans for parents of undergraduate students; and Consolidation loans that offer borrowers refinancing options.

Loans made through these programs support students pursuing postsecondary studies on at least a half-time basis at eligible postsecondary institutions. Student borrowers receiving loans through these programs are allowed to postpone loan repayment until they complete their academic programs. Students are also able to defer repaying their loans in order to pursue additional postsecondary studies.

The loans made through the FFEL and DL programs are low-interest variable rate loans with interest caps that limit the cost to borrowers. Interest rates are determined by statutorily set market-indexed interest rate formulas. Some of the programs' loans are "subsidized" (a reference to the need-based interest subsidies the government provides for borrowers) and others are "unsubsidized," but the same aggregate borrowing limits are extended to borrowers regardless of financial need.

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# Federal Student Loans: Terms and Conditions for Borrowers

## Introduction

The federal government operates two major student loan programs: the **Federal Family Education Loan (FFEL)** program and the **William D. Ford Direct Loan (DL)** program.<sup>1</sup> These programs can trace their roots to the Guaranteed Student Loan (GSL) program, originally enacted in Title IV of the Higher Education Act (HEA) of 1965, to enhance the access students from low and middle income families had to postsecondary education by providing them access to low-interest loans.

The FFEL program, formerly named the GSL program, is authorized by Part B of Title IV of the HEA. Under the FFEL program, loan capital is provided by private lenders, and the federal government guarantees lenders against loss through borrower default. The federal government also provides private lenders a variety of incentives to insure private capital will consistently be available to support FFEL student loans.<sup>2</sup> FFEL program loans are originated by private lenders, and state and nonprofit guaranty agencies receive federal funds to play the lead role in administering most aspects of the FFEL program.

The Federal Direct Student Loan program, established in 1993, and authorized under Part D of Title IV of the HEA, was intended to streamline the student loan delivery system and achieve cost savings. The DL program was originally intended to gradually expand and replace the FFEL program. The DL program provides the same set of loans as the FFEL program, but uses a different administrative structure and draws on a different source of capital. Under the DL program, the federal government essentially serves as the banker — the federal government provides the loans to students and their families, using federal capital (i.e., funds from the U.S.

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<sup>1</sup> There is a smaller, separate, campus-based student loan program (the Federal Perkins Loan program) that is also authorized by the Higher Education Act which will not be discussed in this report.

<sup>2</sup> One such incentive is the “special allowance payment,” a market indexed loan subsidy payment that is made to compensate lenders for the difference between the statutorily set interest rate charged to borrowers and the market rate of return. Another program feature designed to attract private lenders to the program is the Student Loan Marketing Association (Sallie Mae), a Government Sponsored Enterprise (currently in the process of fully privatizing). Sallie Mae was originally established to create a secondary purchase market for federally guaranteed student loans; it was essentially established to ensure that lenders seeking to sell loans would be able to do so. For more information on these FFEL program features see CRS Report RL30656, *The Administration of Federal Student Loan Programs: Background and Provisions*, by Adam Stoll.

Treasury), and owns the loans. Under the DL program, schools may serve as direct loan originators or the loans may be originated by contractors working for the U.S. Department of Education (ED). ED also hires contractors to service the loans.

While the DL program was originally introduced to replace the FFEL program, the 1998 HEA amendments removed the provisions of the law that referred to a “phase-in” of the DL program and those which specified the proportion of new student loan volume to be made through the DL program in particular academic years. Currently both programs are authorized. Postsecondary institutions may apply to participate in one program or in both. Borrowers borrow annually under one program. The program they borrow under is determined by the postsecondary institution they attend.

Together, these federal student loan programs provide more direct aid to support students’ postsecondary educational pursuits than any other source. In FY2003, these programs provided \$45.8 billion in new loans to students and their parents. In that year, the FFEL program provided 8,429,000 new loans averaging approximately \$4,009 each and the DL program provided 2,937,000 new loans averaging approximately \$4,075 each.

This report discusses the major provisions of the law pertaining to federal student loan borrowers who receive loans through the FFEL and DL programs. The primary emphasis is placed on discussing provisions related to borrower eligibility, loan terms and conditions, borrower repayment relief, and loan default and its consequences for borrowers. A companion report titled RL30656, *The Administration of Federal Student Loan Programs: Background and Provisions* has been prepared to discuss provisions of the law that are related to program administration. Both reports provide background information on the FFEL and DL programs. The reports provide updated information through the 1998 reauthorization of the HEA and subsequent amendments enacted through May 2002. These reports will be updated when program changes occur.<sup>3</sup>

## **Types of Loans Available Through the DL and FFEL Programs**

The following types of federally sponsored student loans are available through the DL and FFEL programs to support postsecondary student expenses: Stafford loans, subsidized or unsubsidized; PLUS loans; and Consolidation loans (described below). A common feature of all of these loans is that the federal government (as guarantor or loan-maker) assumes the risk for losses that may occur through borrower default, and pays for the discharge of loans in cases of borrower death, disability, and other limited instances. Another common feature shared by these loans is that, for each type of loan, the federal government establishes by statute the interest rate to be charged to borrowers.

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<sup>3</sup> A glossary of selected financial terms is included in **Appendix I**.

**Subsidized Stafford loans** are low interest, variable rate loans available to undergraduate and graduate students. The federal government “subsidizes” these loans by paying the interest on the loans while the student is in school and during grace periods and deferment periods.<sup>4</sup> The interest rate on these loans is adjusted annually, but may not exceed 8.25%. To qualify for a subsidized Stafford loan, a student must establish financial need.

**Unsubsidized Stafford loans** are low interest, variable rate loans available to undergraduate and graduate students. The federal government does not pay the interest on these loans while the student is in school or during deferment and grace periods. The interest rate is adjusted annually, but may not exceed 8.25%. Students can qualify for unsubsidized Stafford loans regardless of financial need.

**PLUS loans** are variable rate loans available to parents of dependent undergraduate students. The federal government does not pay the interest on PLUS loans while students are in school or during deferment or grace periods. The interest rate is adjusted annually, but may not exceed 9%. Parents can qualify for PLUS loans regardless of financial need.

**Consolidation loans** allow borrowers with existing student loans to combine their obligations and extend their repayment period. The rate for consolidation loans is based on the weighted average of loans consolidated rounded up to the nearest one-eighth of 1%. Borrowers can qualify for consolidation loans regardless of financial need.

## Borrower Eligibility

**Stafford and Plus Borrowers.** Stafford loans, subsidized and unsubsidized, and PLUS loans are the loans initially taken out by students and their parents to pay for postsecondary education. Provisions of the law related to Stafford and PLUS borrowers will be the focus of the initial sections of this report. The provisions of the law specifically related to Consolidation loan borrowers will be discussed in a subsequent section.

### Basic Eligibility Requirements

In general, to be eligible for any new loan under the FFEL and DL programs, a student must be enrolled as a regular student on at least a half-time basis at a participating eligible institution; be maintaining satisfactory academic progress as

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<sup>4</sup> A grace period is a six-month period beginning immediately after a student ceases to be enrolled in school on at least a half-time basis. During the grace period, borrowers are not required to begin repaying their loans. Deferment periods (discussed later in this report) are periods during which borrowers are able to suspend loan repayment (e.g., if they are experiencing economic hardships or pursue additional postsecondary studies).

defined by the school; not owe a refund on a grant under Title IV<sup>5</sup> or be in default on a student loan under the Title;<sup>6</sup> have on file at his or her institution a statement of educational purpose stating that the loan will be used solely for educational expenses; sign a statement that any Selective Service registration requirements were met; and be a citizen or permanent resident alien of the United States.

