Student Aid Policy Analysis

The Impact of *'Persistence of Interest'* on Loan Repayment Rates

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EXECUTIVE SUMMARY

The gainful employment NPRM published in the Federal Register on July 26, 2010, proposes a loan repayment rate metric as "a measure of whether program enrollees are repaying their loans, regardless of whether they completed the program." It implements this by comparing snapshots of the principal balance of the loans at the start and end of the most recent federal fiscal year. However, the loan repayment rate fails to give credit for all borrowers who are making payments on their loans because loan payments are applied first to accrued interest before principal. A borrower must pay off all accrued but unpaid interest before the borrower's payments will reduce the principal balance. This can take more than a year for some borrowers.

The loan repayment rate considers accrued interest that is capitalized when the borrower first enters repayment. But there are circumstances in which accrued but unpaid interest is not capitalized. There are also circumstances in which the interest is capitalized in the middle of the fiscal year, causing an increase in the principal balance relative to the start of the fiscal year.

This *persistence of interest* problem means that a borrower could be making full monthly payments and yet not be counted as repaying the loans. Borrowers who are negatively amortized or who are not making any payments are their loans should be excluded from the numerator of the loan repayment rate. But borrowers who are making payments that exceed the new interest that accrues should be counted in the numerator because they are making progress in paying down the total loan balance.

Thus more of a college's borrowers are actively repaying their loans than the loan repayment rate would indicate.

RECOMMENDATIONS

There are several possible ways in which the limitations of the current loan repayment rate proposal can be addressed.

- The loan repayment rate calculation should be based on comparisons of the sum of the principal balance and the accrued but unpaid interest on the loans as opposed to comparisons of just the principal balance. This will help determine whether the borrower is paying down the total loan balance. Loans in deferment or forbearance will naturally continue to be excluded from the numerator in the loan repayment rate, since borrowers in deferment or forbearance do not make any payments on their loans. Likewise, borrowers in income-contingent repayment or income-based repayment who are making a zero monthly payment or a payment that is less than the new interest that accrues (i.e., negatively amortized) will not be counted in the numerator because the total loan balance will be increasing. This change addresses only the persistence of interest problem, when it is due to uncapitalized accrued but unpaid interest and when it is due to the mid-year capitalization of interest.

- Colleges should be allowed to base the loan repayment rate on either the four most recent federal fiscal years or the prior set of four fiscal years (i.e., years 5 through 8). If the college chooses the prior four year period, it should be required to comply with the stricter 45% loan repayment rate threshold. This recommendation is similar to the accommodation in the gainful employment NPRM for debt to income ratios, where a program may be evaluated based on the prior three year period but held to the stricter 8% and 20% debt to income ratios. There are some types of educational program where the loan repayment rates will increase dramatically after several years. For example, medical school graduates routinely defer repaying their student loans during their residencies and internships when their salaries are lower. Law school graduates may delay repaying their student loans while studying for the bar and for a few years while they gain experience clerking for a judge or working as a prosecutor or public defender (but short of the ten years required for public service loan forgiveness). This change could also provide an option for colleges during recessions, when external factors artificially reduce the loan repayment rates.

- The gainful employment NPRM should be phased in after a three-year delay, as opposed to the current proposal for a one-year delay, to provide enough time for the colleges to adapt to the new regulatory requirements. Without such a delay, the scope of the current loan repayment rate proposal includes some borrowers who will have already separated from the colleges on the date the regulations become effective. It is much more difficult for a college to influence repayment behavior of borrowers after they have already left the college.

  Such a delay is not without precedent. For example, when Congress decided to switch from a 2-year cohort default rate to a 3-year cohort default rate as part of the Higher Education Opportunity Act of 2008, it delayed the effective date for sanctions until three years of official 3-year cohort default rates were available. Congress also delayed the switch to 3-year cohort default rates until FY2009 even though it could have started the switch in FY2007.

