Federal Policymakers Must Act Now to

Reform the Student Loan Default System

FEBRUARY 2022

For too long, the dream of pursuing a college degree has turned into a nightmare of loan default for millions of students. Default disproportionately affects Black students and first-generation students, and most of those who experience default entered college from a low-income background.

Individuals facing economic hardship are often driven further into debt by an ever-mounting and self-defeating cycle of punitive fees and penalties—such as traffic fines and court fees—that perpetuate rather than help resolve financial instability. The student loan default system has the same effect: rather than helping struggling borrowers get back on their feet, it plunges them deeper into poverty. It is especially abhorrent that a program intended to create equitable educational opportunity for all students can instead exacerbate persistent gaps in financial stability by race and income.

> "The student loan default system has the same effect: rather than helping struggling borrowers get back on their feet, it plunges them deeper into poverty.

In March 2020, in response to the COVID-19 crisis, the federal government paused student loan payments, interest, and collections, and recently extended these benefits until May. However, when repayment restarts, millions of borrowers—especially those who were in default prior to the pause—are at risk of severe economic upheaval. Policymakers must use all available tools to protect financially vulnerable borrowers from ending up back in default and at risk of having their wages, tax credits, and federal benefits seized, including the child tax credit (CTC) and the earned income tax credit (EITC), both critical financial lifelines that have reduced poverty for millions of families.[1]

THE DEFAULT SYSTEM IS PUNITIVE & SELF-DEFEATING

Beyond taking immediate action to protect borrowers in advance of a repayment restart, policymakers—across the Biden Administration and Congress—must re-think the structure of student loan default and make systemic reforms to ensure that its consequences are no longer punitive and self-defeating.

Before the repayment pause, too many borrowers were struggling to manage their debt. One-quarter (25%) of all Direct Loan borrowers were either delinquent or in default at the end of 2019, and over a million Direct Loan borrowers entered default in 2019 alone.[2]

Federal student loan default, which happens if a borrower misses payments for at least 270 days, comes with severe consequences. The entire loan balance becomes immediately due and borrowers face ongoing damage to their credit score, along with a range of potential collection fees. Ironically, borrowers in default are not allowed to enroll in income-driven repayment (IDR) plans, which can provide more affordable monthly payments. The federal government can also wield its vast extra-judicial collection powers by garnishing wages and seizing social benefit payments (such as Social Security) and tax refunds, including critical family resources like the CTC and EITC.

In addition, the federal government, along with states and colleges, can impose a series of harsh penalties that are unrelated to collecting payments, including restricting access to further federal aid, withholding a student's academic transcripts, and suspending professional and even driver's licenses.

These measures are not only punitive, they're self-defeating: in undermining someone's ability to cover basic expenses, return to school, keep their job, or even drive a car, the student loan default system makes it harder for someone who is already struggling to secure their financial footing. Borrowers also face significant bureaucratic hurdles in attempting to resolve a default;

even those who successfully resolve a default may re-default within a few years.[3]

The vast majority of those who experience student loan default have faced persistent economic and social vulnerability. As of 2017, roughly 90 percent of those who had defaulted within 12 years of enrolling in college received a Pell Grant at some point, meaning they entered college with a household income of less than $40,000.[4] Those who were the first in their family to attend college are also more likely to default: nearly a quarter (23%) of first-generation students defaulted on their loans within 12 years, compared to 14% of non-first-generation students.[5]

> "The vast majority of those who experience student loan default have faced persistent economic and social vulnerability.