Undergraduate, graduate, and professional students attending colleges, community colleges, universities, professional schools, or vocational and trade schools are eligible for Stafford loans. Under certain circumstances, students who have not obtained a high school diploma or its equivalent may be eligible for student loans. Non-high school graduates may be eligible for Stafford loans or their parents may be eligible for PLUS loans only if the student passes an independently administered examination that has been approved by the Secretary of Education, or undergoes state-established processes approved by the Secretary that establish his or her ability to benefit from the education or training to be provided.

Parents are eligible to take out a PLUS loan on behalf of dependent students provided that the student meets the basic eligibility criteria cited above. In addition, to be eligible for a PLUS loan, a parent cannot have an adverse credit history.

## Determining Eligibility for Particular Types of Loans

**Dependency Status.** The types of loans available to students and their families and available borrowing limits vary in accordance with a student's dependency status. Dependency status is determined by students' responses to questions on the Free Application for Federal Student Aid (FAFSA), which must be filled out by all students applying for federal financial assistance. Basically, students are deemed to be independent if they are 24 years old by December 31 of the award year; if the student is married; has children or other dependents for whom they are responsible for providing support; is an honorably discharged veteran; or if the student is an orphan or ward of the court; or is pursuing graduate or professional studies.

Dependency status is significant because it determines the type of borrowing available to students and their families, which in turn affects the borrowing limits (discussed below) available to them. Of particular importance is the fact that PLUS loans — the loans with the most flexible borrowing limits are only available to parents of *dependent* students. At the same time, independent students are extended

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<sup>5</sup> Federal Pell grants, Federal Supplemental Educational Opportunity Grants (SEOGs), and State Student Incentive Grants (SSIGs). All are need-based grants. A student would owe a refund on a grant if he or she received an overpayment.

<sup>6</sup> In addition to the loans under the FFEL and DL programs, Title IV authorizes Federal Perkins loans which are need-based loans administered by participating schools. Only students enrolled in those institutions are eligible for such loans. Students who default on FFELs, DLs, or Federal Perkins loans may have their eligibility for Title IV aid restored through rehabilitation provisions that may vary by program. Reinstatement is only available once.



higher personal borrowing limits than dependent students.<sup>7</sup> The operating assumption is that students and their parents will borrow to support the postsecondary education of dependent students, whereas, independent students will be supporting their studies without parental assistance. The set of loans available to students and their families align with this assumption.

Dependency status also determines which set of income and assets is included in need analysis calculations (discussed below). Need analysis calculations for independent students are based on the *student's* income and assets (along with those of a spouse if applicable), whereas need analysis calculations for dependent students are based on the income and assets of the student and those of his or her *parent(s)*.<sup>8</sup>

**Need Analysis.** Another important determinant of student loan eligibility and available borrowing limits is need analysis. Applicants for Stafford loans must undergo a “need test” through which their family’s or their own expected contribution to college expenses is determined based on available financial resources. Under need analysis, an Expected Family Contribution (EFC) is calculated and subtracted from an estimated Cost of Attendance (COA) to determine the amount of aid applicants are eligible to receive. Additional calculations are then performed to determine the composition of the student’s aid package. For instance, undergraduate students must receive a determination of whether or not they are eligible for a federal Pell grant (a form of aid available only to undergraduates) prior to being certified by their school as being eligible for a Stafford loan. This is designed to provide maximum grant aid first to needy students before they incur loan debt.

Also, additional calculations are done to determine the proportion of subsidized (versus unsubsidized) Stafford loan aid that the applicant is eligible to receive. To determine the amount of subsidized Stafford loan aid for which the student is eligible, up to maximum annual borrowing limits, the following calculation is performed:

$$\text{COA} - (\text{EFC} + \text{EFA})$$

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<sup>7</sup> It should be noted that dependent undergraduates may be eligible to receive the larger unsubsidized Stafford loan limits available to independent students (displayed in **Table 1**) if a financial aid officer determines that exceptional circumstances would preclude the student’s parent(s) from borrowing a federal PLUS loan to meet the family’s expected family contribution to the student’s college expenses and if the family is otherwise unable to pay the expected contribution.

<sup>8</sup> Parental income and assets can be defined in a variety of ways in cases where a student’s parents are not married to each other. See the Free Application for Federal Student Aid for additional information.

The EFC is summed with estimated financial aid from other sources (EFA)<sup>9</sup> and this total is subtracted from the estimated cost of attendance.<sup>10</sup> The result of this calculation is the amount which may be borrowed under subsidized loans. If this calculation produces a number lower than the combined subsidized and unsubsidized annual loan limit, the student is eligible to borrow up to the full annual loan limit by taking out an unsubsidized loan to bridge the gap.

For example, if a first year dependent undergraduate student had an EFC of \$4,000, received an estimated \$1,000 in other types of financial aid and had an estimated cost of attendance of \$7,000; the calculation performed to determine the student's eligibility for a subsidized Stafford Loan would be as follows:  $\$7,000 - (\$4,000 + \$1,000)$ . This would produce a result of \$2,000. The statutorily set Stafford loan limit for first year dependent undergraduate students is \$2,625 (see below). Hence, under this scenario, the student would be able to borrow \$2,000 in subsidized Stafford loans and the remaining \$625 in unsubsidized Stafford loans. In general, the higher the EFC determined under need analysis or the greater the amount of other aid for which the student qualifies, the lower the amount of a subsidized Stafford loan the student may receive.

Students are eligible for an unsubsidized Stafford loan up to the annual Stafford loan limit without regard to the EFC, that is, only considering the total cost of attendance minus other aid.

## Loan Terms and Conditions

### Loan Limits

The student loan principal that may be borrowed annually as well as the aggregate limit on outstanding principal is established by law. Any fees for which the borrower is liable are also included under these limits. Federal Stafford loan limits — the maximum principal that may be borrowed — vary by year in school and by dependency status.

For students enrolled for less than one year, limits are prorated based on the fraction of the academic year for which they are enrolled; an "academic year" is defined in the law as a minimum of 30 weeks instruction in which a full-time student is expected to complete a minimum of 24 semester or trimester hours, 36 quarter hours, or 900 clock hours.

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<sup>9</sup> Other financial assistance includes Federal Pell grants, Federal Supplemental Educational Opportunity Grants, Federal Perkins loans, Federal Work-Study assistance, veterans' education benefits (with certain exceptions) and any other grants, loans, or scholarships.

<sup>10</sup> "Cost of attendance," for purposes of the FFEL programs is defined in Part F of Title IV. It generally includes tuition and fees, an allowance for books, supplies and transportation, room and board, and other expenses related to school attendance.

**Table 1** shows limits for the set of loans available to dependent students and their parents, and for the set of loans available to independent students.

**Table 1. Annual Loan Limits for Dependent Students and Their Parents, and for Independent Students**

Type of borrower	Type of loan available	Total annual loan limit <sup>a</sup>
<i>Dependent students and their parents</i>		
Dependent students (eligible for need-based Subsidized Stafford loans) <sup>b</sup>	Subsidized Stafford loan Unsubsidized Stafford loan	1 <sup>st</sup> year \$2,625 2 <sup>nd</sup> year \$3,500 3 <sup>rd</sup> year & beyond \$5,500
Dependent students (not eligible for need-based Subsidized Stafford loans)	Unsubsidized Stafford loan	1 <sup>st</sup> year \$2,625 2 <sup>nd</sup> year \$3,500 3 <sup>rd</sup> year & beyond \$5,500
Parents of dependent students	PLUS loan	No specified annual loan limit <sup>c</sup>
<i>Independent Students</i>		
Independent students (eligible for need-based Subsidized Stafford loans) <sup>d</sup>	Subsidized Stafford loan Unsubsidized Stafford loan	1 <sup>st</sup> year \$ 6,625 2 <sup>nd</sup> year \$ 7,500 3 <sup>rd</sup> year & beyond \$10,500 graduate (any year) \$18,500
Independent students (not eligible for need-based Subsidized Stafford loans)	Unsubsidized Stafford loan	1 <sup>st</sup> year \$ 6,625 2 <sup>nd</sup> year \$ 7,500 3 <sup>rd</sup> year & beyond \$10,500 graduate (any year) \$18,500