LOAN REPAYMENT RATE

The gainful employment NPRM bases program eligibility for federal student aid on the satisfaction of three affordable debt metrics: the loan repayment rate, the debt-service-to-income ratio and the debt-service-to-discretionary income ratio. The loan repayment rate is effectively a performing assets ratio, calculating the percentage of federal student loans[1] recently[2] entering repayment that have either been paid in full[3] or where there has been a reduction in the principal balance for the borrower's federal student loans during the most recent federal fiscal year. The draft regulations at 34 CFR 668.7(b)(3)(i) specify

[1] Including any capitalized interest on the date the loans entered repayment.
[2] Within the previous four federal fiscal years, but not including any loans that entered repayment in the last six months of the most recent fiscal year (after March 31).
[3] Loans repaid through a consolidation loan are not considered paid in full for the purpose of the loan repayment rate unless the consolidation loan itself has been paid in full.

that a Reduced Principal Loan (RPL) is a loan "where payments made by a borrower during the most recently completed FFY reduced the outstanding principal balance of that loan from the beginning of that FFY."

Nonperforming loans, such as those currently in a deferment, in forbearance or in default are excluded from the numerator. Loans in income-contingent repayment (ICR) and income-based repayment (IBR) must be making payments to principal to be included in the numerator. Approximately 45% of loans in ICR and IBR are making a zero monthly payment, and an additional 11% are making a payment that is less than the interest that accrues, so only about half of loans in ICR and IBR are making a payment to principal.

As written, however, the draft regulations not only yield a lower loan repayment rate based on the current status of a loan as a nonperforming loan, but also based on the past status. A borrower could be making regular full amortized monthly payments during the most recent federal fiscal year and still not be counted in the numerator because those payments can be masked by previously accrued but unpaid interest, including interest from an in-school or military deferment and interest that was capitalized in the middle of the fiscal year.

PERSISTENCE OF INTEREST

This *persistence of interest* problem occurs because payments on a loan are applied first to collection charges and late fees, next to accrued but unpaid interest, and finally to principal. The monthly payments will not count as reducing the principal balance until all of the accrued but unpaid interest has been repaid, even if the monthly payments exceed the new interest that accrues each month.

If the unpaid interest is subsequently capitalized, it is treated as part of the principal balance. However, if the capitalization occurs during the most recent federal fiscal year, it will appear to have increased the principal balance as compared with the principal balance at the start of the fiscal year, and the monthly payments will not be counted as reducing the starting principal balance until they pay off at least as much principal balance as equals the interest that was capitalized. Such a loan is performing, but is not treated as such by the gainful employment NPRM's loan repayment rate metric because of events in the middle of the fiscal year. Only if the capitalization occurs before the start of the fiscal year will a loan with one or more regular amortized payments (i.e., the payments exceed the month's new interest) during the most recent federal fiscal year be recognized as a performing loan, since the capitalized interest will then be part of the comparison baseline.

The persistence of interest may partly explain why some for-profit colleges estimated much higher loan repayment rates for their unconsolidated borrowers than the loan repayment rates for all borrowers released by the US Department of Education on August 13, 2010.[4] Other possible reasons include inaccurate estimates of capitalized interest and loan cancellation amounts,[5] as well as inaccurate disbursement rates and a failure to account for borrowers in income-contingent repayment or income-

[4] ifap.ed.gov/eannouncements/081310ReleaseGainfulDataTechDocNPRM.html and www2.ed.gov/policy/highered/reg/hearulemaking/2009/integrity-analysis.html

[5] The college interfaces to NSLDS and other US Department of Education databases provide information about loan originations, but not about amounts subsequently returned to the lender and not about the amount of deferred interest that was capitalized when the borrower's loans entered repayment after the end of the grace period.

based repayment.[6] All of these could lead to overstating the amount of loans to be included in the numerator. It is also likely that consolidation loans have a lower loan repayment rate due to adverse selection, since borrowers who are having trouble repaying their loans often consolidate their loans to obtain a lower monthly payment. (Consolidation can also be abused as a default aversion technique. If a delinquent loan is consolidated before the loan is in default it resets the default/delinquency clock since the consolidation loan is a new loan.)

APPLICATION OF PAYMENTS TO PRINCIPAL AND INTEREST

The regulations at 34 CFR 685.211(a) discuss the preference order for applying payments on a federal education loan. Note that even if the borrower makes an extra payment above the required payment, it is still applied to outstanding interest before principal.