Those who started school but never completed a degree or credential are at particular risk of default, as they've taken on debt but received no associated economic benefit. These borrowers—who represent about half of those who default—typically owe relatively small balances, with nearly two-thirds owing less than $10,000 and more than one-third owing less than $5,000.[6] Black students also face persistent repayment distress. The effects of systemic racism and the resulting racial wealth gap, along with employment and wage discrimination, mean that Black students are more likely to borrow for college and more likely to struggle with repayment. In addition, for-profit colleges that offer little to no payoff for their students target and disproportionally enroll Black students.[7] As of 2017, nearly half of Black borrowers had defaulted within 12 years of entering college.[8]

HOW POLICYMAKERS CAN BETTER PROTECT STRUGGLING BORROWERS

Protect low-income borrowers from harmful involuntary collections. Borrowers with defaulted loans can have their wages garnished, and those receiving federal benefits or tax refunds can have those funds garnished by the federal government through the [Treasury Offset Program (TOP)](). These involuntary collections can compound financial hardship for those who can least afford it. We recommend that garnishments and offsets be eliminated, or, at minimum, be capped at a reasonable level for all borrowers and that borrowers with low incomes be entirely exempted from garnishments and TOP collections.

Allow borrowers in default to access IDR plans. Borrowers in default are not currently able to access IDR plans. Defaulted borrowers need an affordable repayment option, and involuntary collection tools often take a far higher share of resources from borrowers than those same borrowers would pay under an IDR plan. In addition, some borrowers are not eligible to cure their default. Allowing borrowers in default to access IDR could also streamline and reduce confusion between payment requirements in the repayment system and the default system. These payments should be counted toward forgiveness under IDR.

Remove the mandate that borrowers pay their own collection costs; limit collection fees. When a borrower makes payments to a collection agency on a defaulted student loan, a sizeable portion of their payment is typically applied to collection fees, which can be as high as 40% on some loans (note: it is unclear how this may change when defaulted loans are no longer transferred to private collection agencies). Policymakers should remove the mandate that borrowers pay these costs and should implement a low statutory cap on the fees that can be charged to borrowers in default.

> "The effects of systemic racism and the resulting racial wealth gap, along with employment and wage discrimination, mean that Black students are more likely to borrow for college and more likely to struggle with repayment.

Prohibit transcript withholding. Currently, some colleges and universities withhold students' academic transcripts if the student owes, or is alleged to owe, a debt to the institution. Withholding transcripts causes severe hardships for students, because a transcript is often required to secure a job, to apply or transfer to another school, or to obtain certain licenses. Schools should be prohibited from this practice.

Remove the record of default from a borrower's credit history once they resolve the default, regardless of how they resolved it. Federal student loan borrowers can resolve their default through several avenues, including full repayment, loan rehabilitation, or loan consolidation. While each of these options resolves the default, only borrowers who complete the loan rehabilitation process will have the record of default removed from their credit history. A record of default on a borrower's credit history can have a severe and long-lasting impact. The default record should also be removed from the credit history of borrowers who resolve their default loan through repayment or consolidation.

Prohibit states from suspending, revoking, or denying state-issued professional licenses or issuing penalties due to student loan default. Some state regulatory boards suspend professional licenses — and, in some cases, driver's licenses — if the holder defaults on a federal student loan. Predictably, suspending licenses decreases rather than increases the likelihood that the defaulted borrower will repay the loan, making these laws a catch-22 for borrowers. States should be prohibited from suspending, revoking, or denying state licenses solely because borrowers are behind on their federal student loan payments.

Allow borrowers to rehabilitate their loan(s) more than once. Borrowers are currently only able to rehabilitate their loans once, but many borrowers who cure their default can end up re-defaulting. These borrowers should be given another chance to cure their default through rehabilitation.

Allow real bankruptcy relief for student loan borrowers and reinstate a statute of limitations for student loans. Federal bankruptcy law treats student loans even more stringently than other forms of consumer debt, excluding them from discharge except in exceedingly rare cases of proven "undue hardship." To remove barriers to relief for borrowers who are truly unable to repay, policymakers should restore borrowers' ability to discharge student debt through bankruptcy. Policymakers should also implement a reasonable statute of limitations on the collection of student loans.

HOW POLICYMAKERS CAN BETTER PREVENT DEFAULT

Make IDR work better for borrowers. Despite the availability of IDR plans—and significant improvements to program design and generosity over time—too many borrowers continue to struggle with repayment, with some even defaulting despite being enrolled in IDR.