- Students eligible for both subsidized and unsubsidized Stafford loans may not exceed these total borrowing limits. In other words, the combined subsidized and unsubsidized Stafford loans within any given year cannot exceed these maximum annual limits.
- Dependent students eligible for subsidized Stafford loans, may receive up to the entire annual loan limit in subsidized Stafford loans, depending on their level of need.
- PLUS borrowers may borrow any amount up to the dependent student's cost of attendance minus other aid (i.e., EFA).
- Independent students eligible for subsidized Stafford loans are not eligible to receive up to their total annual loan limit in subsidized Stafford loans. **The maximum annual amount they can receive in subsidized Stafford loans as undergraduates is capped at the level available to dependent students.** In other words, in the following years of study they are eligible to receive up to the following amount in subsidized Stafford loans: 1<sup>st</sup> year — \$2,625; 2<sup>nd</sup> year — \$3,500; 3<sup>rd</sup> year — \$5,500. **As graduate students, the maximum annual amount they can receive in subsidized Stafford loans is \$8,500.** Unsubsidized Stafford loans can be used to bridge the gap between the subsidized Stafford loan amount the student qualifies for and the total annual loan limit.

## Aggregate Borrowing Limits

Limits are also placed on the total amount of outstanding student loan debt (i.e., principal) undergraduate and graduate and professional students may accumulate. No aggregate limits are placed on PLUS loans for parents, however. The loan limits for student borrowers are presented in **Table 2**.

**Table 2. Limits on Students' Aggregate Outstanding Student Loan Debt**

Academic level/program & dependency status	Aggregate limits on total outstanding loan debt	Aggregate limits on subsidized Stafford Loan debt	Aggregate limits on unsubsidized Stafford Loan debt
Dependent undergraduates	\$23,000	The entire \$23,000 can be subsidized loans (depending on need).	The gap between the amount of (need-based) subsidized loans the borrower qualifies for and \$23,000 can be filled by unsubsidized loans.
Independent undergraduates	\$46,000	Up to \$23,000 of the available \$46,000 can be subsidized loans (depending on need).	The gap between the amount of (need-based) subsidized loans the borrower qualifies for and \$46,000 can be filled by unsubsidized loans.
Graduate and professional students	\$138,500 (including undergraduate loans)	Up to \$65,500 of the available \$138,500 can be subsidized loans (depending on need).	The gap between the amount of (need-based) subsidized loans the borrower qualifies for and \$138,500 can be filled by unsubsidized loans.

## Interest Rates

**Stafford Loans.** Subsidized and unsubsidized Stafford loans share the same interest rate. The Stafford loans currently being disbursed are variable rate loans. The formula used to calculate the variable interest rate for these loans is determined by statute and stays in effect from the time the loan is disbursed through the life of the loan (provided that the loan is not refinanced through a consolidation loan).<sup>11</sup>

The rate for Stafford loans is adjusted annually, and is determined every June 1, becoming effective July 1 through the following 12-month period. The variable rate is calculated based upon the bond equivalent rate of the 91-day Treasury bill plus a premium which differs depending on whether the borrower is in-school or in repayment.<sup>12</sup> For loans made from July 1, 1998, through June 30, 2006, the borrower interest rate is based on the 91-day Treasury bill plus 1.7% for those in school, and the 91-day Treasury bill plus 2.3% for those in repayment.<sup>13</sup> The interest rate charged to Stafford loan borrowers for loans disbursed during this period, however, is capped at 8.25%.

The formula in effect for calculating Stafford loan interest rates for loans disbursed from July 1, 1998 through June 30, 2006 was first enacted in June 1998. It was extended in the HEA amendments of 1998 and then again in P.L. 107-139. When introduced, the rate-setting formula reduced the premium payment for borrowers (both in-school and in repayment) by 0.8 of one percentage point. As **Table 3** shows, the Stafford loan interest rates have been changed many times since the initial GSL program was launched in 1965. Until 1992, student interest rates were fixed rates. The 1992 HEA amendments changed Stafford loan interest rates from fixed to variable rates, to make interest more responsive to market conditions.

**Table 3** presents the student loan interest rate formulas that have been in effect over the course of the program.

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<sup>11</sup> The interest rate formulas for Stafford and PLUS loans establish statutory maximum rates for loans. The formulas are designed to provide borrowers low cost loans, and the statutory rates are the rates generally charged to borrowers (even though lenders can charge less).

<sup>12</sup> Interest rates are adjusted annually based on the bond equivalent rate of the 91-day Treasury bill at the final auction held prior to June 1.

<sup>13</sup> A differential rate is provided for those in school and in repayment because loan servicing costs are lower during the in-school period, when no payments are required.

**Table 3. Student Loan Interest Rates**

Disbursement period	Interest rate in effect
November 8, 1965 - August 2, 1968	6% fixed rate
August 3, 1968 - December 31, 1981	7% fixed rate
January 1, 1981 - June 30, 1988	9% fixed rate
July 1, 1988 - September 30, 1992	8% fixed rate for first 48 months; 10% fixed rate for remaining repayment period
October 1, 1992 - June 30, 1994	91-day T-bill + 3.1%; capped at 9%
July 1, 1994 - June 30, 1995	91-day T-bill + 3.1%; capped at 8.25%
July 1, 1995 - June 30, 1998	91-day T-bill + 2.5% for in-school, grace or deferment periods; 91-day T-bill + 3.1% for repayment periods; capped at 8.25%
July 1, 1998 - June 30, 2006	91-day T-bill + 1.7% for in-school, grace or deferment periods; 91-day T-bill + 2.3% for repayment periods; capped at 8.25%

Until 1994, the Stafford loan interest rates charged depended largely on whether the borrower had outstanding debt under the program. As a rule, borrowers with outstanding debt retained the interest rate provided under previous Stafford loans. Borrowers with no outstanding debt were considered “new borrowers,” and received the interest rate effective at the time for new loans. This practice ended with the passage of the Student Loan Reform Act in 1993 (P.L.103-66).

**PLUS Loans.** The PLUS loans currently being disbursed are variable rate loans. The formula used to calculate the variable interest rate for these loans is determined by statute and stays in effect from the time the loan is disbursed through the life of the loan (provided that the loan is not refinanced through a consolidation loan).

The rate for these loans is adjusted annually, becoming effective July 1 through the following 12-month period.<sup>14</sup> The interest rate formula for new PLUS loans disbursed from July 1, 1998 through June 30, 2006 is the bond equivalent rate of the 91-day Treasury bill plus a premium of 3.1%, capped at 9%. This formula, first enacted in June 1998, and extended in both the HEA amendments of 1998 and then again in P.L. 107-139, changed the index from the 52-week Treasury bill to the 91-

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<sup>14</sup> For PLUS loans with a Treasury bill index, rates are adjusted annually based on the bond equivalent rate of the Treasury bill at the final auction held prior to June 1. For loans based on the one-year constant maturity Treasury yield, the rates are adjusted annually based on the weekly average one-year constant maturity Treasury yield, as published by the Board of Governors of the Federal Reserve System for the last calendar week ending before June 26.

day Treasury bill. It was expected that this change would produce slightly lower rates for borrowers. As **Table 4** shows, the PLUS interest rate formula has been changed several times since the loans have been available.