> *Payment application and prepayment.*
>
> (1) Except as provided for the income-based repayment plan under §685.221(c)(1), the Secretary applies any payment first to any accrued charges and collection costs, then to any outstanding interest, and then to outstanding principal.
>
> (2) A borrower may prepay all or part of a loan at any time without penalty. If a borrower pays any amount in excess of the amount due, the excess amount is a prepayment.
>
> (3) If a prepayment equals or exceeds the monthly repayment amount under the borrower's repayment plan, the Secretary—
>
> i. Applies the prepaid amount according to paragraph (a)(1) of this section;
>
> ii. Advances the due date of the next payment unless the borrower requests otherwise; and
>
> iii. Notifies the borrower of any revised due date for the next payment.
>
> (4) If a prepayment is less than the monthly repayment amount, the Secretary applies the prepayment according to paragraph (a)(1) of this section.

Similar regulations appear at 34 CFR 682.209(b). The regulations at 34 CFR 685.221(c) provide for a different payment application order for the income-based repayment plan, but again interest comes before principal.

> *Payment application and prepayment.* The Secretary applies any payment made under an income-based repayment plan in the following order:
>
> (1) Accrued interest.
>
> (2) Collection costs.
>
> (3) Late charges.
>
> (4) Loan principal.

ACCRUED BUT UNPAID INTEREST

There are many circumstances that result in accrued but unpaid interest that either remains uncapitalized or may potentially be capitalized after the start of the most recent federal fiscal year:

- During a deferment on an unsubsidized loan or a forbearance on subsidized and unsubsidized loans, interest continues to accrue. If the borrower elects to defer repayment of interest, it will be

[6] While most of the years in question occurred before the July 1, 2009 launch of income-based repayment, income-contingent repayment is available only in the Direct Loan program and most for-profit colleges were in the FFEL program, FFEL borrowers could consolidate into the Direct Loan program to obtain income-contingent repayment.

capitalized at status changes, such as the end of the grace period, when the loan enters repayment, at the expiration of the deferment or forbearance, or upon default.[7] Accrued but unpaid interest is also capitalized upon consolidation, as are collection charges and late fees.

- If a borrower enters repayment in the middle of the most recent federal fiscal year, the principal balance at the start of the fiscal year will not include the accrued but unpaid interest, since that interest will capitalize when the borrower enters repayment, not before.[8] This can include borrowers who reach the end of their grace period as well as borrowers who lost their grace period through consolidation or through the early repayment status loophole.[9]

- A borrower repaying loans under income-based repayment might accumulate accrued but unpaid interest if the borrower's payments are less than the interest that accrues. While this interest will be capitalized when the borrower no longer qualifies for income-based repayment, it remains uncapitalized until then. It is possible for a borrower to increase his or her monthly payments enough to eliminate negative amortization while remaining eligible for income-based repayment. For example, an increase in income might cause the monthly payment to increase beyond the new interest that accrues but less than the standard 10-year repayment amount. Such a borrower will shift out of a negative amortization situation but the accrued but unpaid interest will not be capitalized. The monthly payments are applied first to accrued but unpaid interest, so this borrower will still not count in the numerator of the loan repayment rate. Since the annual adjustments to a borrower's monthly payment under income-based repayment are based on the calendar year (i.e., the prior year's adjusted gross income as reported on the federal income tax return) such changes in the monthly payment are likely to occur in the middle of the federal fiscal year.

- A borrower who is delinquent but then resumes making full voluntary monthly payments will have up to 12 months of accrued but unpaid interest. (A default can be prevented by making a payment in the 90 day claim period before the lender files a claim with the guarantee agency. With the Direct Loan program a borrower can make a payment on day 360 of the delinquency and prevent the loan from going into default.) It can take longer than the rest of the current federal fiscal year for the borrower's payments to catch up with the accrued but unpaid interest.

- A borrower whose loans are in default can have an unlimited amount of accrued but unpaid interest incurred after the loan went into default. That accrued but unpaid interest may persist even after the loan has been rehabilitated. (Also, technically a rehabilitated loan is still considered to be in default until the loan is sold to a lender.)

- Loan amortization errors by education lenders can lead to underpayment of interest and principal. The most recent well-publicized example occurred in late 2002 and affected more than 1 million borrowers. The gainful employment NPRM does not allow appeals for improper loan servicing.