Too many borrowers who default never make it into IDR, and even for some who do, income-based payments can still be too high. Borrowers also struggle to navigate the bureaucratic hurdles of enrolling in and staying enrolled in IDR plans. Also, many enrollees who are making regular IDR payments still struggle with negative amortization if their monthly payments are not enough to cover accruing interest. As a result, their balance balloons, even as they make regular payments. This is financially damaging and psychologically discouraging for the borrower and undermines IDR's effectiveness.

For IDR to better protect borrowers from unaffordable payments, keep borrowers out of default, and provide a reliable light at the end of the tunnel for debt that does not pay off, policymakers must make significant reforms to IDR design and implementation. These reforms should include adjusting the IDR formula to protect more of a borrower's income and reduce monthly payments, restraining balance growth by fully subsidizing any unpaid interest, shortening the repayment term from its current 20–25-year period, and expanding access to IDR.

> " Too many borrowers who default never make it into IDR, and even for some who do, income-based payments can still be too high.

Automatically enroll distressed borrowers into an IDR plan. While borrowers should have a choice between a fixed repayment option and an income-based option, borrowers who are severely delinquent on their loans should be automatically enrolled in an IDR plan to help them avoid the severe consequences of default. While IDR is not right for everyone, it is always preferable to default, and IDR payments can be as little as $0 for borrowers with very low incomes. Borrowers should be notified that they will be enrolled in IDR if they do not act and should be given the opportunity to opt out before a set deadline.

Provide transparency throughout servicing and collections transitions. In fall 2021, Federal Student Aid announced plans to terminate its contacts with the private companies that had been responsible for collecting defaulted loans. The Department must be transparent as to how this shift will affect borrowers. In addition, as the Department continues developing its new servicing platform, it must ensure that the new system is transparent to borrowers, that contractors' incentives are aligned with borrower success, and that contractors are subject to strong oversight.

Provide better data on who struggles with repayment. Publicly available data on how borrowers navigate student loan repayment is scarce, making it difficult for policymakers and other stakeholders to make evidence-based assessments of what works best to keep borrowers out of default. The Department should publish more comprehensive data — including key disaggregates — on student repayment outcomes and variability in student borrower pathways, including default. This would equip policymakers, researchers, and advocates to better identify potential interventions to help struggling borrowers and address persistent inequities by race and income. As part of this effort, the Department should publish annual default rates at the institution level (including branch campuses) from one through seven years in repayment, in addition to the three-year rates used for accountability at the institution and servicer levels.

ENDNOTES

[1] The National Academies of Sciences, Engineering, and Medicine. 2019. *A Roadmap to Reducing Child Poverty*. https://bit.ly/3lQkntt.

[2] Calculations by TICAS using data from the U.S. Deparment of Education's Federal Student Aid Data Center using the files "Portfolio by Delinquency Status (DL, FFEL, ED-Held FFEL, ED-Owned)," "Direct Loan and Federal Family Education Loan Portfolio by Loan Status," and "Federal Student Aid Portfolio Summary," accessed on September 22, 2020. See https://bit.ly/2IDdpKW, https://bit.ly/1O6zgrW, and https://bit.ly/2hvfiOd.

[3] National Consumer Law Center. 2020. *Congress Must Provide Relief to Defaulted Student Loan Borrowers*. https://bit.ly/33sbdE3.

[4] Center for American Progress. 2017. *Who Are Student Loan Defaulters?* https://bit.ly/3dod9z1.

[5] The Institute for College Access & Success. 2018. *Students at Greatest Risk of Loan Default*. https://bit.ly/3yjdYTu.

[6] Center for American Progress. 2017. *Who Are Student Loan Defaulters?* https://bit.ly/3dod9z1.

[7] The Institute for College Access & Success. 2021. *Student Debt and the Class of 2020*. https://bit.ly/3dOIrQU.

[8] Center for American Progress. 2017. *New Federal Data Show a Student Loan Crisis for African American Borrowers*. https://ampr.gs/33snyrN.