**Table 4. PLUS Interest Rates**

Disbursement period	Interest rate in effect
January 1, 1981 - September 30, 1981	9% fixed
October 1, 1981 - October 31, 1982	14% fixed
November 1, 1982 - June 30, 1987	12% fixed
July 1, 1987 - September 30, 1992	52-week T-bill + 3.25%; capped at 12% <sup>a</sup>
October 1, 1992 - June 30, 1994	52-week T-bill + 3.1%; capped at 10% <sup>a</sup>
July 1, 1994 - June 30, 1998	52-week T-bill + 3.1%; capped at 9% <sup>a</sup>
July 1, 1998 - June 30, 2006	91-day T-bill + 3.1%; capped at 9%

- a. The Consolidated Appropriations Act for FY2001 (P.L. 106-554) includes an amendment to the HEA that changes the index used in the formulas that determine the interest rates for PLUS loans disbursed between July 1, 1987 - June 30, 1998. The amendment substituted the one-year constant maturity Treasury yield for the 52-week Treasury bill. This change, which affects interest rate adjustments made for any 12-month period beginning on or after July 1 of 2001, became necessary because the Department of Treasury decided to stop issuing 52-week Treasury bills.

**Interest Discounts.** It should be noted that, with regard to both Stafford and PLUS loans, the HEA explicitly permits FFEL lenders to offer borrowers lower rates than those specified above. In the FFEL program it has become common practice for lenders to offer borrower interest rate discounts as incentives for on-time repayment.<sup>15</sup>

Similarly, ED may provide interest rate reductions in the DL program to encourage on-time repayment of loans provided the reductions are cost-neutral to the federal government. The DL program currently offers borrowers a 0.25 percentage point interest rate reduction for paying electronically (through electronic debit accounts). In addition, the DL program is offering an up-front interest rate rebate equal to 1.5% of the original loan principal on loans disbursed for the 2000-2001 academic year and thereafter. Borrowers must make their first 12 payments on time to keep this rebate, which amounts to an interest rate reduction of .024 percentage points each year for a loan repaid over a standard 10-year repayment period.

## Borrower Fees

In addition to being responsible for repaying loan principal and interest, Stafford and PLUS borrowers are responsible for paying origination fees and loan insurance

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<sup>15</sup> For additional information on the discounts offered by FFEL lenders see *The Greentree Gazette*, May 2003. p. 84-93.

fees. These borrower fee payments help offset federal subsidy costs. In essence, these fees pass along some of the federal cost of insuring and subsidizing loans to the borrowers.

Origination fees are calculated as a proportion of loan principal borrowed, and are added to loan principal and subsequently deducted proportionately from each installment payment of the proceeds of the loan prior to payment to the borrower. For loans disbursed on or after July 1, 1994, the origination fee for PLUS loans and subsidized or unsubsidized Stafford loans is not more than 3% in the FFEL program. In addition, for FFEL program loans, guaranty agencies may require borrowers to pay a loan insurance premium of not more than 1% on subsidized and unsubsidized Stafford loans and on PLUS loans.

In the DL program, the borrower paid a 4% origination fee to the federal government until recently. On June 16, 1999, ED announced a reduction in the origination fees for subsidized and unsubsidized Stafford loans from 4% to 3%, effective August 15, 1999.<sup>16</sup>

In the FFEL program, the lender is required to pay the 3% origination fee to the federal government; the lender can choose whether or not to pass the entire fee on to the borrower, within certain limitations. The loan insurance premiums (which defray default costs) that lenders collect are paid to the guaranty agency or the federal government. Therefore, the lender does not keep any of the fees paid by the borrower but passes them on to the appropriate entity.

Since FFEL program lenders are authorized, but not required, to collect origination fees<sup>17</sup> when they elect not to charge the full fees to borrowers they become responsible for paying the federal government the portion of the fees they do not charge borrowers (i.e., the amount the lender receives from the federal government in interest and special allowances is required to be reduced by the amount the lender is authorized to collect as an origination fee).

To attract borrowers, lenders may pay the fee without passing on the cost to students. Guaranty agencies may or may not assess an insurance premium. This practice may have increased as the FFEL loan industry experienced competition from the DL program. Hence it's not always a certainty that an FFEL borrower will be charged an origination fee or insurance premium. In contrast, the HEA requires the DL program to charge an origination fee to all borrowers.

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<sup>16</sup> Some controversy exists over the authority of the Secretary to make this reduction. See Press Release on DL website: [<http://www.ed.gov/Direct Loan/bulletin/99/dlb99-36.html>]. See also *Education Daily*, June 18, 1999. p. 3.

<sup>17</sup> However, FFEL lenders that charge an origination fee must assess the same fee to all borrowers, with one exception. The lone exception to this rule is that a lender may assess a lesser origination fee for a borrower demonstrating greater financial need as determined by such borrower's adjusted gross family income.



## Repayment Terms

**When Repayment Begins for Different Types of Loans.** Stafford subsidized and unsubsidized loan borrowers are not required to begin repaying their loans while in school and during the six-month “grace” period immediately following their departure from school. In contrast, repayment of PLUS loans commences not later than 60 days after loans are disbursed.

**Interest Payments.** For subsidized Stafford loan recipients, the federal government pays the interest on the loans while students are in school, and for a 6-month grace period thereafter; whereas for unsubsidized Stafford loans, the interest accrues while the borrower is in school and during the six-month grace period immediately following their departure from a program. Unsubsidized Stafford loan borrowers can begin paying this interest while in school and during the six-month grace period, either on a monthly or quarterly basis, or it is added to the loan principal (i.e., capitalized), increasing the borrower’s debt until repayment of principal begins.

**Repayment Options Within the FFEL and DL Programs.** All FFEL and DL borrowers are given the opportunity to choose among a series of repayment options. In general, within the DL and FFEL programs, PLUS and Stafford borrowers are afforded the opportunity to choose among the same repayment options (one exception, for PLUS borrowers in the DL program, is discussed below).

As will be discussed below, there are some differences between the repayment options made available to borrowers in the DL program and the repayment options made available to borrowers in the FFEL programs.

**FFEL Borrower Repayment Options.** All FFEL Stafford and PLUS borrowers are allowed to choose among standard, graduated, and income sensitive repayment plans. Under these options, repayment must occur over a period not to exceed 10 years. For new borrowers on or after October 7, 1998, who accumulate (after such date) outstanding loans totaling more than \$30,000, a fourth repayment option is available — an extended repayment plan — under which repayment must occur within a time period not to exceed 25 years.

If a FFEL borrower fails to select a repayment plan, the borrower is provided a standard repayment plan. FFEL borrowers may switch to another repayment plan once annually. No repayment plan may require a borrower to repay a loan in less than five years, unless the borrower specifically requests a shorter period. Under all available repayment plans, the borrower’s payments may not be less than the interest due.

**DL Borrower Repayment Options.** All DL Stafford and PLUS borrowers are allowed to choose among standard, graduated, and extended repayment plans. Income contingent repayment is available to all unsubsidized and subsidized Stafford

borrowers.<sup>18</sup> Under the standard repayment plan, repayment must occur over a period not to exceed 10 years; and under the income contingent repayment plan, repayment must occur over a period not to exceed 25 years. Repayment periods for extended and graduated repayment plans vary with the size of the loan and are presented below.

If a DL borrower fails to select a repayment plan, he or she will repay under the standard repayment plan.<sup>19</sup> DL borrowers may switch to another repayment plan at any time. Under all available repayment plans (with the exception of income contingent repayment), the borrower's payments may not be less than the interest due.<sup>20</sup> The regulations in effect at the time a borrower enters repayment govern the repayment terms available to him or her.

## Description of Repayment Plans

**Standard Repayment Plan.** Under the standard repayment plan, borrowers make fixed monthly payments of at least \$50 for up to 10 years.<sup>21</sup> The FFEL and DL program offer the same standard repayment plan.

**Graduated Repayment Plans.** Graduated repayment plans assume that a borrower's income will increase over the repayment period. Under such a plan a borrower makes smaller payments early on in a repayment period, and larger payments later on. The graduated repayment plans offered to DL and FFEL borrowers are similar, but not identical.