[7] Per section 428H(e)(2) of the Higher Education Act of 1965.
[8] Only borrowers entering repayment during the first half of the fiscal year, through March 31, are included in the loan repayment rate calculation.
[9] The early repayment status loophole was repealed by Congress effective July 1, 2006 by the Higher Education Reconciliation Act of 2005. However, there are still borrowers who entered repayment during the award and fiscal years within the scope of the gainful employment metrics.

There are also other circumstances in which a borrower's loans might be considered nonperforming despite the borrower making full monthly payments on the loans. For example, if a borrower consolidates loans from more than one institution, the other institution's loans will cause an increase in the borrower's principal balance. It is unclear whether the loan repayment rate calculation disaggregates the loans included in a consolidation loan according to the source institution.

WHEN DO PAYMENTS REDUCE THE PRINCIPAL BALANCE?

In light of the persistence of interest problem, the suggestion from the US Department of Education that just a $1 payment over the course of a year is sufficient to cause the loan to be counted in both numerator and denominator is a bit specious. That $1 payment would be applied to accrued but unpaid interest and so would not count as reducing the principal balance. In all likelihood the borrower would have to make a substantial payment above and beyond the regular monthly payments in order to be counted in the numerator, probably several hundred or even several thousand dollars. Moreover, the payment must be made by the borrower, not the institution.[10]

Consider an unsubsidized Stafford loan that was in a deferment or forbearance that ended in the middle of the most recent federal fiscal year. At the start of a 10-year repayment term, slightly less than half of the monthly payment is applied to interest (49.2%), leaving slightly more than half of the monthly payment available for paying down accrued but unpaid interest. Thus it will take at least as many months as the loans were in deferment to retire the accrued but unpaid interest. Even more months will be required for longer repayment terms, since more of the monthly payment is applied to newly accrued interest and less is available to repay the pre-existing accrued but unpaid interest (and eventually the principal balance of the loan). The ratios for longer repayment terms and the Direct and FFEL Grad PLUS loans are illustrated in the table on the right.

Portion of Initial Payment Applied to Interest	Unsubsidized Stafford (6.8%)	Direct Grad PLUS (7.9%)	FFEL Grad PLUS (8.5%)
10-year term	49.2%	54.5%	57.1%
20-year term	74.2%	79.3%	81.6%
30-year term	86.9%	90.6%	92.1%

The following chart illustrates the number of months of full payments that will be required to pay off the accrued but unpaid interest (or the capitalized increase to the principal balance) on an unsubsidized Stafford loan.

Deferment Duration	6.8% / 10-year Repayment Term	6.8% / 20-year Repayment Term	6.8% / 30-year Repayment Term
3 months	3 months	9 months	19 months
6 months	6 months	17 months	37 months
12 months	12 months	32 months	67 months
24 months	22 months	59 months	114 months
36 months	32 months	82 months	152 months

[10] While the gainful employment NPRM does not establish any penalties for a college making a payment on behalf of the borrower, section 462(g)(1)(C) of the Higher Education Act of 1965 specifies that such a loan will be considered to be in default.

The next chart illustrates the number of months of full payments that will be required to pay off the accrued but unpaid interest (or capitalized interest) on a Grad PLUS loan in the Direct Loan program.

Deferment Duration	7.9% / 10-year Repayment Term	7.9% / 20-year Repayment Term	7.9% / 30-year Repayment Term
3 months	4 months	12 months	27 months
6 months	8 months	22 months	50 months
12 months	14 months	41 months	87 months
24 months	27 months	73 months	141 months
36 months	39 months	99 months	181 months

The next chart illustrates the number of months of full payments that will be required to pay off the accrued but unpaid interest (or capitalized interest) on a Grad PLUS loan in the FFEL program.

Deferment Duration	8.5% / 10-year Repayment Term	8.5% / 20-year Repayment Term	8.5% / 30-year Repayment Term
3 months	4 months	13 months	32 months
6 months	9 months	26 months	60 months
12 months	16 months	46 months	98 months
24 months	29 months	80 months	156 months
36 months	42 months	108 months	196 months

Thus even a short deferment could persist long enough to prevent the monthly payments from reducing the principal balance below the initial principal balance at the start of the fiscal year. The persistence of interest for a borrower who uses income-based repayment or rehabilitates a defaulted federal student loan is even longer.