Under a FFEL graduated repayment plan, fixed payment amounts established at the beginning of repayment are smaller at first and larger during later years of repayment, within certain limits (no payment can be more than three times greater than any other).<sup>22</sup> This is to avoid offering very low initial payment amounts and excessively high ending payment levels which could contribute to default. Repayment must occur within 10 years.

Under the DL graduated repayment plan, the borrower makes fixed monthly payments at two or more levels (usually a lower amount for the early years of repayment and a larger amount in the later years) over a period of time that varies with the size of the loan and is the same as for the extended repayment plan (presented below). Further, the borrower's payments may not be less than the interest

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<sup>18</sup> PLUS borrowers are not eligible for income contingent repayment.

<sup>19</sup> Regulations on the Direct Loan program repayment options can be found at 34 CFR 685, Sections 208-211.

<sup>20</sup> Income contingent repayment allows negative amortization (see glossary for definition).

<sup>21</sup> Because of the variable interest rate, the loan holder may adjust either the size of the monthly payment or the length of the repayment period annually. If the change in interest rates would result in a borrower being unable to complete repayment within the 10 year maximum, the loan holder may provide administrative forbearance for a maximum of three years (effectively extending the repayment period).

<sup>22</sup> See 34 CFR 682.209(a)(7)(ii).

due or less than 50% of the monthly payment required under the standard plan or more than 150% of the monthly payment under the standard plan.

**Extended Repayment Plans.** Under the FFEL extended repayment plan, borrowers make fixed or graduated monthly payments of at least \$50 for a period of time that varies depending on the amount of the loan. Repayment must occur within 25 years.<sup>23</sup>

Under the DL extended repayment plan, borrowers make fixed monthly payments of at least \$50 for a period of time that varies depending on the amount of the loan. These terms are as follows.

<b>Amount</b>	<b>Maximum Term</b>
less than \$10,000 . . . . .	12 years;
\$10,000 but less than \$20,000 . . . . .	15 years;
\$20,000 but less than \$40,000 . . . . .	20 years;
\$40,000 but less than \$60,000 . . . . .	25 years; and
\$60,000 or more . . . . .	30 years. <sup>24</sup>

**Income Sensitive Repayment Plans.** Income sensitive repayment plans, available only through the FFEL program, also assume that a borrower’s income will increase over the repayment period. Under an income-sensitive plan, the payment amounts may be adjusted annually to reflect changes in a borrower’s income. However, these repayment plans are limited in the amount of adjustment that can be made by statutory requirements that the loan be repaid within the 10-year maximum and that monthly payments are, at a minimum, sufficient to cover interest (i.e., no negative amortization).<sup>25</sup>

**Income-Contingent Repayment.** Finally, under the income-contingent repayment plan, available only through the DL program, the borrower annually repays an amount based on the total amount of the borrower’s loan, adjusted gross income, and family size for a period up to 25 years (income-contingent repayment is not available to PLUS loan borrowers). **Under the income contingent repayment option, students repay based on annual income for up to 25 years with any remaining amount owed on the loan discharged at that time.**

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<sup>23</sup> As was noted earlier, extended repayment is only available to new borrowers on or after October 7, 1998, who accumulate (after such date) outstanding loans totaling more than \$30,000.

<sup>24</sup> As with the standard repayment, the Secretary may adjust the fixed monthly amount or the repayment term to take into account the impact of variable interest rates.

<sup>25</sup> It should be noted that FFEL program regulations (34 CFR 682.209(a)(7)(viii)(D) and 682.211(i)(5)) allow lenders some flexibility to extend repayment up to 15 years through “administrative forbearance” to accommodate the variable interest rates and sensitivity to very low incomes under this repayment plan.

The rules include the following key provisions: A borrower's annual payment (divided by 12 for the monthly amount) is calculated as a percentage of the standard amortization amount under a 12-year repayment term for their outstanding debt level. The percentage varies from approximately 55% of the standard amount to 200%, depending on income. The payment *amount* thus varies directly with income and debt, up to a very high income. However, a borrower's monthly payment is capped at 20% of *discretionary* income (defined as adjusted gross income minus the poverty level for the borrower's family size as published annually by the U.S. Department of Health and Human Services (HHS)).<sup>26</sup> Thus a borrower at the poverty level or below would not be required to make any payment. For borrowers whose monthly payment amount is greater than 0, but less than \$5, a \$5 minimum monthly payment is required.

Under this income-contingent formula, it is possible that the amount a borrower is required to pay monthly may not equal the accrued interest on his or her loan; when this happens, the unpaid interest is added to the principal amount, i.e., capitalized. This is also referred to as negative amortization. The rules for the income-contingent repayment plan provide that such capitalization shall not exceed 10% more than the original principal amount, after which interest continues to accrue and must be paid, but is not capitalized (i.e., the principal amount cannot increase to more than 110% of the original loan).

Internal Revenue Service (IRS) involvement in the income-contingent plan is limited to disclosure of borrower tax return information to the Secretary to enable ED to calculate repayment amounts annually.

**Alternative Repayment Plans.** Also, other alternatives for repayment of DL program loans may be provided by the Secretary on a case-by-case basis to accommodate a borrower's unique circumstances.

**Prepayment.** Under both the FFEL and DL programs, there is no penalty assessed for prepayment of loans. That is, borrowers may repay the principal on their loans ahead of schedule, and cannot be assessed charges for doing so.

## Borrower Repayment Relief

Features of the FFEL and DL programs provide repayment relief to borrowers who may have or are having difficulty in making payments on their student loans. The text below discusses provisions under which borrowers may reduce, temporarily or permanently cease, or otherwise alter the monthly repayments that would be required under the amortization schedule for the loan under its original terms. Such provisions authorize:

- deferments

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<sup>26</sup> *HHS Poverty Guidelines for All States (except Alaska and Hawaii) and the District of Columbia.* Currently, for a family of one, the 2004 HHS poverty guideline is \$9,310; for a family of two it is \$12,490.

- forbearance
- loan consolidation (i.e., refinancing)

Most of these features are designed to prevent loans from going into default, and to prevent loan debt from inhibiting borrowers from pursuing further studies.

## Deferments and Forbearance

Deferment and forbearance are the primary means through which a borrower is temporarily relieved of his or her obligation to make scheduled loan payments. Any period during which a borrower is in deferment or forbearance is *excluded* from the calculation of the repayment period.

### Deferments

A deferment is the temporary cessation of the borrower's obligation to repay loan principal, usually limited by law to a specific period of time, because he or she meets certain conditions. Deferments enable borrowers to suspend loan repayment while they are pursuing additional postsecondary education, and during periods of unemployment and economic hardship.

Deferments are borrower specific, i.e., once a borrower has received a deferment for the period specified in law, he or she is not eligible to receive additional deferments for the same condition even if the borrower takes out a new loan. Because of frequent amendments, the types of deferment for which borrowers are eligible can vary according to when the loan is taken out, what type of loan it is, and whether the borrower has an outstanding balance in other loans.<sup>27</sup> As a general rule, until July 1, 1993, one set of conditions for deferments applied and after that time new conditions apply to new borrowers, who have no outstanding balance in loans.<sup>28</sup>

For subsidized Stafford loans, the federal government pays the interest during the deferment period; for all other loans, the borrower is responsible for the payment of accrued interest, either by making such payments monthly or quarterly or by having the interest added to their principal balance (i.e., capitalized).

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<sup>27</sup> For example, for PLUS loans disbursed after July 1, 1993 to borrowers with no outstanding balance on or before such date, borrowers are eligible for any deferment as long as the *parent* meets the deferment condition. For other PLUS borrowers — those borrowing before that date or those with outstanding balances as of that date — the parent is eligible not only for in-school, disability, or unemployment deferments, but the parent may also receive a deferment as long as the dependent *student* is attending school.

<sup>28</sup> Borrowers with outstanding loan balances prior to July 1, 1993 are eligible to defer loans under a broader set of criteria than are available to other borrowers. For instance, they may defer loans during periods of service in the U.S. Armed Forces, Peace Corps, VISTA, or the Public Health Service; while serving as medical interns or residents or while teaching in shortage areas. For information on eligibility criteria for deferment for those with outstanding loan balances prior to July 1, 1993, see CRS Report 94-810, *The Federal Family Education Loan Programs*, by Margot A. Schenet (archived, available from author).

The 1992 HEA amendments made a major change in deferments by consolidating the terms under which borrowers qualify. These deferments only apply to new borrowers with the first disbursement of their loan proceeds on or after July 1, 1993. These deferments and their time limits are:

- 1) any period during which the borrower is pursuing at least a half-time course of study as determined by the eligible institution he or she attends, is pursuing a course of study pursuant to a graduate fellowship program approved by the Secretary of ED, or is pursuing a course of study pursuant to a rehabilitation training program for disabled individuals approved by the Secretary;<sup>29</sup>
- 2) no more than three years during which the borrower is unemployed; and
- 3) no more than three years for economic hardship. The law defines economic hardship as:
  - a) the borrower earning an amount not exceeding the greater of the minimum wage or 100% of the poverty level for a family of two;
  - b) the borrower having a federal educational loan debt burden that equals or exceeds 20% of adjusted gross income and the borrower's income is not more than 220% of the amounts in "a" above after subtracting the debt payments; and
  - c) other regulatory criteria established by the Secretary of ED that include as primary factors the borrower's income and debt-to-income ratio.

## Forbearance

Forbearance is the practice under which lenders grant borrowers temporary relief from their obligation to repay because the borrower is willing but unable to meet regular payment obligations. Forbearance can constitute lower monthly payments than would otherwise be expected, or total cessation of payments ("complete" forbearance).

Forbearance for the FFEL and DL programs (except administrative forbearance) must be "complete" unless the borrower chooses to make smaller payments or extend the time period of repayment. Unlike deferments for subsidized Stafford loans, when the interest is paid by the federal government, *any* borrower under forbearance is liable for all accrued interest during the forbearance period. Also unlike deferments, forbearance is granted at the option of the loan holder, under most circumstances (exceptions are noted below), rather than mandated.

Forbearance is usually used to prevent a loan from defaulting, but holders of defaulted loans may also use forbearance during collection on a defaulted loan. Another form of forbearance is administrative forbearance. Administrative

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<sup>29</sup> The law specifically precludes Stafford borrowers from eligibility for this deferment if they are serving in a medical internship or residency program.

forbearance (which does not require the borrower's permission) can be used under limited conditions as authorized by the Secretary.<sup>30</sup> The Secretary has used administrative forbearance to provide relief for borrowers affected by military mobilizations in recent years.<sup>31</sup>

The law establishes three conditions under which loan holders are *required* to forbear loans. One is any year when the borrower is serving in a medical or dental residency or internship and does not qualify for a deferment; the second condition is for up to three years when the borrower's Title IV, HEA debt burden equals or exceeds 20% of income. Third, forbearance is required for any year when the borrower is serving in a national service position for which the borrower receives a national service educational award under the National Service and Community Service Trust Act of 1993.

The 1998 HEA amendments removed requirements that requests for forbearance be written. In addition, the 1998 amendments authorized the granting of forbearance for up to 60 days after a borrower's request for: deferment; change in repayment plan; consolidation of loans; and forbearance. This 60-day period is provided to allow time for the processing of requests, and interest may accrue but may not be capitalized during this time period.

## Loan Consolidation

Consolidation loans offer borrowers refinancing options. Consolidation loans enable borrowers to simplify the repayment of loans by combining multiple loans into one. Consolidation loans also enable borrowers to lower monthly payments by extending the repayment period. Additionally, consolidation loans afford borrowers the opportunity to lock in a fixed interest rate on their student loans, based on the weighted average of the interest rates in effect on the loans being consolidated rounded up to the nearest one-eighth of 1%, capped at 8.25%.

A complex set of provisions has been enacted to regulate competition for consolidation loan refinance business among loan holders within the FFEL program and across the DL and FFEL programs; and to protect borrowers — ensuring they are afforded equitable refinancing options. As is discussed below, terms and conditions for FFEL and DL consolidation loans are not identical.<sup>32</sup>

**Loans Eligible for Inclusion in a Consolidation Loan.** A FFEL consolidation loan must be comprised of at least one eligible underlying FFEL loan.

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<sup>30</sup> Under final regulations published June 29, 1994, these include up to three years if variable interest rate changes preclude a borrower's ability to repay the loan in 10 years under the standard or graduated repayment plans, and up to five years if a borrower's income precludes the ability to repay in 10 years under the income-sensitive repayment plan.

<sup>31</sup> For details on forbearance and limited deferments available to such individuals see the ED's Dear Colleague Letter Gen-03-06, Mar. 2003.

<sup>32</sup> For a comprehensive examination of the differences between FFEL and DL consolidation loans see CRS Report RL31575, *Consolidation Loan Provisions in the Federal Family Education and Direct Loan Programs*, by Adam Stoll.

A DL consolidation loan must be comprised of at least one eligible underlying FFEL or DL loan. The FFEL and DL loans that are eligible for inclusion as underlying loans in a consolidation loan are: subsidized and unsubsidized Stafford loans, PLUS loans, and in some instances consolidation loans (discussed below).<sup>33</sup> Other types of federal student loans made outside of the FFEL and DL programs are also eligible for inclusion in a consolidation loan, including Perkins loans, Health Professions Student loans (HPSLs), Health Education Assistance loans (HEALs), and Public Health Service Act Nursing Student Loans (NSLs).

Generally, within the FFEL program, a set of loans can only be consolidated once. That is, an existing FFEL consolidation loan can only be included as an underlying loan in a new FFEL consolidation loan if it is combined with other eligible loans that have not previously been consolidated. Within the DL program, loans may be consolidated more than once.<sup>34</sup>

**Borrower Eligibility for Consolidation Loans.** The basic requirement for FFEL consolidation is that the borrower must have outstanding principal on at least one FFEL loan that is eligible for inclusion in a consolidation loan.<sup>35</sup> For DL consolidation, the borrower must have outstanding principal on at least one FFEL or DL loan that is eligible for consolidation.

Applicants for FFEL consolidation loans must either be in repayment status or in the six-month grace period after they leave school when applying for a consolidation loan. Applicants for DL consolidation loans may apply during these periods, and also while still in school.

Defaulted borrowers who have already made arrangements to repay their obligations satisfactory to the guaranty agency or the Secretary of Education, are eligible for consolidation loans. Making “satisfactory repayment arrangements,” for

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<sup>33</sup> GSL program (formerly the name of the FFEL program) loans are also eligible for inclusion in a consolidation loan. For the purposes of loan consolidation, loans disbursed under the GSL program count as FFEL program loans.

<sup>34</sup> As is discussed below, consolidation loans currently being disbursed are fixed rate loans. The weighted average of the interest rates on the underlying loans being consolidated (rounded up to the nearest one-eighth of 1%) serves as the basis for determining the fixed interest rate on consolidation loans. If an existing consolidation loan has already locked in a fixed rate, that rate is used in “weighted average calculations” should the existing consolidation loan be included as an underlying loan in a subsequent consolidation.

<sup>35</sup> There has been some debate as to whether FFEL lenders are authorized to make consolidation loans consisting exclusively of underlying DL loans. There has also been debate about whether this issue is addressed directly in statutory or regulatory provisions. In practice, up until very recently, FFEL lenders commonly made consolidation loans consisting exclusively of underlying DL loans. Recent sub-regulatory guidance provided by ED states that such consolidation loans will not be insured on or after May 1, 2004 (see March 15, 2004 letter to National Council of Higher Education Loan Programs from the Office of Postsecondary Education detailing this guidance).



a borrower with a defaulted FFEL or DL loan, means the defaulted borrower has made at least three voluntary on-time consecutive payments.<sup>36</sup>

Married persons, each of whom has eligible loans, are eligible for a joint consolidation loan. Only one of the borrowers must meet the full set of individual eligibility requirements. However, each agrees to become jointly and severally liable for repayment of the note.