CAUSES OF HIGH DEFERMENT AND FORBEARANCE RATES

Sometimes the use of deferments and forbearances is natural and not due to a college promoting deferments and forbearances as part of a default rate management program. For example, medical school graduates routinely obtain a deferment or forbearance during their residencies and internships. Law school graduates routinely defer repayment while they study for the bar and may clerk for the courts or serve as a prosecutor for a few years to gain experience.[11] (Distinguishing between deferments and forbearances for students who drop out and students who graduate is not a practical solution, since there is no way to distinguish the deferments and forbearances that resulted from a default rate management program from the more natural deferments and forbearances.)

It is also clear that the colleges that previously were more aggressive in promoting the use of deferments and forbearances as part of their default rate management will be more severely impacted by the persistence of interest problem.

[11] The gainful employment NPRM provides for an exception for public service loan forgiveness but not for other forms of up-front loan forgiveness, where borrowers may elect a deferment instead of income-based repayment.

When a college has previously managed its default rates through deferments and forbearances, and is now reforming its practices to comply with the regulatory changes, the persistence of interest problem will prevent the changes from having an impact on the loan repayment rates until the next fiscal year. At that point any capitalized interest will be included in the baseline principal balance at the start of the fiscal year. (It is still possible that some borrowers will continue to have interest capitalized in the middle of a subsequent fiscal year due to continuing reliance on deferments, forbearances and income-based repayment. The persistence of interest problem will probably continue to have a significant impact on loan repayment rates until current borrowers have reached the three-year limit on eligibility for the economic hardship deferment.)

The gainful employment NPRM will cause an improvement in loan repayment rates by getting existing programs to improve their loan repayment rates and by terminating the programs that fail to improve. If the goal of the gainful employment NPRM is to terminate most programs that have engaged in active management of default rates without giving them a realistic opportunity to improve their performance, then there is no need for a year delay until the rule becomes effective. If the goal of the gainful employment NPRM is to allow colleges to adapt to the new requirements and mitigate the number of programs negatively affected (e.g., by reducing tuition, abandoning default rate management programs, improving academic quality, implementing more selective admissions policies and adopting targeted academic and financial literacy counseling), then a single phase-in year is probably inadequate. It does not allow enough time for the changes in college practices to have an impact on their loan repayment rates. A minimum of two full fiscal years of phase-in are necessary to reduce the impact of the persistence of interest problem. However, a three-year phase-in period seems more appropriate, especially considering that the gainful employment metrics involve three prior award years and four prior fiscal years, at least one of which has already passed.[12]

The persistence of interest problem can also potentially be addressed by examining the payment history for evidence that a payment exceeded the new interest that accrued that month. Another approach involves basing the balance snapshots on the sum of the principal balance and any accrued but unpaid interest as opposed to just the principal alone. Either method would not provide a waiver for borrowers who are currently in a deferment or forbearance or negatively amortized under income-based repayment, but would treat borrowers who have resumed making full voluntary monthly payments in the numerator of the loan repayment rate sooner.

The US Department of Education should also consider disaggregating loan repayment rates by Pell Grant recipient status, to see how loan repayment rates vary when Pell Grant recipients are excluded. Pell Grant recipients are more likely to be affected by the persistence of interest problem.

[12] There is also a similar issue with regard to new programs. The US Department of Education would require enrollment projections for five years before basing eligibility on the three metrics. This works well for Associate's degree programs, since the five years will include three years of completers. However, Bachelor's degree programs, as well as graduate and professional degree programs, are usually longer in duration and may have only one year of completions available at the end of the five-year period. That will mean that the loan repayment rate will be weighted more heavily to students who dropped out of the program than to students who completed the program, since there will be more years of dropouts than years of completions. The initial loan repayment rates will not be reflective of the loan repayment rates a few years later when the number of years of completions is the same as the number of years of dropouts. The US Department of Education should consider substituting a requirement for three years of completers instead of the requirement for five years of enrollment projections.