**Borrowers' Ability to Choose Among Consolidators.** FFEL borrowers whose loans are held by one holder must first attempt to consolidate their loans with that holder.<sup>37</sup> If a consolidation loan is unavailable from that lender or the lender does not provide the borrower with an income sensitive repayment plan acceptable to the borrower, then the borrower may pursue other FFEL consolidation loans. Other FFEL borrowers, with loans from more than one FFEL lender, may seek a consolidation loan through any FFEL lender. If FFEL borrowers certify that they are unable to secure a consolidation loan through FFEL lenders, or that they are unable to secure a FFEL consolidation loan with income sensitive repayment terms (deemed to be acceptable by the borrower),<sup>38</sup> the borrower may pursue a DL consolidation loan.<sup>39</sup>

DL borrowers may pursue consolidation loans within the DL program. DL borrowers are also able to consolidate their loans through FFEL lenders provided they are consolidating outstanding DL loans with FFEL loans.

**Interest Rates for Consolidation Loans.** The existing consolidation loan interest rate for loans disbursed on or after February 1, 1999 through the FFEL and DL programs is the weighted average of the interest rates on the loans consolidated rounded up to the nearest one-eighth of 1%, capped at 8.25%. The 1998 HEA amendments put in place a common interest rate for both programs, for loans

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<sup>36</sup> It should be noted, however, that any defaulted borrower against whom a court has issued a judgement or against whom a wage garnishment order has been issued is ineligible for FFEL consolidation loans. Such borrowers may be eligible for consolidation in the DL program with the Secretary's approval.

<sup>37</sup> If a FFEL lender secures an insurance agreement to make consolidation loans, the lender may offer consolidation loans (upon request) to all borrowers for whom the lender is the sole loan holder. Also, if FFEL lenders opt to make consolidation loans, the lenders may not discriminate against borrowers seeking a consolidation loan, based upon: a) the number and type of eligible student loans the borrower seeks to consolidate; b) the type of institution the borrower attended; c) the interest rate to be charged to the borrower (which varies in accordance with when the loans being consolidated were initially disbursed). Additionally, FFEL lenders may not discriminate with regard to the types of repayment schedules they make available to borrowers.

<sup>38</sup> For all FFEL consolidation loans made on or after July 1, 1994, lenders have been required to offer borrowers income sensitive repayment plans, established by the lender, in accordance with regulations promulgated by the Secretary.

<sup>39</sup> For FFEL borrowers who also have outstanding DL program loans, this certification is not required. Such borrowers are free to pursue consolidation in the DL program.

disbursed on or after February 1, 1999. Prior to that interest rates used in the FFEL and DL program differed.

In recent years, the interest rate for FFEL consolidation loans was based on the weighted average of the interest rates on the loans consolidated rounded up to the nearest whole percent. In contrast, as was allowed by the statute, ED chose not to make the terms and conditions of Direct Consolidated Loans the same as those for FFEL Consolidation. Instead of a fixed interest rate based on the average of the loans consolidated as in the FFEL program, student borrowers' DL consolidation loans had the same variable rate and interest caps as Stafford loans, and Direct Plus Consolidation rates were the same as prevailing PLUS loan rates.

**Interest Rate Discounts.** The HEA explicitly permits FFEL lenders to offer borrowers lower rates than those specified above. Some FFEL lenders offer consolidation loan interest rate discounts as incentives for on-time payment.<sup>40</sup> Additionally, borrowers are able to take out FFEL program consolidation loans while in their grace period. This enables borrowers with Stafford loans to utilize the grace period interest rate (which is .60 percentage points lower than the in-repayment rate) in the "weighted average calculations" (described above) that determine the fixed rate for the consolidation loan.

ED may provide interest rate reductions in the DL program to encourage on-time repayment of loans provided the reductions are cost-neutral to the federal government. The DL program currently offers borrowers a .25 percentage point interest rate reduction for paying electronically (through electronic debit accounts). The DL program also currently allows DL borrowers to consolidate their loans while in school or in their grace period. As noted above, this provides borrowers with Stafford loans the opportunity to utilize the in-school/grace period interest rate — which is .60 percentage points lower than the in-repayment rate — as the basis for determining the fixed rate for the consolidation loan.

**Consolidating Stafford Subsidized with Unsubsidized Loans (Retaining Interest Subsidies).** Stafford loans, subsidized and unsubsidized, are eligible for inclusion in a consolidation loan. Stafford subsidized and unsubsidized loans can be included in the same consolidation loan, and they can be consolidated with other federally supported student loans held by a student borrower. However, up until the passage of the Student Loan Consolidation Act (SLCA) of 1997, Stafford subsidized loans that were incorporated into FFEL consolidation loans only retained their interest subsidy if they were consolidated exclusively with other subsidized Stafford loans.<sup>41</sup> For FFEL consolidation loans that have been made after the passage of the SLCA, that include Stafford subsidized loans and other types of loans that are unsubsidized, the interest subsidy is now retained. On these consolidation loans, the

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<sup>40</sup> For additional information on the discounts offered by FFEL lenders see *The Greentree Gazette*, May 2003. p. 84-93.

<sup>41</sup> The interest subsidy that is pertinent for consolidation loans is the subsidy during periods of deferment, i.e., for loans that retain this subsidy the borrower is not responsible for paying interest that accrues during periods of deferment.

federal government pays interest subsidies during deferment only on that portion of the loan that is subsidized.

Under the DL program, borrowers have always been afforded options that enabled them to consolidate all of their loans while preserving interest subsidies on Stafford subsidized loans.

**FFEL Consolidation Loan Repayment.** Repayment of the consolidation loan begins within 60 days after all holders of the loans being consolidated discharge the borrower’s liability for the original loans. FFEL consolidation loan borrowers may choose among standard, graduated, extended and income sensitive repayment plans offered by lenders.<sup>42</sup> The repayment period on FFEL consolidation loans is determined by the consolidation loan balance *plus* the outstanding balance of any other student loans held by the borrower (the amount of other student loans may not exceed the amount being consolidated). The schedule is as follows:

<b>Amount</b>	<b>Maximum Term</b>
Less than \$7,500 . . . . .	10 years
\$7,500 but less than \$10,000 . . .	12 years
\$10,000 but less than \$20,000 . .	15 years
\$20,000 but less than \$40,000 . .	20 years
\$40,000 but less than \$60,000 . .	25 years
\$60,000 and over . . . . .	30 years

**DL Consolidation Loan Repayment.** The repayment period for a DL consolidation loan begins on the day when the loan is disbursed.<sup>43</sup> DL consolidation loan borrowers may choose any of the four available repayment options (with the exception that PLUS borrowers are not eligible for income-contingent repayment). The repayment schedule for DL Consolidation loan extended and graduated repayment plans, set by regulations issued by the Secretary, is the same as the FFEL schedule above except borrowers with up to \$7,500 can repay consolidation loans over a 12-year period. Standard repayment must occur within 10 years, and income contingent repayment can occur over a period of up to 25 years.

## **Loan Default and its Consequences for Borrowers**

Defaults are a significant problem both for the federal government and for borrowers. Defaults constitute a major cost component in the federal student loan programs. From the borrower’s perspective, default on a student loan can ruin credit and otherwise present a major obstacle to future economic well-being. The consequences of default for borrowers are discussed below.

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<sup>42</sup> FFEL lenders are provided some latitude in crafting repayment plans they feel will be attractive to borrowers so long as the plans lead to repayment within the statutorily established repayment period and require minimum payments not less than interest due.

<sup>43</sup> Borrowers consolidating FFEL or DL loans for which the borrower is in an in-school period receive a grace period prior to entering repayment.

## What is a Defaulted Loan and What Happens to it?

As defined for purposes of the student loan programs, a defaulted loan is one on which the borrower has failed to make a required payment or otherwise violated the terms of the promissory note for 270 days<sup>44</sup> and it is reasonable to conclude that the borrower does not intend to repay the obligation.

## Consequences of Default for Borrowers

When a loan goes into default, the borrower effectively loses all rights and privileges associated with the loan and the agency in charge of collections (i.e., the FFEL guaranty agency or the DL contractor) can demand payment in full of all principal and interest due as well as payment of collection costs. As part of its due diligence requirements, the agency in charge of collection must apprise the defaulter of some of the major consequences of defaults. This section summarizes these and other elements of the law designed to improve collections of defaulted loans. It is important to note that there is no statute of limitations on student loan collections.

**Report to Credit Bureau.** By law, loan holders and the agencies in charge of collection are required to enter into agreements with national credit bureaus to exchange information relating to student borrowers. Such agreements require the guaranty agency to report a loan default and the status of collections on that note. Credit bureaus are authorized to report information on the status of a defaulter's account for seven years from the date the default claim is paid or, if the borrower reenters repayment after defaulting and subsequently defaults, seven years from the date of the subsequent default.

**Offset of Tax Refund.** Defaulters are liable for any federal tax refund due them to be attached by the Internal Revenue Service (IRS) as repayment on their student loan. A number of states also attach refunds due on state income taxes to collect student loans.

**Wage Garnishment.** Notwithstanding any state law to the contrary, guaranty agencies, or the Secretary in the case of loans held by ED, may garnish up to 10% of a defaulter's disposable pay to repay a defaulted student loan. "Disposable pay" is defined as that part of compensation remaining after deducting amounts required by law to be withheld. Defaulters must be given written notice of the intent to garnish and have rights to examine the debt record, have a hearing concerning the existence and amount of the debt or repayment terms, and to establish a repayment schedule before garnishment begins. In the past, garnishment has particularly been used as a tool against defaulters who are federal employees.

**Ineligibility for Student Aid.** Students who have defaulted on a Title IV loan are ineligible for student aid. Defaulters having made 6 consecutive monthly payments on their defaulted loans may have eligibility restored, but a borrower may only benefit from this provision once.

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<sup>44</sup> Three hundred thirty days if the loan is repayable in installments less frequent than monthly.

**Lawsuit.** The ultimate tool used to collect on a defaulted student loan is litigation under which the agency in charge of collection sues the defaulter to compel repayment of the loan. Such civil suits are required to be instituted under the due diligence regulations unless the note is assigned to ED for collection through the IRS offset program, the lawsuit costs would exceed those of the likely recovery or the borrower does not have the funds to satisfy the judgment on the debt or a large portion of it.

## **Loan Rehabilitation**

Loan rehabilitation offers defaulted borrowers an opportunity to have their loan reinstated as an active loan and restore benefits and privileges they have as borrowers. If the defaulter makes 12 consecutive monthly payments under a payment plan agreed to by the borrower and guaranty agency (or the Secretary), the loan may be sold or reinstated (in the case of DL loans) at which time the individual is again eligible for full borrower privileges, such as deferments. In implementing these provisions, the guarantor or ED must require a monthly payment that is “reasonable and affordable” based on the borrower’s financial circumstances. Borrowers whose defaulted loans are assigned to ED are offered the opportunity to obtain direct consolidation loans which provide them access to income contingent repayment.

## **Loan Discharge and Forgiveness**

### **Loan Discharge**

Borrowers may have their debt repaid by the federal government under certain circumstances through discharge or “forgiveness.” The authority for discharge of borrower liability for the loan is confined to instances when any repayment would appear unreasonable.

Loan liability is discharged if the borrower dies or becomes permanently and totally disabled. Federal PLUS loans may also be discharged if the student for whom the parent borrower received the loan dies. Federally sponsored student loans are generally not dischargeable through personal bankruptcy actions brought either under Chapter 7 or Chapter 13 of the bankruptcy code;<sup>45</sup> although an exception is made for economic hardship.

The HEA also provides for the discharge of a borrower’s liability for a loan (including any interest and collection fees owed by the borrower) under any of the following circumstances if the borrower received the loan on or after January 1, 1986. Borrowers are eligible for a loan discharge if the student borrower (or the student on whose behalf a parent borrowed) was unable to complete his or her educational program because the school closed. Any period of the student’s attendance at the institution at which the student was unable to complete the course

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<sup>45</sup> See 11 U.S.C. 523; 11 U.S.C. 1328.

of study because of closure is not counted against the total period of the student's eligibility for additional student aid. Borrowers are eligible for loan discharge if the school falsely certified the student's eligibility to borrow. The HEA also provides for discharge of borrower liability for all or a portion of a loan if an institution fails to refund the appropriate amount of loan proceeds to a lender or to the Secretary on behalf of a borrower. If the borrower had defaulted on the loan discharged under the above circumstances, his or her eligibility for further student aid is restored.

## **Loan Forgiveness**

Borrowers may have a portion of their loans repaid through loan forgiveness. Forgiveness is typically used as an incentive for borrowers to be employed in certain activities or professions.

The 1998 HEA amendments established a teacher forgiveness program for new borrowers (with no outstanding student loan balance as of October 1, 1998) who are not in default.

Under the program, after student borrowers complete 5 consecutive years of teaching in schools with high concentrations of economically disadvantaged students,<sup>46</sup> the borrower may have up to \$5,000 of their outstanding loan amount forgiven. For qualified borrowers (who meet the criteria above), loan forgiveness is an entitlement, not subject to appropriations.

The 1998 amendments also authorized a small demonstration program under which students who receive a degree in early childhood education and work full-time for at least 2 consecutive years as a childcare provider in low income communities can have 20% of their outstanding subsidized and unsubsidized Stafford loan balance cancelled on qualified loans in each their second and third years of service, and 30% forgiven after both their third and fourth years of service. This program would be supported through appropriations; with an authorized appropriation level of \$10 million in FY1999, and such sums as may be necessary thereafter. In FY2002, \$1 million was appropriated for the program.

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<sup>46</sup> Those schools that qualify as low income schools under the definition used in the Perkins Loan Cancellation program.

## Appendix 1: Glossary of Financial Terms

**Amortization:** To provide for the gradual reduction and ultimate elimination of a debt through periodic payments sufficient in size to cover interest due and reduce the amount of principal owed.

**Bond Equivalent Rate:** The interest rate on Treasury bills is commonly reported on a “bank discount basis,” a measure that is calculated based upon the face value of a Treasury bill at maturity (as opposed to the purchase price). The bond equivalent rate is the interest payment determined as a percentage of purchase price.

**Capitalizing Interest:** To add accumulating interest to the loan principal thereby increasing the total amount of the loan on which interest is charged. Capitalization of accrued interest would typically occur at one or more intervals when a borrower is not required to make regular interest payments.

**Interest:** A charge for borrowed money, generally a percent of the amount borrowed.

**Negative Amortization:** When required payments on a loan are not sufficient in size to cover accrued interest and unpaid interest is added to loan principal — increasing the borrower’s debt (a scenario that can occur under income contingent repayment).

**Principal:** The amount of money borrowed.

**91-day Treasury-bill:** A short term promissory note issued by the U.S. Treasury, secured by the full faith and credit of the United States. Treasury-bills are issued by the federal government as a means of financing deficits and managing cash flows are generally viewed as risk-free investments. A 91-day Treasury-bill has a maturity of 13 weeks, and the rate for 91-day Treasury-bills is determined when the Treasury auctions the 91-day T-bill, typically on the first business day of the week.

**Variable Interest:** Rate of interest on a loan that is tied to an index (such as the 91-day Treasury-bill), and adjusted periodically in accordance with change in the index.